

This HR Communique is a free human resource briefing distributed by **FINEX 财僑** in electronic format to its clients, talents, and business associates. The aim is to provide quick and brief alerts to recipients on important developments in the human resource and regulatory areas in China, thereby equipping them with timely insights and updates for human resource management and compliance in China.

HR Directors to Review and Ensure IIT Settled for Intra-Group Contracts

As we are already in the 4th quarter of the calendar year approaching the year end, it is always a good HR practice at this time to take a proactive step to review if Individual Income Tax (IIT) obligations and liabilities are being properly complied with in China under the different entities, and also under various internal group arrangements.

One easily overlooked area is the IIT liabilities on contracts between overseas group companies and their Chinese affiliates, whereby employees work in China under contracts for services or for equipment supplies or other arrangements.

Implications

It is not uncommon that overseas companies of MNC groups enter into various contracts at various stages with their affiliate companies in China to provide services (including shared services), supplies requiring installation or advisory services, or for secondment of staff.

Depending on the nature, duration and other elements and terms in these intra-group contracts, employees of overseas companies working under these contracts may attract IIT liabilities in China. If they do, then the companies in China or the overseas employers may have IIT reporting and withholding obligations in China.

Final settlements for IIT as well as Corporate Income Tax in China are all done on a calendar year basis, including on contracted activities. It is a process to review the previous year's tax filings have been done correctly, and to make minor adjustments if any.

In general, non-compliance penalties may be imposed if discrepancies are revealed after the year end by the tax authorities, but self-rectification by taxpayers before the year end

are usually treated with leniency. Therefore it is advisable to do a review before the end of the year. Correct assessment and reporting of the Chinese IIT not only can avoid unnecessary late filing interest and non-compliance tax penalties, but can also allow business teams to have the correct cost budgets for pricing decision purposes. This is particularly important these days in China in view of its continuous emphases on arms-length transfer pricing for intra-group transactions.

Assessment Criteria

Whether overseas employees have to pay IIT in China is very closely related to the nature of the respective contracts and the manner of execution. If an overseas affiliate has constituted a 'place or establishment' under the definition in the Chinese Enterprise Income Tax Law (or a permanent establishment, ie 'PE', under the definition of a relevant tax treaty) by virtue of its activities in China under such contracts, then the respective overseas employees will have to pay IIT on income sourced from China from such contracts even if an employee is in China for only one day.

A 'place or establishment' includes, among other things, a place of management or administration, a place where services are rendered, and also a place of installation, assembly or repair.

On the other hand, a 'PE' under tax treaties is usually defined as a fixed place of business including assembly or installation projects or relevant supervisory activities, or furnishing of services which last for more than 6 months in a 12 month period (the famous 6-month or 183 day rule).

Tax treaties have more lenient definition for a taxable presence. Specific activities are also excluded from the definition of PE, therefore affiliates from treaty countries are usually less likely to be taxed. However, it should be noted that terms under tax treaties may vary and that local tax bureau practices may also be different. HR may want to seek professional advice in correctly assessing the respective IIT exposures.

Secondment Contracts

It is also not uncommon that overseas companies transfer or 'second' existing employees to China to work for their Chinese affiliates for a period of time, say a couple of years, during which period the Chinese affiliates will bear (paid directly to employees or reimburse overseas companies of such costs) all employment and related costs and the employees will receive work instructions from the Chinese companies.

Poorly structured secondment contracts or sometimes the lack of properly executed secondment contracts may result in unnecessary tax exposures in China on the part of the overseas companies. This is because in the event the cost reimbursement option is adopted, if the overseas companies impose mark-ups on the costs recharged, they may be

deemed to be providing services in China by virtue of their employees, and therefore giving rise to Corporate Income Tax and also Business Tax liabilities.

Consequently it is important that HR departments review secondment contracts and arrangements to ensure avoiding potential future challenges by the tax authorities.

Actions

It is advisable that HR teams in China work closely with their business and financial counterparts as well as overseas colleagues to review such group contracts and ensure that correct assessments are carried out. Proper reporting bases should be adopted, thereby to avoid unwanted interruptions to the business and also unnecessary penalties. Better still, a monitoring system should be established on a proactive basis.

As indicated above, IIT exposure is closely related to the nature, duration and other factors such as deployment of employees. Intra-group contracts should be carefully structured and executed for the various activities to help achieving higher IIT and Corporate Income Tax efficiencies in China.

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