From China Visits to Tax-Efficient Subsidiaries

At every stage of China-related activities, it is increasingly important for foreign companies to pay attention to tax risks and precautions. The most surprising risk is how easily business visitors can inadvertently cause their foreign employers to incur tax liability, by creating a permanent establishment in the People's Republic of China (PRC). The biggest trend is towards more governmental scrutiny of tax planning for employees, for secondments, for dual employment, 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 PRC enterprise income tax (EIT) 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:

- Visitors being deemed to be furnishing services, while present in China, "in six out of twelve months" is 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.
- Visitors being deemed to be "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 that are used in order to provide long-term services in the PRC", even if such offices or facilities are made available by the service recipient.
- Services being deemed to be for "the same or a connected project" is affected by the increasing focus of tax authorities on scrutinizing and rejecting tax-driven "contract splitting" (which means seeking to disguise services as being related to a number of unconnected projects). Tax authorities have much discretion, e.g., to consider whether one contract would "stand unaffected" in the absence of another contract.

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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. 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). Once a foreign company establishes a PRC subsidiary, this subsidiary can act as the PRC employer under a dual employment arrangement, or may act as the sole employer.

Avoiding a PE through secondment

A foreign company (the "home company") that has a pre-existing relationship with an employee, and intends to continue that relationship after the period in which that employee works in the PRC, will often find it useful to make a "secondment" of the employee into an employment relationship with a PRC company (the "host company", which is typically, but not necessarily, a subsidiary or other affiliate of the foreign company). Advantages of this approach can include facilitating non-interruption of the employee's home country job seniority, job security and/or employee-benefits. A possible disadvantage is that this approach, by creating a clear record of the employee's activities in the PRC, for the benefit of the host company, ensures that a PE will be deemed to exist if the host company is deemed not to be a "substantive employer". Since the second half of 2009, several local PRC tax authorities have increasingly scrutinized whether PRC affiliates of international groups are actually the substantive employers of individuals that have purportedly been seconded from foreign parents. Since July 2010, it has been clarified that, in order for such a subsidiary to constitute a substantive employer, it must satisfy each of the following criteria:

- The subsidiary holds and exercises the legal and practical power to direct the work of the secondee.
- The subsidiary bears all risks and responsibilities relating to the work product of the secondee.
- The subsidiary holds and exercises the power to determine the number and qualifications of individuals seconded to it.
- The cost of the secondee's salary (and other remuneration directly related to the secondee's work in the PRC) is borne by the subsidiary.
- The parent does not derive profits from the secondment.

Where a seconded employee will continue to perform work for the benefit of a foreign parent or other affiliate, the most prudent solution may be to include a secondment as part of a dual employment arrangement.

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Establishing a PRC subsidiary (vs. representative office)

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), although the once-popular form of a "representative office" (RO) continues to be an alternative (increasingly unattractive, notably for tax planning) if the presence will not entail manufacturing or other business activities.

A RO, despite the apparent attraction of not requiring any capital contributions, is actually not attractive, because it is not tax-efficient and it is only permitted to engage in a narrow scope of activities. ROs are becoming even less attractive as a result of tighter restrictions, and higher potential fines for breaching them, starting from March 2011. Key changes are as follows:

- A foreign company (notably including an offshore intermediary that is established to handle investments and/or activities in China) will be required to have been in existence for at least two years before it can establish an RO.
- A RO will not be permitted to have more than four representatives, including the chief representative.
- More investigatory and punitive powers are granted to the government's registration authority (the Administration of Industry & Commerce), notably including an increase to RMB500,000 (from 20,000) in the maximum fine for exceeding permitted activities.

In comparison, a WFOE is permitted to provide a relatively broad range of services, many of which require only a small contribution of 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 minimize taxes on PRC-source income now face more decisions and tougher scrutiny. The basic structuring decision is where to locate the company investing 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. Companies that are resident in 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 by using a Hong Kong 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, now such tax is increasingly difficult to avoid, because a taxable "indirect equity transfer" 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).

Preferential PRC tax rates on royalties, interest, dividends and (from certain types of PRC assets) capital gains may be enjoyed by a Hong Kong resident company that is a "beneficial owner". These preferences will not be enjoyed by a "conduit company", 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 have the power to determine beneficial owner status case by case, in line with the principle of "substance over form". Their scrutiny appears to have gotten stricter during 2010. 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.

Many of the above activities may be handled by Hong Kong company employees working under the dual employment and/or secondment 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.

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