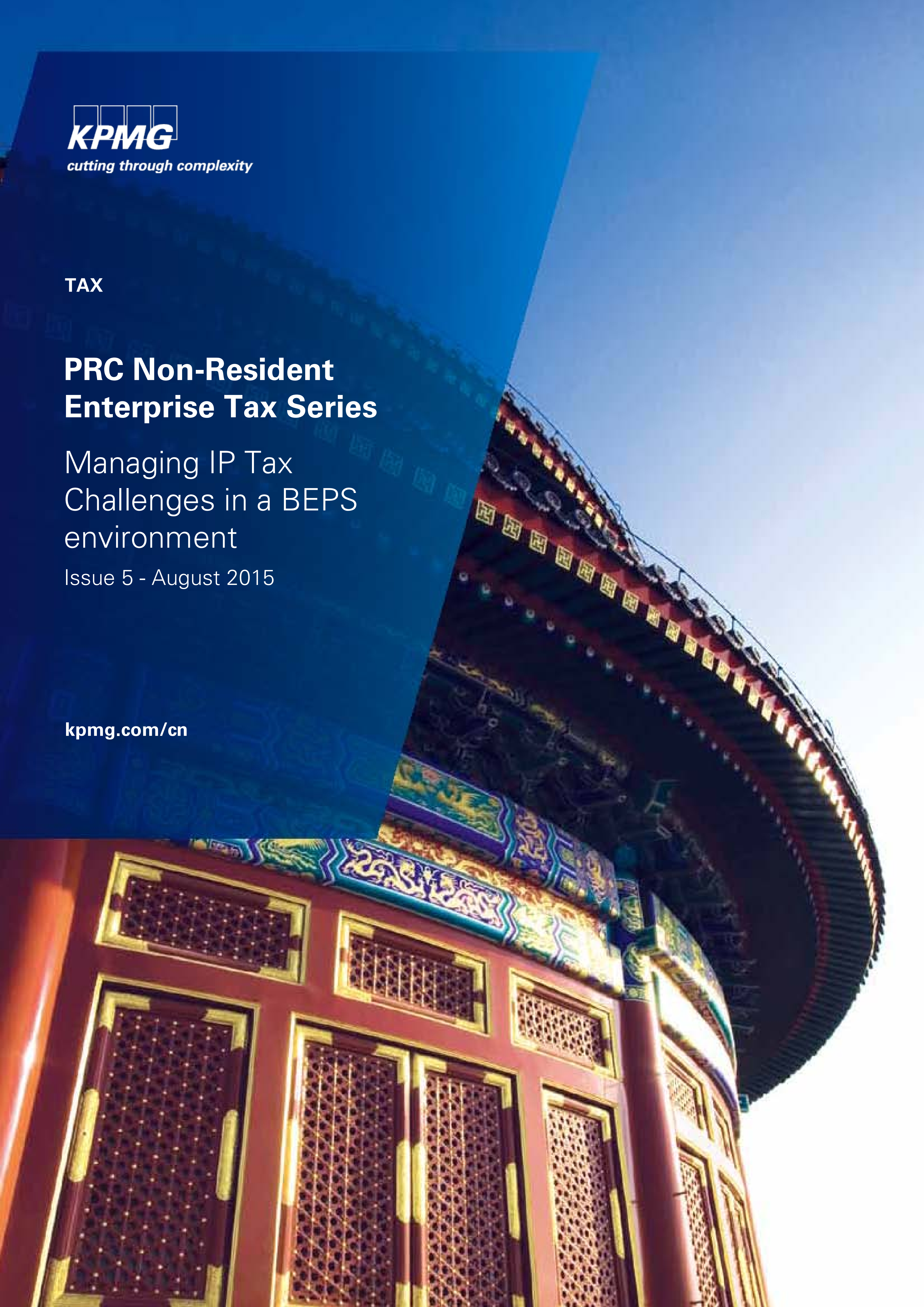

cutting through complexity

TAX

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Managing IP Tax Challenges in a BEPS environment

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Introduction

Multinational Enterprises (MNEs) producing or selling their products in China have long had to contend with the commercial, legal and tax challenges of managing how their Intellectual Property (IP) is used in relation to their Chinese operations. Regulatory approvals for Joint Ventures (JVs) operating in China have often, in the past, required that IP rights or know-how be transferred into or deployed in China, while in other cases MNEs have sought to retain the legal entitlements to their IP outside China, driven by legal protection considerations. China tax management and planning have been built around these fundamental regulatory, commercial and legal drivers for the deployment and ownership of IP for MNEs operating in China.

Recent years have seen significant changes in Chinese tax regulations and practice, particularly in the area of transfer pricing (TP), which have given MNEs cause to rethink existing IP tax management and planning arrangements. Furthermore, likely changes in Chinese and global tax practice, set to emerge from the G20/OECD Base Erosion and Profit Shifting (BEPS) global tax reform initiative, are likely to stress-test certain existing IP management structures, and prompt reorganizations.

The purpose of this publication is to provide an overview of developments in the Chinese taxation of IP and innovative activity, pointing to the opportunities and challenges for MNEs going forward. It also sets out how KPMG China's tax service lines can assist MNEs to adapt to the new environment.

In this regard this publication canvasses three fundamental elements of IP tax management:

Part A - Benefits of Chinese innovation-related tax incentives

Part B - Limiting cross-border tax 'friction'

Part C - Global distribution of MNE IP-related operations: Tax considerations

These tax management objectives need to be balanced against each other and, most importantly, be in line with the commercial objectives of the MNE business in China.

Part A: Benefits of Chinese innovation-related tax incentives

Changes in Chinese TP practice enhance the value of innovation-related tax incentives to MNEs

Prior to the introduction of the new Corporate Income Tax (CIT) law in 2008, Chinese tax incentive policy had been highly geared towards encouraging, in particular, foreign investment into China, especially into the manufacturing sector. This was intended to bring capital, foreign expertise and technology into China and foster the export sector as the leading driver of economic growth.

From 2008 onwards, tax incentive policy no longer discriminated between foreign and domestic investors and focussed more on encouraging certain innovative or socially beneficial activities (e.g. R&D, environmental protection) and on supporting certain identified high-value added industries (e.g. software and integrated circuits) which were regarded as drivers of innovation, rather than supporting manufacturing activity indiscriminately. The importance of these innovation incentives for foreign MNEs with manufacturing, distribution and contract R&D arrangements in China is now being accentuated by developments in Chinese TP practice, as well as by potential future changes to the Chinese 'permanent establishment' (PE) threshold for taxing foreign MNEs with limited China 'tax presence'.

Historically, MNEs with significant manufacturing operations in China were less concerned about booking income in their Chinese entities, in view of the tax holidays and lower tax rates then available for Foreign Invested Enterprises (FIEs). When these incentives were removed post-2008 many MNE groups arranged for their Chinese toll and contract manufacturing arrangements to be so structured that the Chinese manufacturing entity would operate on a 'limited risk' basis. The MNE overseas principal entity would bear all inventory risk and product risk, would hold the IP rights to product and process technology and brands, and pay the Chinese manufacturing entity a moderate fee, reflecting the relatively simple functions conducted and the lack of risks borne. Equivalent 'limited risk distributor' arrangements could be used for sales to Chinese customers, and limited risk contract R&D arrangements for outsourced development work. The locations of the 'principal' entities, which would deal with the Chinese entities and to whom the significant entrepreneurial profits of the MNE would arise, could be chosen according to business requirements and also to manage the effective tax rate for the wider MNE group.

However, a significant shift in Chinese TP regulation has been gathering steam over the last 5 years. Chinese tax authorities now frequently insist that greater profits must be booked to the local Chinese manufacturing, distribution and R&D service entities.

Tax authorities may argue this on the basis that a "market premium" arises to distributors from China's expanding consumer base on China's transition to a full market economy. Tax authorities might also argue that "cost savings" can be realized by MNEs' manufacturing and contract R&D operations due to the use of China's supplier network clusters and pool of low-wage but technically well-educated workers. These factors, warranting greater profit attribution out of MNE global value chains to Chinese operations, are collectively referred to as 'Location Specific Advantages' (LSAs).

Furthermore, tax officials may assert that, through the experience of making goods and/or building market share, the local Chinese subsidiaries of MNEs are creating new production and marketing "local intangible assets". These China-based intangible assets are also asserted to warrant further profit attribution out of MNE global value chains to the Chinese operations. The assertion of the existence of these 'local intangibles' is based on the tax authorities' economic interpretation of the factual arrangements and is not necessarily linked to any legal determination of where, in the MNE group, the legal rights to IP rest.

Not only may it be required by Chinese tax officials, on the basis of the above, that more revenue from MNE value chains be booked to the China entities, but payments by the Chinese entities to overseas related parties for services and royalties may be viewed with scepticism and potentially denied tax deductions (dealt with further in Sections B and C below). The key question posed is, if the Chinese entity has developed and possesses valuable local IP (a conclusion reached on the basis of the 'local intangibles' analysis highlighted above), why should the Chinese entity be making payments abroad in respect of access to IP legally held by overseas companies?

Faced with the possibility of more profit being booked to China on the basis of the new TP rules, so forming a larger tax base to which CIT can be applied, the Chinese innovation-linked tax incentives are becoming ever-more important in reducing the effective tax burden on the expanded tax CIT base. As the developments in Chinese TP practice are being bolstered by the TP proposals emerging from the G20/OECD BEPS initiative, in particular by the reoriented OECD TP focus on functions rather than risks in attributing profits[1], the enhanced importance of innovation-linked tax incentives to China tax management may be viewed as a longer-term trend.

A further new factor likely to be of particular significance in driving this trend forward is the anticipated changes to the Chinese PE tax threshold, set to be made by China in line with the new BEPS PE proposals[2].

PE is the threshold, established under China's tax treaties with other countries, which determines when a foreign company has sufficient 'tax presence' in China that the foreign company can be taxed directly on its profits arising from economic activities conducted in China (i.e. PE is the threshold for the foreign enterprise to be treated as having a 'tax branch' in China, in addition to and separate from whatever subsidiaries the MNE might already have in China).

Briefly stated, many of the distribution arrangements (e.g. Singapore/Ireland/Hong Kong (HK) sales hubs) used at present by MNEs for selling to Chinese customers do not require the use of a local China-based buy-sell distributor, and the resultant booking of profits outside China can reduce China tax payments. The overseas sales hubs may use local Chinese related-party 'marketing support' companies which facilitate the sales from the offshore sales hub to Chinese customers, but do not trigger PE under current Chinese and international rules. Such arrangements now appear to be potentially affected by the new BEPS PE proposals.

In the future, as and when the Chinese roll-out of the BEPS PE proposals extend the application of the PE concept and as Chinese PE enforcement efforts commensurately increase, such sales arrangements may come under greater scrutiny. The activities of the marketing support company may be referred to by the tax authorities to assert that a Chinese PE exists for the overseas sales hub. A move to local buy-sell distributor models by some MNEs, who are currently using overseas sales hubs, might be anticipated in consequence of such PE developments. Such restructured local buy-sell distributors, as noted above in the comments on the Chinese TP trends (i.e. LSAs, local market intangibles), would, going forward, be precluded from limiting taxable profits by asserting that a 'limited risk' arrangement is being used.

Taken in total then, due to the more demanding Chinese TP approaches being adopted towards MNEs' local China subsidiaries, and the likely greater use of local buy-sell distributors in China going forward in response to the coming PE pressures, MNEs are anticipated to record more profits in China in future. Consequently MNEs may be more than ever reliant on national law 'innovation tax incentives' to limit their effective tax rates in China.

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[1] See KPMG China, November 2014, "OECD releases Base Erosion and Profit Shifting recommendations", http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/ChinaAlerts/Documents/China-tax-alert-1410-27-OECD-releases-Base-Erosion-and-Profit-Shifting-recommendation.pdf

[2] See KPMG China, June 2015, "China Tax Alert: China tax planning to be impacted by BEPS Action 7 PE proposals", http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/ChinaAlerts/Documents/China-tax-alert-1506-12-China-tax-impacted-by-BEPS-Action-7.pdf

Chinese 'innovation activity' and 'innovative industry' tax incentives

The Chinese national-level innovation-related tax incentives are generally directed either at (i) innovation activities or (ii) industries regarded as innovation drivers. These typically take the form of 'CIT holidays', lower CIT rates, VAT refunds, and more liberal or bonus tax deductions. Provincial and municipal level governments can also offer tax incentives for innovation activities financed out of the local allocation of tax revenues. This being said, the central government has been more recently clamping down on the grant, by local governments, of tax incentives not aligned with national policies, so MNEs must take care that such incentives are in line with national regulations.

As an example of industry-specific innovation incentives, approved software production companies and integrated circuit design companies can access CIT holidays (2-year exemption, 3-year half CIT rate) or alternatively lower CIT rates (10% CIT rate). VAT refunds may be available for self-produced software and are not subject to CIT if invested back into R&D. Relaxed rules on tax deductions also apply, with employee training expenses being tax deductible without limit whereas normally a 2.5% of total employee remuneration deduction ceiling applies.

Equivalent or longer 'tax holidays' are also available for integrated circuit production enterprises, and for energy conservation and emission reduction projects employing new technological innovations. Enterprises operating in key innovation industries (including the pharmaceutical and IT industries, and transport, telecoms, electronics and instruments manufacturing) can benefit from accelerated depreciation allowances (60% of standard timeframes) and can directly expense purchases of R&D-related equipment.

Beyond the incentives directly at particular innovative industries, national-level tax incentives geared towards general innovative activity include the High and New Technology Enterprise (HNTE) incentive, Advanced New Technology Enterprise (ATSE), the R&D super deduction, and the exemptions for gains on transfers of patented technology up to a value of RMB5m (with a 50% CIT rate applying to transfers with a value above RMB5m). These incentives, and the challenges in obtaining and retaining them, are detailed further below.

High and New Technology Enterprise (HNTE)

The HNTE program offers a 15% CIT rate (as opposed to the 25% CIT rate), as well as raising the ceiling for deduction of employee training expenses to 8% of employee compensation. This has been a highly popular incentive for MNE and local enterprises, and has six qualification criteria, including that the applicant enterprise must:

- Own the IP for the key technologies integral to its products
- Fall within one of eight specified industrial fields (electronic information technology, bioengineering and new medical technology, aeronautical and space technology, new material technology, high-tech service, new energy and energy saving technology, resource and environment technology; and high technology to transform traditional industries)
- Generate sufficient profits from the supply of High and New Technology products
- Have sufficient R&D and science & technology personnel

- Perform R&D and incur sufficient R&D expenses as a percentage of turnover
- Meet a points calculation target

HNTE recognition is performed by a committee comprising the science and technology bureau, tax authority and finance authority at the provincial and/or city level, prior to being granted by the science and technology bureau. The HNTE status is valid for three years but the tests need to be satisfied annually. In practice a number of challenges are observed with obtaining and retaining the HNTE relief.

- If sales of the HNTE enterprises' products have been rising, the HNTE enterprise may, due to an insufficiently commensurate rise in the level of R&D expenditures, cease to satisfy the ratio of R&D expenses to turnover requirement.
- The requirement that the enterprise must 'own' at least one item of 'core IP' can extend to exclusive licenses of greater than 5 years but patentable IP is required, know-how alone being insufficient. In some cases companies may register early stage work with the Chinese patent authorities to satisfy the requirements – whether this suffices to secure the HNTE treatment is judged by and agreed with the local tax authorities on a case by case basis, as is the rather nebulous matter of what precisely qualifies as 'core IP'.
- Ongoing product innovations may mean that the IP, in which the HNTE enterprise has an interest, may need to be re-assessed on a yearly basis to determine whether it remains 'core'. If it has been contractually arranged that an overseas MNE group enterprise will possess the rights to new IP connected with the products sold (whether this IP enhancement has been generated in China or elsewhere), then the HNTE enterprise may need to renew its interest in the 'core IP', whether through outright acquisition, ownership or through a further long-term license, in order to ensure continued qualification for HNTE treatment.
- In practice it has been found that HNTE re-applications and renewals have been declining in recent years in some Chinese tax districts. This may in part be due to the balance which MNEs have had to strike between accessing the HNTE status for their FIEs and maintaining MNE group-wide TP policies; and an increasingly vigilant audit approach taken by the Ministry of Finance and some local tax authorities when assessing HNTE eligibility.
- With respect to the HNTE-TP balance/trade-off, and as has been noted above, in some cases MNEs have characterised their China subsidiaries as limited-risk distributors/ manufacturers/ R&D services providers, engaged in 'routine' activities. However, as is clear from the HNTE qualifying conditions, FIEs that have obtained the HNTE qualification are expected to perform value-adding functions, conduct substantial R&D activities, and utilize key technology, resulting in the creation of IP for which they can claim legal ownership. In this context, the tax authorities may raise a query regarding the 'limited risk' allocation for TP purposes and the parallel HNTE status.

  It is entirely possible that a Chinese entity may be limited risk and still qualify for the HNTE program but documentation should be maintained to reflect this scenario. It is also important to note that HNTE status and royalty payments to offshore parents are not, technically, mutually exclusive. It is entirely possible that an entity in China may both own and generate local core IP and simultaneously pay royalties for other IP that it utilizes during the course of any given year.

However, faced with potential revocation of HNTE status if they do not fulfil the value creation/innovation requirements and upward TP adjustments if they do, some MNEs have refrained from obtaining HNTE status in the first instance. Other enterprises, seeking to claim the HNTE relief, have ceased paying royalties to their offshore holding companies. Insofar as the Chinese tax authorities are now actively disregarding the contractual niceties of limited risk arrangements (regardless of whether such entities have HNTE status or not), and using the LSA and local intangibles concepts to attribute increased taxable profits to MNE FIEs in any case, it may instead be logical for some companies to modify their historic limited risk TP approaches and pursue HNTE status.

- The increasingly vigilant audit approach and tightened HNTE standards adopted by the authorities towards HNTE have led to significant numbers of companies not passing the reassessments, and companies are also being audited between reassessments. This situation may be a reflection of the looser standards which were applied in earlier years and the impact of SAT efforts to inject more rigour into previously permissive local tax authority practices.

Further clarification of the HNTE criteria is anticipated later in 2015, with some measures expected to expand access while others may tighten the criteria for large companies. Efforts are expected to be made to encourage more small to medium size entities to engage in R&D activities; and access to HNTE may be facilitated by allowing entities within the same group to 'share IP' for HNTE qualification purposes. Further types of expenses may be treated as R&D expenses for the purposes of meeting the HNTE ratio requirements (including more types of R&D work outsourced to contractors). At the same time adjustments may be made to the target for R&D expense as a percentage of turnover and to the HNTE revenue calculation.

If, as discussed, the trend in TP practice progressively compels MNEs to make greater use of the HNTE incentive then, in light of the challenges outlined above, such companies should make comprehensive preparations to ensure that the status can be secured and maintained.

Advanced New Technology Enterprise (ATSE)

Another tax incentive program in China is the Advanced Technology Service Enterprise incentive, which may apply until the end of 2018. This program applies to providers of Information Technology Outsourcing (ITO), Business Process Outsourcing (BPO), and Knowledge Process Outsourcing (KPO) services in relation to IT and software related services, data processing and management, R&D and business process design.

Providers must be located in a pilot city (including Shanghai, Beijing, Hangzhou and others). ATSE provides the same 15% CIT rate as the HNTE incentive and an increased deduction ceiling for staff education expenses, also adding a VAT exemption for income from offshore outsourcing services. Compared to HNTE the qualification thresholds for IP ownership and R&D investment are more flexible, though there are requirements concerning the education level of staff and the proportion of income from 'offshore advanced technology services' (≥ 35% of annual income).

R&D Super Deduction

The R&D super deduction (150% of the expense incurred) is likely, for many enterprises, to be more easily accessed than HNTE status given that the former does not focus on R&D expenses as a percentage of turnover, or on the percentage of revenue derived from hi-tech products. Nor does it require that core IP be registered and owned by the Chinese entity. Rather, it focuses on the expenditure incurred being relevant to the development of new knowledge and innovation, which involves improved products and/or processes.

The net saving for eligible R&D activities equates to 12.5% for every eligible expense incurred in the relevant year of income. This assumes that the standard 25% CIT rate applies[3]. The net tax saving will be at 7.5% if a reduced CIT rate of 15% (e.g., HNTE enterprises) applies[4]. R&D super deduction claims must be lodged annually as part of the income tax filing.

Securing and retaining the relief hinges on the taxpayer being able to identify and trace eligible R&D expenses to the relevant categories, and being able to document the technical aspects of product or process development in sufficient detail to substantiate that it occurred and met requisite standards of innovation. Tax and Science Bureau audits may probe the meeting of this standard by checking, inter alia, prototype specification challenges, manufacturing process improvement, product enhancement, engagement with outside specialists and the reconciliation of such activities with relevant expenses.

In practice we note that the science and local tax bureaus have generally taken a reasonable approach when assessing R&D Super Deduction entitlement. However, on rare occasions, it is possible that some tax officials may take a restrictive approach if eligible activities are booked, for example, to ‘cost of goods sold’. This occasional ‘tax accounting’ driver of R&D eligibility in some tax provinces is unique to China, generally does not exist in other countries providing similar R&D incentive programs, and seems at odds with the policy intent behind the R&D Super Deduction program. What is more, while the tax regulations in China indicate that ‘expenses’ and ‘amortisation of intangible assets’ may be claimed under the R&D Super Deduction, the regulations do not clearly state that ‘depreciation of tangible assets’ can also be deducted at the accelerated R&D rate.

It is hoped that, in future, greater consistency will be brought to the interpretation of the R&D Super Deductions rules, including a focus on the activity itself as a driver of eligibility rather than the tax accounting treatment and confirmation that tax depreciation of tangible assets is an allowable expense. It is further hoped that consistency can be brought to the interpretation of the criteria, and to the application procedures, across different tax provinces and that clearer guidelines can be provided.

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[3] Tax deduction of an outlay of RMB 100 gives rise to a cash tax benefit of RMB 25 when the tax rate is 25% (i.e. 25% of RMB 100). Where a further RMB 50 can be deducted (under the R&D Super Deduction) then the cash tax benefit is RMB 12.50 (i.e. 25% of RMB 50)

[4] Tax deduction of an outlay of RMB 100 gives rise to a cash tax benefit of RMB 15 when the tax rate is 15% (i.e. 15% of RMB 100). Where a further RMB 50 can be deducted (under the R&D Super Deduction) then the cash tax benefit is RMB 7.50 (i.e. 15% of RMB 50)

Part B: Limiting tax 'friction'

To the extent that a MNE's local FIE engages in IP-related transactions with the rest of the MNE group overseas, lack of attention to managing tax 'friction' can lead to erosion of the MNE's overall tax position. This may undermine the advantages which the FIE has secured under the local innovation tax incentives. In particular where substantive IP rights are retained overseas and significant royalty payments (and allied service payments) are made out of China, awareness of the CIT withholding tax (WHT), tax treaty, TP, VAT and customs implications is paramount. Part B below deals with these issues in detail while the particular issues arising where a special overseas IP management company is used are dealt with separately in the subsequent Part C.

Licensed technology and related services from MNE partner – CIT WHT and remittance issues

Payments out of China in respect of technology licenses (patents, know how etc) are subject to WHT at 10% (or a reduced treaty rate where applicable) on the basis that they constitute royalties for tax purposes. Service payments out of China, for the provision of expert services related to the implementation of technology, or otherwise for assistance with the conduct or management of IP generation/use in China, may potentially be free of WHT. Nonetheless, particularly where related party transactions are in point, MNEs need to be conscious of the tax risks where either service personnel are on the ground in China for an extended period or where the deemed supply of know-how to the Chinese enterprise through the service provision affects its tax characterisation.

With respect to having service personnel in China the key matter, with which care needs to be taken, is that engineers, technicians or other staff sent to China in connection with service provision do not stay so long as to create a Service PE risk. China's tax treaties typically set the time limit at 183 days within a 12 month time period, with presence of different staff members on connected projects being aggregated. Some older treaties provide for a 6 month rule, which some authorities interpret as being as little as a presence of one day each month over the course of a six month period.

Care needs to be taken that staff (where staff presence unavoidably exceeds the treaty-defined time limits) are formally seconded to the China FIE, and detailed contracting and operating protocols put in place, to avoid any PE risk for the overseas entity[5].

Furthermore, characterization of a service payment as a royalty, requiring application of the 10% WHT rate, may result from an inference that the service provision involves an IP transfer. Where proprietary technology is licensed by a Chinese enterprise from a given overseas company, and technical support and guidance is received from the same overseas company with respect to the utilization of the licensed technology, then a specific tax provision deems the service payment in relation to the support and guidance as a royalty. The authorities are understood to look for transfers of know-how through services which are provided in parallel with the licensing of other legally protected intellectual property (e.g. copyrights, trademarks) or in parallel with the leasing of equipment customized by a foreign related party. The authorities may also range beyond this, looking for transfers of know-how embedded in technical services, even where no other rights are licensed, or equipment is leased, in parallel.

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[5] See KPMG China, June 2013, "PRC Non-Resident Enterprise Tax Series: Managing Chinese taxable presence exposures from secondment arrangements", https://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/Chinese-taxable-presence-exposures-from-secondment-201306.pdf

Consequently, taxpayers need to be careful with respect contracting for and delivering services of training, machine installation, design or marketing services, and trouble-shooting advice. Written deliverables (e.g. formulae, designs, drawings, procedures and methods) or evidence of accumulated skills and experience in the hands of a licensor firm's professional personnel (providing training or guidance), could be viewed as know-how which assists the licensee of the legally protected intellectual property or lessee of the equipment to use that property/equipment in manufacture/promotion/sale of goods.

Services from related parties fall particularly under suspicion given that assisting/training staff from other group entities may be presumed by the authorities to possess experience with and knowledge of the wider MNE's unique technology and customized equipment and processes.

Getting such contracting right is very important as disagreements with the tax authorities on this treatment can lead to complications and delays in remitting service fees from China. Remittances greater than USD50,000 in amount need to be registered with the tax authorities through a 'tax recordal', and this is required to be presented to the bank to process payments. Tax authorities can refuse to stamp this recordal if they disagree with the taxpayer's tax characterization and consider that WHT should be applied to the payments as royalties. The banks in turn may decline to process service fee payments if these have been agreed with the tax authorities to constitute royalties for technology import, but no formal technology import registration with the local department of commerce has been made.

Specific TP considerations for IP licensing

In Part A above an outline was provided of the manner in which Chinese TP trends have required ever more income from MNE global value chains to be booked in a MNE's China entities. In a parallel development, China TP practice has become ever tighter with respect to the granting of deductions for IP license payments made to overseas related parties. This has resulted from refinement and reinterpretation of the general principle that the royalty paid to the IP owner shall be 'commensurate' with the contribution that the IP makes to the economic value of the local operations.

At an earlier point in time the Chinese tax authorities had generally been willing to accept taxpayer TP reports, which justified the pricing fees under related-party IP licensing arrangements with reference to third-party licensing arrangements observable in the market place, with relatively limited scrutiny being applied by the authorities to the precise comparability of the arrangements. The authorities at that time would accept royalty rates as long as they did not exceed a rule-of-thumb rate.

A more sophisticated and assertive approach by the authorities then emerged in relation to loss-making FIEs, with the tax authorities posing the simple question: why would the FIE license the IP in the first instance if they cannot make any economic gain from licensing the IP? This campaign resulted in unwinding of losses by many FIEs, or denial of their tax loss carry-forwards.

The campaign has subsequently been carried forward to challenge even profitable FIEs in cases where rest of the MNE enterprise overseas evidences a higher level of profitability than the Chinese subsidiaries. Part A above noted briefly how the 'local intangibles' concept has been used by the Chinese tax authorities to argue against allowing deductions for outbound license payments. The oft-cited case of Head & Shoulders shows how the authorities rationalize disregarding the value of the overseas-registered and developed IP, in that case the original overseas-registered and developed Head & Shoulders' trademark, as not being of much value to its Chinese operations. The argument is that Head & Shoulders' Chinese-language name (with which Chinese consumers are familiar) bears no resemblance to its English-language name, even if 'Head & Shoulders' in English is also printed on the shampoo bottles. It is argued that the Chinese name of Head & Shoulders constitutes the relevant marketing intangible in a Chinese market context. As the Chinese FIE developed this intangible and built up China market share on the basis of this Chinese name then the Chinese FIE should be viewed as 'owning' the most valuable marketing intangible that the MNE possesses in relation to the China market. Consequently, substantial payments by the Chinese FIE to the overseas parent, for use of the original trademark, would be unwarranted and should not be granted tax deduction.

China's emergent new approach to TP for IP draws on the DEMPE functions[6] concept (development, enhancement, maintenance, protection and exploitation) which has emerged from the OECD BEPS process. DEMPE plays down the role of the financing of IP development, and emphasizes other functions, in determining where the profits from developing and using IP are allocated. It is understood that DEMPE is being incorporated into forthcoming Chinese TP guidance. However, the application by the Chinese tax authorities of DEMPE to allocate returns from IP in a Chinese context is considered by practitioners to have the potential to follow a different course to the application of DEMPE by other (particularly developed country) tax authorities. These differences of application could potentially result in differences in the allocation of returns from IP and might lead to double taxation outcomes.

Firstly, in applying the DEMPE analysis China is considered more likely to emphasize the location of the <u>performance</u> of DEMPE functions, whereas developed countries may emphasize the location of the <u>control</u> of these functions. As an example of the potential impact this might have, the ongoing <u>performance</u> of production and sales activities in China may be viewed by the Chinese tax authorities to evidence that the IP enhancement and exploitation DEMPE functions occur in China. This may lead China to demand a greater profit allocation to China. At the same time other countries may argue for greater allocation of profits to their countries on the basis of the <u>control</u> of the IP enhancement and exploitation DEMPE functions from their jurisdictions. The difference in perceived appropriate profit allocation could lead to double taxation. Secondly, insofar as Chinese TP practice will often identify the existence of 'locally created intangibles' in China, the factoring of such deemed intangibles into the DEMPE approach may lead to further divergences between the IP profit attributions called for by China and by other countries.

Although the IP component of the BEPS initiative is yet to be finalized, prudent taxpayers may do well to commence re-examination of their IP arrangements and internal documentation now to ensure their existing positions are sufficiently defensible under the emerging new TP for IP concepts. Alternatively, such companies may consider modifying their TP structures to be more compatible with a post-BEPS world. It might be noted that, with the planned introduction of Country-by-Country (CBC) reporting, an MNE group with revenue above a certain reporting threshold must disclose to the tax authorities the distribution of its revenues, income, staff, assets and paid taxes across the countries in which it has operations. The need to supply this

[6] OECD Report "Guidance on Transfer Pricing Aspects of Intangibles" issued on 16 September 2014

information, which will form a key input to TP risk assessment and audit selection by tax authorities, is likely to put further pressure on MNE TP planning for IP. Indeed, even for MNEs smaller than those required to prepare the CBC reporting, it appears likely that much value chain information may be required to be disclosed under the upcoming revised China TP contemporaneous documentation local file requirements, leading to higher risk of audit and adjustment.

Customs duty

Beyond CIT, the use of foreign IP in Chinese operations can result in customs duty implications. Imports of materials, products, tools and machinery for use in innovative industries in China will all be subject to customs duty, though exemptions can be provided for the import of tools and machinery used in certain preferred innovative industries.

This being said, the customs authorities can assert that the payment of royalties is linked to the import of goods and machinery and insist on customs duty being levied on the value of the royalty payments as well. A clear example of this would be where the importer cannot contractually purchase the imports without paying certain royalties. Beyond this the customs authorities have argued that the technology paid for as royalties under the license agreement is in fact ‘embedded’ in the imported goods or equipment. As such, customs authorities may take the position that a proper calculation of the customs duty must include this royalty amount. Customs authorities have also been known (in a similar fashion to the tax authorities as mentioned above) to argue that certain services agreements may involve the transfer of production or marketing intangibles/know-how. This is on the basis that these intangibles are embedded in the products/imported machinery, or were used in the overseas processes which led to their creation. In consequence, the authorities insist that customs duty should apply to these amounts too.

In reaction to this taxpayers have sought to show that the license/service agreements, under which the payments were made, related solely to technology/know-how which was used in domestic production/marketing processes carried on in China (and did not relate to technology embedded in the imported goods or machinery). Alternatively, they have sought to show that the same components/equipment may be sourced from third parties and so the MNE proprietary technology/know-how licensed in from related parties should not be automatically linked to such components/equipment.

This is indeed a highly complex area when dealing with the use of foreign IP in China, made harder by the inherent tension between TP and customs practices. Where TP analysis supports a low value being put on imports used in generating China FIE profits, this may satisfy the tax authorities but may be unacceptable to the customs authorities, given the lost customs revenue. Striking the balance is a challenging task, achievable only by applying a rigorous methodology, preparing good quality supporting documentation and maintaining good liaison with the tax and customs authorities.

VAT

Since 2011 China has progressively changed the system for imposing indirect taxes on provision of services, with Business Tax (BT) being replaced with VAT, a process set to conclude in 2016. BT led to greater costs for businesses as, unlike the system for VAT, there was no 'BT' input credit granted to an enterprise, in respect of BT on supplies incurred by the enterprise, against either output VAT or BT on sales made by the enterprise. Consequently BT led to a cascading series of tax charges.

The transition to VAT for license fee payments (as well as for any service payments which the tax authorities may choose to treat as payments for know-how and subject to WHT) substantially eliminates the indirect tax cost of licensing into China. This being said, cash flow burdens can be created by the necessity of paying VAT sometime before an offsetting input credit can be claimed. To the extent that licenses/services are subjected to customs duty, the customs office may impose import VAT on the full value of the imported technology, while the tax authorities again impose VAT on each individual payment; a double VAT outcome. Input VAT credit should hopefully be ultimately claimable for these VAT impositions, but some enterprises have sought to work out arrangements with the tax authorities to avoid the second VAT imposition in the first instance.

Part C: Global distribution of MNE IP-related operations: Tax considerations

The modern MNE increasingly draws its firm value from the complex portfolio of IP assets it has amassed, ranged across the globe. The existence of a cross-border dimension to an MNE's China IP management activity, while it does necessitate careful administration and contracting to limit the 'tax frictions' outlined in Part B, also provides opportunities for commercial and tax efficiency. These efficiencies may be maximized to the extent that a MNE sees a strategic value to concentrating the coordination of its IP development, protection and deployment from a single IP management centre.

Where IP is so concentrated in an overseas company, a China FIE within an MNE group may avail itself of a MNE's overseas-developed technology through cross-border service and license agreements and obtain a tax deduction at the 25% standard PRC CIT rate. This may potentially be while the income from these service fees and royalties is taxed to an overseas entity within the MNE group at a lower tax rate.

Various overseas IP management regimes providing beneficial tax treatment for IP income have become popular in recent years. In particular in the European Union (EU)[7], many countries have offered low effective tax rates on IP income received by IP management companies based in their jurisdictions, delivered by way of special low tax rates, partial exemptions or notional deductions. Countries have varied widely in whether they limit the benefitting income to just patent royalties, or also extend the benefits to income from the licensing of unpatented know-how and software,

[7] Special intangible income regimes (variously called 'patent boxes' and 'innovation boxes') are offered by Belgium, Cyprus, France, Hungary, Liechtenstein, Luxembourg, Malta, the Netherlands, Portugal, Spain and the UK, with Italy and Ireland in the process of introducing these. Royalties, license income, capital gains on intangible assets and even 'embedded royalties' (the element of income from sale of goods which could have been earned through a license) may all benefit from the regimes.

or even marketing intangibles such as brand rights/trademarks. Importantly, countries have also varied in the extent to which they have required benefitting companies to actually conduct related R&D/innovation activity (whether in-house or via subcontracted related/unrelated parties) or whether they allow benefits to accrue to companies which have simply purchased the IP rights from which the IP income derives.

While the tax benefit of IP management company arrangements in relation to China has been given some additional support by the movement from BT to VAT (outlined above), the fact that CIT WHT is imposed on gross payments means that the tax deduction benefit for an IP licensing China FIE may be largely clawed back (dependant on levels of profit margin). While the China-HK DTA offers a sizeable general royalty WHT reduction to 5%, most of China's other DTAs only offer royalty WHT reductions in relation to leases of equipment (i.e. the WHT rate for patents, brand IP, know-how can generally not be reduced below 10%). It might also be noted that 'substance' and other requirements for treaty relief impact on use of IP holding companies in HK.

The general tightening of international tax rules on cross-border tax planning, across the world, in the context of the BEPS initiative, and the parallel EU State Aid investigations of MNE rulings in relation to IP taxation, are also impacting on the tax regimes of historically favoured IP holding jurisdictions. The OECD has set out a new 'substantial activity' requirement[8] for IP regimes using a "modified nexus approach" which links the granting of IP-conditioned tax benefits to the amount of R&D expenditure that is incurred, in developing the relevant IP, by companies benefitting from IP regimes. Consequently, as the new OECD approach is rolled out by countries going forward, MNEs looking to make use of overseas IP holding regimes would need to consider whether a substantial entity, staffed by legal and technology experts, coordinating and conducting IP for the group from the IP holding company's jurisdiction, fits in with the MNE's broader commercial plans.

What is more, expanding further on the discussion in Part B above on the Chinese TP rules for outbound payments of license fees, there are new Chinese TP rules which directly focus on the use of overseas IP holding companies. These rules bite where the latter are perceived to be 'low-function'. SAT Announcement 16[9] (released March 2015) may be read to imply that if the tax authorities find that a foreign company within the MNE group, to which a Chinese subsidiary pays royalties for intangibles licensing, just holds the legal rights to the intangibles and did not contribute (through research or other efforts) to the value of the intangibles, then the authorities may deny a tax deduction for the payment.

Such situation could arise where, for example, ownership of the IP is registered in an overseas entity different from the one which "created" the IP, including IP management entities which acquired patents from other group entities, and sub-licensing arrangements. In the latter case, if sub-licensing is not considered sufficiently substantive (the term being as yet undefined) tax deductions may be lost in China even where the royalty is ultimately taxed at the licensor level.

[8] OECD Report "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance" issued on 16 September 2014

[9] Gonggao [2015] No. 16, "SAT Announcement on CIT Matters on Outbound Payments to Overseas Related Parties", (Announcement 16[2015]); See KPMG China, August 2015, "China Tax Alert: Implementation of Announcement 16", http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/ChinaAlerts/Documents/China-tax-alert-1508-17-Implementation-of-Announcement-16.pdf

At the same time, Announcement 16 also lays out a range of circumstances in which payments, by a Chinese subsidiary to a foreign company within the MNE group, for services from that foreign company, are to be denied tax deductions. Broadly, if the foreign company rendering the services does not appear to have much in the way of substance, or if the services are deemed to have not brought any direct or indirect benefit to the subsidiary (Announcement 16 lays out six such instances) then no tax deduction is allowed. The taking of deductions for technical services may also be complicated where the authorities argue that the existence of a parallel IP licensing agreement means that the services payment is duplication.

Announcement 16 allows tax adjustments to go back 10 years and carries significant retrospective impact for existing MNE operations. The approaches taken in the Announcement are set to be bolstered and clarified further in the upcoming revised TP circular on 'Special Tax Adjustments'.

As can be seen, the use of IP holding companies in connection with Chinese IP tax management is facing strong headwinds. In the future, to the extent commercially feasible and reconcilable to concerns which MNEs may have in relation to the protection of their IP where it is owned by Chinese group entities, recourse to the domestic law tax incentives may become greater as the channels for cross-border IP tax planning are restricted.

How can KPMG China assist?

It is clear from the preceding discussion that IP is becoming increasingly difficult to manage from a commercial and tax perspective in China. In the emerging new IP tax environment certain key areas will require particular focus and attention, and KPMG China stands ready to assist:

- International and Chinese tax law developments in TP and PE will likely have the effect that more MNE value chain income will need to be booked 'onshore' in China. In future there may be a greater risk of double taxation arising from the Chinese tax authorities (and tax authorities in other countries) peering up an MNE's global value chain and seeking to drag profit into their jurisdictions. This means that, going forward, the focus of TP work may be less on limiting MNE profit attributions to given jurisdictions and more on ensuring that all countries in which a MNE operates accept a 'unified narrative' on why profit has been allocated as it has throughout the MNE's global value chain. Achieving agreement on such unified narrative is likely to require greater use of bilateral/multilateral Advance Pricing Agreements (APAs) and Mutual Agreement Procedures (MAP).

  Given that profits booked to China from MNE value chains are very likely to increase in future, the focus of tax management may shift from limiting 'tax contact with' and 'tax presence in' China to ensuring that the greater quantum of profits allocated to China may benefit from the best effective tax rate which can be achieved. As such the various innovation tax incentives, such as HNTE, accelerated depreciation, R&D super deduction, are likely to become significantly more sought after than may have been the case in the past, when the old TP paradigm encouraged some MNEs to shy away from HNTE. At the same time, the fact that MNEs no longer go to China for low cost, but rather because they want to access the expanding Chinese market for their sophisticated products, or because China forms an integral part of their IP-rich global value chains, means that MNEs will inevitably carry out more innovative activity in China in future, putting them within reach of the innovation tax incentives in the first instance.

KPMG China's Global TP team stands ready to assist MNEs with rebalancing their TP strategy to fit the radically changed new environment, with services of TP planning and analysis, APA and MAP assistance, as well as TP documentation support. KPMG China's R&D Tax team can deploy its expertise in assisting MNEs to evaluate their qualification for innovation incentives, consider how best to structure internal procedures and documentation systems to support the application of incentives, as well as supporting MNEs with their tax incentive applications.

- As global value chains become increasingly integrated across national borders, and as China moves beyond low cost to become a key part of the global value chain for high-value innovative products and services, the role of foreign technology, foreign know-how, and foreign expert services as inputs into Chinese high-tech exports is set to rise and rise. While efforts have been made to reduce the 'frictions' arising where goods, services, and technology pass into China as part of these globe-spanning value chains (e.g. FX rule liberalization, better procedures for WHT relief, clearer guidance on secondment PEs), this remains a field fraught with pitfalls and complications.

  KPMG China's Corporate Income Tax team, Customs team, and VAT team stand prepared to assist MNEs with the drafting of contracts, the design and implementation of management protocols, and the intensive interaction with the tax authorities necessary to navigate this thicket.

- The Chinese tax policy measures being introduced currently to restrict the ability of MNEs to take advantage of competing tax systems are in line with the global trend emerging from BEPS and are inevitable. At the same time, the ever increasing complexity for MNEs of managing their expanding global IP portfolios means that there is a real and significant role for IP management hubs to play. KPMG China's International Tax team stands ready to advise on how, where a MNE sees a commercial and strategic need to concentrate the coordination of its IP development, protection and deployment from a single centre, IP holding regimes may be usefully deployed. Advice can be rendered on how this can be done in a manner complementary to commercial objectives while being tax efficient and in full adherence with the emergent relevant Chinese TP and tax treaty rules.

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