Tax Talk

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A 360-Degree Look at Secondment Tax Issues: China, United States, and Germany

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 for two purposes:

- To prevent the application of People's Republic of China (PRC) employment law (which is generally more employee friendly); and
- To preserve the secondee's participation in its 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, 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 costs arising from secondment arrangements unless it accepts taxation on the basis of having a PE in China and pays taxes 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*[4] [2010] No. 75 (Notice 75), issued by the State Administration of Taxation (SAT)[5] in 2010, would provide helpful guidance on structuring cross-border secondment arrangements to mitigate the risk of establishing a PE in China. Although initially 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.

It also states that the secondees of a home country entity assigned 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, Chinese tax authorities may deem the secondee to be 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 on 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; or
- 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 may be formed by taking into consideration whether the secondees (1) create a fixed place of business of the home country entity in China or (2) 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 fac-

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tors 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. This very much follows the style of Chinese regulations, which seldom create safe harbors for taxpayers that would entirely eliminate the tax authorities' discretion.

Bulletin 19[6] (Please refer to Appendix I on page 26 for the English translation of Bulletin 19.)

In the three years since China issued Notice 75, PRC local tax authorities have not widely implemented it. This may be because it was issued specifically in connection with the China–Singapore bilateral tax treaty, resulting in a lack of uniform interpretation and understanding among the different local tax authorities in their approach to the concepts related to PE in general.

Perhaps as a response to both the lack of implementation of Notice 75 and the local tax authorities' unfamiliarity with bilateral tax treaties, the SAT issued *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*[7] (Bulletin 19), which offers further insight into cross-border secondments. Unlike Notice 75, Bulletin 19 provides critical guidance on when a cross-border secondment arrangement will give rise to a home country entity being deemed to have (1) an establishment or place in China under domestic PRC tax law; or (2) a PE under an applicable bilateral tax treaty. (Collectively, these are referred to as having a taxable presence.). In May, the SAT posted an official interpretation to Bulletin 19 on its website.[8]

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

The Bulletin 19 Standards

With regard to cross-border secondment arrangements, whether a home country entity creates a taxable presence in China under Bulletin 19 depends on:

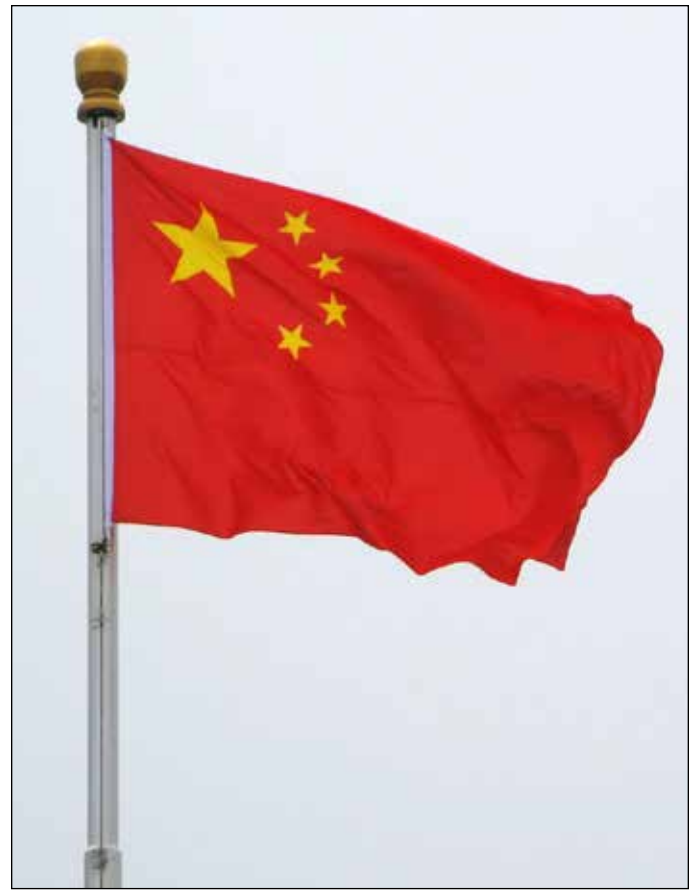
- Whether the home country entity or the host entity is the employer-in-substance of the secondee; and
- Whether the home country entity derives a profit as a result of the secondment arrangement.

Although a secondee will typically remain an employee of the home country entity (that is, the home country entity issues the secondee's employment contract), 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 it:

- 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 that 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 that 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; and
- 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, these are referred to as the supplementary factors).

According to the SAT's official interpretation of Bulletin 19, if tax authorities determine the home country entity to be the secondee's employer-in-substance and any supplementary factors are also present, then they may also determine 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:

- The contracts or agreements among the home country entity, the host entity, and the secondees;
- The management regulations of the home country entity or the host entity concerning the secondees, including those specific to the duties and responsibilities of the secondees, the contents of the secondees' work, work performance appraisals, risk expo-

sure, and so forth;
- Details on payments made by the host entity to the home country entity and the relevant accounting treatment, including information concerning the filing and payment of individual income tax by the secondees; and
- Information on whether or not the host entity has made payments relating to the 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. To reach their conclusion, the tax authorities will likely review and analyze those documents, as well as the economic substance of the arrangement.

Lastly, Bulletin 19 provides a helpful exception for what is commonly known as stewardship activities. According to Bulletin 19, a home country entity does not 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).

Enforceability and Unanswered Questions

The PRC tax authorities have been aggressively targeting foreign companies doing business in China to ensure that the corporations are fully disclosing their income and paying taxes in China. Foreign companies should expect increased scrutiny and greater enforcement. Still, questions remain as to the bulletin's practical implementation. For example, how will the tax authorities assess the secondment arrangement if the host entity is clearly the secondee's employer-in-substance, and 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 establish, secondment arrangements in China, as the parameters and guidance provided 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 arrangements to ensure that (1) the supporting documentation follows the guidelines and principles set out in Bulletin 19 and (2) 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 and Germany

United States

In the United States, the tax impacts of a secondment arrangement, from the perspective of the non-U.S. home country entity, depend upon the existence of a tax treaty between the United States and the non-U.S. jurisdiction. If no tax treaty exists, then the taxation of the secondment agreement, as it impacts the non-U.S. entity, should be analyzed under the U.S. tax rules subjecting foreign persons to U.S. income tax on effectively connected income"generated by the conduct of a U.S. trade or business. Whether a U.S. trade or business exists is a highly factual determination under U.S. federal tax laws, relying on a facts and circumstances test.

In contrast, under a tax treaty, the key question is whether a permanent establishment exists. U.S. tax treaty permanent establishment articles typically focus on three separate tests—asset, agency, and activity—to determine whether a non-U.S. entity has sufficient presence in the United States to qualify as a permanent establishment. While the treaty approach may require an increased amount of presence in the United States by the non-U.S. entity, the ultimate determination of whether the non-U.S. entity has a permanent establishment in the United States remains very much dependent on the facts.

A strategy that may minimize the existence of a permanent establishment by the home country entity in the United States 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 (e.g., the ability to control daily tasks, recall the employee prior to the end of the assignment, appoint a substitute, or discharge the employee) 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 United States.

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

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

Germany

In Germany, the primary question in secondment agreements is whether the non-German home country entity that seconds the employee establishes a taxable presence in Germany under German domestic tax laws. Sections 12 and 13 of the German General Tax Code (AO) address these issues. If there is a taxable presence, one needs to investigate whether an applicable tax treaty between Germany and the home country entity's jurisdiction of residence limits Germany's right to impose an income tax. If that is not the case (either because there is no treaty or because the home country entity has a permanent establishment in Germany for purposes of the applicable treaty), the home country entity is, in principle, subject to German corporate income tax. However, one still needs to determine which income should be allocated to the German taxable

presence, both under domestic tax laws and the tax treaty, if any.[9]

It should be noted that German domestic tax laws distinguish between permanent establishments and permanent agents. Permanent establishments (Section 12 AO) are defined as fixed places of business or installations through which a taxpayer operates. The notion of permanent establishment under the domestic tax laws is therefore associated with a physical presence (office or other location, or fixed installation, such as a pipeline or a server). By contrast, permanent agents (Section 13 AO) are persons who "regularly arrange the business affairs of an enterprise and that are subjected to the instructions of that enterprise." An entity is also deemed to be a permanent agent if it "regularly concludes or arranges contracts or generates orders for an enterprise."

Since a permanent establishment requires an element of physical presence under German tax laws, this would only be the case if the secondee has at his or her disposal a specific office or other working space not at the host entity's discretion. This should rarely occur. The risk is far more pronounced that the secondee is qualified as a permanent agent of the home country entity. However, the tax treaties into which Germany has entered to date generally provide for additional requirements that need to be fulfilled if an agent will also constitute a permanent establishment for purposes of that treaty.

A word concerning employee status may also be helpful. The qualification of the secondee as an employee of the German host entity, legally or in substance, is not ultimately dispositive as to whether the home country entity has established a taxable presence in Germany. Naturally, the two issues are interdependent. If a secondee is subject exclusively to the instructions of the German host entity, that secondee is likely to qualify as an employee of that host entity, a qualification that one would generally want to avoid due to the very strict German employment laws and temporary nature of the secondment. Simultaneously, it would be best to also avoid qualifying as a permanent agent, as this may have a worse impact. One should note that the individual tax status of the secondee—and the obligations of the German host entity to make withholdings for individual German income tax and social security contributions—needs to be assessed separately.

Depending on the facts and circumstances, a secondment can create a permanent establishment of the home country entity for domestic German tax purposes. As is the case in China and the United States, the German tax authorities (and the tax courts) will not be bound by the legal qualifications made by the parties involved. Rather, they will investigate the substance of the agreements, looking to the rights and obligations established and will verify that the behavior is, in fact, in line with those agreements.

Finally, even if the home country entity has created a taxable presence in Germany and is therefore subject to German corporate income tax, there will be room for discussion (and dispute) with the German tax administration regarding the profit or loss that is to be allocated to that presence. In this regard, there is a dispute among legal scholars and tax practitioners about how the income generated by a dependent agent's activities should be determined.

In short, similarity to the Chinese and American approaches, the determination of whether the non-German entity has a taxable presence in Germany is a highly factual inquiry. In practice, however, the content of the legal arrangements made among the home country entity, the German host entity, and the secondee will largely predetermine the tax analysis and so should be carefully considered before undertaking a secondment. If the risk of creating a taxable presence is pronounced, one ought to consider documenting arm's length consideration between the home country entity and the host entity for the services provided bt the secondee to limit tax risk exposure. ⊙

Endnotes

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

[2]While the term "permanent establishment" (or "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 the concept of PE. An establishment or place includes: a business agent and 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.

[3]Notice 75 specifies the cross-border secondment arrangement as one where a foreign parent company sends the secondee to its subsidiary (or subsidiaries) in China.

[4]SAT, *Interpretations of the Provisions in the Agreement Between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Its Protocols* (Sept. 1, 2010) *Guo Shui Fa* [2010] No. 75.

[5]The highest PRC government agency responsible for tax enforcement.

[6]Unlike Notice 75, the cross-border secondment arrangement in Bulletin 19 is not limited to the situation of a foreign parent company sending the secondee to its subsidiary or subsidiaries in China.

[7]SAT, *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* (April 2013) SAT Announcement [2013] No. 19 (printed on page 26 of this magazine).

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

[9]In other words, a tax treaty may completely prevent Germany from exercising its right to tax (because the home country entity does not have a permanent establishment in Germany for purposes of the treaty) or limit that right (because the treaty imposes rules on the attribution of income that are different from German domestic laws).

Appendix I
(Hogan Lovells' Unofficial Translation)
Announcement of the State Administration of Taxation on 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

To the offices of the State Administration of Taxation and local tax bureaus of all provinces, autonomous regions, municipalities directly under the Central Government, and cities with independent development plans:

Pursuant to the *People's Republic of China Enterprise Income Tax Law* and the implementing regulations thereof, agreements for the avoidance of double taxation between the Chinese government and foreign governments (including the tax arrangements with the Hong Kong and Macau Special Administrative Regions, hereinafter collectively referred to as "Tax Agreements"), the *Circular of the State Administration of Taxation on Issuing the 'Interpretation of the Government of People's Republic of China and the Government of the Republic of Singapore Concerning the Agreements and Protocols for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Income Tax'* (SAT [2010] No. 75) and other such provisions, the State Administration of Taxation hereby issues the following Announcement on enterprise income tax levying issues in relation to non-resident enterprises dispatching personnel to provide services within the People's Republic of China (the "PRC"):

If a non-resident enterprise dispatching personnel to provide services within the PRC (hereinafter the "Dispatching Enterprise") assumes some or all of the liabilities and risks associated with the work of the dispatched personnel, and the Dispatching Enterprise regularly assesses and evaluates the work performance of the dispatched personnel, such Dispatching Enterprise will be deemed to have an establishment or place within the PRC to provide labour services; if the Dispatching Enterprise is a contracting party to a Tax Agreement, and the establishment or place providing labour services has a relatively fixed or permanent place of business, such establishment or place shall constitute a permanent establishment within the PRC.

The following factors must be taken into account when determining the status of a Dispatching Enterprise as set out above:

The PRC enterprise receiving the labour services (hereinafter collectively referred to as "Receiving Enterprises") pays management fees or service fees to the Dispatching Enterprise;

The amount which the Receiving Enterprise pays to the Dispatching Enterprise exceeds that of the wages, salaries, social insurance fees, and other expenses advanced or paid by the Dispatching Enterprise to or on behalf of the dispatched personnel;

The Dispatching Enterprise does not pay to the dispatched employee all of the relevant fees paid by the Receiving Enterprise, but rather keeps a certain amount of such fees;

The amount of the individual income tax on the wages and salary of the dispatched personnel borne by the Dispatching Enterprise is not fully paid in China;

The Dispatching Enterprise determines the number of employees to be dispatched, their qualifications, remuneration criteria, and their place of work within the PRC.

Where the Dispatching Enterprise only dispatches employees to provide labour services within the PRC for the purpose of exercising shareholders' rights or safeguarding its lawful shareholders' rights and interests in the Receiving Enterprise (including the dispatching of employees to advise the Receiving Enterprise with respect to investments, or take part in the Receiving Enterprise's general shareholders' meetings, board meetings, or to engage in other such activities on behalf of the Dispatching Company), the Dispatching Enterprise will not be deemed to have an establishment or place or a permanent establishment in the PRC merely on the basis of such activities having been carried out on the business premises of the Receiving Enterprise.

Dispatching Enterprises and Receiving Enterprises which satisfy the conditions specified in Article 1 hereof must carry out tax registration and record-filing, file tax returns, and attend to any other relevant tax matters in accordance with the *Administrative Measures on the Administration of Taxes in Relation to the Contracting of Projects and Provision of Labour Services by Non-Resident Entities* (SAT Decree No.19).

Dispatching Enterprises which satisfy the conditions specified in Article 1 hereof must accurately calculate their income in accordance with law and truthfully report their earnings and pay enterprise income tax accordingly. Tax authorities shall have the right to assess the amount of taxable income in accordance with the relevant regulations in the event that the Dispatching Enterprise fails to accurately report its earnings.

Competent tax authorities, when determining the income tax obligations of a non-resident enterprise, must strengthen tax administration in relation to personnel dispatching activities, by focusing on reviews of the following information as associated with personnel dispatching activities, as well as the economic substance and execution of personnel dispatching arrangements:

The contract or agreement between the Dispatching Enterprise, the Receiving Enterprise, and the dispatched personnel;

The management regulations of the Dispatching Enterprise or the Receiving Enterprise concerning the dispatched personnel, including specific regulations in relation to the duties and responsibilities of the dispatched personnel, the contents of their work, work performance appraisals, risk exposure, and so forth;

Details on payments made by the Receiving Enterprise to the Dispatching Enterprise and the relevant accounting treatment; information concerning the filing and payment of individual income tax by dispatched personnel; and

Information on whether or not the Receiving Enterprise has made payments relating to personnel dispatching activities by way of offsets, forgiveness of debts, related party transactions, or other forms of concealed payments.

When determining the tax obligation of a Dispatching Enterprise pursuant to the Enterprise Income Tax Law and this Announcement, the competent tax authority must strengthen its coordination and communication with the competent tax authorities for the individual income tax and business tax issues pertaining to labour services provided by dispatched personnel and exchange information concerning the provision of labour services provided by dispatched personnel in order to ensure that the relevant tax policies are accurately implemented.

When implementing tax treatment in relation to non-resident enterprises dispatching personnel to provide labour services as specified in this Announcement, the relevant payment procedures must be carried out for the Dispatching Enterprise or the Receiving Enterprise in a timely manner and in strict accordance with the relevant regulations.

This Announcement shall come into force on June 1, 2013. Matters arising prior to the effectiveness hereof, but for which tax treatment has not yet been carried out, shall be attended to in accordance with this Announcement.

State Administration of Taxation
April 19, 2013