Dealing with Intercompany Expenses

I. Initial Setup Costs

It normally takes four to six months to complete the application for setting up a Foreign-invested Enterprise (FIE) application and organize the opening of a bank account for the new company. However, there are start-up costs in the interim phase, such as the following items:

- lease deposit for premises
- salary charges for general manager (GM) and staff
- legal consulting fees
- traveling / relocation fees
- office decoration fees
- equipment purchases
- other office administrative expenses

Some foreign investors meet their local cash requirements by sending the start-up funds to their local agent or the personal account of an employee to cover the initial costs. The problem with this approach is that, although these funds are paid for the purpose of the FIE set up, they will not be recognized as part of capital injection once the business license is issued. To be recognized as capital injection, funds must be transferred by the foreign investor from their overseas account to the nominated capital account directly, not via any third party.

Over the years, we have seen foreign investors deal with this problem in various ways. However, there is no perfect solution so far due to the rules and regulations relating to incorporation and foreign currency control. Every option has its level of feasibility, as well as carries its own limitations. We discuss these options and their feasibility and potential risks/limitations below.

1. Opening a temporary special foreign exchange expense account

According to the State Administration of Foreign Exchange (SAFE), if foreign investors planning to establish enterprises with foreign investment in China need to conduct market research, planning and preparatory works for establishing institutions in China at the initial stage, they can open an expense account (upon obtaining the notification for advance examination and approval of the company name from the administrations of industry and commerce). The foreign investor can then deposit foreign exchange funds into this account to settle payments.

To apply for such a special foreign exchange account, the foreign investors should submit an application to SAFE consisting of documents certifying the truthfulness and legality of the investments. SAFE will decide the upper limits on the amounts in the relevant account, the

extended deposit duration and scope of settlements, etc., and conduct routine supervision. Normally, the deposit duration is 3 months and the upper limit of the balance is USD 100,000, or the equivalent of 5% of the total investment amount.

Funds should be remitted by the foreign investors in the form of foreign currency exchange instead of cash deposit. Settlements and transfers of funds in the account are verified by SAFE on a case-by-case basis. Where a foreign investor establishes an FIE in China, any balance remaining in the special foreign exchange account can be transferred to the capital account of the FIE. All amounts that are transferred to the temporary account will constitute capital for the purposes of the FIE capital requirements.

Based on our experience, the application procedure for opening this expense account might take 2-3 months. In addition, complex verification procedures are necessary to complete settlements and transfers of funds, and the account is also subject to routine supervision from SAFE.

Due to the heavy application requirement and long processing time for the setup of such an expense account, it becomes practically quite difficult and costly to proceed, which is why most FIEs do not choose this option even though it could be the best solution from the legal perspective.

2. Foreign investors paying on behalf of FIE, with FIE reimbursing at a later stage

Normally, foreign investors would consider the easiest and most efficient way of managing these initial setup expenses is to have them paid firstly by the headquarters on behalf of the FIE. After the bank account is set up and capital injected, the FIE then repays the headquarters. Although this arrangement seems practicable and easy, companies frequently encounter trouble when remitting funds overseas and incur heavy tax burdens due to foreign currency control and tax regulations. We analyze this option from two perspectives below:

2.1 Foreign Currency Control Consideration

2.1.a Payment of reimbursement costs under “non-trade” transactions

SAFE regulates foreign currency payments to overseas. According to SAFE, payment of reimbursement costs are classified as “non-trade” transactions (except for the purchase price for fixed assets/inventory, which is classified as “trade” transactions and discussed in Section 2.1.b below). Reimbursement costs in foreign currency that can be remitted overseas by the FIE are generally **limited** to:

- expatriate salary;
- expatriate welfare and social insurance;
- overseas traveling and training expenses for employees.

Normally, it is very difficult for an FIE to reimburse expenses aside from those mentioned above overseas (including to the headquarters). One of the situations under which an FIE may remit such other expenses is if the FIE is listed in SAFE as a "listed transnational corporation for direct non-trade foreign currency transactions".

A "transnational corporation" is a corporation that concurrently comprises of affiliated companies both at home and abroad, and whose global or regional (including China) investment management functions are exercised by one of its affiliated companies within China. Such corporations can include Chinese-funded holding corporations (namely Chinese-funded transnational corporations) and foreign-funded holding corporations (namely foreign-funded transnational corporations).

Generally speaking, to be qualified as a "transnational corporation", the FIE should be classified as a Chinese holding company or regional headquarters, foreign investment research center or advanced FIE as specified by the Ministry of Commerce (MOFCOM). This entails meeting much higher requirements in terms of total investment for FIE.

For transnational corporations that are listed in SAFE, the payment of the following non-trade foreign currency transactions to overseas can be debited directly at the designated bank:

- expatriate salary, bonus and subsidy;
- expatriate welfare and social insurance;
- overseas traveling and training expenses for employees;
- management expenses such as research and development expenses, procurement expenses and marketing expenses apportioned by a transnational corporation and its affiliated companies;
- other expenses which should be apportioned by a transnational corporation and its affiliated companies.

In Beijing, in addition to transnational corporations, wholly-foreign owned corporations that fulfill the below three criteria can apply to become a listed company in SAFE for direct non-trade transactions:

- have committed no major acts in violation of foreign exchange control provisions during the previous three years;
- has a sound financial standing;
- has a comparatively large volume of receipts and payments in its current account and exercises major influence on the locality.

For reimbursement expenses not mentioned above (*i.e.*, expat salary, welfare and insurance, and training and traveling), and for FIEs which are not listed in SAFE, if the amount of reimbursement

expenses is USD 100,000 or below, it is possible that the payment can be directly remitted by FIE upon assessment by the bank. However, in practice, banks tend to be conservative and strictly follow SAFE policy. They are thus reluctant to approve the remittance of reimbursement expenses that are not specified as permissible under SAFE's guidance rules, and would instead refer such assessment to the SAFE. For payment exceeding USD 100,000, the bank will directly request assessment approval from SAFE. The possibility of obtaining approval from SAFE for the remittance of these expenses is normally very small.

For a typical FIE, the setup costs are normally not limited to the permissible expense items mentioned in Section I above. As a result, the FIE might face difficulties in remitting those funds to foreign investors due to the restrictions in foreign currency control.

2.1.b Payment of reimbursement costs under "trade" transactions

An FIE might need to purchase fixed assets from an overseas or domestic supplier in its establishment phase before receiving its business license and registering with Customs, and the overseas headquarters might offer to settle the payment for the fixed assets or inventory to the supplier and charge back to the FIE later on. In the case of purchase of fixed assets from an overseas supplier using funds from the foreign investor overseas, the FIE will encounter problems when remitting the fund overseas to the headquarters to reimburse the costs. This is because payment of purchase price for imported fixed assets falls under "trade" transactions and require the presentation of certain documents, *e.g.* invoice and import documentations such as custom clearance documents to the bank, in order for the bank to process the remittance of foreign exchange overseas.

Since the FIE had not yet completed Customs registration at the time of import, it would have had to entrust another company to import the equipment on its behalf. Therefore the importation documentation, instead of bearing the FIE's name, would be in the name of the entrusted company. As a result, the FIE would not be able to present the documents necessary for remitting the purchase price back to the overseas headquarters.

In the case of purchase of fixed assets from a domestic supplier prior to the FIE's official establishment using funds of the overseas investor, the FIE will face similar problems. Foreign exchange remittance under "trade" transactions is only permissible when settling cross border transactions such as import and export. When equipment is purchased domestically, the FIE will not be permitted to remit the relevant funds in foreign currency to the headquarters.

The FIE also encounters another problem where the equipment or fixed assets are purchased by another company on its behalf. Without invoice issued in the FIE's name, it will not be able to accurately account for the depreciation of the equipment/fixed assets, and therefore the calculation of the profit will also be inaccurate, resulting in the overpayment of profit tax.

To alleviate the obstacles present in the above scenarios, our advice is that the purchase contracts for fixed assets/equipment should be entered into between the overseas or domestic supplier and the FIE directly. The contract should be executed directly by the FIE through its export-import agency, without involving any other party.

2.2 Tax Considerations

Considering the limitations mentioned above relating to foreign currency control, FIEs might look for other alternatives for repayment, such as entering into a service agreement with the headquarters. This alternative is feasible though not recommended due to tax inefficiency reasons as below:

- service fees remitted overseas are subject to business tax (BT) and other additional surcharge taxes which currently total 5.6% of the service amount;
- service fees might also be subject to Corporate Income Tax (CIT) @ 25% if, based on the tax authority's assessment, the foreign company constitutes a Permanent Establishment (PE) in China (please refer to Section II below). CIT would be calculated based on a deemed profit rate determined by the tax authority;
- service fees might also be subject to withholding tax if they relate to passive income such as royalty, patent or technology transfer.
- for service fee remittance over USD 30,000, the bank will require a tax clearance certificate issued by the tax authority to prove that all taxes have been withheld and paid before the payment is made.

In addition to these taxes that may be imposed, when the FIE goes through annual tax reconciliation procedures, any payables that remain unsettled for a long period of time might also face the risk of being challenged by the tax authorities or auditors. Such payables remaining unsettled for over 3 years could be adjusted to income and considered when calculating taxable income in the current year according to China tax laws. Therefore simply booking the transaction as an account payable and not dealing with the payment also will eventually have consequences for the FIE in China.

With both foreign currency restrictions and potential tax burdens, making the payment of setup costs via the foreign investor on behalf of the FIE and later charging back the expenses to the FIE might not be a favorable option. We have seen many cases where, in the incorporation stage, the foreign investors deal with initial set up activities in China by entering into purchasing / service contracts with vendors / consultants / suppliers, and pay all the setup expenses directly to third parties with the invoices addressed to the foreign investors (overseas). Later, after the capital funds are injected and the FIE is running, they expect to claim back these expenses. However, the FIE encounters problems remitting funds overseas to reimburse those expenses, and the foreign investors have to look for other alternative ways to repatriate these funds.

Some have succeeded through service agreements between the headquarters and the FIE with taxes imposed relating to payment of service fees. Others have booked such expenses as intercompany charges and, due to difficulties in remitting back the money, the amounts were kept long overdue until the incumbent auditor required such long outstanding payables to be adjusted to income for annual income tax reconciliation.

3. Foreign investors paying on behalf of FIE without reimbursement

In this case, foreign investors pay the setup costs directly to the vendors (both local and international vendors) and do not charge the costs back to the FIE. In this case there are no issues relating to foreign currency payment, no risk of fund repatriation tax, and no effect on the FIE's cash flow as well. This is the easiest way to handle the setup costs. The expenses will eventually be recorded in the financial statements of the headquarters as a deduction of its taxable income, and accordingly they cannot be used to claim deduction of taxable income in China when the FIE is making profit.

4. Foreign investors paying to an employee's bank account in China

The payment for setup costs could initially be paid to a personal bank account belonging to the GM or another employee in China. When the RMB account is ready, the GM could claim the expenses from the FIE as a staff reimbursement so that the start-up cost will show on the FIE's local book for CIT deduction.

This could be an easier solution for a small amount of start-up cost. The problem arises when the setup costs are larger, as individuals are only allowed to convert USD 50,000 per year. Expatriates might face an additional conversion limit per day (the specific amount depends on the bank). The company should also consider the inherent risk in sending a large amount of funds into a personal bank account. There have been cases of employees receiving such sums and subsequently disappearing.

5. Related Party who has establishment in China paying on behalf of FIE, with FIE reimbursing at a later stage

If the foreign investors have other establishments in China (they could be in the form of Representative Office or another FIE) which has sufficient cash, the start-up costs can be funded by this related party and arranged for settlement later when the RMB account is ready. No tax will be imposed and no foreign currency restrictions apply to payments in RMB made by an FIE on behalf of another related party FIE in China.

However, if the payment is made by an RO, this might attract challenge by the tax authority as ROs are not supposed to pay any expenses on behalf of other entities, *i.e.*, related party or non-related party companies. Such expenses could potentially be considered as a cost of the RO

itself. As ROs typically pay tax on a cost-plus method which incurs tax at a rate of 11.56% of the expense amount, the tax burden is potentially rather high.

6. Conclusion

As mentioned above, there is no ideal solution for this issue. In certain cases, the FIE can manage to negotiate longer payment terms from suppliers so that the expenses can be paid from the FIE's own bank account. However, this tends to be difficult for some payments such as deposits which need to be settled soon after the contract is signed. One important thing to keep in mind is that, for all expenses which will be eventually charged back to FIE, official tax invoices with the title consisting of the full FIE Chinese name should be collected from vendors in order for the expenses to be deducted for taxable income calculation.

II. Issue of Permanent Establishment (PE) related to Staff Assignment / Secondment to China and the Payment of Expatriate Salary to Overseas

An overseas parent company establishing an FIE (subsidiary) in China might assign its personnel to work at the China subsidiary for a short or long period. Since the middle of 2009, local tax bureaus in China have tightened up the tax administration of such secondment arrangements. Overseas parent companies might be challenged that their actions constitute provision of services to their China subsidiary and hence creation of a Service PE in China, resulting in tax implications.

On 26 July 2010, the State Administration of Taxation (SAT) issued Guoshuifa [2010] No. 75 ("Circular 75") regarding the Double Tax Agreement (DTA) concluded between China and Singapore, and also issued the Departmental Interpretation Notes related to Circular 75 to provide clear interpretation of PE issues and guidance on how to determine the existence of a PE. The Chinese tax authority has been applying this interpretation to guide its tax practice towards Singapore as well as other countries.

Under the China / Singapore DTA, the provision of services by an enterprise through its employees or other personnel engaged by the enterprise will constitute a PE only if such activity continues (for the same or related project) for a period or periods aggregating more than 183 days within any 12 months. This type of PE is generally known as a "Service PE".

The Circular provides the following factors to help assess whether the secondees assigned to the Chinese subsidiary are actually working for the overseas parent company, resulting in the creation of a Service PE:

- the overseas parent company has authority over the secondees' work and bears the relevant responsibility and risks resulting from their work;
- the number of secondees to the subsidiary company and the standard of such assignment is decided by the overseas parent company;

- the salary and wages of the secondees is borne by the overseas parent company; or
- the overseas parent company obtains profits from the subsidiary company from assignment of such employee.

If these requirements are met, a Service PE will be deemed to exist. Accordingly, when the parent company collects the relevant service fees from the subsidiary company, the service fees should be charged in accordance with an arm's length transaction. In addition, the service fees will be subject to CIT based on a deemed profit ratio determined by the tax authority. The service fees will also be subject to Business Tax (BT) and other local surcharge taxes as well. These taxes should be withheld from the payment to overseas and paid to the tax office before the payment is executed. The salary expenses paid to secondees during their stay in China are subject to Individual Income Tax (IIT) based on the number of days the employees spent in China.

If, upon the request of the Chinese subsidiary company, the parent company assigns personnel to work for the subsidiary, and those personnel are employed by the subsidiary company, their work is directed by the subsidiary company with the subsidiary company bearing the relevant liabilities and risk related to the work, the activities of these secondees **shall not** result in the creation of a PE in China. In this case, the secondees' salaries, regardless of whether they are paid by the subsidiary or directly by parent company, are subject to IIT in China as other Chinese nationals.

According to SAFE, salaries of expatriates remitted to overseas are classified as non-trade transactions. For payment of salary to overseas exceeding USD 30000, the bank would require a tax clearance certificate from the authorized tax bureau. The documents below might need to be presented for tax bureau assessment in order to obtain the tax clearance certificate:

- project contract / secondment contract;
- employment contract;
- copy of passport of expatriate with entry exit records;
- tax payment slips;
- others