Tax Analysis

SAT clarifies when a secondment arrangement creates a PE

Introduction

China's State Administration of Taxation (SAT) issued guidance on 19 April 2013 (Bulletin 19), that clarifies when the secondment of an employee by a nonresident company will give rise to a taxable presence (i.e. establishment) – or permanent establishment (PE) – in China. This was followed by a SAT interpretation note issued on 6 May. Bulletin 19 clarifies and expands on SAT guidance on secondments released in 2010 (Guo Shui Fa [2010] No. 75 (Circular 75)). The new rules articulated in Bulletin 19 apply as from 1 June 2013.

Bulletin 19 provides welcome clarification of the PE risk associated with certain secondment arrangements and, in this regard, it introduces a two-prong test for determining whether a seconded employee remains the employee of the nonresident company (with the result that the activities of the expatriate employee create a PE in China) or whether the individual is an employee of the host Chinese company. The guidance also directs the Chinese tax authorities to undertake a robust review of documentation and the substance of secondment arrangements, and sets out the type of documentation/information that companies should maintain to minimize challenges.

A. "Two-prong" test

Although not specifically stipulated in the bulletin (but described in the separately issued Interpretation Note), the SAT takes the position that an establishment will arise under Chinese domestic law if the nonresident company satisfies a two-prong test for determining whether a seconded employee remains the employee of the nonresident company (with the result that the activities of the expatriate employee create a PE in China) or whether the individual is an employee of the host Chinese company. The guidance also directs the Chinese tax authorities to undertake a robust review of documentation and the substance of secondment arrangements, and sets out the type of documentation/information that companies should maintain to minimize challenges.

Basic factor: The nonresident company bears all or part of the responsibilities and risks for the work product of the seconded employee and routinely conducts the individual's performance evaluations.

Five reference factors:
1) The Chinese company pays management or service fees or fees of a similar nature to the nonresident company;
2) The payments made by the Chinese company to the nonresident company are greater than the amount of the remuneration, social welfare and other costs of the seconded employee paid by the nonresident company;
3) The payments made by the Chinese company are partially retained by the nonresident company;
4) The remuneration borne by the nonresident company was not fully taxed in China; and

1 Qin Li China Lawyers is part of the Deloitte global network.
5) The nonresident company decides on the number, qualification, remuneration and working place of seconded employees.

The Bulletin further provides that, for purposes of the application of a tax treaty, a PE would exist if the establishment through which the business of the nonresident is carried on is relatively “fixed” and "permanent."

B. Documentation and substantive review

To determine whether the nonresident company has any enterprise income tax liability, Bulletin 19 stipulates that the tax authorities should review specific documents, as well as the actual substance of the secondment arrangement.

The following documentation and information will be relevant:

- Any agreements between the nonresident company, the Chinese company and the seconded employee;
- Any internal management guidelines prepared by the nonresident company or the Chinese company in respect of seconded employees, e.g. with respect to job responsibility, risk, evaluation, etc.;
- Information on payments made by the Chinese company to the nonresident company, the relevant accounting treatment and the settlement of the seconded employee’s individual income tax (IIT) liability; and
- Information on any disguised payments (e.g. offsetting, the waiver of debt, related party transactions, etc.) relating to the secondment.

C. Stewardship services

Bulletin 19 provides that if the seconded employee furnishes services in China solely for the purpose of exercising the rights of a nonresident company (that is the shareholder of the Chinese company), these activities should not give rise to an establishment or PE of the nonresident company in China. Examples of such activities include the provision of investment advisory services to the nonresident company in respect of the Chinese company and representing the nonresident company at shareholder and/or board of directors meetings.

Preliminary Observations

A critical factor in ascertaining whether a PE in China has been created as a result of the activities of an expatriate employee is the actual identity of the "employer" of the individual concerned. To that end, Bulletin 19 continues to adopt the substance over form approach in making such a determination and provides for a "two-prong" test. The basic determining factors and approach of this test are an extension of the principles in Circular 75 and are largely consistent with the relevant principles in the 2010 OECD Model Treaty. The basic factor focuses on the relationship between the nonresident company and the individual: whether in substance they still maintain an employer-employee relationship. The five reference factors largely focus on financial arrangements between the nonresident company and its Chinese affiliate to assess whether the nonresident company derives income as a result the arrangement.

Bulletin 19 is helpful in clarifying the PE risk associated with typical secondment arrangements. The SAT seems to discourage certain reimbursement schemes. Currently, many nonresident companies pay remuneration and other related costs to a seconded employee in advance, then seek full reimbursement from the Chinese affiliate through a service fee arrangement (or other transactions), with or without a mark-up. Such structures are often set up to take account of various business and regulatory considerations (e.g. SAFE constraints, etc.). However, unless the characterization of the relationship between the nonresident company and the seconded employee is beyond doubt (unless it is totally clear that "basic factor" test is not satisfied), the first of the five reference factors seems to suggest that such a reimbursement scheme would be detrimental when determining whether a PE has been created by the activities of a seconded employee.
Further, the first three reference factors seem to imply that a PE in China could be created where a group company deploys employees worldwide through an internal HR company, which typically charges a small fee.

On the other hand, the second and third reference factors reconfirm the SAT’s view in Circular 75 that, from a Chinese enterprise income tax perspective, a direct reimbursement by a Chinese company is acceptable if the nonresident company does not earn a profit from the arrangement. The arrangement itself should not be viewed as a negative factor in determining whether a PE is created as a result of a secondment arrangement.

Lastly, as stated above, Bulletin 19 mandates that the tax authorities undertake a vigorous review to assess the tax obligations of a nonresident company. To minimize the possibility of challenges, all documentation relating to secondment arrangements should be drafted with care and should include the intercompany agreement, the secondment policy and guidelines, the employee secondment letter and details of any reimbursement requirements. Affected companies also should ensure the terms of the documentation are adhered to and that the substance of the arrangement (e.g. activities carried out by both the companies and the individual) supports what is prescribed in the documentation.

Short and medium-term secondment
Further to Circular 75, Bulletin 19 explicitly links the Chinese IIT treatment of an individual seconded by a nonresident company with a potential PE assessment of the nonresident company.

Bulletin 19 specifically requires that the "remuneration borne by the nonresident company and not fully taxed in China" be considered as one of the criteria in determining whether a PE exists. This implies that under a secondment arrangement that does not constitute a PE, individuals assigned by a nonresident company to its Chinese affiliate normally should be the economic employees of the local affiliate, and the affiliate should properly report their Chinese IIT. If the nonresident company continues to bear the remuneration costs for such individuals and the remuneration is not fully taxed in China, the nonresident company may be considered the economic employer of the individuals during their secondment in China, which could result in a PE. In practice, this position could impact nonresident companies that send foreign individuals to work in China for a short or medium-term period and continue to bear the costs of the remuneration of the individuals and try to limit travel to China to avoid reporting their Chinese IIT. These types of mobility arrangements are clearly at risk under Bulletin 19 and should be reviewed carefully.

Dual-employment
Companies also should examine any dual employment arrangements, under which a seconded employee works for both the nonresident company and the Chinese affiliate and receives remuneration from both companies. In practice, it is often difficult to demonstrate to the satisfaction of the Chinese tax authorities that there is a clear separation of work (under a dual employment arrangement) performed by the individual for the Chinese company and the nonresident company and the corresponding risk and responsibility borne by both companies. Therefore, in these cases, a thorough review of the assignment/employment structure and relevant documentation is recommended to avoid a potential PE challenge.

Conclusion and Recommendations

While Bulletin 19 provides welcome guidance on the PE risk associated with certain secondment arrangements, the bulletin heralds a stepping up of the SAT’s administration of cross-border secondment arrangements. A nonresident entity that assigns employees to China to perform services for a Chinese subsidiary or an affiliate for extended periods without having the subsidiary/affiliate employ the individuals locally run the risk of being regarded as having a PE in China as a result of the individuals’ activities. This is an area where taxpayers can expect intense scrutiny from the Chinese tax authorities. Companies that regularly assign or second expatriate employees to Chinese subsidiaries/affiliates should review their secondment practices and policies to ensure that both the form and substance of the arrangements are aligned with the guidelines in Bulletin 19, Circular 75 and the Commentary to the OECD model treaty.

Note: Contents discussed in this Tax Analysis pertains to Deloitte International Tax Services and Global Employer Services.
Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

**Beijing**
Kevin Ng  
Partner  
Tel: +86 10 8520 7501  
Fax: +86 10 8518 7501  
Email: kevng@deloitte.com.cn

**Chongqing**
Claude Gong  
Partner  
Tel: +86 23 6310 6206  
Fax: +86 23 6310 6170  
Email: clgong@deloitte.com.cn

**Dalian**
Frank Tang  
Partner  
Tel: +86 411 8371 2888  
Fax: +86 411 8360 3297  
Email: ftang@deloitte.com.cn

**Guangzhou**
Constant Tse  
Partner  
Tel: +86 20 8396 9228  
Fax: +86 20 3888 0121  
Email: contse@deloitte.com.cn

**Hangzhou**
Qiang Lu  
Partner  
Tel: +86 571 2811 1901  
Fax: +86 571 2811 1904  
Email: qilu@deloitte.com.cn

**Hong Kong**
Sarah Chin  
Partner  
Tel: +852 2852 6440  
Fax: +852 2520 6205  
Email: sachin@deloitte.com.hk

**Shenzhen**
Constant Tse  
Partner  
Tel: +86 755 3353 8777  
Fax: +86 755 8246 3222  
Email: contse@deloitte.com.cn

**Shanghai**
Eunice Kuo  
Partner  
Tel: +86 21 6141 1308  
Fax: +86 21 6335 0003  
Email: eunicekuo@deloitte.com.cn

**Southern Region**
Davy Yun  
Partner  
Tel: +852 2852 6538  
Fax: +852 2520 6205  
Email: dyun@deloitte.com.hk

**Tianjin**
Jason Su  
Partner  
Tel: +86 22 2320 6680  
Fax: +86 22 2320 6699  
Email: jassu@deloitte.com.cn

**Wuhan**
Justin Zhu  
Partner  
Tel: +86 27 8526 6618  
Fax: +86 27 8526 7032  
Email: juszhu@deloitte.com.cn

About the Deloitte China National Tax Technical Centre
The Deloitte China National Tax Technical Centre ("NTC") was established in 2006 to continuously improve the quality of Deloitte China’s tax services, to better serve the clients, and to help Deloitte China’s tax team excel. The Deloitte China NTC prepares and publishes “Tax Analysis”, “Tax News”, etc. These publications include introduction and commentaries on newly issued tax legislations, regulations and circulars from technical perspectives. The Deloitte China NTC also conducts research studies and analysis and provides professional opinions on ambiguous and complex issues. For more information, please contact:

**National Tax Technical Centre**  
E-mail: ntc@deloitte.com.cn

**Eastern Region**
Leonard Khaw  
National Leader & Partner  
Tel: +86 21 6141 1498  
Fax: +86 21 6335 0003  
Email: lkhaw@deloitte.com.cn

**Northern Region**
Angela Zhang  
Partner  
Tel: +86 10 8520 7526  
Fax: +86 10 8518 1326  
Email: angelazhang@deloitte.com.cn

**Southern Region**
Davy Yun  
Partner  
Tel: +852 2852 6538  
Fax: +852 2520 6205  
Email: dyun@deloitte.com.hk
If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/cn/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. More than 200,000 Deloitte professionals are committed to becoming the standard of excellence.

About Deloitte in Greater China

We are one of the leading professional services providers with 21 offices in Beijing, Hong Kong, Shanghai, Taipei, Chongqing, Dalian, Guangzhou, Hangzhou, Harbin, Hsinchu, Jinan, Kaohsiung, Macau, Nanjing, Shenzhen, Suzhou, Taichung, Tianjin, Wuhan and Xiamen in Greater China. We have nearly 13,500 people working on a collaborative basis to serve clients, subject to local applicable laws.

About Deloitte China

In the Chinese Mainland, Hong Kong and Macau, services are provided by Deloitte Touche Tohmatsu, its affiliates, including Deloitte Touche Tohmatsu Certified Public Accountants LLP, and their respective subsidiaries and affiliates. Deloitte Touche Tohmatsu is a member firm of Deloitte Touche Tohmatsu Limited (DTTL).

As early as 1917, we opened an office in Shanghai. Backed by our global network, we deliver a full range of audit, tax, consulting and financial advisory services to national, multinational and growth enterprise clients in China.

We have considerable experience in China and have been a significant contributor to the development of China's accounting standards, taxation system and local professional accountants. We provide services to around one-third of all companies listed on the Stock Exchange of Hong Kong.

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the “Deloitte Network”) is by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

©2013 Deloitte Touche Tohmatsu Certified Public Accountants LLP