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TAX LAW ALERT

From China Visits to Tax-Efficient Subsidiaries

Tax risks and precautions deserve increasing attention from foreign companies at every stage of PRC-related activities. The most surprising risk is how easily business visitors can inadvertently cause their foreign employers to incur tax liability, by creating a PRC permanent establishment (PE). The biggest trend is towards more governmental scrutiny of tax planning for employees, for investments and for cross-border transactions, including the uses of a tax-effective jurisdiction such as Hong Kong.

A foreign company that provides services by means of employee visits to the PRC runs several risks: of creating a permanent establishment (PE); of suffering intrusive investigations; and of bearing substantially higher taxes and costs than if it had conducted its operations through a well-structured PRC subsidiary. Reasons for this include the following:

- The rule that a PE (unlike a subsidiary) cannot deduct (from taxable income) payments to its parent of interest and certain fees.
- The likelihood that a PE will be deemed to have taxable profit calculated according to its costs or revenues (rather than its net income).
- The risk of visiting employees being subject to PRC individual income tax (IIT), and owing higher tax than employees of a PRC subsidiary, due to lack of tax reduction arrangements.

When do visits create a PE?

All visits by service-providing employees (except for employees engaged in approved bonded processing activities) are subject to relatively stringent tests that determine when a PE is created. Since 2008, key tests have been interpreted as follows:

- "Working from a fixed place of business" is difficult to avoid in light of the policy specifying that such a place includes "offices or other office facilities employed to provide long-term services in the PRC", even if such offices or facilities are provided by the service recipient.
- "Furnishing of services in six out of twelve months" is also difficult to avoid in light of the official view that a "month of presence" may result from presence during as little as one day in that month.
- The determination of whether services are for "the same or a connected project, which is a third key test, is affected by the increasing focus of tax authorities on scrutinising and rejecting tax-driven "contract splitting" (that seeks to disguise services as being related to a number of unconnected projects). In making this determination, tax authorities have

This is the current version of an article that has appeared, in updated versions, in the China Business Handbook 2008, 2009 and 2010 editions, under the title "Tax Planning".

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For more information about our China practice, please visit our website: www.orrick.com/china much discretion, e.g., to consider whether one contract would "stand unaffected" in the absence of another contract.

Avoiding a PE through dual employment

A foreign company will not create a PE if the work performed by its employees during PRC visits is covered by separate employment contracts between the employees and one or more PRC companies. This type of "dual employment" has the additional attraction of clearly separating the employees' remuneration into two categories: the first being for work inside the PRC (subject to IIT) and the second being for work outside the PRC (not subject to IIT). In contrast, if a PE is created, then the employees whose work is connected with the PE would normally have great difficulty demonstrating which portion of the remuneration should be exempt from IIT. Dual employment is also attractive where an employee is primarily employed by a PRC company, while making frequent visits outside the PRC to do work that can reasonably be covered by an employment contract with a non-PRC company. For dual employment to be respected by PRC tax authorities, the following tests must be met:

- A commercial justification is required for the existence of separate contracts.
- The roles and responsibilities under each contract must be distinct from those under the other.
- The lines of control and reporting of each position must be clear and distinguishable.
- The split of remuneration between the two contracts must be reasonable (especially if the two employers are affiliates or have other economic relationships), e.g. reflecting the respective duration, status and difficulty of work inside and outside China.
- The PRC employer must not bear (directly or indirectly) the cost of the foreign employer's remuneration of the employee (other than carefully designed reimbursement of certain administratively justified costs).

A variety of PRC companies can act as the PRC employer under dual employment. Examples include a PRC agent or customer of the foreign company (although use of a customer will draw particular scrutiny to the question of whether the employee's work for the PRC customer should be deemed to be a fee-earning service provided by the foreign company). At a more mature stage of activity in the PRC, the PRC employer may be the foreign company's subsidiary.

Establishing a PRC subsidiary

When a foreign company is ready to establish its own presence in the PRC, the logical form of that presence is a wholly-foreign owned enterprise (WFOE). The once-popular form of a "representative office" continues to be an alternative where the presence will not engage in manufacturing. But a representative office is actually not attractive, despite the apparent attraction of zero capital contributions, because it is not tax-efficient and it is permitted to engage in only a narrow scope of activities. In comparison, a WFOE in recent years has been permitted to provide a flexible range of services, without requiring contribution of much capital. Key tax planning decisions relating to WFOE establishment include the following:

- Determining whether it is possible for the WFOE to meet the detailed requirements (for expenses, revenue and ownership relating to intellectual property) to qualify for tax preferences as a High/New Technology Enterprise (HNTE).

- Considering whether to establish a "cost sharing arrangement" (CSA) with associated enterprises, in order to share common costs incurred for the joint development of intangible assets and/or the provision or receipt of services.

- Considering whether (and when) to reduce future audit risk and uncertainty by negotiating with tax authorities an "advance pricing agreement" (APA), which would proactively address the complex issue of intra-group transfer pricing.

- Considering whether to establish, in a suitable offshore location, a substantive (rather than a "conduit") company to handle PRC investment and transactions.

Hong Kong as location for investments, transactions and operations

Foreign groups seeking to minimise taxes on PRC-source income now face more decisions and tougher scrutiny. The basic structuring decision is where to locate the company making investment (of "registered capital") into a PRC subsidiary (and receiving the subsidiary's distributable profits as well as the eventual gains from selling ownership of the subsidiary), and receiving from the PRC various contractual payments such as service fees, intellectual property royalties and loan interest. Residents of Hong Kong and a few other jurisdictions are eligible for certain lower PRC tax rates than residents of the US, EU countries and most other jurisdictions. Foreign companies and individuals can enjoy a number of benefits, both old and new, by using a Hong Kong company to invest in a PRC subsidiary and to handle transactions with it. Foreign companies and individuals can enjoy a number of benefits, by using a Hong Kong or other offshore company to invest in a PRC subsidiary and to handle transactions with it. A key and continuing benefit is the freedom to sell the offshore company without approval from the PRC government. The avoidance of PRC income tax on any resulting capital gains was a longstanding benefit but, under relatively vague rules announced in December 2009, such tax will not be avoided on an "indirect equity transfer", which will be deemed to occur if the sold offshore company lacks business objectives and was established in order to avoid PRC tax. (In any event, capital gains are normally exempt from tax under Hong Kong's relatively narrow tax system).

More recent benefits for Hong Kong

Companies include preferential PRC tax rates on royalties, interest, dividends and (from certain types of PRC assets) capital gains. But not every Hong Kong resident company can enjoy these preferences. A new condition is that the company must prove that it has the status of a "beneficial owner". These preferences will not be enjoyed by a "conduit company", (a concept introduced into PRC tax policy in 2009), which is an entity that:

- Engages in no, or nearly no, substantive operational activities such as manufacturing, trading, or provision of management services or other services.

- Has established residence in a particular jurisdiction for the purposes of evading tax, reducing tax, or transferring or sheltering profits.

The PRC tax authorities will determine beneficial owner status case by case, in line with the principle of "substance over form". An applicant's chance of being deemed a beneficial owner will be reduced by each of the following factors (all of which are intended to be considered and balanced, without any particular weighting having been indicated):

- It is obliged to pay or distribute all or a major portion (e.g., above 60%) of its PRC-source income within a specified time limit (e.g., within 12 months after receipt) to residents of another jurisdiction.

- It has no, or nearly no, operational activities except holding the properties or rights from which PRC-source income is generated.

- It has assets and staff that are disproportionately small in comparison with its PRC-source income.

- It has no, or few rights, to control or dispose of, or assumes little or no risk in connection with, its PRC-source income.

- If its PRC-source income is generated by a loan agreement, and it has loan or deposit agreements with another person specifying similar amounts, interest rates, and creation dates.

- If its PRC-source income consists of royalties generated by a transfer or license agreement for usage or ownership of copyright, patent, or technology, and it has transfer or license agreements with another person providing for similar royalties.

In order for a Hong Kong resident company to satisfy many of these factors, it is useful to involve the company in funding, support, administration and/or supervision of subsidiaries' and cross-border operations in the PRC and the surrounding region. Hong Kong has long been a regional hub for such intra-group activities, as well as for externally sourced services in sectors such as transportation, distribution, advertising, finance, accounting, tax planning and law.

Hong Kong dual employment and taxes

Many of the above activities may be handled by Hong Kong company employees working under the dual employment structure discussed above. Hong Kong is an attractive place for part-time or full-time residence of senior personnel, notably because of its international schools, widespread use of English, and low and narrow individual income ("salaries") tax.