A 360-Degree look at Secondment tax issues: China and the United States

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In this article, Roberta Chang discusses the recent guidance issued by the Chinese State Administration of Taxation on when a foreign company's secondment arrangement into China will be deemed to have created a taxable presence. Christine Lane and Gene Magidenko comment on how the Chinese regulations on cross-border secondment arrangements differ from those under US tax laws.

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CHINA

BACKGROUND

When structuring cross-border secondment arrangements, a foreign company dispatching the secondee (the **"Home Country Entity"**) to a company in China (the **"Host Entity"**) will typically maintain its employment relationship with the secondee in order to:

- prevent the application of PRC employment law (which is generally more employee friendly) and
- preserve the secondee's participation in their home country benefits[1].

However, focusing on these goals exposes the arrangement to the risk of the Home Country Entity being deemed to have a permanent establishment ("PE")[2] in China. In 2009, the Chinese tax authorities launched a campaign to closely scrutinize cross-border secondment arrangements and adopted a general policy of deeming Home Country Entities to have created PEs in China. Since 2009, it is generally impossible for the Home Country Entity to be reimbursed for the costs arising from the secondment arrangement, unless the Home Country Entity accepts taxation on the basis that it has a PE in China and pays tax accordingly. Through its foreign exchange controls, China further safeguards payments related to cross-border secondment arrangements. For example, China prevents such payments from being remitted from the country without the relevant tax bureau confirming either that the remittance is not subject to tax in China or that, if any taxes are due, they have been duly paid.

NOTICE 75[3]

Most tax practitioners initially hoped that Guo Shui Fa [2010] No. 75 ("**Notice 75**"), issued by the State Administration of Taxation ("**SAT**")[4] in 2010, would provide helpful guidance on structuring cross-border

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1 For example, a 401(k) retirement savings plan in the United States.

2 While the term "PE" is used in bilateral tax treaties and does not exist under PRC domestic law, the concept of "establishment or place" under domestic law is similar to PE. An "establishment or place" includes a fixed place of business, such as a management establishment, a business establishment, an office, a factory, a site for natural resource exploration and exploitation, a site for contracted construction, installation or assembly projects, or a site where labor services are performed, and a business agent.

3 In the context of Notice 75, the cross-border secondment arrangement is specifically between a foreign parent company sending the secondee to its subsidiary (ies) in China.

4 The highest PRC government agency responsible for tax enforcement.

secondment arrangements to mitigate the risk of establishing a PE in China. Although Notice 75 was issued as an interpretation of the China-Singapore bilateral tax treaty, Notice 75 states that it applies to the interpretation of all of China's bilateral tax treaties with the same provisions.

Notice 75 states that the secondees of a Home Country Entity seconded to work at a Host Entity in China will be deemed to be working for the Home Country Entity in those cases where, among other factors, the Home Country Entity earns a profit from the arrangement. Under Notice 75, if any one of the following conditions is met, it may be determined that the secondee is working for the Home Country Entity:

- the Home Country Entity has the right to direct the secondee's work and bears the risks and responsibilities for such work
- the Home Country Entity decides the number of secondees sent to the Host Entity and the standard of such secondees
- the Home Country Entity bears the salaries of the secondees
- the Home Country Entity derives a profit from the Host Entity as a result of the secondment arrangement.

Once the Chinese tax authorities determine that the secondee is working for the Home Country Entity, a PE in China should be determined by taking into consideration whether the secondees (i) create a fixed place of business of the Home Country Entity in China or (ii) furnish services on behalf of the Home Country Entity in China for a time period over the stated threshold in an applicable bilateral tax treaty.

Notice 75 does not explicitly state that the absence of all four factors means that a secondee will not be deemed to work for the Home Country Entity and thereby avoid creating a PE for the Home Country Entity in China. However, this is very much in the style of Chinese regulations which seldom create "safe harbors" for taxpayers that would entirely eliminate the discretion of the tax authorities to reach their own conclusion.

BULLETIN 19[5]

In the three years since Notice 75 was issued it has not been widely implemented by the PRC local tax authorities. Possibly, this is because Notice 75 was issued in connection with the China-Singapore bilateral tax treaty and there is a lack of uniform interpretation and understanding among different local tax authorities in their approach on the concepts related to PE.

Perhaps as a response to both the lack of implementation of Notice 75 and to the fact that the local tax authorities that have direct jurisdiction over taxpayers are generally not familiar with bilateral tax treaties, the SAT issued in April of this year *Relevant Issues Concerning the Levying of Enterprise Income Tax in Relation to Non-resident Enterprises Dispatching Personnel to Provide Services Within the People's Republic of China* (SAT Announcement [2013] No. 19; "**Bulletin 19**"), which offers further guidance on cross-border secondments. Bulletin 19 goes further than Notice 75 did in that it provides guidance on when a cross-border secondment arrangement will give rise to a Home Country Entity being deemed to have (i) an establishment or place in China under domestic PRC tax law or (ii) a PE under an applicable bilateral tax treaty (collectively, these are referred to as having a "**taxable presence**"). An official interpretation to Bulletin 19 was posted on the SAT's website in May of this year.[6]

Bulletin 19 became effective on 1 June 2013 and also applies to previously existing arrangements awaiting final tax treatment.

The nuts and bolts of Bulletin 19 – meeting the standards

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[5] Unlike Notice 75, the cross-border secondment arrangement in Bulletin 19 is not limited to ones between a foreign parent company sending the secondee to its subsidiary (ies) in China.

[6] Please refer to http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138532/12302989.html.

Under Bulletin 19, whether a Home Country Entity creates a taxable presence in China by virtue of a cross-border secondment arrangement focuses on two fundamental inquiries:

(a) whether the Home Country Entity or the Host Entity is the "employer-in-substance" of the secondee and

(b) whether the Home Country Entity derives a profit as a result of the secondment arrangement.

Although a secondee will typically remain an employee of the Home Country Entity (that is, the secondee's employment contract is signed with the Home Country Entity), Bulletin 19 looks beyond the legal form of the employment relationship and applies the widely recognized "substance-over-form" principle to determine who is in fact the "employer-in-substance". According to Bulletin 19, a Home Country Entity is the “employer-in-substance” of the secondee and creates a taxable presence in China if the Home Country Entity:

- assumes some or all of the liabilities and risks associated with the secondee's work and
- regularly assesses and evaluates the secondee's performance.

Bulletin 19 also requires the following factors to be taken into account:

- whether the Host Entity pays management fees or service fees to the Home Country Entity in relation to the cross-border secondment arrangement
- whether the amount which the Host Entity pays to the Home Country Entity exceeds the wages, salaries, social insurance fees, and other expenses advanced or paid by the Host Entity to or on behalf of the secondee
- whether the Home Country Entity pays to the secondee all of the relevant fees paid by the Host Entity
- whether the secondee's individual income tax has been fully paid in China
- whether the Home Country Entity determines the number of secondees to be dispatched, their qualifications, remuneration criteria and their place of work within China,

(collectively, the "**Supplementary Factors**").

According to the official interpretation of Bulletin 19 posted on the SAT's website, if it determined that the Home Country Entity is the secondee's "employer-in-substance", then generally speaking, if any Supplementary Factor is also present, this should lead to a determination that a taxable presence has been established.

Bulletin 19 stipulates that the tax authorities should review specific documents to determine whether the Home Country Entity has a taxable presence in China. These documents include:

(a) the contract or agreement between the Home Country Entity, the Host Entity, and the secondees

(b) the management regulations of the Home Country Entity or the Host Entity concerning the secondees, including specific regulations in relation to the duties and responsibilities of the secondees, the contents of the secondees’ work, work performance appraisals, risk exposure and so forth

(c) details on payments made by the Host Entity to the Home Country Entity and the relevant accounting treatment; information concerning the filing and payment of individual income tax by the secondees and

(d) information on whether or not the Host Entity has made payments relating to secondment arrangement by way of offsets, forgiveness of debts, related party transactions or other forms of concealed payments.

The burden of proof is on the taxpayer, who needs to gather and produce the relevant supporting documents. The tax authorities will need to review and analyse those documents, as well as the economic substance of the arrangement, to reach their conclusion.

Lastly, Bulletin 19 provides a helpful exception for what is commonly known as "stewardship activities". According to Bulletin 19, a Home Country Entity will not be deemed to have a taxable presence in China if the cross-border secondment is arranged solely for the purpose of enabling the Home Country Entity to exercise its shareholder rights (for example, attending shareholder or board meetings) or to safeguard its lawful shareholder rights and interests in the Host Entity (for example, advising the Host Entity with respect to investments).

Observation – enforceability and unanswered questions

The PRC tax authorities have been aggressively targeting foreign companies doing business in China to ensure they are fully disclosing their income and paying taxes in China. Foreign companies should expect increased scrutiny and greater enforcement. As is often the case with China, at this stage questions remain about how Bulletin 19 will be implemented in practice. For example, how will the tax authorities assess the secondment arrangement if the Host Entity is clearly the secondee's "employer-in-substance" yet one of the Supplementary Factors is satisfied, indicating that the Home Country Entity is making a financial gain from the arrangement? Nevertheless, Bulletin 19 is a welcome development for foreign companies that already have, or are planning to put in place, secondment arrangements in China, as the parameters and guidance provided in Bulletin 19 are clearer than those previously set out in Notice 75. To mitigate the risk that they will create a taxable presence in China, Home Country Entities should review their existing secondment arrangements and structure new secondment arrangements to ensure that (i) the supporting documentation follows the guidelines and principles set out in Bulletin 19 and (ii) in practice the secondment arrangement is implemented in accordance with such documentation.

COMPARISON OF THE TAX ISSUES IMPACTING SECONDMENT ARRANGEMENTS AND THE FORMATION OF PERMANENT ESTABLISHMENTS IN THE UNITED STATES
UNITED STATES

In the United States, the tax impacts of a secondment arrangement, from the perspective of the non-US entity or "Home Country Entity" depend upon whether there is a tax treaty between the US and the non-US jurisdiction. If no tax treaty exists, then the taxation of the secondment agreement, as it impacts the non-US entity, should be analyzed under the US tax rules subjecting foreign persons to US income tax on "effectively connected income" generated by the conduct of a "US trade or business". Whether a US trade or business exists is a highly factual determination under US federal tax laws.

In contrast, under a tax treaty, the key question is whether a "permanent establishment" exists. US tax treaty permanent establishment articles typically focus on three separate tests — asset, agency, and activity — to determine whether a non-US entity has sufficient presence in the US to qualify as a "permanent establishment". While the treaty approach may require an increased amount of presence by the non-US entity in the US, the ultimate determination of whether the non-US entity has a permanent establishment in the US remains a highly factual inquiry.

A strategy that may minimize the existence of a "permanent establishment" by the Home Country Entity in the US is to structure the secondment agreement in such a way that the Home Country Entity is considered merely the "payroll agent" and not the employer of the seconded employee. As a general approach, an employer/employee

relationship will be deemed to exist where the entity has a right to control and direct the individual who performs the services. In this context, it is important to consider several factors, including whether the Home Country Entity has the right to control the assignment of the seconded employee (ability to control daily assignments, recall employee prior to end of assignment, appoint a substitute, discharge the employee, etc.), and whether the seconded employee has the ability to conclude contracts on behalf of the Home Country Entity. If these factors are present it may be more probable that the Home Country Entity would be considered to have a "permanent establishment" in the US.

It should be emphasized that merely stating that the seconded employee is employed by the US entity in an employment agreement or secondment agreement is unlikely to avoid the non-US entity from being treated as having formed a permanent establishment in the US. As discussed previously, an analysis of all the particular facts and circumstances in each case is needed to determine which entity is the true employer and whether the non-US entity has a permanent establishment in the US.

The above discussion is general in nature and only focuses on the tax implications of a secondment arrangement and permanent establishment from a non-US entity perspective. Other US tax issues, including the proper reporting and remitting of US payroll taxes, should also be considered. Additionally, the seconded employee may have US income tax and reporting obligations.

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