

Tax in China newsletter

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Tax news

Chinese group reorganisations: past, present and future

Are you planning to carry out a reorganisation of your Chinese subsidiaries, or have you done so since 2008? If so, you need to be aware that you may have to effect any transfers at market value. Failure to do so could result in unanticipated tax liabilities.

Many groups with Chinese subsidiaries carry out reorganisations periodically, either of their foreign holding company's investment in their Chinese companies or internally within the Chinese sub-group. If you have done so since 2008, or are planning to do so in the future, for tax purposes it is important that you carry out these transactions at a fair market value. It is our experience that this is often not the case, usually for good reasons, but this requirement can no longer be ignored.

Until 2008, it was possible to effect corporate restructuring transactions at a value other than at 'arm's length'. However, from 1 January 2008, China's Corporate Income Tax (CIT) regime has explicitly required corporate restructuring transactions to be effected at fair value. There have since been a number of circulars released in order to provide more clarity on this and on the acceptable methods of valuation, but awareness of these has not been as good as it perhaps should have been.

However, two recent cases in Dalian and Nanjing have been heard which have underlined this requirement to effect transactions at fair value and the fact that the tax authorities are paying attention to this point.

In the Dalian case, the Dalian State Tax Bureau started their investigation after reading press reports of a sale of a Chinese company to a third party, even though there was nothing explicit in the tax filings of the company or its parent. In the Nanjing case, a company was filing for Hong Kong treaty benefits for its parent company in 2010. However, the Nanjing State Tax Bureau went back to 2008 to chart the history of how the Hong Kong parent came to own the Chinese company and found taxable transfers of which it was previously unaware.

There are important lessons to be learnt from these two cases. It shows that even if transactions are not directly reported to the authorities, it is important to ensure that they are done properly. It also demonstrates that time is not a barrier for an incorrectly effected transaction to be uncovered.



Unfortunately, many taxpayers continue to follow the previous practice and effect transactions at cost. Whereas there used to be a blanket exemption before 2008, companies should no longer take it for granted that a transfer at cost will be without challenge from the Chinese tax authorities.

It should be noted that, even though a transaction may be completed at market value, a taxable gain may not arise because tax deferral treatments may still be available through Special Tax Treatments (under Circular 59 and Public Notice No. 4).

PwC observations

Internal group restructuring transactions can no longer be at cost. Companies should not take it for granted that a transfer of cost will still be free of challenge.

In terms of the Chinese local-level tax authorities' approach to valuations to work out market value, they had previously been comfortable with figures produced by Chinese based valuers and valuations. However, they are now starting to challenge these values. The Dalian case seemed to suggest that the internationally recognised Capital Asset Pricing Model approach may be the preferred method, although the Dalian State Tax Bureau also accepted the income multiple approach. This move to accept internationally recognised valuation approaches could signify a move towards international practices with respect to transfer pricing.

Conclusions

So, in summary, if you have undertaken or are planning to undertake a transfer of your Chinese subsidiaries, you now need to make sure you have a credible valuation and you use that valuation as the transaction price for that subsidiary.

If you would like more information, simply call or e-mail the contact below.

Contact

Jürg Niederbacher
juerg.niederbacher@ch.pwc.com
Tel: +41 58 792 42 93

Hot topic

International assignments to China: a challenge for employers and employees

The challenges of international assignments are very diverse and include personal, legal and economic aspects, from overseas health insurance to cultural training and work visas. For the employer, many of the factors that need to be taken into account become routine with the increasing number of assigned staff. For the employee, who often goes abroad for the first time on behalf of his company, those aspects represent hurdles to be overcome.

Some challenges also await the experienced employer with international assignees. This article addresses these issues in the first part. In the second part it outlines the most important tax aspects for the employee.

Challenges for the employer

The tasks that an employer has to deal with depend decisively on the following question: are there any planned assignments of its workforce to China or business trips or project activities that could lead to tax liabilities due to periods unexpectedly exceeding those allowed?

Tasks for business trips and short-term assignments

Business activities in a guest country, which become ever more complex, can make project-related short-term assignments and business trips to China to a standard in many firms. This entails substantial tax and legal risks.

According to Chinese national law, an employee becomes tax liable in China and the employer must pay taxes if the employee stays more than 90 days per calendar year in China (provided that the wages are not borne by a Chinese subsidiary, in which case the employee is tax liable in China from day one). The employer should therefore ensure that staff who work continuously or repeatedly in China do not exceed the 90-day limit, insofar as a Chinese individual income tax liability should be avoided.

In relation to Switzerland the 90-day limit has been extended to 183 days per calendar year on the basis of the current double tax treaty. However, the wages in case of a period exceeding the 90-day limit for a stay or for several stays of up to 183 days in China are only tax exempt after approval by the Chinese authorities (application or registration procedure). In such a case the employer needs to initiate the procedure.

The double tax treaty with China includes a passage differing from the usual Swiss double tax treaties which defines permanent establishments related in particular to services. This means that companies that are not resident in China and whose employees are assigned for projects there can trigger a permanent establishment of the Swiss company in China with a respective corporate income tax liability.

For construction firms there is a special method to count the six-month limit: the activity of individual (different) employees who remain on a construction site in China for a few days within the six-month period can together generate a permanent establishment, whereby the respective corporate income tax liability arises in China. The employees themselves become income tax liable from the first day of their activity in China since their wages are borne by the emerging permanent establishment. The Swiss company therefore has to monitor travel in order to prevent the creation of a permanent establishment.

Tasks for international assignments to China

Challenges associated with assignments range from the optimisation of assigning conditions with regard to the legal framework to the administration of assigning procedures and the successful reintegration of staff in the home organisation. The following sections offer an overview of the different work, social insurance and tax law aspects.

Labour legislation provides assigning companies with several possible arrangements that can be adapted to individual cases with respect to cost considerations, assignment duration and continuance in the Swiss social insurance system (among which a dormant home work contract plus an international assignment agreement or a local employment contract in China).

Since the end of 2009 Chinese tax authorities have watched the constellation “international assignment agreement” particularly closely. The background: The Chinese authorities now control in detail whether there is a “genuine” assignment to China or whether the employee possibly generates a services-related permanent establishment. Accordingly companies should ensure with this chosen alternative that the international assignment contract contains clear rules regarding issues such as authority over the employee or the reporting line (both must be tied to the Chinese host company to avoid the creation of a permanent establishment). Discussions with the authorities can only be minimised that way.

The employer must continue to conform to social insurance legislation: The employer has to inform the employee of possible social insurance consequences of the assignment to China, whereby it should be stressed that there is no social insurance treaty between China and Switzerland, which is why it may come to double contribution liability and undesirable insurance gaps.

Employees should especially take heed of Chinese developments as to other insurance aspects (e.g. illness, care and accident insurance). Until now it was not compulsory and partly not possible for foreign nationals to take part in the local Chinese insurance systems so that whenever possible additional voluntary coverage in Switzerland was duly recommended. A number of changes will now apply with the centralised Chinese social insurance law that came into force on 1 July 2011.

A practical challenge for the employer arises above all from the already mentioned intensified control by the Chinese authorities of whether a services-related permanent establishment is created by the assignment of the employee.

If a local employment contract with the employee is not possible, a detailed documentation of the affiliation with the Chinese host company is increasingly important to avoid a services-related permanent establishment from coming into being.

Other aspects

- Other costs associated with the assignment of employees must be in line with standard internal transfer pricing principles.
- In case of a (voluntary) application of the 2006 Chinese accounting standards management compensation (in total) must be presented in the financial statements.

Challenges for employees

An international assignment to China promises professional and personal advancement for any Swiss employee. On the other hand, it entails many unknowns and imponderables, for which the employee imperatively needs his employer's support. The following section provides some insights into the characteristics of the Chinese income tax system, which fortunately is less complicated than might be expected.

Main features of income taxation in China

Each month a wage tax (a tax at source on wages) is levied at employer level in China. In addition the employee in China must submit as a rule a Chinese annual tax return. In principle the employee is tax liable to the extent of his activities in China. An employee only becomes fully tax liable, i.e., on his entire world income, if he stays in China for five consecutive full years. This consequence is generally undesirable, also because of the significant administrative burden involved, which is why most long-term assigned employees in China take a “tax break”.

The Chinese income tax system can be described as a “lean” tax system in that it includes few options to claim special deductions or scales: for instance the common tax assessment of both spouses is not possible. However, there is a general deduction of 4,800 renminbi (approx. CHF 650) a month; some private living expenses such as apartment rent and restaurant costs are also deductible to a certain extent for employees on international assignment to China. The progressive tax rate lies between 5% and 45% (the maximum tax rate applies for a monthly income in excess of 100,000 renminbi, i.e., approx. CHF 13,000).

Assigned workers in the focus of tax authorities

As the salary for internationally assigned employees generally remains at home country level and is in most cases enhanced with expatriate allowances, Swiss workers in China are automatically high-income earners, who include by definition employees with an annual income in excess of 120,000 renminbi (approx. CHF 16,000).

Starting in June of last year the Chinese tax authorities have put these high-income earners in the focus of their assessment practices with Guoshuifa (circular) 54. Its key element is cooperation between the different Chinese authorities. This has consequences!

For instance the administration reverts to information of the Ministry of Public Security to determine the days of residence and travel of the persons concerned.

This circular has already led to an increase of tax inspections for executives in particular in the agglomerations of Beijing, Shanghai and Guangzhou.

Risk of double taxation

The following constellation, by way of example, can lead to double taxation: An employee is assigned to China as an engineer for one year. His family stays in Switzerland. During his assignment the employee is partly in Switzerland to carry out his work.

Due to family circumstances the employee is still considered as a resident of Switzerland according to the double tax treaty provisions between Switzerland and China (article 4 paragraph 2 letter a). Swiss workdays are therefore taxable in Switzerland. On the other hand the assigned employee's activity during the duration of his assignment in China is taxable in its entirety in China according to Chinese national law. This includes the salary related to the Swiss workdays. China only taxes the workdays actually spent in China in special justified cases – such as in the presence of a split contract. For such solutions it is imperative to clarify the social insurance consequences in individual cases.

Conclusion

The challenges associated with international assignments are various and can highly differ depending of the type of assignment. In view of optimising tax and social insurance consequences it is usually indispensable to consider the case-related specifics. Even for companies that often assign workers abroad, ongoing monitoring during an assignment in China is essential in order to avoid unnecessary costs.

If you would like more information, simply call or e-mail one of the contacts below.

Contacts

Stefan Schmid
stefan.schmid@ch.pwc.com
+41 58 792 44 82

Yolanda Krüttli Wehrenberg
yolanda.kruettli@ch.pwc.com
+41 58 792 45 33

“What should Swiss companies consider when choosing between a WFOE and a JV?”

A common question from foreign investors coming into China is what they should consider when choosing the appropriate entry vehicle, particularly when deciding whether a Wholly Foreign Owned Enterprise (WFOE) or a Joint Venture (JV) is most suitable. We asked Anthea Wong, a Partner at PwC China who specialises in China investment business advisory:

“What should Swiss companies consider when choosing between a WFOE and a JV?”

WFOEs and JVs are among the most common investment vehicles used by foreign investors to enter the China market. We would like to clarify first that JV here refers to a company established by foreign companies or individuals and Chinese companies. In China, there are two different forms of JV, these being: Equity Joint Ventures (EJV) and Cooperative Joint Ventures (CJV). EJV is a legal company with limited liability while CJV may or may not have legal person status depending on the terms of the CJV Contract which is the paramount document of any CJV. A company established by two or more foreign companies or individuals is still classified as a WFOE.

The first and foremost factor to consider is whether WFOEs are allowed in your proposed industry. The PRC National Development and Reform Commission and Ministry of Commerce have issued the “Catalogue for the Guidance of Foreign Investment Industries” (“Catalogue”) to guide and regulate which industries are encouraged, permitted, restricted or prohibited for foreign investment and which industries only allow foreign companies to enter by way of forming a JV with Chinese partners.

In general, WFOEs and JVs are both limited liability companies and are subject to the same PRC tax treatments. For example, Corporate Income Tax (CIT) is levied upon the actual profit of both WFOEs and JVs. The standard CIT rate is 25%. A lower tax rate is available for qualified small and thin-profit enterprises (20%) and for qualified new/high tech enterprises (15%).

Therefore, if an industry has no restrictions on the permitted investment vehicles according to the “Catalogue”, you should further take the following financial and commercial factors into consideration:

The financial perspective

From a financial perspective, there are some key differences between EJVs, CJVs and WFOEs that you should be aware of:

<i>Sharing of profit and loss</i>	
EJV	Profit and loss are shared according to JV partners’ respective equity interest.
CJV	Profit and loss are shared according to the provisions of the JV Contract.
WFOE	The foreign investor takes full ownership of both profit and loss.

After-tax reserve funds before any profit distribution can be made

EJV	Required to provide for the following three reserve funds: • Reserve Fund • Staff Welfare and Bonus Fund • Enterprise Expansion Fund The percentage of the above reserve funds shall be determined by the Board of Directors.
CJV	This has legal person status and shall also provide for the same three reserve funds as an EJV.
WFOE	Required to provide for the following reserve funds: • Reserve Fund • Staff Welfare and Bonus Fund The allocation to the Reserve Fund shall not be less than 10% of the after-tax profit until the cumulative amount reaches 50% of the registered capital, and then no more allocation may be made. The percentage of the Staff Welfare and Bonus Fund shall be determined by the Board of Directors.

Recovery of capital

EJV	Neither foreign partner nor Chinese partner can recover capital during the operational period of an EJV. Capital is recovered only upon the liquidation of the EJV. Upon liquidation, any losses must be settled before any capital is recovered.
CJV	Recovering capital during a CJV's operation is possible; however this must be agreed in the CJV contract. For the foreign partner to recover capital during the operation of the CJV, the contract must stipulate that all of the CJV's fixed assets will be reverted to the Chinese partner upon expiration of the CJV. Any losses of the CJV must be settled before any recovery of capital is permitted.
WFOE	As with an EJV, the foreign investor cannot recover capital during the operational period of the WFOE. Once operations cease, any losses made must be settled before any capital is recovered.

The commercial perspective

From the commercial perspective, you should take the following factors into consideration:

Market development and penetration: A JV may enable a foreign investor to leverage on the Chinese partner to gain quicker market penetration than that possible through a WFOE. In addition, nowadays the Chinese partner may also wish to develop overseas markets. Therefore, you may also need to consider what you could bring to the Chinese partner so as to reach a win-win situation in this regard.

Requirements on special resources: If your proposed business will require special resources (such as land, utilities or technology) which you do not have and you could not easily obtain in China, a JV may be a better choice for you, because your designated Chinese partners could invest in these special resources as a capital contribution or provide these resources to the JV by charging certain fees.

Autonomy of management/balance of power: The advantage of a WFOE is that the foreign investors can have full decision-making authority regarding the business plan and operational issues of the company. In the case of a JV, it is important to consider the protection of the foreign investor's interest by carefully considering issues such as the ratio of equity interest, structure of the board of directors and the protocol of decision-making process.

Intellectual property protection: The risk of IP or know-how being misused or disclosed is one of the most common concerns for foreign JV partners. IP protection should be carefully considered when concluding any JV agreements. The risk of licensing or transferring technology to a WFOE is, generally, more manageable.

Cultural issues: Harmonious integration of the business culture and management style of the JV partners into a JV may be harder to accomplish, while it is easier for foreign investors to maintain their own business culture and management style in a WFOE.

Conclusion

These are some of the key considerations when choosing between a WFOE and a JV, but in practice every case is unique, and different factors will become important. We would be happy to discuss your individual situation with you.

If you would like more information, simply call or e-mail the contact below.

Contact

Anthea Wong
Tel: +86 10 6533 3352
anthea.wong@cn.pwc.com

About the Swiss-Chinese Chamber of Commerce

The Swiss-Chinese Chamber of Commerce (SCCC) is a Swiss-based non-profit association registered in Zurich. Close to 700 corporate and individual members, among them the leading banks, trading companies, insurances and industrial firms have joined the association, making it one of the largest bilateral Chambers in Switzerland. Since its inception in 1980, the Chamber has always contributed to the development of the bilateral economic relations and with its diversified range of services it has consistently assisted the many Swiss companies doing business with and investing in China.

For more information visit: www.sccc.ch

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