Providing back office services in China: beware of the tax risks

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The Chinese tax authorities are getting more aggressive on permanent establishment assessment. General back office services provided onshore by a foreign company can trigger a permanent establishment of the foreign company in China.

Multinational groups often provide Chinese subsidiaries with back office services in finance, HR, and IT amongst others for which they charge service fees. And often employees of the overseas company travel to China to deliver these services. Traditionally, short business trips lasting less than 183 days each, do not usually create a tax problem for either the foreign company or the employees. But if these services are delivered regularly, they may create tax exposure for the overseas company in China.

Introduction of a case
China’s tax authorities required the foreign investor (“Investor”) in a Chinese subsidiary (“WFOE”) to levy individual income tax (“IIT”) on the salary income of employees that the Investor sent to China. These employees visit China for internal functional meetings (i.e. HR, IT, finance, etc.) with staff of the WFOE.

The WFOE has a management service agreement (“Agreement”) with the Investor by which it pays for the Investor’s back office services. The WFOE has withheld tax on service fees paid to the Investor for years to make the remittance of service fees to the Investor. It was the first time that the tax authorities have asked the Investors’ employees to pay IIT in China.

Because the Investor’s employees are temporary visitors, they questioned the legal basis on which the tax authority levied IIT. Surprisingly, the tax authority said that the Investor created a permanent establishment (“PE”) under the Agreement by providing services and must therefore pay IIT on salary income generated during their stay in China.

What can we learn from the case?
Assessing PE risk
A Permanent Establishment or PE is a concept that is peculiar to China’s double tax treaty framework. Most of China’s double tax treaties define it as: “a fixed place of business through which the business of an enterprise is wholly or partly carried on”.

In practice, a PE is most commonly triggered when a foreign business provides onshore services for a project or related projects.

• Can back-office-services contribute to establishing a PE?

In 2010, the Chinese tax authorities published their double tax treaty interpretation in which they conclude that services under the double tax treaty includes services provided in relation to the business operation and management of a company. Therefore management related services can in theory contribute to the PE existence of a foreign service provider in China.

This interpretation taken by the Chinese tax authority also concurs with the OECD standards that “a fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concerned cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level”.

• Are the services under the Agreement related?

When assessing whether different services are rendered for “related projects” for the purpose of PE assessment, the Chinese tax authority uses the test of “commercial and geographical coherence” in which it considers the following questions:

- Are the projects provided under the same contract?
- Is the agreement signed with the same or a related person?
- Is the nature of the projects the same?
- Are the projects performed by the same people?

1. Under previous rules, for payment of service fees exceeding USD 30,000, banks in China required tax clearance certificates from the tax authorities proving that the Chinese tax liabilities in relation to the payments have been settled. Under the current rules, the threshold has been raised to USD 50,000.
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It is quite unusual for the tax authorities to regard a foreign company as having a PE in China for providing back office services to its local subsidiary. In this case, the local tax authority seems to have taken a comprehensive approach in reviewing different services under the Agreement and, for the purpose of the PE assessment, deemed that all services are related for the purpose of managing the WFOE.

- Consequence of having a PE
  Having a PE in China creates the following tax implications for the foreign service provider:
  - the foreign company’s profit attributable to the PE, which is usually assessed on a deemed basis, is subject to 25% corporate income tax (“CIT”)
  - the deemed service income of the PE is subject to applicable turnover taxes (i.e. VAT or business tax)
  - the salary income of the employees working in the PE is subject to individual income tax, regardless of the duration of stay of those employees in China (in other words, the employee’s IIT status is not protected by the 183-day threshold under most double tax treaties).

Other potential issues

Is cost allocation allowed?

Generally China’s tax law prohibits a parent company from allocating costs to its subsidiaries. In this sense, all inter-company services should be charged based on actual services. If the company paying the service fee fails to substantiate to the tax authority that there are actual services by providing the service agreement and other supporting documents, the tax authority may regard this as a cost allocation between the headquarters and subsidiaries and thus disallow the deduction of the service fee for the service recipient’s CIT purpose.

What happens if the service fee is accrued but not paid?

As part of the global transfer pricing policy, some foreign companies still allocate management costs to their Chinese subsidiaries even being aware that the subsidiaries may have problems deducting the cost for the CIT purpose and have difficulty in making the payment due to Chinese tax and foreign exchange reasons. As a result, the Chinese subsidiaries accrue a payable to headquarters which cannot ever be paid. There is a risk that such payables – from the CIT’s perspective – would eventually be treated as taxable income of the subsidiary if the payables cannot be paid.

How to mitigate the tax risks

Foreign companies providing back office services may need to reconsider the way in which they provide services to mitigate the presence of its employees in China. For instance, some management related meetings can be conducted via video or telephone conference so that the foreign company does not necessarily have to send its people to China at the risk of being exposed to Chinese taxes. Other methods, such as splitting the general management service agreement to separate project agreements may also lower the PE appearance of the foreign company.

While finding a PE to have been established by providing back office services is not yet the tax authority’s stated approach, this instance may indicate a shift to a more aggressive PE policy.

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