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## Case study - commissionaire arrangement could constitute a permanent establishment in China

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#### In brief

- » Commissionaire arrangement might result in a permanent establishment (“PE”) status depending on the arrangement.
- » Corporate Income Tax (“CIT”) can be applied when a foreign enterprise is deemed as constituted a PE in China.
- » Review and stay informed of the international taxation trend is recommended.

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**In detail****1. Introduction**

Commissionaire arrangement, including agency arrangement, is often chosen as one of the market entry modes by foreign enterprises to conduct business operations in China through an agreement with a local partner. Such an arrangement is frequently conceived advantageous for the foreign enterprise, on the belief that the profit derived would not be eligible to Chinese Corporate Income Tax ("CIT") since a Permanent Establishment ("PE") is not constituted. However, such reasoning could be a risky fallacy. China has already enacted related regulations, while following closely international taxation developments, e.g. OECD's Base Erosion and Profit Shifting action plans ("BEPS"), with specific clarifications that a PE status might be constituted albeit a commissionaire arrangement.

We illustrate here how a supplier, in Germany in this example, is deemed as constituting a PE in its China operation operated via an agency agreement.

**2. Case details**

A German supplier appoints a third-party Chinese company as its agent in China, under an agency agreement. The agent is responsible for marketing and promotion, customer management and order solicitation in China which accounts for 90% of its business operations, and the German supplier will sell its goods directly to the Chinese customers.

According to Article 5.5 of China-Germany DTA (2014 version), a PE is deemed constituted when:

- "...a person (note 1) – other than an agent of an independent status to whom paragraph 6 applies – is acting in a Contracting State on behalf of an enterprise of the other Contracting State and has, and habitually exercises, in that Contracting State an authority to conclude contracts in the name of the enterprise..."

Based on this article, the analysis should be developed in two folds as shown below:

- » Does the agent have an independent status?

To determine whether an agent is of an independent status, China's tax circular Guo Shui Fa [2010] No.75 has suggested a series of factors including the degree of freedom and the risk bearer of the agent's business activities, the number of enterprises represented by the agent, and the extent of reliance on professional knowledge of the agent by the overseas enterprises.

OECD's BEPS action plan 7 published in 2015 has also suggested a more rigid scrutiny regarding the same issue including, whether the agent acts exclusively or almost exclusively on behalf of the foreign enterprise in its ordinary business conducts, whether the risks are borne by the agent or the foreign enterprise, and whether the agent's business activities are subject to significant control from the foreign enterprise.

In this example, the agreement between the German supplier and the Chinese agent stipulates that:

- The operations / handling of business activities is carried out by the agent with close guidance and instructions from the German enterprise; and

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<sup>1</sup> Pursuant to China-Germany DTA, and Guo Shui Fa [2010] No.75, "person" refers to an individual, a company and any other body of persons.

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- Business risks are majorly borne by the German enterprise.

The details of the agreement have invoked an implication that the agent, in carrying out its business activities in China, has limited business freedom and is subject to the German enterprise's instructions, combined with the explicit stipulation of risks of these supervised activities being borne by the German counterpart, and the high percentage of business accounted for from the agreement which implies that the agent is almost exclusively acting on behalf of the German supplier; it thus leads to the judgment that it is less likely the agent is deemed of an independent status for the said business.

- » Is the agent concluding contracts on behalf of the German enterprise?

The same agreement stipulates that:

- The Chinese agent is granted with rights to, on behalf of the German supplier, negotiate contract details and issue documents for the German supplier in China;
- The Chinese agent is not entitled to conclude contracts in the name of the German supplier in China. Negotiated contracts are subject to the German supplier's approval and signing.

Despite the agreement's deliberate stipulations, one should examine the significance of the activities of the agent, which is representing its German counterpart to negotiate and issue documents, except signing the agreement. Such artificial fragmentation of the negotiation activity can be understood as an effort to argue that it is merely engaged in a preparatory or auxiliary task. However, such fragmentation could be challenged and is not sufficiently safe from PE implication.

According to China's Guo Shui Fa [2010] No.75 and OECD's BEPS Action Plan 7, 'concluding contracts' shall be interpreted in a broader sense that:

- The contracts are not concluded in the name of but still binding to the non-residential enterprise;
- Concluding does not only refer to the signing behavior itself but also includes playing the principal role leading to the conclusion of contracts, such as participation in contract negotiations and discussions on the contractual clauses by the agent, and
- Conclusion could be said accomplished by the agent through such negotiation and discussion of the contract details that leads to the signing of the contract even by another person in another state.

Notwithstanding the agreement's explicit exception, it is evident that the Chinese agent in essence is acting on behalf of the German supplier, indeed has and habitually exercises in China an authority to conclude contracts in the name of the latter.

To conclude, viewing that the agent is less likely to be independent, and acting on behalf of the German supplier to conclude contracts, a PE status can be deemed as constituted in China and China CIT should apply.

### WTS observation

In light of the example above amid its circumstantial specifics, and with regard to compliance to related taxation regimes, your attention is drawn that a commissionaire arrangement in a similar fashion, should be subject to a proper review; or in case such an agreement has already been reached, an adjustment might be necessary.

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Meanwhile, international taxation regime is rapidly developing. Loopholes are being sealed with refined regulations. Different implications and risks previously overlooked could emerge. To keep reviewing and staying informed of the legislative development at home and abroad is vital to sustainability of the operation.

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