Hogan Lovells

New tax bulletin will change the tax landscape for many foreign universities in China

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In August 2016, we reported a case (the *Nottingham* case) whereby Nottingham University was ordered to pay ¥10.8 million (roughly US$1.5 million) in tax in China as a result of, among other things, being determined to have a permanent establishment (PE) in China. There are two main takeaways from the *Nottingham* case

- the Chinese tax authorities are getting more sophisticated with their understanding of the PE concept, and
- given the magnitude of the settlement involved in the *Nottingham* case, it is likely that the Chinese tax authorities will be actively seeking to identify other potential situations where foreign universities may have a PE in China.

The combination of the above two points is a major tax development affecting Sino-foreign cooperative education institutions and programs in China in the form of the recently-issued Circular of the State Administration of Taxation on Certain Issues relating to the Implementation of Tax Treaties[1] (Bulletin 11). Under Bulletin 11, (i) Sino-foreign cooperative educational institutions without legal person status (more typically known as Non-Independent CEIs) and (ii) premises used to carry out academic and teaching activities in connection with Sino-foreign cooperative educational programs (more typically known as CEPs) will each constitute a PE of the foreign university in China[2]. It appears from Bulletin 11 that the Chinese tax authorities have taken the view that Non-Independent CEI and CEP will result in a de facto fixed place of business PE for a foreign university engaging in either of these two forms of Sino-foreign cooperative education activities.

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[1] Bulletin of the State Administration of Taxation [2018] No. 11, dated 9 February 2018 and effective on 1 April 2018.

[2] Generally speaking, when offering education programs in China that primarily enroll Chinese students, a foreign university must cooperate with a Chinese education institution as its partner and obtain the approval from the competent education authorities. The three common types of arrangement are:

- a Sino-foreign cooperative education institution with independent legal person status
- a Sino-foreign cooperative education institution without independent legal person status (Non-Independent CEI);a Non-Independent CEI is an institute affiliated with its Chinese partner, with no independent legal personality
- a Sino-foreign cooperative education program (CEP); a CEP has no independent legal personality and it is an integral part of its Chinese partner

Bulletin 11 does not provide any guidance on how a foreign university's PE will be taxed in China. Reported tax cases and other available guidance suggest that

- once a foreign university is deemed to have a PE in China, there are two ways that the PE can be taxed: (a) based on its actual profit from the activities constituting the PE or (b) based on the deemed profit approach using its revenues or costs/expenditures derived from or generated in China;
- taxation on a "deemed profit basis" can result in a foreign non-profit university being taxed in China even where it is not making an actual profit from its activity in China and is using the funds consistent with its non-profit mission; and
- to be taxed on actual profit basis requires the foreign university to keep accurate accounting records and books for its activities in China.

One area that is often overlooked by foreign taxpayers who are found to have created a PE in China is the implications of its PE status on the Chinese individual income tax (IIT) liability of its employees. Under most tax agreements between China and other countries or regions, an individual who is employed by a non-Chinese employer to work in China under a temporary assignment is exempt from IIT in China in any given calendar year if all of the following three conditions are met:

- the individual stays in China for 183 days or less in the aggregate during the calendar year
- the individual's income is not paid by or on behalf of a PRC employer
- the individual's income is not borne by the PE of the overseas employer

If a foreign entity is found to have a PE in China, the 183-day exemption does not apply and foreign employees who travel to China on behalf of the foreign entity that has a PE will be subject to IIT, even if they spend 183 days or less in China. In fact, a month before the *Nottingham* case, the Beijing local tax bureau reported a case whereby the foreign shareholder of a Sino-foreign joint venture (JV) company was ordered to pay ¥23 million (roughly US$3.6 million) in IIT on behalf of its employees who were sent to China to provide services to the JV after it was found to have a PE in China. In light of Bulletin 11, foreign universities with Non-Independent CEIs or CEPs in China will need to consider whether they have made adequate provisioning against potential tax liabilities and to consider whether their employees may be exposed to IIT liability in China and how to deal with that potential liability.

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