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China
Looking Ahead
(2nd Edition)

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INTERNATIONAL TAX REVIEW™

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Editorial

Welcome to the second edition of China – Looking Ahead, a series of articles published in association with KPMG.

This year's publication analyses and comments on key developments in China's tax system in light of the priorities laid out in China's 12th Five Year Plan, which covers 2011 to 2015 and which was approved in March 2011 by the National People's Congress. It looks particularly at China's attempts to align its rules with international practice in areas such as transfer pricing, anti-avoidance and environmental taxation.

The 13 articles consider how China is looking to modernise its tax system in a series of areas, while retaining reserving the right to its own approach to implementation and enforcement. The subjects under discussion in this guide include advance rulings, tax audits, treaty interpretation, Customs and property taxation.

Taxpayers are always concerned at the prospect of change as it risks the possibility of more uncertainty being introduced into the system. However, with the scale of China's ambitions to create a modern, international tax system that can be compared favourably to those in the rest of the world, a period of upheaval is inevitable.

Possibly the biggest change in the immediate future is the amalgamation of Business Tax and VAT into one national system of VAT for goods and services. The pilot programme and the implications of the changes for the financial services industry are comprehensively dealt with in two chapters in this publication.

We hope these articles will help you when dealing with your tax affairs in China.

Ralph Cunningham
Managing editor
International Tax Review

Foreword

Khoonming Ho, Tax Partner in charge of China and Hong Kong SAR, KPMG

It seems like only yesterday that the first edition of the "China Looking Ahead" series was published. In the 2011 edition, we went back in time and reviewed the Chinese tax reforms over the course of the past three decades, analysed the tax policy objectives in the 12th Five Year Plan, and commented on the tax measures undertaken by the Chinese Government.

As the year of the Dragon is fast reaching an end, it is time to take stock and cast our sight ahead. In this second edition, we review China's major tax policies and practices in 2012, and evaluate their impacts on multinational companies and consider possible changes to the Chinese tax regulations in the new year. Although we do not claim to be able to predict the future, several forecasts in the 2011 edition have materialised in the past year, and we hope our forecasts assisted our readers to gain a head start in their preparations. We will continue to express our thoughts on the future changes in China's tax environment and how foreign investors can prepare for such changes. It should be noted that the content of this publication is not intended as predictions or forecasts in respect of the Chinese tax policies and should not be relied upon as such.

The greatest change in the Chinese tax system during 2012 is the Value Added Tax (VAT) reforms. In the first edition, we discussed the tax cascading issue in the services industry under the business tax regime, and envisioned that a VAT system would be introduced to address the issue. Since then, a VAT pilot programme has been implemented which applies to selected service industries. The VAT pilot programme has been progressively expanded from Shanghai to Beijing and a number of provinces in China. The pilot programme will continue to spread to other cities and provinces over the course of the next 12 – 18 months. In the chapter "VAT Reform – into the Future", we look at the scope of the VAT reforms and point out the opportunities and risks. Furthermore, in the chapter "Financial Services Sector – The Last Frontier for Chinese VAT Reform," we contemplate how a VAT system could apply to China's financial service industry when the VAT reforms are expanded to additional service industries.

In the first edition, we evaluated how China's general anti-avoidance rules, which serve as the foundation of the beneficial ownership and indirect transfer rules, affect cross-border tax planning for foreign investors. We also discussed how tax uncertainty could be reduced by introducing an advanced ruling system. Our recent meetings with the State Administration of Taxation indicate that the prospect of an advance ruling system in China is increasingly promising. We examine the significance of this development in the chapter "Advance Rulings – A Giant Step for China."

In this edition we investigate the latest tax developments for foreign investors in three chapters entitled "New Landscape of Chinese Tax Treaties", "Has Vodafone Decision Made China Change Her Mind?", and "Lures and Challenges of Chinese Tax

Rules for Private Equity Funds" where we assess the issues arising from an industry perspective.

In the first edition we identified Tax Compliance Agreements (TCA) as a burgeoning tax administration practice in China. TCA has become much more prevalent in 2012 and is addressed in the chapter "Ever Challenging Tax Audit Environment". In addition, we also examine the newest trends in Chinese transfer pricing and customs investigations in the chapters entitled "Firmer Stance on TP Enforcement" and "Chinese Customs in Uncertain Times".

Three potential areas of regulatory change are also highlighted in this edition. In the chapter "Road to A Comprehensive IIT System", we explore how the existing individual income tax system may be reformed to achieve more equitable income distribution. In the chapter "Property Tax: Where Does It Go from Here?", we review the real property tax pilot programmes in Shanghai and Chongqing and contemplate the direction of a national real estate tax system for individuals. In the chapter "Will Tax Help Save the Chinese Environment?", we delve into the progress of the resource tax reform, and envisage the shifts and turns in the future of environmental tax reform in China.

Lastly, this 2012 edition encapsulates the key new tax policies in the pipeline in Hong Kong, covering important subjects such as treaty development, Islamic financing and advance pricing agreements.

China has reached a historic time with respect to its future path. In the first two quarters of 2012 the country's economic growth slowed down, averaging 7.8%. The economy is expected to face substantial challenges in 2013. In the 2012 National People's Congress session, Premier Wen Jiabao emphasised that expanding domestic demand is essential to sustaining China's long-term economic growth, and will be the focus of the Chinese government. The tax policies discussed in this edition are intended to help China navigate through the rough periods ahead. Foreign investors are strongly advised to take the existing and potential future tax rules into consideration when making business decisions.

In his report at the 18th National Congress of Communist Party of China (CPC) which ran from November 8 to November 14 2012, Hu Jintao, the General Secretary, stated that new ways would be needed to implement the a strategy of innovation-driven development, structural reform, and international economic cooperation and competition, and that new efforts would be required for the promotion of ecological progress.

We believe that the new leadership will stay the course of economic reform and adhere to the tax legislation agenda underpinning the 12th Five-Year Plan. In the long run, staying attractive to foreign investors will remain a priority for China. The Chinese government is expected to keep improving the Chinese tax environment in terms of cost, certainty, and transparency.

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Khoonming Ho is the tax partner in charge of China and Hong Kong SAR. Since 1993, Khoonming has been actively involved in advising foreign investors about their investments and operations in China. He has experience in advising issues on investment and funding structures, repatriation and exit strategies, M&A and restructuring.

Khoonming has worked throughout China, including Beijing, Shanghai and southern China, and has built strong relationships with tax officials at both local and state levels. Khoonming has also advised the Budgetary Affairs Committee under the National People's Congress of China on post-WTO tax reform. Khoonming is also actively participating in the government consultation project about the forthcoming VAT Law. He is a frequent speaker at tax seminars and workshops for clients and the public, and an active contributor to thought leadership on tax issues.

Khoonming is a fellow of the Institute of Chartered Accountants in England and Wales (ICAEW), a member of the Chartered Institute of Taxation in the UK (CIOT), and a fellow of the Hong Kong Institute of Certified Public Accountants (HKICPA).

Ever challenging tax audit environment

David Ling, Eileen Sun and Bruce Xu discern future trends in tax audits from audit cases conducted in the past year and tax compliance measures to be rolled out in coming years.

Since the 2008 global financial crisis, Chinese tax authorities have taken important steps to intensify tax investigation. China's 12th Five-Year Plan (5YP) explicitly outlined strengthening tax investigation and encouraged enhanced tax compliance. This spirit is reflected in recent Chinese government circulars that serve as guidance to tax investigations in 2012.

Within the Chinese tax authorities, the tax investigation department (TID) is given the responsibility to supervise tax compliance and secure State tax revenue. The TID generally takes the lead among various government branches in conducting PRC tax audits, and for this reason, receives special funding from the State to ensure that tax investigations are carried out effectively. In recent years, to enhance relationships with the taxpayers, the word "investigation" is sometimes replaced by the softer term "inspection" in official publications. In essence, however, these two terms entail basically the same working procedures and examination scope.

In 2011, the TID focused on these areas:

- identifying and punishing tax non-compliance and offences
- conducting special tax inspections at the national and the regional levels
- monitoring and examining taxpayers with major tax revenue sources
- cracking down on criminal activities related to government-issued tax invoices.

Based on published data, in 2011, the TID processed a total of 212,000 tax investigation and prosecution cases, and recovered Rmb92.35 billion ($14.78 billion) for the State treasury (including back-due taxes, late payment surcharges, and penalties). Those figures are lower than comparable numbers during the 2008 financial crisis. However, more sophisticated investigation approaches and techniques adopted by the TID have caused extraordinary pressure for taxpayers in China.

Tax audit in 2012

General guideline

At the beginning of 2012, the State Administration of Taxation (SAT) issued 'Key Points for National Tax Investigation Work' in 2012 (General Guideline), which sets the tone for the 2012 tax audit. The General Guideline lists these action items for the TID:

Improve the general tax environment

The TID should:

- perform regular tax inspections, investigation and prosecution of major tax offences;
- make special tax inspections and special regional tax rectifications;
- carry out inspections of key tax sources; and
- continue to crackdown on criminal activities related to official invoices.

Conduct tax investigations in a lawful manner

The TID should conduct tax investigation cases by:

- following the law;
- improving the quality of its tax audit; and
- strengthening its internal control and supervision processes.

Specifically, the TID's investigation process should be divided into target identification, case examination, case review, and enforcement. The TID should manage all four components and ensure that the different components are separate from each other and yet serve as checks and balances mutually to minimise irregularities.

Modernise the tax investigation process

The TID should leverage international best practices to:

- refine tax investigation procedures;
- enhance the level of information technology in tax investigation;
- improve the capability of existing software modules for selecting audit targets and conducting audits; and
- develop an effective whistleblower system.

In addition, the SAT requires that information should be shared among tax investigation teams within the TID and an internal database should be built for major, controversial or complex audit cases. Furthermore, the SAT encourages joint tax investigations by State and local tax bureaus, and mandates that major tax audits must be reported to, and coordinated by, upper-level tax authorities.

The General Guideline sets aggressive national targets for 2012 tax investigations. On average, it should be proved retrospectively that more than 90% of investigation targets have been selected correctly. Furthermore, more than 90% of the tax investigation cases launched in 2012 should be wound up within the year. Finally, more than 90% of taxes assessed during the 2012 tax investigations should be collected and deposited to treasury coffers within the year.

Special tax inspections

In 2012, the SAT continues to carry out special tax inspections nationwide. In *Guoshuifa* [2012] No 17 (Circular 17), the SAT classifies tax inspections into three categories:

- industry-specific tax inspections;
- region–specific tax inspections; and
- inspections of key taxpayers with major tax revenue sources.

Industry-specific tax inspections

As in 2011, industry-specific tax inspections include mandatory inspections and discretionary inspections. Mandatory inspections will focus on these targets:

- Enterprises that are issued with VAT special invoices for finished oil products;
- Capital related transactions such as equity investment and disposition;
- Enterprises that claim VAT refunds on exports of electronic products, garments, and furniture; and
- Trading companies that undertake export business on behalf of their clients.

In recent years, several tax audit cases involving capital related transactions were reported, with hundreds of millions of RMB collected in each of these cases. As a result, the SAT attaches great importance to these kinds of transactions and designates multiple audit target areas, such as green-field investments, initial public offering (IPO) financing, corporate internal restructuring, M&A, shareholding alliances, venture capital investments, and financial investments for the local TIDs.

Compared to 2011, the scope of discretionary inspections has expanded in 2012. Not only have the real estate industry, the construction and installation industries, high-income individuals, and non-resident financial enterprises remained as audit targets, but local commercial banks and joint-stock banks are also red-flagged.

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David joined an international accounting firm in the US in 1992 after obtaining his master's degree in US taxation. He transferred to China in 1993 and has worked in the Hong Kong, Beijing, Shanghai and Shenzhen offices. He became a tax partner in 2002 and joined KPMG's Beijing office the same year.

David has extensive experiences in China tax planning and tax negotiation with counterparties. His expertise includes advising foreign companies in establishing operations in China, particularly in the establishment of investment holding companies and foreign invested trading companies. He also has extensive knowledge of PRC Customs regulations, foreign exchange control policies, and other regulatory regulations.

David has long-standing relationships with various PRC authorities including the Ministry of Commerce, the State Administration for Industry and Commerce, the State Administration for Foreign Exchange, Customs and the tax authorities at both central and local levels.

Region–specific tax inspections

With regards to region–specific tax inspections, the SAT requires that all tax authorities launch special tax investigations in geographic locations where tax non-compliance is prevalent, especially in places where enterprises processing agricultural products are heavily concentrated and tax irregularities are found to be commonplace. The SAT will select some key locations to supervise such inspections or to lead the inspections directly.

Key taxpayers inspections

The SAT listed 14 mega-sized stated-owned enterprises (SOEs) and foreign invested enterprises (FIEs) as targets under the category of "key taxpayers with major tax revenue sources". These enterprises span the steel, petroleum, coal, automobile and home care industries. The SAT will continue to play the role of central coordinator in such taxpayer-specific inspections.

As in 2011, the three types of inspections described above began in March 2012 and concluded at the end of October 2012. The tax years covered by these tax inspections are 2010 and 2011. If tax non-compliance is discovered, tax inspections can be rolled back to prior years. A Special Tax Inspection Notice accompanying Circular 17 provides detailed guidance to local TID officials, including how to select targets, what inspection methods to use, and what examination scope to include.

National tax source survey

In addition to tax inspection plans deployed by the SAT, the Ministry of Finance (MOF) is also carrying out a key tax source survey. According to *Caishui* [2012] No 29 (Circular 29) issued by MOF in 2012, more than 1,000 large-scale SOEs and FIEs are being surveyed. The main purpose of the survey is for statistical analysis, for example, to understand the distribution of major tax revenue sources in China, and to gather comments and recommendations on existing tax policies. Unfortunately, some local tax authorities ignored this policy intent and simply chose the taxpayers nominated in the survey list as primary tax inspection targets.

The 2012 tax source survey started in the first quarter of 2012. The finance departments at provincial level were required to report data covering at least 60% of the nominated enterprises in their jurisdictions to the MOF within 20 days of the quarter's end.

Future trends in tax investigation

Intra-government collaboration

In the 2012 tax inspection plan, the TID is asked to cooperate closely with other government organisations on tax audits. These government organisations include:

- The tax collection and administration departments;
- State tax bureaus, and local tax bureaus within the tax system; and
- Government branches outside the tax system such as the Public Security Bureau, the Administration of Industrial and Commerce (AIC), the Public Prosecution Bureau, Courts, Customs, and financial institutions.

Chinese tax authorities are building and refining an information sharing mechanism with other government organisations. For instance, according to *Guoshuifa* [2011] No126 issued by the SAT, the tax authorities and the AIC branches are already exchanging information on transfers of listed and non-listed equity interests every month. Information sharing among different government entities will facilitate an in-depth examination of equity transactions by Chinese tax authorities.

Self-examination

Self-examination by taxpayers remains a preferred method of tax investigation for Chinese tax authorities. In 2009, the SAT requested 70 large-scale enterprises to conduct self-examination. From the tax authorities' viewpoint, self-examination is highly cost-effective. It saves administrative expenses for the tax bureaus, and yet can recover significant amounts of underpaid taxes.

Nevertheless, self-examinations create a huge workload for the targeted taxpayers, which have to perform time-consuming procedures prescribed by the tax bureaus to prove their compliance status and justify their tax positions.

In 2012, PRC self-examinations were carried out at several levels. On a key taxpayer level, the SAT designated the affiliates of a large state-owned oil and gas group as self-examination targets.

Furthermore, the Large Business Enterprise Division and its branches within the PRC tax authorities will organise

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Eileen has been providing China tax consultancy services in Hong Kong and Shenzhen to foreign investors for more than 10 years. Before this, she worked in the UK for a chartered accountancy firm.

enterprises to perform self-examination on a regional basis. Local tax bureaus will also arrange and manage self-examination for taxpayers in their areas.

New tax audit techniques

To improve audit efficiency, the TID is trying out more advanced investigation techniques and methodologies. In 2011, some provincial and municipal tax authorities started a pilot application of the "tax audit work paper model" for inspecting large-scale enterprises.

The model leverages work processes used in statutory financial audits, strengthens the financial information gathering process by using electronic data storage and transmission, and applies tax analysis to the information collected.

The model enables a complete and in-depth inspection of taxes, transactions, and specific issues, and maintains control over the investigation process and quality. We understand the SAT is satisfied with the results of the model and plans to promulgate it nationwide in the near future.

Under the guidance of the SAT, local tax authorities are also seeking to establish a tax risk assessment model targeting designated industries, (for example, banking and insurance) that require special knowledge to analyse.

The industry-specialised tax assessment model:

- outlines the major tax risks in an selected industry;
- develops normal ranges for various financial or tax indicators reflecting each risk; and
- helps tax officials choose the right audit targets in that industry.

And some tax authorities also hired accounting firms via public bidding and involved them in tax audits. Firms of certified public accountants (CPA) possess unique technical knowledge and industry expertise that can be used to analyse taxpayer data and identify tax risks. Properly leveraging the professional capabilities of accounting firms in tax investigations can not only improve audit quality, but can also partially resolve the resource shortage issues experienced by the TID.

Tax risk control and tax compliance agreement

Since 2009, the SAT has been encouraging enterprises to establish effective tax risk control systems.

An effective tax risk control system will help businesses detect tax risks at the embryonic stage and address these risks before they materialise into major tax non-compliance, which could lead to penalties for the taxpayers. For example, a tax invoice management system is fundamental to tax collection and administration in China.

In previous years, tax investigation officers have heavily focused on invoices during tax inspections. There are numerous cases where taxpayers could not claim expense deductions or where severe penalties have even been imposed simply because of their poor management of invoices. As such, setting up and implementing an effective invoice management system may greatly reduce tax audit risks.

The tax compliance agreement (TCA) system introduced by the SAT in 2011, gives an additional impetus to taxpayers for setting up or improving tax risk control systems.

A TCA is a relatively new tax management process in China and developed from the notion that a well-established tax risk control framework for enterprises will reduce tax non-compliance risks.

In short, a TCA is a legal agreement entered into between a taxpayer and its in-charge tax bureau. The agreement normally states the obligations of the tax bureau and the taxpayer, at least in broad terms. For example, the tax bureau may promise that it will:

- respond to the taxpayer's inquiries with more definitive responses,
- assist the taxpayer with improving their internal tax risk control system; and
- eliminate repetitive tax inspections;

The taxpayer may promise to:

- maintain good tax compliance status;
- build an effective internal tax risk control system: and
- make timely disclosures to the tax bureau on significant tax matters.

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Bruce Xu was a senior tax official of the Shanghai District Tax Bureau before joining KPMG. He has about 10 years experience with the PRC tax authorities, which provides him with a deep understanding of tax regulations and strong technical capabilities. He also maintains extensive networks within the Shanghai Tax Bureau.

Since joining KPMG Shanghai in 2003, Bruce has provided tax services to clients in a wide variety of industries such as media, automobile, engineering, real estate, banking and retail. With his good working relationship with tax officials and extensive experience with PRC tax authorities, he has also been involved in many tax audit defence engagements and has extensive experience in assisting multinationals in their restructuring and M&A activities in China.

Under a TCA, the tax authorities still need to supervise taxpayers by . However, such supervision will be conducted with a higher level of understanding and trust.

In principle, all levels of Chinese tax authorities can execute TCAs with taxpayers. In 2011, the Beijing State Tax Bureau (BSTB) firstly concluded a TCA with five large local enterprises. Tax bureaus in various places have followed suit and entered into numerous TCAs in their local jurisdictions. On October 12 2012, the SAT signed its first three TCAs with China National Offshore Oil Corporation, China Life Insurance (Group) Company and Siemens Ltd China. Under the TCAs, the three enterprises are entitled to apply for advance rulings from the tax authorities. As we predicted, the pilot scheme for the system of advance rulings will be initially limited to taxpayers who have entered into TCAs. For more discussion on the linkage between advance rulings and TCA, please refer to Chapter 2 of this edition of the "China Looking Ahead" series.

Some issues have arisen during the implementation of TCAs in China and need to be resolved soon:

1. If a taxpayer has branches or operations in several tax jurisdictions, the definitions of how a TCA should be arranged among the multiple taxpaying units and tax bureaus, and how the rights and obligations of its branches in various locations, is unclear.
2. Compared with similar programmes overseas, the TCAs concluded in China so far tend to be high-level in nature. They only describe the general principle of cooperation between the tax bureaus and the taxpayers, but do not spell out sufficient levels of detail. Taxpayers often hope that TCAs would specifically document the rights and obligations for a participating enterprise, for example, if a taxpayer meets its reporting duties, over what period can tax inspections be waived.

The SAT and the local tax authorities are exploring solutions to these issues. In the future, the SAT may design TCA templates with typical articles and provisions included and customise the templates for different levels of tax authorities. This will help standardise the TCA process in China.

Looking ahead

Taxpayers in China are facing unprecedented pressures. The pressure results from the relentless tax investigation initiatives launched at multiple levels. The pressure also originates from the tax authorities' greater skills in using various audit techniques, which force taxpayers to provide more detailed and complete disclosure. How to deal with tax investigations appropriately and resolve tax disputes is a challenge faced by most companies operating in China.

To deal with this challenge, it is imperative that taxpayers establish optimised tax internal control systems as soon as possible to ease such pressure. In general, taxpayers should consider implementing risk control measures such as:

- Setting up a complete set of control procedures and fix the control points
- Establishing tax standardisation and automation management processes and risk control processes
- Setting up tax risk communication mechanisms
- Updating control points regularly and optimising internal management
- Establishing a rational and effective internal tax management department
- Evaluating the professional ethics and capabilities of tax staff
- Integrating their tax risk control system and other risk control systems of the enterprise.

Advance rulings – a giant step for China

Tracy Zhang, William Zhang and Karmen Yeung advise that Chinese tax authorities are aiming to provide more enhanced taxpayer services, for example, guiding taxpayers to comply with regulations voluntarily, helping taxpayers manage risks and providing taxpayers with tailored assistance.

Reflecting the new service mindset, the State Administration of Taxation (SAT) is expected to introduce a system of advance rulings for enterprise taxpayers in China in the foreseeable future. This is a very significant development in China's tax administration. The contemplated advance ruling system focuses on enhancing taxpayer services and cooperation and marks a new era in the relationship between taxpayers and tax officials in China.This article examines the significance of the development, the potential scope of the new Advance Rulings system, the general comparisons with Advance Rulings systems used internationally, and its likely scope of operation in China.

According to 2009 statistics released by the OECD, 28 of its then-30 member countries, including Australia, Canada, France, Germany and the US, have implemented advance ruling systems, sometimes referred to as private rulings or product rulings. Among 13 major non-OECD countries, 12 countries, such as Singapore, South Africa and Argentina, have adopted similar regimes.

of Advance ruling systems are relatively commonplace, and their essential features are similar in many jurisdictions. It is therefore not surprising that China's proposed system is modelled on international examples from countries such as Australia, New Zealand and Canada.

What is an advance ruling?

An advance ruling is simply a tax authority's interpretation of how the tax laws should be applied to a given set of facts submitted by a taxpayer. In common terms, it is a systematised way of interpreting tax laws. The term "advance" is intended to refer to the fact that the system focuses on rulings given before the transaction or event occurs.

Generally speaking, advance rulings have not been previously available to taxpayers in China, except for the advance pricing arrangement (APA) programme in a transfer pricing setting. However, the SAT has routinely issued policy rulings to lower-level tax authorities in China, explaining their interpretation of the law.

The critical distinction about advance rulings is that they are addressed to taxpayers rather than the tax authority. Once issued, advanced rulings would be binding on the Chinese tax authorities involved.

Why does the advance rulings system matter?

Tax uncertainties in China

The single biggest reason why this system is so important in China may be succinctly stated in a word – certainty. While certainty is important to any organisation, it is particularly difficult to achieve in China. There are three main reasons why.

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Tracy is a PRC regulatory and tax specialist on China investment related issues. Since 2004, she has been functioning as one of the leaders of the financial services tax team in KPMG Beijing, looking after domestic and foreign financial services, private equity and real estate clients. She has also been involved in:

- developing structures for foreign investments into China;
- tax due diligence reviews in connection with M&A transactions;
- and advising on cross-border transactions.

- Tax regulations in China are, in relative terms, light on substantive detail, and are sometimes general in their application. These regulations are supplemented by a large volume of quasi-legislative materials such as circulars, whichfulfil a similar role to public rulings used in other jurisdictions. However, circulars are often basic in their operation and can be readily replaced. Some of them conflict with each other, and sometimes raise more questions than they answer. The generality of the regulatory environment also leaves broad discretion to tax administrators.
- Tax administration in China is still in a developmental phase. Businesses can encounter challenges in achieving consistency of decision-making between tax officials on relatively routine matters, not to mention an understanding of complex transactions. While the SAT has made enormous progress in a short period of time, new policies and procedures will take some time to be implemented in full.
- The regulatory environment in other jurisdictions is often supported by case law, which may fill certain gaps in the interpretation of the law and regulations. However, in China, there is a dearth of case law in tax, so those gaps often remain unfilled.

The role of advance rulings

For companies doing business in China, particularly those affiliated with overseas headquarters, a combination of these factors can create a tax environment which is difficult to manage and has unacceptable levels of risk.

A plethora of surveys on tax risk management regularly highlight the fact that the primary objective for businesses in managing tax risks is to limit unwelcome tax surprises. It is therefore critical that the framework for managing tax risks in China develops in such a way to facilitate and encourage effective control over tax risks. The introduction of a system of advance rulings should go a long way toward addressing these risks. With advance rulings, taxpayers can reduce the risk of penalties and interest when taking positions on tax returns.

When tax returns are under review or audit, taxpayers can rely on the interpretation of the law provided in advance rulings as a defence. In addition, armed with information provided in advance rulings, taxpayers can make the required disclosures of tax entitlements or obligations associated with given transactions on financial statements more accurately.

On various occasions, the SAT has clearly acknowledged the shared benefits of effective tax risk controls, and said it wants to use the advanced rulings system as a tax risk control measure.

From the SAT's perspective, an advance ruling system would:

- significantly enhance the degree of tax compliance and the quality of tax administration;
- save time for tax authorities in audit;
- allow early detection of taxpayers' issues in applying laws;
- identify areas of focus for taxpayers' training programs; and
- improve the public image of the tax authorities.

What will China's future advance rulings system be like?

As noted earlier, the formal introduction of an advance rulings system in China should take place in the near future. We have been actively providing technical input to the SAT on the advance rulings systems being operated in other jurisdictions and making recommendations for the implementation in China. These features of the proposed system in China are based on our understanding during that consultation process:

Eligibility

There are indications that at this stage, the SAT intends to limit advance rulings to taxpayers who have signed tax compliance agreements (TCAs) – essentially taxpayers with effective systems of tax risk controls and a desire to cooperate with the SAT transparently. The linkage with TCAs is discussed further below.

The rationale is that advance ruling applications normally require a detailed presentation of factual materials that are supportable by complete and reliable document trails. This may be beyond the capacity of many small and medium-sized enterprises in China.

Prospectivity

At this stage, the advance rulings system will be largely prospective in application. That is, taxpayers can seek advance rulings on proposed transactions. Initially, there may be limited scope for them on transactions which have already occurred.

Binding effect

Advance rulings are intended to bind the tax authorities in respect of the issue(s) ruled upon. They cease to be binding if there is a change to the law, or the information upon which the ruling was given is erroneous. These protective measures are a hallmark of most advance ruling systems throughout the world.

And despite the intended binding effect in principle, it remains to be seen when a taxpayer seeks to enforce an advance ruling with a local tax bureau in China that did not participate in issuing the particular ruling, whether the taxpayer will encounter significant challenges from a practical standpoint.

Cost

It is likely that the SAT will not charge taxpayers for seeking advance rulings. The 2009 OECD report highlights the fact that only a minority of tax authorities in the world levy fees for issuing rulings.

Timing

The usual time-frame for obtaining an advance ruling is expected to be within four months from making an application. However, fast-tracked applications may be granted in special circumstances, for instance where rulings are being sought on market-sensitive transactions.

Publication

There are indications that advance rulings will probably be published in China, though taxpayer-specific confidential information will be omitted. This is a crucial transparency measure, which should ensure greater consistency in decision-making by Chinese tax authorities, and enables other taxpayers (and their advisers) to obtain a better understanding of the reasoning adopted by the SAT.

How will the advance rulings system work in China?

The broader context in which the system of advance rulings is being introduced in China is vitally important in understanding how they will work.

Biography

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William Zhang has been providing PRC business, tax and regulatory advisory services for various multinational companies since 1997. He has assisted many multinational companies in making investments in China and has extensive experience in serving clients engaged across a wide spectrum of industries. His experience includes:

- assisting multinational companies in formulating expansion strategies into the PRC;
- setting up and structuring their business operations in the PRC;
- fulfilling relevant registration and filing requirements to the stage of working out practical solutions to various tax issues; and
- exploring possible tax planning ideas for clients.

In particular, William has advised many multinational companies engaged in the industrial and consumer markets (including the electronics industry, home appliance manufacturing, auto and auto components and chemistry) on their day-to-day operations, including:

- performing tax health checks to identify non-compliance tax issues and tax planning opportunities;
- performing tax due diligence work; and
- providing tax restructuring advice for M&A activities, and advising on tax efficient investment and exit strategies.

William was seconded to the international corporate tax group of KPMG London's office for one year, focusing on various international tax projects for European companies.

Pilot programme

The SAT recently introduced two new circulars (*Guoshuifa* [2009] 90 and *Guoshuifa* [2011] 71). The two circulars establish a framework through which taxpayers may enter into TCAs with the tax authorities. The Chinese system of TCAs is loosely modelled on the Dutch system of horizontal monitoring. The objective of TCAs and horizontal monitoring is to modernise the nature of the relationship between taxpayers and tax authorities so that both parties engage with each other based on principles of mutual trust, respect, cooperation and transparency.

Many large taxpayers have recently entered into TCAs with the SAT where they agree to:

- put in place tax risk controls;
- provide information to the tax authorities on a timely basis in advance of transactions;
- and seek to resolve issues with tax officials on a proactive basis.

The *quid pro quo* for this approach is that taxpayers obtain enhanced services from the tax authorities, and from an internal organisational perspective, they can better manage their tax risks. The opportunity to obtain advance rulings is seen as a key component of facilitating the management of tax risks and enhanced voluntary compliance.

Not surprisingly, the pilot scheme for the system of advance rulings will initially be limited to those taxpayers who have entered into TCAs. For these taxpayers, the benefits of managing tax risks more effectively may drive them to request advance rulings proactively. Furthermore, the opportunity to obtain advance Rulings may lure more taxpayers into entering into TCAs.

It is hoped that after the pilot scheme is in operation, the system of advance rulings will be open to all taxpayers. However, in a country with more than 1.3 billion people, that task could prove daunting.

To meet this challenge, the SAT will establish a core team with control over rulings. This is critical to ensuring consistency and quality of decision-making. To avoid duplication with existing processes, the SAT will decline to issue rulings on transactions, which are already the subject of an audit, which involve questions of fact, or which contain issues already directly covered by existing circulars. This should ensure that the SAT's resources are dedicated to resolving real issues of interpretative difficulty.

Ruling process

The actual process of applying for advance rulings will be consistent with international practices. Taxpayers will be required to provide the SAT with, for example, the facts or draft transaction documents upon which the ruling is based, the details of the issue on which the ruling is to be issued, and the time period of application of the ruling. Taxpayers will also have the opportunity to set out their views in the ruling application, which should contribute to better decision-making.

Where taxpayers fail to provide the SAT with all of the relevant information, they will be advised of this and given an opportunity to submit further details. However, once rulings are issued, taxpayers will be required to implement the arrangement in accordance with that ruling and must advise the SAT if the transaction does not proceed or does not proceed as planned. This should mitigate some of the risks of advance rulings being misused.

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Karmen Yeung has extensive experience providing PRC corporate and individual tax advisory advice to foreign investment enterprises in the PRC. She has advised multinational corporations on their investment structures in China and on establishing tax efficient supply chain models, particularly relating to sourcing, manufacturing, distribution and retailing in China from the corporate income tax, transfer pricing, value added tax and customs duty perspectives.

A double-edged sword?

One common experience of taxpayers in other jurisdictions is that seeking an advance ruling can be a double-edged sword. On one hand, the taxpayer may receive confirmation of the position they were seeking and can then proceed with certainty. On the other hand, they may not receive the answer they were hoping for, but still have disclosed that particular transaction to the tax authorities. Some taxpayers hesitate to seek advance rulings for this reason.

In an era of electronic data collection and instantaneous communication, global sharing of information among tax authorities, cooperative relationships between taxpayers and tax authorities, and obligations to notify and quantify tax risks to tax authorities and financial markets, this type of thought process is quickly becoming an anachronism. The ability of taxpayers to shield transactions from the eyes of prying tax officials is becoming much more difficult.

It must also be noted that if a tax official is provided with the facts in advance of a transaction and presented with a properly articulated position of the taxpayer, the tax official is more likely to view the contemplated transaction with an open mind and resolve any uncertainties in favour of the taxpayer, compared with the situation where details of the transaction are begrudgingly provided to tax officials in the heat of an audit.

And taxpayers can always decide not to proceed with a transaction if the ruling is unfavourable – that option does not exist in a tax audit environment.

Looking ahead

Chinese tax authorities have studied the advance ruling systems used in other countries and will be seeking to leverage those experiences and best practices.

If the SAT successfully implements an advance Ruling system, it will achieve a breakthrough in Chinese tax administration. Such a system would:

- significantly enhance voluntary compliance and the quality of tax administration for eligible enterprises;
- elevate taxpayer services to a higher level;
- materially decrease tax compliance costs for both taxpayers and tax authorities; and
- represent an important step towards modernising tax administration in China.

Lachlan Wolfers, leader of the centre of excellence of indirect tax of KPMG China, is an adviser on this chapter.

New landscape of Chinese tax treaties

At an operational level, in contrast to China's willingness to enter into new tax treaties, the PRC tax authorities have shown a clear propensity towards a more restrictive tax treaty interpretation and administration approach that, in practice, has served to limit foreign investors' ability to access tax treaty benefits, explain Christopher Xing, Chris Ho and Roger Di.

A notable feature of the China (PRC) network of tax treaties in recent years is its continued expansion. This trend reflects the shift of China's economy from primarily a recipient of foreign capital to one where outbound investment is increasingly common and growing rapidly.

In recent years, Chinese tax authorities have demonstrated a "hardened approach" towards the administration of tax treaty benefits in tax circulars governing the determination of beneficial ownership over passive income. This is also reflected in their stance in combating arrangements that are perceived to be an abuse of tax treaties. Tax treaty abuse forms a specific basis of challenge under the PRC domestic general anti-avoidance rules (GAAR). This article discusses Chinese tax authorities' recent interpretive approaches applied in the administration of tax treaties and the likely trend for the future.

China's treaty network becoming extensive

As of October 2012, China has entered into 99 double tax agreements (DTA) with other countries and regions, including Hong Kong SAR [Special Administrative Region] and Macau SAR. Much of China's overseas investment lies in resource-rich parts of the world, and China's recent treaties were often entered into with countries in these areas. In the last few years, China signed DTAs with quite a few African countries,for example, Egypt, Zambia and Botswana, and South America, for example, Brazil and Venezuela.

The expansion of China's tax treaty network is likely to continue given the importance of promoting international trade and bilateral investment and encouraging outbound investment, particularly with countries in Africa and South America

Tax treaty interpretation and application

China's DTAs are based on a mixture of the OECD Model Tax Convention on Income and on Capital (OECD Model) and the UN Income and Capital Model Tax Convention (UN Model).

To streamline the interpretation and application of tax treaties entered into by China with other jurisdictions, the State Administration of Taxation (SAT) issued *Guoshuifa* [2010] No 75 (Circular 75) on July 26 2010. Circular 75 not only interprets the articles in the DTA between China and Singapore (PRC-Singapore DTA) but also explains other Chinese DTAs that have similar provisions as those in the PRC-Singapore DTA.

Circular 75 contains the most comprehensive explanations of tax treaty articles that the SAT has issued to date. In a broad sense, though much of Circular 75 is comparable with the commentary on the OECD Model Tax Convention (OECD Commentary), there are notable interpretational deviations from the OECD Commentary. These differences are discussed below.

Firstly, in the context of treaty benefits availability, the beneficial owner requirement is set out in Circular 75 for dividends, interest and royalties with reference to *Guoshuihan* [2009] No. 601 (Circular 601). Circular 601 amplifies the beneficial owner concept that is often found in Chinese DTAs and emphasises that a non-resident enterprise must be a beneficial owner to qualify for treaty benefits. The beneficial owner concept means that a treaty applicant cannot be a conduit or agent, and should not only control the disposition of the income and the underlying property, but also generally conduct substantive business operations. A number of negative factors that point towards a treaty applicant not being the beneficial owner are listed in Circular 601. The enumerated factors are more stringent than those in the OECD Commentary.

Secondly, in the context of the dividends article, the OECD Model does not require that a company receiving dividends must have owned at least 25% of the capital for a specified period before distribution. Instead, it is at the discretion of the contracting states to include such a condition through bilateral negotiations. Circular 75 makes references to *Guoshuihan* [2009] No. 81 (Circular 81), which requires that equity interests in a PRC company be held for at least 12 consecutive months before the dividend is declared and paid. Since the 12-month period requirement is not stipulated in the PRC-Singapore DTA (and many other DTAs that China has entered into), this requirement represents a unilateral condition imposed by the SAT for a Singaporean tax resident to enjoy treaty benefits under the dividend article. It remains uncertain whether the Singaporean government would agree to such a holding period requirement.

The issuance of Circular 75 is an example of the PRC tax authority's commitment to achieve uniformity in tax treaty interpretation, application and administration. Despite certain deviations from the OECD Commentary, it nevertheless showcases a continuing effort by the SAT to improve the technical knowledge of local tax authorities and to mitigate variances in local interpretations and practices concerning the implementation of DTAs across the country. Given the stricter interpretation for treaty relief application on passive income, taxpayers should consult professional advisers about revisiting their equity holdings and exit strategies.

A strengthened treaty enforcement approach under Circular 601

On the administrative side, PRC tax authorities have also introduced procedural requirements under *Guoshuifa* [2009] No 124 (Circular 124) that a foreign investor seeking treaty protection needs to follow. In this regard, one of the specified documents to be submitted to the PRC tax authorities is a tax residency certificate issued by the tax authority from the foreign investor's country of residence. In addition, as mentioned above, the foreign investor needs to demonstrate that it has beneficial ownership over the China-sourced passive income per Circular 601.

Since the issuance of Circular 601 in 2009, the beneficial ownership test has attracted much attention in the PRC treaty field. Circular 601 mandates that a foreign investor must demonstrate commercial substance (commercial substance) to be considered a beneficial owner for PRC treaty purposes. This emphasis on commercial substance (for example, people, assets and operations) goes beyond the typical requirements under the OECD Commentary. An illustrative example would be the Anhui case (reported in March 2011) under which the Anhui State Tax Bureau denied a Barbados company withholding tax relief under the PRC-Barbados DTA on dividend income derived from its PRC joint venture (PRC JV). After reviewing the incorporation information for the Barbados company, the tax bureau determined that the Barbados company was an offshore limited liability entity under Barbados law and had no commercial presence in Barbados and ruled that the Barbados company was a conduit and not a beneficial owner of the dividend received from China.

Given the significant impact of Circular 601 on the availability of treaty benefits under existing structures for investment into China, and its consequences for future tax

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Chris is a member of the China tax sub-committee of the Hong Kong Institute of Certified Public Accountants and is an editor of the Asia-Pacific Journal of Taxation. He is also a regular speaker and writer on tax matters, and has published numerous articles on Chinese taxation in various journals.

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Chris holds a bachelor of laws degree from the University of Hong Kong. He is a certified tax adviser and a fellow member of the Taxation Institute of Hong Kong.

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Roger has extensive experience in representing foreign investment companies and China domestic companies in negotiating with the authorities on various issues and assisting in various tax disputes/tax audits.

Roger was the head of the China Centre of Excellence of KPMG US in New York in 2009 and 2010, and was responsible for designing China investment structures, China tax planning and advising on investment regulation and taxation issues for companies in North America. Before that, he worked in KPMG's Vancouver and Toronto offices for a period of time, advising on China regulations and taxation for Canadian investors.

Roger is a frequent speaker at events organised by KPMG and various professional organisations, banks and universities in North America and China.

planning, the investment community has been keen for the SAT to clarify the operation of Circular 601 in practice. After several rounds of consultation, the SAT issued Announcement [2012] No 30 (Announcement 30) on July 29 2012. While this has clarified important matters of application, some significant issues with Circular 601 still remain open.

For instance, it remains unclear whether a treaty applicant that does not have sufficient commercial substance in the local jurisdiction could qualify as a beneficial owner where commercial substance exists in group companies in the same jurisdiction, or in another jurisdiction that has a PRC DTA with equivalent treaty provisions. In this respect, Announcement 30 merely clarifies that where an "agent or designated payee" receives income, in an agency or nominee capacity for another party (the principal), then Chinese tax authorities should look at the principal in making the beneficial ownership assessment.

Consequently, some groups are now considering whether to get lower tier holding companies lacking in substance, to declare themselves to be holding the equity of a Chinese company in trust for a higher-tier parent holding company, where substance does exist. In the absence of a specific provision allowing the consideration of the parent holding company's substance, this is a potential alternative. However, it is uncertain whether the tax authorities would accept such an argument.

One positive development in Announcement 30 is that where an overseas listed company (Listed Parent), or its same-country subsidiaries, receives dividends from China, a safe harbour provision securing DTA relief on PRC dividend withholding tax is now available. If the recipient company is a resident in a DTA partner state and listed in that jurisdiction, it will automatically satisfy the beneficial ownership criteria without the need to prove that it does not fall foul of the Circular 601 criteria. However, for same-country subsidiaries of the Listed Parent looking to access the safe harbour relief, issues may arise if these are held via third-country intermediate holding companies that are subsidiaries of the Listed Parent or if the subsidiaries are tax residents in the Listed Parent's country but are incorporated elsewhere.

Another positive development in Announcement 30 from an administrative viewpoint is the requirement that any in-charge tax bureau, which rejects a DTA relief claims on the grounds of lacking beneficial ownership needs to report to and obtain approval from the provincial level tax authority in charge. This procedure may help reduce variations in the interpretation and application of Circular 601 by local tax bureaus. Provisions are also included to ensure greater consistency on tax treaty relief treatment where the same non-resident recipient derives similar types of passive incomes from multiple investments in different jurisdictions in China.

Circular 601 applied to capital gains relief

In practice, the Circular 601 criteria are also applied to capital gains even if the capital gains article under the DTA contains no reference to the beneficial ownership concept. Neither Chinese domestic law nor Circular 601 treats beneficial ownership as a criterion for seeking treaty relief under the capital gains article of a DTA. Even so, there are tax cases in which treaty relief for capital gains was denied due to a lack of commercial substance on the part of the treaty applicant. When making decisions in such cases, Chinese tax authorities pointed to the list of 'adverse factors' set out in Circular 601 as a reference.

For example, in a Shenzhen case reported in September 2011, a Hong Kong company (HK Co), a wholly owned subsidiary of a Cayman company (Cayman Co), transferred its entire 14% equity interest in a PRC company (PRC Co), which is listed on the Shenzhen SME Board.

The Shenzhen Tax Bureau applied the substance-over-form principle and found that the HK Co did not have commercial substance based on these grounds:

- HK Co's paid-up capital was not commensurate with the large returns from the PRC investments;
- HK Co's had no business operation in Hong Kong other than passively holding its equity investment in PRC Co; and
- HK Co lacked personnel in Hong Kong.

For these reasons, the Shenzhen Tax Bureau denied HK Co the capital gains tax relief under the PRC-Hong Kong DTA.

The theoretical basis for tax rulings of this nature has not been consistently explained to the public. It could be that Chinese tax authorities consider there to be an implicit beneficial ownership requirement in relation to capital gains relief, or that the China tax authorities are simply applying the GAAR in relation to perceived treaty shopping.

And if tax authorities are genuinely applying a beneficial ownership approach in assessing DTA capital gains relief claims, the question arises as to whether Announcement 30 is of relevance to such claims. In particular, it might be asked whether the nominee/agent look-through provision in Announcement 30 has implications for fund investors into China (for example, private-equity funds, hedge funds and mutual funds), or whether future tax circulars (such as the long-awaited QFII (Qualified Foreign Institutional Investor) tax circular) will take a different approach.

Regardless of the legal and regulatory rationale, we recommend that foreign investors looking to avail treaty relief on capital gains ensure that the treaty applicant has enough commercial substance according to the criterion in Circular 601.

Treaty shopping and GAAR based challenges

Another of our experiences is that Chinese authorities are increasingly challenging treaty-based claims using the substance over form doctrine. Multinational companies with PRC operations should examine their existing or proposed holding company structures for robustness and take remedial action where appropriate.

China did not explicitly introduce the concept of GAAR until 2008 when the new PRC Corporate Income Tax (CIT) Law came into effect. Since then, Chinese tax authorities have implemented several measures to limit the scope of treaty shopping and other perceived treaty abuse practices. Specifically, *Guoshuifa* [2009] No 2 states that abuse of treaties is to be regarded as one of the tax avoidance schemes to which the GAAR applies. This provision shows a clear willingness of the SAT to apply GAAR in the international tax and treaty context.

Recent DTAs that China has entered into with Hong Kong, Singapore, Malta and the UK have incorporated provisions on domestic GAAR legislation. As an example, Article 26 (Miscellaneous Rule) of the PRC-Singapore DTA provides that "nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to the Agreement".

And when interpreting Article 13(5) of the PRC-Singapore DTA on capital gains, Circular 75 refers to the GAAR principle under the Chinese domestic tax law. Specifically, the Chinese tax authorities could apply GAAR on any indirect offshore disposal of PRC companies, and impose PRC tax, based on *Guoshuihan* [2009] No 698 (Circular 698) issued in late 2009, if the offshore disposal is viewed as tax driven.

The extent of interaction between Circular 698 and the Chinese tax treaty network is unclear from the existing cases. For example, the capital gains article of the PRC-US DTA permits China to tax gains realised from the disposal of Chinese equity interests by a US transferor, if a US transferor owns at least 25% of the Chinese tax-resident enterprise.

For example, suppose that a US company disposes of a Hong Kong company, which owns a Chinese resident enterprise and China seeks to tax the US transferor under Circular 698. In this case, the US transferor could argue that the Hong Kong company is not a Chinese tax-resident enterprise, a term defined in the PRC-US DTA. Therefore, the US transferor could potentially take the position that the Chinese authorities are not allowed to tax the gains under the capital gains article of the PRC-US DTA, contrary to what Circular 698 would suggest.

Furthermore, if China does impose income tax pursuant to Circular 698, the residence country of the transferor may refuse to grant a foreign tax credit for the Chinese income tax. For example, the residence country may only give credit for Chinese income tax on gains 'arising' in China. Tax authorities in the residence country may argue that gains from an indirect transfer do not arise in China and any Chinese tax paid by the transferor under Circular 698 may be voluntary in nature. In fact, comments made by US Treasury officials in 2011 suggested that the Internal Revenue Service (IRS) could possibly take such an approach.

Clearly uncertainties exist in this area. Taxpayers should appeal to the SAT to further clarify its position, and work with competent authorities from other countries, possibly through Mutual Agreement Procedures, to limit double taxation and frictions that may arise.

Exchange of information clauses

China's campaign to fight cross-border tax fraud and evasion depends heavily on its ability to obtain information on non-resident enterprises' home jurisdictions. As a result, China is also accelerating the signing of tax information exchange agreements (TIEAs) with countries with no DTAs. In recent years, China has executed TIEAs with Argentina, Bahamas, Bermuda, Cayman Islands, Guernsey, Isle of Man, Jersey and the British Virgin Islands. These countries do not have DTAs with China and most of them are tax havens.

For existing DTA partner countries, China is making efforts to incorporate the latest version of the exchange of information articles into its DTAs. For instance, according to a recent release from the Indian Finance Ministry in February 2012, China is seeking to broaden the scope of the exchange of information article in its income tax treaty with India to fight cross-border tax avoidance and abuse.

Evolution of treaty policy

China's treaty network is likely to continue to evolve and to reflect the international tax development and economic realities. China is broadening its treaty network with countries in Africa and South America to further encourage outbound investment. There is also an increasing focus on the exchange of tax information and other articles enabling the invocation of the domestic GAAR, which may override treaty benefits where there is no genuine commercial purpose to a given transaction or structure.

To promote certainty in application and administration of Chinese treaty interpretation, the SAT has issued a supplemental circular on beneficial ownership to amplify Circular 601. The new circular provides a welcome safe harbour provision and an agency principle, but has left important issues such as look-through treatment unanswered. Taxpayers should appeal to the SAT to provide clarity on areas of ambiguity discussed in this article, such as how to apply the look-through treatment in the fund industry, and how to apply treaties in the context of indirect transfers.

Has the *Vodafone* decision in India made China change course?

Perhaps the most significant development in China's corporate income tax (CIT) arena in recent years is the country's adoption of general anti-avoidance rules (GAAR), advise Abe Zhao, Grace Xie and Jean Ngan Li. Their introduction indicates that China is taking firm action to rein in abusive tax planning behaviour that results in tax losses, and is bridging the gap with well-established international practices.

GAAR in China

The enactment of a general anti-avoidance rule (GAAR) in China is consistent with a worldwide trend by tax administrations to emphasise business purpose in recognising tax outcomes. A commercial arrangement must not have the elimination, reduction, or deferral of Chinese corporate income tax (CIT) as its main objective. Otherwise, the arrangement runs the risk of being re-characterised for Chinese CIT purposes, and the intended tax result may be denied.

The Chinese GAAR is loosely defined. It highlights the need for a business purpose, yet there is little explanation as to what a business purpose is. It is supported by several soft doctrines such as "substance over form" and "step transaction" whose meanings are equally ambiguous. The Chinese tax authorities intended to make the GAAR a legal theoretical platform upon which specific tax circulars are issued to address transactions that are identified to have tax-avoidance potential.

However, transactions that have not been specifically addressed are not off-limits under the GAAR. Therefore, a new tax idea that was not previously contested or prohibited by existing tax laws could now be challenged by the Chinese authorities, though the ingenuity of the idea may well go beyond the sophistication level of current tax laws. In effect, this wide reach of the GAAR has placed tremendous power in the hands of local Chinese tax authorities and creates significant limitations on businesses' ability to conduct effective tax planning in China.

GAAR and indirect transfer

Circular 698

One of the specific tax circulars issued under the auspice of the GAAR is *Guoshuihan* [2009] No 698 (circular 698) from the State Administration of Taxation (SAT) in 2009. Under this circular, if a foreign investor disposes of the ownership interest in a Chinese investee company by indirectly transferring the shares of an intermediate non-resident special purpose vehicle (SPV) that holds the ownership interest in the Chinese investee company, the foreign investor must submit a set of prescribed documents to the local PRC in-charge tax bureau to report the indirect transfer, unless a very narrowly defined safe harbour exception applies.

Upon examination of the submitted documents, if the local tax bureau decides that the interposition of the SPV in the offshore holding structure lacks a legitimate business purpose, it could disregard the existence of the SPV and re-characterise the indirect transfer as a direct transfer. Though this is not specified in circular 698, the tax authorities typically look at whether the SPV has sufficient physical substance in the local jurisdiction to assess whether its existence serves a business purpose.

It was speculated that the drafting and issuance of circular 698 may have been partly influenced by the Vodafone case in India. Highlights of the Vodafone case are reiterated below for comparison purposes.

Vodafone

In 2007, Vodafone International Holdings BV (Vodafone NL) indirectly acquired a controlling interest in Hutchison Essar Limited (HEL India), an Indian company, through the purchase of shares in a Cayman entity.

The Indian tax authorities disregarded the intermediate entities between the direct shareholder in HEL India and the ultimate selling foreign shareholder, and viewed this offshore transaction as taxable in the hands of the seller under Indian domestic laws.

Indian tax authorities then held that Vodafone NL, as the buyer, was obligated to withhold applicable Indian tax from payments made to the seller, and sought to recover taxes from Vodafone that would have been paid by the seller, along with interest and penalties.

Vodafone filed a writ petition in the Bombay High Court challenging, among other things, the jurisdiction of the tax authorities in the matter. In 2008, the Bombay High Court held that the tax authorities had made a *prima facie* case that the transaction was a transfer of capital assets situated in India. Vodafone then challenged the order of the Bombay High Court before the Supreme Court. By its order in January 2009, the Supreme Court directed the tax authorities to first determine the jurisdictional challenge raised by Vodafone.

In May 2010, the tax authorities held that they had jurisdiction to proceed against Vodafone for their failure to withhold. This decision of the tax authorities was challenged by Vodafone before the Bombay High Court, which dismissed Vodafone's petition in September 2010.

Vodafone thereafter filed a special leave petition before the Indian Supreme Court. In January 2012, that court reversed the decision of the Bombay High Court and ruled that the Indian tax authorities did not have territorial jurisdiction to tax the offshore transaction and Vodafone was not liable to withhold Indian taxes.

Vodafone's victory in court was short-lived. Though the Direct Taxes Code Bill, 2010 pending in the Indian Parliament contained proposals for taxing indirect transfers on a going forward basis, the Finance Act, 2012 passed by the Indian Parliament in May 2012 amended India's tax law and granted taxing rights over indirect transfers of Indian entities by non-residents to Indian tax authorities retroactively from 1962.

In practice, such cases can be re-opened for the last six years. In effect, this amendment overturns the verdict by the Indian Supreme Court in the *Vodafone* case. Vodafone has served the Indian government a notice challenging the retroactive tax amendment, so the Vodafone saga may continue.

Mindful of the concerns expressed over the retrospective changes, as well as about the scope and the extent of these amendments, the Indian government appointed an expert committee under the chairmanship of Parthasarathi Shome (a former adviser to the finance minister) to examine the applicability of these amendments.

In its draft report, the committee has recommended that the amendment should not be retrospective in its operation. It also made several recommendations dealing with the applicability of the amendment and the manner of determining the tax liability in cases of indirect transfers.

Comparative analysis

The main tax law provision that the Indian government relied on is section 9(1)(i) of the 1961 Income Tax Act, which prescribes that income accruing or arising directly or indirectly from the transfer of a capital asset situated in India is deemed to accrue or arise in India in the hands of a non-resident.

Section 9(1)(i) does not use the words look-through or indirect transfer so the focus of controversy is whether it can be interpreted expansively to authorise look-through treatment in indirect transfers. The Indian Supreme Court commented that look-through treatment is not provided in section 9(1)(i) literally and cannot be read into the tax law by mere interpretation.

Though Indian tax law does not have a GAAR section, the Supreme Court agreed that the government could invoke a judicial GAAR principle to pierce the corporate veil and look through the intermediate holding companies when a business purpose is lacking. However, the Supreme Court indicated that look-through treatment is appropriate only after the Indian government can establish that the holding structure is a sham or tax-avoidant. In doing so, the Indian Supreme Court stated that the Indian government needs to take a holistic approach and consider factors such as:

- the timing of establishing the holding structure;
- the duration of the holding structure;
- the period of business operations in India;
- the generation of taxable revenues in India; and
- the timing of the exit.

The Chinese legal and regulatory framework on the taxation of indirect transfers is more explicit. The GAAR is officially part of the 2008 CIT law and circular 698 unambiguously subjects indirect transfers to Chinese taxation if the holding structure lacks a reasonable business purpose.

As China does not have an advanced judicial system in the tax area, unlike India, there is no argument about whether existing statutory and regulatory authorities allow the taxation of indirect transfers in China.

The main area of debate in circular 698 is the meaning of an argument about whether existing statutory and regulatory authorities allow the taxation of indirect transfers in China. Doing so, for example, whether it has people and operations in the local jurisdiction, to assess business purpose.

A holding company without personnel and operating assets would probably be disregarded in an indirect transfer, though the holding company was interposed with various legal and business considerations. In contrast, the Indian Supreme Court recognises that investing in the host country through an intermediate holding structure is a common international practice and usually serves legitimate commercial purposes such as the facilitation of a future exit or the limitation of legal liability.

To apply look-through treatment, the onus is on Indian tax authorities to prove that the holding structure is an artificial device for tax evasion. Apparently, the interpretation of business purpose by the Indian Supreme Court is more lenient than Chinese tax authorities as the business purpose of the holding structure does not equate to a physical substance in the intermediate holding company.

The combined effect of the Indian Supreme Court verdict and the Indian 2012 Finance Bill on Chinese tax policy regarding circular 698 is probably neutral at present. In view of the judicial development in India, we discussed with the SAT the tax treatment of indirect transfers between China and India and inquired about the effect the verdict of the Indian Supreme Court may have on the enforcement of circular 698 in China. The feedback was that the implementation of circular 698 will follow its own path in China and is likely to not be influenced by foreign tax developments.

Since the Indian Supreme Court verdict, two major indirect transfer cases were reported by the Chinese media. In the first case, the tax authorities in Qidong, Jiangsu province disregarded an offshore intermediate holding company and collected RMB299 million ($47 million) of Chinese CIT and late interest from the overseas transferor. At the time of reporting, the Qidong case represented the largest collection of tax revenue from a single circular 698 audit.

The record lasted only a couple of months. In April 2012, a second circular 698 case was reported where the local tax authorities in Jincheng, Shanxi province (Shanxi Case) collected RMB403 million of Chinese CIT from a re-characterised indirect transfer.

New development

As the Indian Supreme Court pointed out in its *Vodafone* verdict, tax policy certainty is crucial for foreign taxpayers to make investment decisions, while a lack of certainty and transparency in a tax system tends to deter such investment.

Since the issuance of circular 698, the SAT has received numerous appeals from the business community on the importance of tax certainty. The emphasis of physical substance assessing business purpose potentially draws many indirect transfers into the Chinese tax net, though these intermediate holding structures serve legitimate commercial reasons and reflect common industry practices.

The fact that no basic threshold has been defined for the level of physical substance makes the business purpose determination highly subjective. Many multinational companies have to cope with the tough issues of whether to report indirect transfers and whether to record PRC tax provisions accordingly in financial statements.

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Serving both China inbound and outbound clients, Abe has extensive experience in:

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- Financing and intangible licensing/transfer arrangements;
- Repatriation and exit planning;
- The design and development of international tax efficient supply chains;
- Tax structuring for inbound and outbound private equity investment;
- Foreign tax credit computation and analysis;
- Transfer pricing controversy and documentation; and
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He is a frequent speaker at seminars and forums and regularly contributes to academic journals on tax subjects.

Abe received his bachelor of business degree from the People's University of China, a masters in economics from the University of Virginia, and a masters in accountancy from the University of Georgia. He is a licensed US certified public accountant (CPA), and has received certified management accountant (CMA) and certified financial manager (CFM) certifications from the Institute of Management Accountants.

The wide coverage of circular 698 and the strong focus on commercial substance in assessing business purpose may have increased the tax costs of multinational companies doing business in China.

To temper the potential negative impact of circular 698 on legitimate business transactions, the SAT plans to release an interpretative circular to carve out certain internal reorganisation transactions with no tax avoidance motives from look-through treatment. Early draft versions of the interpretative circular were issued for major accounting firms to comment on since August 2011, and it appears that the SAT is getting close to finalising the circular after multiple rounds of discussion and revision.

A recent version of the draft circular suggests that certain internal reorganisations may be deemed to have business purposes and be exempt from look-through treatment. Such exceptions may possibly be granted to indirect transfers where the transferor and the transferee are related parties in terms of equity ownership, or where the ultimate shareholders of the Chinese subsidiaries remain the same after the transaction. The transferor needs to submit specified documents to the Chinese tax bureau in charge to obtain approval. This draft circular, if finalised, could substantially alleviate the uncertainty described above and facilitate internal reorganisations by foreign investors.

When it comes to indirect transfers of Chinese subsidiaries, foreign transferors often struggle with the question of whether to report the transactions voluntarily to Chinese tax authorities in compliance with Circular 698. In the interim, the SAT has also been designing ways to promote reporting and penalise parties for non-compliance. For instance, the SAT is thinking about incentivising buyers to play a bigger role in indirect transfer reporting and tax collection. In the Shanxi Case mentioned earlier, when the local tax authorities initially could not get the offshore transferor to settle the Chinese tax levied, they requested the offshore buyer in the transaction to withhold the tax amount. This tactic successfully pressured the transferor to cooperate in the subsequent tax collection process.

And if an indirect transfer is taxable in China according to circular 698, but the tax assessment was not settled by the transferor, recent conversations with the SAT suggested that the tax burden may be passed on to the buyer through the preservation of historical PRC tax basis in the equity transferred.

For instance, if an indirect transfer is re-characterised as a direct transfer of Chinese equity interest under circular 698 and the selling price in the indirect transfer is more than the PRC tax basis of the Chinese equity interest deemed to be transferred, the lower PRC tax basis of the transferor will pass on to the buyer even though the buyer has paid a higher purchase price (unless the transferor has settled the PRC tax owed on the indirect transfer).

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Grace Xie started her career as a professional accountant in 1993 in Sydney, Australia. She joined KPMG Hong Kong in 1998 to specialise in PRC tax, and moved to KPMG Shanghai in 2001.

In her career as a tax consultant, she has advised multinational clients across a wide variety of industries, including the manufacturing, trading and service sectors. She advises clients on corporate and personal taxation, and business matters relating to the establishment of business entities in the PRC, the structuring of remuneration packages and ongoing operations. Grace also has extensive experience advising multinationals on restructuring and M&A activities in China.

Grace has assisted many foreign investors regarding their China transactions, tax due diligence and tax structuring. She has in-depth knowledge of the key tax risks and exposures for manufacturing companies in China.

When the buyer indirectly sells the Chinese equity interest later and the indirect transfer is subject to Chinese tax again under circular 698, the outstanding tax from the previous transferor is now passed onto the buyer because the PRC tax basis in the Chinese equity interest has not been stepped up to the purchase price for the buyer in the previous indirect transfer.

If such a measure is implemented, it is expected that buyers would be strongly incentivised to either withhold tax from the purchase proceeds or demand a guarantee in the transfer agreement that the transferor would settle any Chinese tax owed.

GAAR and M&A

Though the indirect transfer provisions of Circular 698 attract the most attention, an often neglected aspect of the circular is that most of its provisions address direct transfers, that is, a non-resident enterprise sells the equity interest that it directly holds in a Chinese subsidiary.

Gains realised by the non-resident transferor from direct transfers are normally subject to a 10% PRC withholding tax in the absence of treaty exemption. Article 9 of circular 698 states that if a direct transfer meets the requirements of special tax treatment under China's tax reorganisation regulations, PRC withholding tax may be deferred on the direct transfer.

China's tax reorganisation regulations consist of two main circulars, *Caishui* [2009] 59 (Circular 59) and SAT Announcement 2010-4.

Circular 59 was jointly issued by the Ministry of Finance (MOF) and the SAT and brought in the concepts of ordinary tax treatment and special tax treatment:

- Ordinary tax treatment is the default, under which gains realised are usually subject to immediate taxation; and
- Special tax treatment, which means complete or partial tax deferral on gains realised, is the exception and only transactions that meet specified requirements can enjoy it.

Generally, five types of corporate reorganisation may be eligible for special tax treatment, if the specific reorganisation transactions satisfy a set of general conditions, including the:

- "business purpose,"
- "continuity of interest,"
- "continuity of business enterprise,"
- "substantially all,"; and
- "qualified equity consideration" requirements.

From the PRC tax standpoint, a direct transfer under circular 698 is a cross-border transaction because the transferor is not a resident enterprise in China. However, the Chinese tax reorganisation rules are strict when granting special tax treatment to cross-border transactions. To qualify for special tax treatment, besides the general conditions enumerated above, the buyer also needs, for example, to be directly held and wholly owned by the transferor.

Cross-border asset reorganisations that result in direct transfers of Chinese equity interests are generally beyond the scope of special tax treatment. The SAT is aware of the restrictive nature of circular 59 in cross-border tax reorganisations, and the limited practical use of article 9 in circular 698. However, as circular 59 was jointly issued by the MOF and the SAT, any relaxation of it requires coordination between these two government branches and therefore, may potentially be time consuming. Based on recent conversations with the SAT, we understand that such an effort within the government has been initiated; however, it is hard to predict how long the process may take.

Learning from others

China has caught up with international practices and adopted some well-established tax principles. One such example is the GAAR legislation, which spawned the indirect transfer rules in circular 698. Under this circular, the SAT imposed expansive reporting requirements on taxpayers and adopted a draconian interpretation of business purpose for the use of intermediate holding companies in indirect transfers.

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Jean Li started her tax profession in Australia in 1997, and was seconded from the KPMG Sydney office to the Beijing office in 2001.

In the last 11 years in China, Jean has acquired significant experience in advising multinational clients on taxation and business regulations in respect of business activities in the PRC and cross-border transactions. She also has extensive experience in handling the anti-avoidance cases, including Circular 698 indirect transfer cases and transfer pricing audit defence cases. In addition, she assisted Danish clients to conclude bilateral advance pricing arrangements (APA) in 2010 and 2012, respectively, and also worked on the first APA case, which involved the Large Enterprise Division of the State Administration of Taxation in 2011.

The SAT is aware of the judicial development of the *Vodafone* case in India. However, there is no indication that the evolution of this case would relax the enforcement efforts of the indirect transfer rules in China.

The PRC tax authorities are continuously setting new tax collection records in auditing indirect transfer cases. On a brighter note, the SAT contemplates issuing a new supplemental circular that may provide relief from look-through treatment regarding certain internal reorganisation transactions.

On the direct transfer side, article 9 of circular 698 refers to China's M&A tax regulations to exempt withholding tax in certain cross-border reorganisations. However, this potential relief measure is seldom invoked in reality, because the existing M&A tax regulations exclude most cross-border reorganisation transactions from special tax treatment.

Businesses should continue to communicate with the MOF and SAT to lobby for broader and more taxpayer-friendly cross-border M&A tax rules. Through continued regulatory refinement, China has the potential to develop a sophisticated GAAR system that can effectively curb tax abusive behaviour and yet provide taxpayers with a more transparent and stable tax environment.

Uday Ved and Hariharan Gangadharan of KPMG India were advisers on this chapter.

Lures and challenges of Chinese tax rules for private equity

China has rapidly become one of the world's premier destinations for private equity (PE) investment and sources of PE fund raising. John Gu, Paul Ma and Darren Bowdern expound the opportunities and risks in Chinese tax rules for PE funds.

Investments by foreign private equity (PE) funds in China have been accelerated by economic difficulties in the West since the 2008 global financial crisis and by the European debt crisis.

In tandem with this increase in investment volume, there has been a steady evolution in the form of investment arrangements and domestic fundraising activities, with foreign PE investors increasingly shifting their focus from offshore funds, typically denominated in US dollars, to onshore RMB-denominated funds, whose establishment:

- allows foreign PE funds to tap into the deep pool of capital and liquidity in the Chinese domestic market;
- provides a more direct route for investing into or within China; and
- potentially mitigates the difficulties encountered by foreign PE funds.

Regardless of which approach is taken, both offshore and onshore PE funds face their own unique tax and regulatory challenges.

With the Chinese government enforcing stronger anti-tax avoidance rules, offshore PE fund structures are subject to increasing scrutiny by PRC tax authorities. Meanwhile, onshore PE fund structures are also constrained and frustrated to some degree by the developing nature of the relevant tax and regulatory framework in China.

Challenges for offshore PE funds

Offshore PE funds have historically been the most popular products promoted by PE fund sponsors, and they are supported by a large group of traditional PE investors such as endowments and pension funds. Such funds have achieved great success, not only in transforming many State and private Chinese companies into successful public companies, but also in generating great investment returns for investors.

Offshore PE fund structures typically consist of a single or multiple tiers of special purpose vehicles (SPV) to hold Chinese investments. An offshore holding structure also offers greater flexibility and tax efficiency for strategising exit options. These typically include an:

- offshore indirect exit through the sale of the SPV;
- offshore direct exit through which the Chinese entity is sold directly by the SPV; and
- onshore exit by way of a direct disposal of the onshore business or assets.

Foreign PE funds generally do not prefer a direct onshore exit through a sale of business assets or direct sale of PRC companies. Besides facing uncertainty in regulatory approval procedures, the divestment at this level would attract higher corporate income tax (CIT) charges on gains of the sale of assets as well as various transactional/indirect taxes ,which in aggregate, can be significant (especially for real property investments). Furthermore, such divestments would also create complex capital and income repatriation issues for foreign funds, from the PRC foreign exchange perspective.

Comparatively, the first exit option is the most effective from tax leakage and cash repatriation standpoints compared with the second and third options. However, because of changes in tax rules noted below, the first option now faces its own unique Chinese tax challenges, which foreign PE funds must consider.

Offshore indirect exit – the challenge of circular 698 and its enforcement

Before the release of *Guoshuihan* [2009] No 698 (circular 698) by the State Administration of Taxation (SAT) in December 2009, the common practice among foreign PE funds was to exit through the disposal of an offshore SPV that held the Chinese equity interest by the next offshore SPV up the chain (known as the indirect transfer or exit).

This exit route enabled foreign PE funds to effectively achieve a tax-free exit because the resulting capital gain was considered to be foreign source income derived by a non-resident and hence outside the scope of Chinese income tax.

The issuance of circular 698 introduced reporting requirements and anti-tax avoidance measures aimed at countering offshore disposals that the SAT regards as abuse of legal organisation form in many cases. This has undermined and even put a stop to the historically preferred indirect exit option.

Under circular 698, where the offshore indirect exit is viewed by the SAT as lacking reasonable business purpose and constituting an "abuse of organisational form", the SAT is empowered to invoke the general anti-avoidance rules (GAAR) under the CIT Law to treat the transaction as a direct sale of the equity interests in Chinese companies, imposing a 10% withholding tax on the gains. It should be noted that the voluntary reporting done under circular 698 requirement does not automatically trigger Chinese CIT on the offshore indirect exit of PRC companies. Chinese CIT would only be imposed if the GAAR is invoked.

It is evident that the Chinese tax authorities have increasingly applied the GAAR as a weapon of choice in combating perceived tax abuses. In the last couple of years, a series of high-profile circular 698 enforcement cases, involving well-known PE investors and listed companies in cities or provinces such as Jiangsu, Henan, Shantou, Guizhou, Qizhong and Jincheng, were made public. A significant amount of Chinese CIT was imposed and collected in each of these cases.

The most challenging aspect in dealing with circular 698 for a foreign PE fund is the way in which the Chinese tax authorities apply the "reasonable business" test, the critical criterion in deciding whether or not the GAAR should be triggered. In this regard, tax authorities are adopting a rather narrow one-dimensional approach in assessing whether abuse of organisational form existed and whether the offshore structure was established for reasonable business purposes.

Specifically, the Chinese tax authorities have put a predominant emphasis on the economic substance level of the offshore SPV structure, such as the number of employees, the physical business premises, the scale of operation, the amount of business assets and the level of capitalisation with respect to the offshore SPVs.

Unlike some other foreign jurisdictions, the business rationale surrounding the offshore structure is given a back seat or less consideration in the assessment process. The circular 698 assessment approach has inevitably created difficulties for offshore PE funds as they typically do not require substantive operational presence in the offshore SPVs.

Additional difficulties faced by foreign PE funds in strategising exit options stem from the many uncertainties with circular 698 compliance and enforcement. For example, when a buyer acquires the shares in an offshore holding company that holds Chinese equity interests directly or indirectly and if the vendor is liable to Chinese tax under circular 698 but refuses to pay, it is unclear what Chinese tax exposure the buyer may have. If the GAAR is applied to the transaction under circular 698, technically speaking, any Chinese CIT should be imposed on the vendor.

However, there have been cases in which PRC tax authorities have sought to collect withholding tax (WHT) from the

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John has bachelor of business and master of finance degrees. He is also a member of the Institute of Chartered Accountants in Australia and a member of the Hong Kong Institute of Certified Public Accountants.

target or from the purchaser. For example, in the Shanxi Jincheng case, the buyer was reportedly instructed by Chinese tax authorities to withhold tax from the purchase consideration.

And the purchaser may run the risk that Chinese tax authorities revise down its PRC tax basis in the shares of the offshore holding company acquired so that the Chinese CIT unpaid by the vendor in the transfer under Circular 698 can be recouped from the purchaser when the purchaser disposes the shares again in the future.

Recent intelligence suggests that the SAT may move to specifically provide for this measure in a new tax circular. Specifically, if the offshore seller in the indirect transfer did not report the transaction and settle any PRC CIT under circular 698, the tax basis used by the purchaser to calculate gains from a future indirect transfer would be limited to its share of the registered capital of the underlying Chinese entity that is being indirectly transferred.

However, if the offshore seller in the indirect transfer complied with circular 698 and settled any PRC CIT that is imposed, the acquisition consideration paid by the purchaser may serve as the tax basis in a future indirect transfer.

Such regulatory changes, if adopted, would affect the way PE funds value offshore indirect acquisitions and offshore indirect exits, due to the potential loss of PRC tax basis for future indirect transfers.

Other uncertainties of circular 698 awaiting guidance from the Chinese tax authorities include:

- the tax computation methodology;
- the interaction of the circular with China's tax treaties network (particularly regarding the availability of foreign tax credits); and
- the impact of the Chinese corporate reorganisation rules under the CIT Law.

It is understood that the Chinese tax authorities may consider granting relief on circular 698 reporting and tax imposition for qualifying internal reorganisations.

It is also worth noting that Chinese tax risks may exist for the disposal of shares in foreign incorporated companies in the absence of circular 698.

This risk was highlighted in a 2010 case involving Vodafone's disposal of shares in China Mobile Ltd, which was a Hong Kong incorporated company, but was treated as a Chinese tax resident enterprise (TRE) because its place of effective management was in China. The gains derived by Vodafone from the share disposal were deemed to be China-sourced income due to the TRE status of China Mobile Ltd, and as a result, were subject to Chinese CIT.

Recently, the SAT has heightened scrutiny of the TRE status of foreign-incorporated enterprises with significant management functions performed in China. Offshore PE funds need to take extra care to control the associated Chinese tax risk.

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- Performing tax due diligence on a wide range of industries including real estate, telecommunications, energy and resources, consumer markets, e-commerce and financial services
- Advising on onshore and offshore fund structuring and formation
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Paul previously worked at Morgan Stanley in both New York and Hong Kong as an in-house tax counsel. He also worked at Ernst & Young New York as a US tax specialist.

Paul has a masters of accounting degree from the University of North Carolina at Chapel Hill, a masters in economics degree from Kent State University and a bachelor in economics degree from Nankai University. He is a member of the American Institute of Certified Public Accountants (AICPA).

Offshore direct exit – uncertainty and challenges for tax treaty relief

Under Chinese CIT Law, capital gains on the disposal of Chinese equity interest by a foreign shareholder is China-sourced income and subject to CIT at 10%.

When setting up an offshore holding structure, PE funds often use an intermediate holding company in an appropriate tax treaty jurisdiction to mitigate this exposure. Certain Chinese treaties (for example, those with Hong Kong, Singapore and Mauritius) provide Chinese CIT relief on the capital gains if certain shareholding conditions are met and that the Chinese target company is not land-rich.

However, since 2008, the SAT has introduced a series of measures to limit the scope of treaty shopping and other perceived treaty abuse practices. It is now a requirement for foreign investors to apply for approval from Chinese tax authorities following the procedures in circular 124 before they can enjoy treaty benefits on certain China-sourced passive income categories.

In circular 601, the SAT sets out seven adverse factors that will be used in assessing whether a foreign investor is a beneficial owner of the dividend, interest and royalty income originating from China. A foreign investor that is not a beneficial owner will not be able to access the relevant PRC treaties for these income types.

A concern for offshore PE funds is whether the beneficial ownership requirement, which is not a specific criterion under the capital gains tax article of Chinese treaties or under any domestic tax law, should apply to treaty relief claims on capital gains. Despite the lack of explicit guidance at the national level, there have been reported cases where the SAT has cited a lack of commercial substance (which is vital in assessing beneficial ownership specified by the SAT in circular 601) at the level of the tax treaty relief claimant and denied the capital gains tax relief.

Since it is often difficult for offshore PE funds to establish the required commercial substance at an offshore intermediate holding company, these cases have no doubt added another layer of uncertainties and challenges for offshore PE funds looking to invest in China.

With these changes, offshore PE funds face greater challenges when managing PRC tax leakages in their offshore fund structures. Though it is common for PE funds to use offshore SPVs with little business substance, Chinese tax authorities apparently do not take this characteristic of the PE industry into consideration and are more indulgent in administering the commercial substance test. This may reduce the incentives for offshore PE funds to invest in Chinese portfolio companies, and deprive Chinese companies of global PE capital and expertise, which could help grow their businesses on the world stage.

It is hoped that with continuous industry lobbying, the SAT will take a more business-friendly approach and provide more clarity and greater relief to offshore intermediate holding companies of PE funds seeking Chinese tax treaty benefits on capital gains.

The challenges for onshore Rmb-denominated funds

Closer to home, China's sustained economic growth, the continuous wealth accumulation by private entrepreneurs and public companies, and the gradual relaxation of rules for foreign direct participation in the domestic PE fund industry, have attracted many foreign fund sponsors and investors to consider setting up Rmb funds.

The advantages of Rmb funds are apparent. First, Rmb funds raise capital directly from local investors, including Chinese institutional investors, social security funds, government funds of funds and high-net-worth individuals. Second, compared with offshore funds, Rmb funds possess relative flexibility and agility when making domestic investments as they are generally not subject to cumbersome foreign investment approvals and foreign-exchange control measures.

Foreign investors' participation in Rmb funds was further boosted in March 2010, when the Chinese government introduced measures that permit the establishment of wholly-owned foreign invested partnerships (FIPs) or Sino-Foreign FIPs. More importantly, the measures officially permit foreign investors to invest in the form of a limited partnership.

Municipal governments in several cities such as Shanghai, Tianjin and Beijing, have subsequently introduced Qualified Foreign Limited Partner (QFLP) programmes that encourage the establishment of FIPs (including limited partnerships) for equity investment purposes.

The challenging aspect for many offshore PE fund sponsors in RMB funds is that the prevailing Chinese CIT regime is unclear on many aspects of the taxation of Chinese partnerships (including FIPs).

The fundamental tax principle is that a Chinese partnership is not a taxable person for CIT purposes. Circular 159 confirms that a Chinese partnership should be treated as a "pass-through" entity for CIT purposes, and that a partnership's Chinese resident partners are subject to CIT or individual

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Darren has a bachelor of commerce degree from the University of Melbourne and is a fellow of the Hong Kong Institute of Certified Public Accountants and a member of the Institute of Chartered Accountants in Australia.

income tax (IIT), as appropriate, on their respective shares of profits. However, circular 159 does not address many other tax issues relevant to the foreign partners of a FIP, which are listed as follows:

Whether permanent establishment is deemed for all foreign partners

The first area of uncertainty is whether a foreign partner in a FIP would be subject to CIT as if it has a permanent establishment in China on its allocable share of the FIP's income. If the answer is yes, a full 25% CIT rather than a 10% WHT will apply on the foreign partner's allocable share of profits in the FIP. This issue will be particularly relevant when a foreign partner generates gains on the disposal of a Chinese equity investment through an FIP.

A draft of the partnership tax implementation rules suggests that the SAT may be leaning towards taxing all foreign partners in an FIP on a full assessment basis at 25% CIT as if they have a permanent establishment in China, without considering the foreign partners' levels of participation in the FIP's business (for example, limited partner vs general partner).

If this position is retained when the partnership tax implementation rules are released, foreign fund investors participating in Rmb funds (either as a limited or a general partner) will face higher tax charges and will need to re-assess the costs and advantages of pursuing this partnership model for investing into China.

It appears that local tax authorities in a limited number of locations have already started adopting the full 25% CIT assessment method for taxing foreign partners in a domestic partnership. Such treatment could also potentially be applied to the taxation of a general partner's carried interest in a Rmb fund, so that the 25% CIT rate may apply. In that case, careful carried interest planning in the fund management structure would be necessary.

Whether the interest expense of a foreign partner is deductible for CIT purposes

Assuming that a foreign corporate partner incurs interest expenses that are attributable to the FIP (for example, interest on loans used to finance equity injections into the FIP) and that there is a treaty between China and the country of the foreign corporate partner with a business profits article that is broadly in line with the OECD Model, it would seem that the interest expenses should, in principle, be deductible in China.

It could be argued simultaneously that the interest incomes for the creditors are non-Chinese sourced and therefore are not subject to Chinese interest withholding tax and Business Tax (BT). In practice, however, chances are that the Chinese tax authorities will accept the deductibility of interest expense for Chinese CIT purposes only if the interest incomes for the creditors are subject to Chinese interest withholding tax and BT. Again, the official tax treatment remains unclear.

Other areas of tax uncertainties

Other areas of ambiguity in the RMB fund area include whether the Chinese tax authorities will grant flow-through treatment on the FIP's income in character, and whether a foreign investor in the FIP can claim benefits under an income tax treaty between its residence jurisdiction and China. The use of partnership tax losses and the stamp duty treatment of capital contributions to partnerships are also areas that require official clarification.

In the context of onshore PE investment, media reports indicate that the SAT may consider introducing a profits tax or CIT on unrealised floating gains booked by either the existing shareholders of a company upon introducing a PE investor, or an existing PE investor upon listing the portfolio companies in an initial public offering (IPO), though no disposal has taken place and there is no clear basis allowing such tax to be levied against unrealised gains. The applicable tax rate is rumoured to be between 35% and 40% on the built-in appreciation, for example, the difference between the price paid by the existing shareholders for the initial investment and the price paid by an incoming PE investor, or the difference between the price paid by an existing PE investor and the actual IPO price. Such a tax on floating unrealised gains, if indeed being introduced, would certainly be controversial and seriously dampen the investment returns of PE funds in China.

Looking ahead

It is expected that fund raising and investment by both offshore and onshore PE funds in China will continue to increase. Meanwhile, the relevant PRC laws, regulations and tax policies will keep evolving.

The Chinese tax regime (particularly circular 698 and the partnership taxation rules) create significant complexities and difficulties for PE fund investors in selecting the optimal fund or deal structures. PE funds should develop a good grasp of the new rules and enforcement practices to mitigate adverse PRC tax results and maximise the bottom lines. Professional tax advisers should be involved to help PE investors navigate through the uncertain and fast-changing tax landscape in China.

Firmer stance on transfer pricing enforcement

Chi Cheng, Irene Yan and Kelly Liao observe that some of the local tax jurisdictions within China where subsidiaries of foreign multinationals are concentrated, have seen their tax collections in 2012 drop by as much as 30%. Given this overall deterioration of the economic environment, will China continue to press ahead with its aggressive transfer pricing agenda?

With 25 years of transfer pricing enforcement experience, Chinese tax authorities are at a crossroads in charting the course of transfer pricing administration for 2012 and beyond. Having witnessed exponential growth in tax collections associated with transfer pricing over the past few years, Chinese tax authorities are facing increased challenges as the country's economic growth slows amidst a global economic downturn.

One major issue that Chinese tax authorities need to address at this juncture is whether they should shift the focus of their transfer pricing administration.

After years of practice, Chinese tax authorities are entering into a stage of maturity and have tested many of their approaches and agendas. Given the Chinese government's reputation for seeking new breakthroughs and accomplishments, has the time come again for Chinese tax authorities to reorient themselves and further enhance transfer pricing administration?

Answers to the above are influenced by an important factor – by and large, Chinese tax authorities are short of resources for transfer pricing enforcement. Officially, around 200 transfer pricing specialists are deployed in tax bureaus around the country. Among this number are six at the national headquarters level, the State Administration of Tax (SAT). In reality, not all of these 200 officials can devote themselves to transfer pricing on a full-time basis.

State of play – *ex ante* tax avoidance prevention dominates the transfer pricing agenda

Since late 2010, Chinese tax authorities have been emphasising their "three-dimension anti-tax avoidance system" in regulating transfer pricing issues, which comprises three elements, that is, Administration, Service and Investigation.

Investigation or tax audit is historically the focus of transfer pricing administration for Chinese tax authorities. Service primarily refers to accommodating taxpayers' requests for advance pricing arrangements (APAs) and mutual agreement procedure (MAP).

APAs gained popularity in China as taxpayers want prior certainty for their transfer pricing arrangements. APAs can also be used to resolve past transfer pricing issues and disputes. Under the roll-back mechanism of an APA, transfer pricing policies agreed upon between a taxpayer and the Chinese tax authority can be retroactively applied to the years before the period covered by the APA, if the facts and circumstances of the prior transactions are similar, if not identical, to the situations in the APA.

MAP focuses on resolving cross-border tax issues between China and a foreign jurisdiction with which China has an income tax treaty. Conclusions drawn in the MAP could potentially provide guidance to taxpayers and tax authorities in similar transactions in the future.

Administration, which tops the list of the three elements, was identified by the SAT as one of its missions in 2010, though the concept was not explicitly defined. While the term can have a wide array of interpretations, in the minds of Chinese tax authorities, the concept centres around the daily monitoring of taxpayers' transfer pricing arrangements and taking any preemptive measures to correct problems identified within the tax year. This boils down to closely examining a taxpayer's financial performance, its filings on related-party transactions lodged with the corporate income tax (CIT) return and its contemporaneous transfer pricing documentation, among others.

The core of the administration element is to remind taxpayers to voluntarily stay away from transfer pricing-related tax avoidance schemes by putting taxpayers constantly on alert and to prompt self-examination and self-adjustments to identify transfer pricing irregularities.

One of the local tax authorities in China even issued a circular to openly advocate self-adjustment by taxpayers to increase tax revenue to "meet the arm's-length standard". In some regions, a large number of loss-making companies were asked to make upward self-adjustments to their taxable income before their annual tax filings.

The administration element has become the most significant incremental tax revenue contributor since 2011. The latest statistics show that the Chinese authorities' anti-tax avoidance efforts increased tax revenue by Rmb23.9 billion in 2011, of which about Rmb20.8 billion ($3.3 billion) came from administration, Rmb0.7 billion from service and Rmb2.4 billion from investigation . In particular, the additional tax revenue collected under the administration bucket in 2011 is up by 190% compared to 2010.

As part of the administration efforts, Chinese tax authorities treated transfer pricing documentation administration with the utmost priority, and urged local tax authorities to conduct more detailed reviews of transfer pricing documentation and related-party transaction filings submitted by taxpayers. This is evidenced by the fact that local tax authorities are demanding a greater number of companies to submit transfer pricing documentation reports for inspection. For example, all companies in Shanghai that meet the criterion for transfer pricing documentation preparation are required to submit their transfer pricing documentation to the in-charge tax bureaus.

We understand that the SAT is concerned about the level of taxpayer compliance with transfer pricing documentation requirements and is demanding higher qualitydocumentation in the future. Poor quality transfer pricing documentation is more likely to draw the tax authorities' attention. It would make a push for taxpayers to conduct self-examination and self-adjustment more likely and can even trigger a full-blown transfer pricing audit.

Self-adjustment by a taxpayer is generally outside the scope of a corresponding adjustment and other remedial measures. In other words, a unilateral increase in taxable income by the taxpayer does not necessarily lead to a reduction of taxable income for its counter-party in a related-party transaction (RPT). Therefore, self-adjustment could lead to double taxation and increase the overall tax burden of the corporate group. Furthermore, a self-adjustment does not prevent tax authorities from conducting formal transfer pricing audits either.

The focus on administration and self-adjustment allows Chinese tax authorities to alleviate resource shortages. Compared to a transfer pricing audit, self-adjustment requires less time and effort on the part of the tax authorities. Tax officials not specialising in transfer pricing can carry out

Biography

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Chi started his transfer pricing career in Europe with another leading accounting firm, covering many of Europe's major jurisdictions while based in Amsterdam, before returning to China in 2004.

In addition to lecturing at many national and local training events organised by the Chinese tax authorities, Chi has provided technical advice on a number of recent transfer pricing legislative initiatives in China. A frequent speaker on transfer pricing and other matters, his analyses are regularly featured in tax and transfer pricing publications globally. Chi has been recommended as a leading transfer pricing adviser in China by the Legal Media Group.

He holds a masters degree from Maastricht University in international business studies. He is also a chartered controller in Belgium.

most of the supervision work of self-examination. Furthermore, the focus on administration allows China to continuously push through its tough transfer pricing enforcement agenda, while the informal nature of the concept also leaves some flexibility for the tax authorities to adjust their approach and degree of aggression as they see fit.

Ex post transfer pricing audit as the last resort

While China is shifting its focus to more proactive transfer pricing management, audit continues to play an important role in transfer pricing enforcement. In recent years, the SAT:

- adopted the approach of quality over quantity in selecting transfer pricing audit targets; and
- directed resources to cases with a large volume of RPTs and significant tax adjustments.

This trend is corroborated by the steady increase of tax revenue collected from transfer pricing investigations, from Rmb460 million in 2005 to more than Rmb2.4 billion in 2011.

And the SAT has renewed its campaigns on group, regional and industry-level joint transfer pricing audits, targeting companies in industries such as automobile, financial services, distribution and pharmaceuticals. This industry-specific approach has contributed to the increase in profit levels across the targeted industries. It is reported that the SAT has selected retail, real estate and shipping by as their 2012 targets.

While self-examination may target a large cross-section of taxpayers of different sizes, the SAT has vowed to focus its audit efforts on large taxpayers and aim at significant revenue recovery from each case.

Recently, the SAT embraced a by region, by industry" audit approach. Specifically, the SAT will analyse the main industries in different regions and identify the industries where most transfer pricing-related adjustments are expected to arise upon audit. The SAT will then designate such industries as transfer pricing audit targets for local tax authorities from different regions. Knowledge and experiences gained by region and by industry will be shared within the tax bureau system throughout the country.

After years of extensive transfer pricing investigation of traditional tangible goods buy-sell transactions, the Chinese tax authorities have also broadened their target transactions to include intercompany equity transfer, intangibles licensing, and financing transactions. The SAT has recently announced the conclusion of a thin capitalisation in Shanxi province.

And the tax authorities seek to apply more sophisticated transfer pricing methodologies than before. In our daily practice, we have noticed a trend that government auditors have been using more quantitative methods in recent transfer pricing investigations.

Biography

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Irene Yan is a partner in KPMG China's global transfer pricing services group and is responsible for the Northern China region. She joined KPMG in Beijing in 1993. With more than 19 years experience with KPMG, she has a broad knowledge of PRC taxation, particularly corporate income tax, indirect tax and individual income tax.

Irene has conducted research and has been actively involved in the PRC inter-company transfer pricing practice since the late 1990s. She has extensive experience in operational transfer pricing, business model tax optimisation, contemporaneous transfer pricing documentation, transfer pricing due diligence and risk assessment, controversy resolution, unilateral advance pricing arrangements (APA) and bilateral APAs.

Her rich experience covers industrial markets, the information, communication and entertainment markets, consumer markets, property and infrastructure, energy and resources, and financial institutions. Her clients include a number of multinational enterprises with investments in China as well as large domestic enterprises with overseas investments covering diverse industries.

The APA and MAP space

China has one of the world's most active APA programmes and has launched many bilateral competent authority proceedings. It has signed close to 70 APAs since 2005. More than 40 agreements were unilateral APAs and the remaining were bilateral.

While far more unilateral APAs than bilateral APAs were concluded, most of the unilateral APAs were signed several years ago and therefore have expired already. The number of bilateral APAs signed each year has been increasing while the number of unilateral APAs signed every year has been decreasing. The number of bilateral APAs signed was more than that of unilateral APAs in 2009 for the first time. Today, bilateral APAs are the predominant component of China's APA programme.

Though not officially announced, the SAT's view is that a transfer pricing arrangement agreed upon in an APA may serve as a precedent for other taxpayers that operate in the same industry or conduct similar transactions. Therefore, the

SAT pays extra attention to consistency and ensures that the level of margins concluded in an APA does not set a negative example for future transactions. This level of caution from the SAT in APA negotiations, coupled with the shortage of transfer pricing resources within the Chinese tax authorities, has led to significant delay in and processing time for concluding an APA.

Due to limited APA resources, theChinese tax authorities increasingly focus on APA cases that have broader and more profound implications for their overall transfer pricing enforcement agenda when selecting which APA applications to accept.

If a taxpayer is in one of the focused industries, the SAT deploys novel transfer pricing methodologies, and its transactions entail a complex set of transfer pricing issues, these factors increase the likelihood of the taxpayer's APA application being accepted and processed.

The Chinese competent authory faces similar resource shortages. However, the SAT regards accepting a MAP as its legal obligation. This MAP process, while less publicised and hence less known to taxpayers, can be an effective tool to mitigate the impact of a contentious audit in China. The Chinese authorities have a relatively high success rate of concluding MAP agreements, which can provide taxpayers with longer-term certainty and double tax relief.

We do not expect China to drastically alter its course of offering APA and MAP as a service to taxpayers. Though the SAT will probably increase its transfer pricing resource base from six to 14 people in 2012, compared to other countries, the number of transfer pricing specialists available is far from adequate to handle many APA cases. With other tasks on the SAT, APAs will remain available to a relatively small number of taxpayers in the foreseeable future.

Branching out to a new transfer pricing issue – equity transfer among related parties

Multinationals frequently engage in reorganisations that may require equity transfers among related parties. In the past, many taxpayers carried out the transfers at book value or nominal value, and at best, only performed a rough valuation to support the transfer price. Understated transaction prices on equity transfers often led to underpayment of Chinese CIT.

Chinese transfer pricing regulations explicitly cover four categories of RPTs, that is:

- tangible property sales;
- intangible property transfers;
- rendering of services; and
- financing transactions.

The SAT noticed that a lack of regulation of intercompany equity transfers resulted in potentially significant losses of PRC tax revenues and is looking to include equity transfer as the fifth category of RPTs that are subject to the arm's-length standard.

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Kelly started specialising in transfer pricing in 2004. She has been actively assisting multinational companies in transfer pricing dispute resolution, tax efficient supply chain planning, rationalising transfer pricing policies, formulating cost recharging policies and applying for APAs in China.

Kelly's clients include a number of multinational and domestic enterprises across wide range of industries, including chemical, electric and electronics, pharmacy, machinery, consumer goods, retail, and property and infrastructure.

However, the prevailing Chinese transfer pricing regulations do not readily provide guidance as to how to apply the arm's-length standard for equity transfers between related parties.

The SAT indicates that it welcomes internationally accepted methodologies to value equity, such as the income approach, the market approach and the net asset approach. There were discussions on the use of the replacement cost approach, though based on our communications with the SAT, the predominant preference is on the income approach.

Recently, the Chinese tax authorities have audited a few high profile equity interest transfer cases by. These audits all led to additional tax collections.

The application of the income method is also becoming a prominent discussion topic for the annual transfer pricing/anti-avoidance national training session that the SAT conducts for PRC tax officials.

The SAT is expected to release an important circular in the near future that prescribes contemporaneous documentation requirements for intercompany equity transfers. This will impose a reporting obligation on taxpayers involved in an intra-group equity transfer. An analysis of the arm's-length nature of related-party equity transfer transactions will probably be part of the documentation. The circular will specify several allowable valuation methods and taxpayers may be required to use more than one method to corroborate the final valuation result.

Centralised management will continue

Since 2004, the SAT has been taking steps to centralise the management of transfer pricing administration, which was previously handled by local tax authorities at various levels in China.

A unified reporting mechanism for all transfer pricing audit cases was established in 2005. This marked a big step in the SAT's centralisation effort. Under this mechanism, all transfer pricing audit cases must be reported to the SAT at the time they are initiated by local tax authorities. Furthermore, all such cases must go through final review and approval by the SAT before the local tax authorities can close them. This trend of centralisation has continued. Recently, the SAT added a process to enhance the centralised reporting system for unilateral APAs, which in the past were more in the hands of the local tax bureaus.

In March 2012, the SAT issued an internal circular titled "Joint Review Rules for Significant Special Tax Adjustment Cases (Provisional)" and officially established an expert joint-review programme at the national level.

The circular aims to standardise transfer pricing investigations by local tax bureaus and improve the quality of significant cases through the involvement of an expert panel.

The national panel, which consists of five experts randomly selected from a specialist pool, will analyse and discuss transfer pricing cases passed up by local tax bureaus before they are reported to the SAT for a final review.

The establishment of the expert joint-review programme shows that the SAT, with its resource constraints at the central level, is looking to leverage certain local specialist resources and maintain central management at the same time. The SAT has also been urging provincial and municipal level tax bureaus to establish their own expert joint-review programmes to enhance the quality of transfer pricing audits.

In addition to the expert joint-review mechanism, the SAT is also considering the establishment of a number of anti-avoidance centres in key cities in China. This is another measure to ensure experience sharing and working efficiency among tax authorities. The anti-avoidance centres will not only support transfer pricing administration in their own jurisdictions, but will also provide support to other tax bureaus in neighbouring jurisdictions.

Development of a transfer pricing risk index system

A top item on the SAT's transfer pricing agenda is to develop a risk index system. Such a system would help the SAT identify companies suspected of transfer pricing violations and select them as targets for investigation.

It is likely that the development of the index system will be based on an internal database of the SAT, which hasunder development in recent years and contains information from taxpayers' RPT filings since 2008 as well as other potentially useful data. In the past, the SAT frequently used this database to cross-reference and cross-examine comparable companies in benchmarking analyses.

The risk index system will help Chinese tax authorities to follow the industry-focused approach and identify industries, corporate groups, and individual companies with low profit margins. Chinese tax authorities can also use the index system to conduct comparative analyses of RPTs by industry, year, and region.

The tax authorities are also undertaking studies on industry-specific tax-avoidance schemes to intensify anti-tax avoidance enforcement within different industries.

The risk index system will also be used to select transfer pricing self-examination targets and audit targets systematically. Besides, this database and the associated data mining software will offer Chinese tax authorities a huge reservoir of secret comparable data, which may further increase the challenges for taxpayers in transfer pricing investigations.

Looking ahead

Chinese tax authorities are pressing ahead with their aggressive transfer pricing enforcement agenda as they wrestle with resource constraints in an uncertain economic environment. Many of the predictions/speculations we made in the first edition have ensued.

In 2012, the SAT's focus is to further formalise detailed work processes in areas such as:

- controlled foreign corporation administration;
- general anti-avoidance administration; and
- counter-measures against taxpayer practices of utilising tax haven jurisdictions.

Tax bureaus will continue to review RPT filings and contemporaneous documentation strictly to ensure that industry-wide, region-wide, and group-wide audits have sound theoretical foundations. Finally, the SAT will continue bilateral negotiations with tax authorities of other countries under the APA and MAP programmes.

While broadening its transfer pricing/anti-avoidance agenda and branching into new technical areas such as related-party share transfer, the SAT is also taking actions to improve efficiency and consistency in transfer pricing administration. The risk indexing system, the expert joint-review panel, the anti-avoidance centres and the "by industry, by region" approach are a few key initiatives that if implemented successfully, will take the Chinese transfer pricing enforcement to new heights.

VAT reform – into the future

On January 1 2012, the Chinese government took a giant step forward in its plan to replace the dual system of indirect taxes in China, being Business Tax (BT) and Value Added Tax (VAT), with a single VAT across both the goods and services sectors. Lachlan Wolfers, John Wang and Shirley Shen envision how the process that started with the commencement of a pilot scheme in Shanghai will progressively expand across China.

The VAT pilot programme applies in Shanghai (from January 1 2012), Beijing (from September 1 2012), Jiangsu and Anhui provinces (from October 1 2012) and Fujian and Guangdong provinces (from November 1 2012).

The pilot programme will be expanded to Tianjin, Zhejiang and Hubei provinces from December 1 2012 and it is widely speculated, to the remainder of China progressively from 2013.

The replacement of business tax (BT), which is a tax on business, with a VAT, which is a tax collected by businesses, but effectively borne by the end-consumer, is a welcome change. While the short timeframes for implementation of just six weeks in Shanghai and four weeks in Beijing proved challenging for businesses, in the longer term, the move to a broad-based VAT for the goods and services sector further aligns China's system of indirect taxes with global best practice.

Background to indirect taxes

Before looking to the future, it is necessary to provide a brief background about the operation of the indirect tax regime in China.

Before the commencement of the pilot programme three main forms of indirect taxes existed in China:

- VAT, which applies to both the sale and importation of goods and the provision of repair and processing services, generally at a rate of 17%;
- BT, which is effectively a form of turnover tax, applicable to the services industry and levied at rates of either 3% or 5% (with the exception of entertainment services, which can be as high as 20%); and
- Consumption tax, which is applicable to the manufacture or sale of 14 different categories of goods, typically luxury goods (for example, watches, cosmetics), goods with environmental impacts (for example, motor vehicles) or health impacts (for example, alcohol and cigarettes).

The ultimate objective of the VAT reforms is to replace the antiquated BT system with a modern VAT regime for the services industry. As is not uncommon in China, reforms of this nature commence by way of a pilot programme, typically limited to one city or province, thereby allowing policy-makers the opportunity to assess the impact, and make changes where necessary.

VAT pilot programme

The rules for the pilot programme are contained in two circulars issued jointly by the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) in November 2011, referred to as *Caishui* [2011] 110 and *Caishui* [2011] 111.

Those circulars seek to apply VAT to:

- the provision of transportation services (at the rate of 11%);
- the leasing of tangible assets (at the rate of 17%); and
- the provision of modern services (at the rate of 6%).

In this context, the definition of modern services is relatively broad and captures R&D and technical services, information technology services, cultural and creative services, logistics and ancillary services, and certification and consulting services.

The result is that VAT now applies to practically all service industries in cities and provinces, which have adopted the pilot programme, with the exception of post and telecommunications services, real estate and construction services, entertainment services, and financial and insurance services.

Like most VAT regimes, there is a threshold at which businesses are required to register for VAT, account for output VAT on their supplies, and are entitled to claim input VAT credits for the inputs to their business. In China, these businesses are referred to as 'general VAT taxpayers'.

The threshold for registering as a general VAT taxpayer under the pilot scheme is Rmb5 million ($795,000) or more of annual turnover. Businesses with a turnover of less than this threshold are still eligible to register as general VAT taxpayers, but they must demonstrate that they have sound accounting systems and records.

Where a business does not meet the Rmb5 million threshold and chooses not to register as a general VAT taxpayer, they effectively pay VAT on their gross revenue at the rate of 3%. The VAT for this group of businesses, known as small scale taxpayers, operates as a form of turnover tax, because those businesses are not eligible to claim input VAT credits.

Clearly one of the big challenges with the pilot programme is limiting the tax to those cities and provinces that have adopted the pilot programme. The way this has been done is by applying VAT if the branch of the business making the supply is based in a city or province, which has adopted the pilot programme, while retaining BT for supplies of services made through other branches in China.

The difficulty with this regime is that a business with branches in different locations needs to separately track their outputs, and their inputs, and account for VAT or BT accordingly.

Furthermore, for those businesses previously eligible to account for BT on a net basis, such as logistics businesses, there are special rules in the pilot programme to preserve their entitlement to deduct certain inputs (which are not subject to VAT) in calculating their net VAT liability each month.

While these procedures are complex and their scope sometimes uncertain, ultimately these measures are designed to minimise any detrimental impact for these businesses during the transition from BT to VAT. Once the VAT reforms apply across China and to all service industries, much of this complexity ceases to arise.

A further noteworthy aspect of the pilot programme is the treatment of cross-border transactions. In this regard, it is important to note that under the BT regime, the import and export of services were effectively subject to BT, usually at a rate of 5%. This result arose because of the fact that in 2008, the rules were amended so that BT would apply if either the supplier or the recipient was in China.

The VAT pilot programme moves away from this concept, and in so doing, seeks to promote exports, consistent with international best practice. It does this by treating the export of services as being either zero rated or exempt from VAT, pursuant to Circular *Caishui* [2011] 131.

Furthermore, the import of services is subject to VAT by way of a withholding regime. That is, if the supplier has an agent in China or the purchaser of the services is in China, then they are required to withhold VAT.

However, if the purchaser of the services is registered as a general VAT taxpayer, they should be able to claim an offsetting input VAT credit. In this way, the treatment of imported services is similar to reverse charge systems used in other jurisdictions.

The response from businesses, particularly multinational companies, to the more beneficial rules for exports and imports of services has been very positive. However, it is important to strike a note of caution given the potentially narrow way in which the exported services concessions may be interpreted in practice, and the need to satisfy certain approval and documentation requirements, as initially outlined in Announcement 13 of 2012.

Overall, the rules for the pilot programme represent a giant step forward in the modernisation and development of indirect taxes in China. While the rules still retain some uniquely Chinese characteristics, the broad principles upon which they are based are similar to the VAT regimes applicable internationally.

Process and timeframe for expansion of the pilot programme

The VAT pilot programme is merely the first step in the reform process. In particular, the reforms are being expanded in two ways.

Expansion by geography

The first way is the expansion of the pilot programme geographically. That is, the rules for Shanghai's pilot programme are progressively being adopted by other cities and provinces. Indeed, it is widely speculated that the remaining provinces in China may join from early 2013.

Interestingly, the pilot programme has created a ripple effect among the business community. That is, service providers located in cities immediately surrounding cities and provinces that have adopted the pilot programme have potentially been placed at a commercial disadvantage.

These service providers generally have a higher tax burden under BT than it would be under VAT, and their business customers are ineligible to claim credits for the purchase of their services.

Equally, businesses already paying VAT (for example, manufacturers of goods) may have a preference for engaging service providers in cities and provinces that have adopted the pilot programme who can provide them with VAT invoices upon which credits can be claimed, instead of BT.

Not surprisingly, with the Chinese government having embarked on this reform process, there are significant benefits in expanding it quickly across China, so that all businesses are on a more equal footing. Furthermore, for larger businesses with branches in multiple locations throughout China, simplification will only be achieved when they are able to operate a single VAT system across all of their branches, as compared with having VAT in some places, and BT in others. In short, the timely expansion of the pilot program geographically is critical to the success of these reforms.

Expansion by industry

The second way in which the pilot programme is expected to be expanded is in terms of the types of services, which are subject to VAT. Financial services and insurance, post and telecommunications services, entertainment services, real estate and construction services are all examples of industry segments which are still paying BT.

Already, some preliminary work is underway to consider how VAT should apply to these sectors. In most jurisdictions with a VAT, financial services and real estate transactions present the most complex policy challenges for taxpayers and the tax authorities. How the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) will approach the application of VAT to these industries will be awaited with interest.

The timing of the expansion of the pilot programme both geographically and by industry is a source of considerable speculation. Two main factors will have an impact on timing.

First, the VAT pilot programme results in a rearrangement of fiscal relations between the central government and local governments, given that the central government collects VAT (and retains 75% of the revenue, with the remaining 25% going to local government), while local governments collect and retain BT. Consequently, negotiations between the central government and local governments need to take place, and administrative collection arrangements resolved. This is no small task.

Second, the Chinese government has a history of engaging in indirect tax reforms as a means of addressing economic conditions. Indeed, during the 2008 global financial crisis, a key component of the government's stimulus measures included creating an entitlement for VAT taxpayers to claim input VAT credits on the purchase of fixed assets (for the first time). If economic conditions globally deteriorate or remain unstable, it would not be surprising to see the pace of the reforms accelerated.

Assuming the absence of any unusual fluctuations in global economic conditions, and assuming negotiations between the central government and local governments proceed relatively smoothly, then we would expect the pilot programme to be expanded geographically across China early in 2013; to be closely followed by the expansion of the VAT reforms to other service industries over the course of the next two years. In short, VAT reform will be an ongoing process over the next few years.

Opportunities and risks

General feedback

While the VAT pilot programme is only in its infancy, the feedback from business has been extremely positive. There are a number of reasons for this:

- Generally speaking, businesses now paying VAT have been able to factor VAT into the prices of the services they provide to their customers

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Lachlan is regularly invited to advise the Ministry of Finance and the State Administration of Taxation in relation to the VAT reform programme, as well as other tax reform initiatives such as the introduction of a system of advance rulings. He holds a masters of taxation with first class honours, as well as combined economics and law degrees, also with honours, all from the University of Sydney.

Lachlan has also co-written the leading textbook on capital gains tax in Australia, as well as writing chapters for textbooks on income tax and GST. He is a regular presenter and media commentator on tax issues, both in China and previously in Australia.

- Business-to-business transactions do not result in real VAT liabilities, whereas in the past these transactions resulted in a BT cost
- For the first time, service businesses registered as general VAT taxpayers are eligible to claim input VAT credits for the goods, fixed assets and services they acquire in their business
- Businesses already registered as general VAT taxpayers before the commencement of the pilot programme (for example, because they may sell goods) are eligible to claim input VAT credits for the services they now acquire from other general VAT taxpayers.

In other words, by removing the bifurcation in taxes between businesses selling goods (VAT) from those providing services (BT), both groups of taxpayers have ultimately benefited.

The logical extension of this concept is that for businesses yet to be subject to the VAT pilot programme, there is a clear commercial benefit in deferring the purchase of fixed assets and other services until such time as they are registered as general VAT taxpayers. That way they will be eligible to claim input VAT credits for their purchases, unlike in the past.

Transportation and logistics sector

One group of taxpayers who have not generally fared as well from the VAT pilot programme is the transportation and logistics sector. Businesses providing transportation services have shifted from paying BT at the rate of 3%, to VAT at the rate of 11%. While it is generally an invalid approach to compare tax rates of BT and VAT, in the transportation sector the tax bases under each form of tax are relatively similar. The logistics sector has also been affected, in part because of the fact that their primary input is transportation services.

With the benefit of hindsight, the MOF and the SAT may have wished to reconsider their decision to apply the VAT pilot programme to this sector. Fundamentally, transportation and logistics involve the movement of goods or people, or arranging the movement of goods or people, from one place to another. Applying a new tax, which is limited to particular cities or provinces is therefore ill suited to this sector. Perhaps it may have been better to have moved this industry to VAT at a later date, at a single point in time right across China.

Having said that, the government has acknowledged these concerns and is offering financial assistance measures to this sector (and any others) adversely affected by the reforms. After all, this is why a pilot programme is a useful technique for reform, because it allows changes to be made more readily to adapt to the needs of taxpayers.

Risks

In terms of the risks associated with these reforms, we will focus on only two in the interests of brevity.

The first risk is identifying whether the contract between the supplier and the purchaser allows for the passing on of VAT. The pilot programme rules contain very little about this in the way of grandfathering relief. Basically, if the contract does not allow the supplier to pass on VAT, then the supplier must bear the VAT with effect from the commencement of the pilot programme until such time as the contract ends. The only exception to this is for leases of tangible assets, where a special transitional rule provides for the continuation of BT until such time as the contract is terminated.

The message from this is simple. Businesses providing services in China, or to a customer in China, need to ensure their contracts are updated to allow them to pass on VAT.

The second risk arises from the short timeframe for implementation of the pilot programme. With multiple VAT rates, strict invoicing processes and complex rules relating to the interaction of VAT and BT, the potential for error is significant.

Businesses with branches in cities or provinces which have adopted the pilot programme, would be well advised to conduct a health check to ensure that errors are identified and corrected before they are replicated across China as the reforms progress. In most cases, we have identified from these health checks that businesses are under claiming input VAT credits.

Finally, it must be acknowledged that the favourable feedback from businesses subject to the pilot programme is due in

Biography

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John Wang was previously a tax official in the Chongqing Municipality State Tax Bureau, with more than seven years of tax audit and administration experience.

John joined KPMG China after completing his MBA courses in the UK in 2004.

In his career as a tax consultant at KPMG, John has deployed the knowledge and skills acquired from both his work at the tax authority and his MBA studies in providing advisory services to multinational clients and domestic clients in a wide variety of industries. John has been actively involved in helping companies prepare for the continuing PRC VAT reform.

no small part to the considerable efforts of the MOF and the SAT in implementing the pilot programme. Their tax officials provided very real assistance to affected businesses. Successfully implementing a new tax regime in short time periods of only four to six weeks certainly takes hard work and dedication.

Longer-term indirect tax issues

On any reasonable view, the government has made significant progress in reforming indirect taxes in China. However, for a government keen to embrace reforms and adopt global best practice, there is still more that could be done. In this section, we examine what further reforms should be considered.

Golden Tax System

As a starting point, anybody familiar with the tax system in China will be aware of the so-called 'Golden Tax System'. This is effectively the information technology system, which links the sales made by a business, through the invoicing system with data, which is transmitted to the tax authorities.

The difficulty with the Golden Tax System is that it has inadvertently had the effect of elevating the form of documentation to a level which, in many cases, overrides economic substance.

For example, without a special VAT invoice, a general VAT taxpayer may be ineligible to claim an input VAT credit, irrespective of its ability to demonstrate that a qualifying purchase has been made through alternative forms of evidence. The flipside of this is that if a business holds a valid special VAT invoice, then it is tantamount to currency, irrespective of whether the invoice properly reflects the true substance of the transaction.

The end result is that the excessive reliance on documentation potentially serves to encourage fraudulent invoicing or perhaps more commonly, a not so infrequent failure by some businesses to issue invoices in the mistaken belief that this avoids triggering an obligation to remit VAT.

The use of the Golden Tax System also necessitates a significant amount of manual processing, or dual record-keeping by businesses, particularly because of the difficulties in integrating data entered into the Golden Tax System with businesses' own IT systems. This makes the management of indirect taxes in China more time-consuming and prone to error, at least compared with experiences internationally.

Consolidated VAT filing

In terms of administrative requirements for taxpayers, a further feature of the Chinese system is that registration and reporting obligations are handled at the branch level of the business. This means that for businesses with multiple legal entities, and/or multiple branches of each legal entity in China, compliance may need to be managed centrally by a large team, with a skeleton team providing support at the branch level, or decentrally, with the concomitant lack of controls.

To address these issues, the government is likely to allow the consolidation of VAT reporting once the reforms have been expanded right across China. That is, by allowing the branches of a single legal entity to lodge a single VAT return, or ideally, by allowing the various legal entities in a wholly-owned corporate group to lodge a single VAT return.

Encouragingly, Circular 110 foreshadows the possibility of some form of consolidation allowed in the near future. Such a move would serve the interests of corporate groups in reducing compliance costs and easing administration for both taxpayers and tax officials alike.

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Shirley has strong experience in the energy and natural resources industry. She provides tax health check, tax provision review, tax due diligence, structuring and planning advice to major multinational and domestic clients. Her experience includes:

- Pre-investment consultation;
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- Joint venture contracts for business and tax issues;
- Corporate and individual taxation;
- Cross-border tax structures/issues; and
- Foreign exchange.

She is actively involved in the VAT reform in China by assisting the Legislative Affairs Office of Budgetary Affairs Commission of the National People's Congress and the Ministry of Finance.

Shirley is a key member of KPMG's Indirect Tax Center of Excellence and has been involved in many VAT reform projects for multinational companies and state-owned enterprises. She is also a frequent speaker on VAT reform at various conferences and seminars across the country.

Miscellaneous

In terms of some longer-term wish-list areas for reform, in the interests of brevity, we have listed only three below:

- Allowing refunds for businesses where input VAT is more than output VAT in any given tax period. At present, only exporters are eligible for refunds. Other taxpayers are required to carry forward the balance, though the loss may be used indefinitely.
- Reforming the categories of goods subject to consumption taxesand the rates of consumption tax applicable to those goods. Many of the items now subject to consumption tax do not reflect modern concepts of luxury items, such as women's cosmetics, watches, or motor vehicles. Moreover, the high rates of consumption taxes potentially only serve to encourage an increasingly wealthy population to purchase these items outside of mainland China (for example, in Hong Kong) at significantly lower prices.
- Aligning the various rates of VAT now applicable in China. As a result of the pilot programme, there are now at least five different VAT rates in regular use – 17% (general rate for goods), 13% (reduced rate for some goods, for example foodstuffs), 11% (transportation services), 6% (modern services) and 3% (small scale taxpayers). The use of multiple rates can lead to inefficiencies and inequities for businesses selling reasonably similar goods or services which are taxed differently.

Looking ahead

The reforms of indirect taxes in China are a welcome initiative for business. The ultimate objective of replacing BT with a VAT across the service sector is an important stage in the development and modernisation of indirect taxes in China. The commencement of the pilot programme is a significant first step, which has been successfully implemented by the MOF and SAT.

The early success of the pilot programme will undoubtedly spur policy makers to continue the reform process and to expand the VAT reforms to other provinces and to all service industries over the next few years.

Financial services – the last frontier for VAT reform

Lewis Lu, Lachlan Wolfers and Christopher Abbiss agree that the future of China's financial services industry is at a critical juncture with the proposed reforms of indirect taxes. The choices to be made will highlight whether the government favours international competitiveness and expansion of the sector over the maintenance of existing tax revenues.

China's 12th Five-Year Plan (5YP) seeks to shift the country's previous focus of rapid growth in gross domestic product to more balanced, coordinated and sustainable economic development.

The Chinese government is introducing a number of new tax measures to:

- distribute wealth more evenly;
- encourage domestic consumption;
- restructure the Chinese economy; and
- support the growth of the services industries, including the financial services sector.

To reach the goals of the next 5YP, the Chinese government needs to undertake major tax reforms to create a more equitable tax environment. A top priority is the value added tax (VAT) reforms, which seek to move transactions and activities traditionally covered by Business Tax (BT) to VAT.

The VAT reforms commenced with a pilot programme in Shanghai on January 1 2012 and initially cover the transportation, asset leasing and modern services industries. The programme was expanded to Beijing on September 1 2012, Jiangsu and Anhui provinces on October 1 2012 and Fujian and Guangdong provinces on November 1 2012. It will further be expanded to Tianjin, Zhejiang and Hubei provinces on December 1 2012 and progressively to other cities and provinces throughout China.

At this stage, the pilot programme does not include financial services. However, the government is considering widening the scope of the reforms to encompass financial services and has recently conducted a consultation with business and tax advisers.

Business Tax regime for the financial services sector

BT regime

For the past two decades, China has operated two parallel indirect tax systems. All entities and individuals providing services in China (including banking and financial services), transferring intangible assets or dealing in real estate are subject to BT.

By contrast, entities and individuals selling or importing goods or providing repair or processing services are subject to VAT. There is also a third form of indirect tax in China, consumption tax; however, it is not affected by the VAT reforms and is outside the scope of this article.

With a few exceptions, BT is levied on the gross turnover or receipt from taxable transactions. There is no input credit mechanism. The BT rate varies from 3% to 5% depending on the type of transaction (with the exception of entertainment services, which can have a BT rate of up to 20%).

Financial services are subject to BT at a rate of 5%. Under the BT regime, a bank located in China will be subject to 5% BT on loan interest income, gains from transferring financial securities (including foreign exchange and derivative instruments), commission income and other financial services income. In general, no input credits can be claimed by the bank for costs associated with undertaking these financial transactions.

Main issues

A key problem with the BT regime is the issue of cascading tax as financial services providers cannot claim a credit for the indirect tax paid on their inputs.

When services are delivered successively by multiple service providers along the supply chain, BT is imposed on every service provider; the service price at any point in the supply chain will effectively incorporate the BT costs incurred by the previous service providers.

There have been some attempts by Chinese tax authorities to alleviate the cascading tax issue. For example, a BT exemption is granted for inter-bank interest income. However, these measures are piecemeal solutions, and are incapable of addressing a much broader problem that is inherent in the BT regime.

Under the regime, BT also applies to each branch of a legal entity as if the branches are legally independent. As a result, transactions between branches of the same legal entity can also attract BT, which further exacerbates the cascading tax issue.

And the BT regime does not prescribe clear treatment for the financial services sector. For example, there has been no clear pronouncement from the tax authorities about the BT treatment of derivatives and other complicated financial products. This lack of regulatory guidance complicates BT compliance in the financial services sector.

Another challenge financial service providers face is how to determine the tax base of financial securities trading transactions for BT purposes. As a partial relief to the cascading tax issue, when a financial service provider trades financial securities, the costs of financial securities sold by the service provider can be deducted from the selling price so that only the net gains are subject to BT.

When calculating the net gains, financial securities are classified into four major categories, that is, equity, bonds, foreign exchange and others. Trading gains and losses from the same category of financial securities can be offset against each other within the same fiscal year through a year-end settlement/ refund mechanism.

If an annual net loss results within one category, the loss cannot be carried forward to the next fiscal year or be used to offset gains from another category in the same year. As a result, companies engaged in financial securities trading cannot fully utilise all trading losses, and suffer from tax inefficiency under the BT regime.

VAT reform proposals

Pilot programme in Shanghai

Circulars *Caishui* [2011] No 110 and *Caishui* [2011] No 111 issued by the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) officially inaugurated the VAT reforms in China.

The pilot programme replaces BT with VAT in certain industries such as transportation, asset leasing and modern services. It is speculated that it will be expanded to other service industries beginning in 2013. The precise date for any expansion to the financial services sector is not yet known.

The simplified VAT method

Caishui [2011] No 110 contemplates that financial services and insurance businesses will, in principle, be subject to a "simplified VAT method" when the VAT reforms are extended to the financial services and insurance sectors. However, it is unclear exactly what financial services the simplified VAT method will be applied to and what the VAT rate will be.

Under a simplified VAT method, output VAT is payable based on the consideration for a taxable financial transaction (outputs), at a prescribed tax rate. The financial services provider cannot claim any input VAT credits for the expenses it incurs in providing financial services, and if the recipient is a general VAT taxpayer, they similarly cannot claim an input VAT credit. In essence, the simplified VAT method is similar to the VAT regime applicable to small-scale VAT taxpayers now as well as the BT regime.

The main advantage of the simplified VAT method is its administrative ease due to its similarities with the existing BT

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regime. However, the simplified VAT method does not solve the cascading tax issue as it taxes a financial transaction regardless of whether any incremental value is generated.

Considering that most developed countries exempt financial services from VAT, adopting a simplified VAT method for all financial services may make China less competitive compared with other jurisdictions.

While the use of a simplified VAT method may seem relatively straightforward in theory, a number of issues would still need to be resolved. For example:

- What is the scope of financial services subject to the simplified VAT method;
- How should cross-border financial services be dealt with;
- What happens under a VAT system to those financial services exempt from BT (for example, certain life insurance products, deposit interest); and
- What happens to those financial services which are subject to BT on a net basis (that is, where deductions are allowed against gross revenue subject to BT)?

Other options for the financial services sector

Though *Caishui* [2011] 110 contemplates the adoption of the simplified method when the VAT reforms are extended to the financial services and insurance sectors, we understand that the government is also studying the merits of these other options:

Exemption method

The first method under consideration, besides the simplified VAT method, is the exemption method. As noted previously, many developed economies including EU member states, New Zealand, Singapore, Australia and Canada, have adopted the exemption method, where outputs are not subject to VAT, but no input VAT credits can be claimed for goods and services acquired in relation to providing the financial service in general.

Historically, the main reason for adopting the exemption method is that it is difficult to identify and accurately measure the value-added portion of the financial service on a transaction-by-transaction basis.

For example, it is difficult to match the deposit interest paid by a bank to customers (as a cost of financing) to the interest income earned by the bank from lending to borrowers,to quantify the value-added amount subject to VAT.

With the exemption method, no VAT liability is imposed (explicitly) on financial services supplied to customers. However, the exemption method effectively forces financial services providers to absorb the VAT incurred on their inputs as business costs or to embed those costs into prices charged to customers.

Zero-rated method

Secondly, the government is assessing the pros and cons of the zero-rated method, which does not tax outputs, but allows a full input VAT credit on goods and services acquired by the financial services provider in providing the services.

The most obvious benefit of this method is that it is internationally competitive. Under a zero-rated method the financial service provider is eligible to claim full input VAT credits for their costs.

This method is not preferred by most countries' fiscal authorities. Due to the size of the financial services sector and the resulting amount of VAT credits that would have to be granted, government tax revenues could be significantly affected. In short, it is unlikely to be adopted.

Normal taxation method

The Chinese government is also evaluating the normal taxation method, which taxes outputs but allows financial services providers to claim input VAT credits on goods and services acquired in providing the service.

The normal taxation method provides a potentially greater capacity for financial services providers to pass on VAT to their customers and helps address the cascading tax issue that exists in the BT regime. The downside is that it is difficult to

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Lachlan is regularly invited to advise the Ministry of Finance and the State Administration of Taxation in relation to the VAT reform programme, as well as other tax reform initiatives such as the introduction of a system of advance rulings. He holds a masters of taxation with first class honours, as well as combined economics and law degrees, also with honours, all from the University of Sydney.

Lachlan has also co-written the leading textbook on capital gains tax in Australia, as well as writing chapters for textbooks on income tax and GST. He is a regular presenter and media commentator on tax issues, both in China and previously in Australia.

value the intermediation services provided by financial services providers on a transaction-by-transaction basis (the same argument that most developed countries have used for choosing the exemption method).

And another challenge would occur in China in dealing with the large volume of special VAT invoices that financial services providers would need to issue.

In China, special VAT invoices must be issued on special equipment sourced from the government; the process is tightly controlled and monitored by the government. The sheer volume of VAT invoices to be issued under the normal taxation method and the accompanying IT-related issues to be resolved in the financial services industry would be breathtaking.

Which method is preferred?

Different perspectives between industry and government highlight the difficulties in reaching a single conclusion as to the preferred method. For example, the financial services sector may prefer the zero-rated method over the other methods because it can offer its products at more competitive prices, while getting input VAT credits on goods and services they acquire or consume. It would also ensure China's VAT system for financial services is internationally competitive, thereby advancing the objective of developing Shanghai in particular as a global financial centre.

From the government's perspective, the zero-rated method or the exemption method may not be preferred because the government would lose a significant amount of tax revenue from the financial services sector, when compared with the amount of indirect tax collected under the existing BT regime.

Some proponents of the simplified VAT method also note that China's banking industry is highly regulated, whereby both the interest rate on deposits and the interest rate on lending are to a large extent controlled by the state. This effectively gives banks a guaranteed profit margin on their traditional deposit taking and lending businesses. So purely from an economic theory perspective, these proponents argue that a guaranteed profit margin already incorporates an allowance for indirect taxes.

Given there is no perfect VAT method for the financial services sector in China that meets the objectives of all participants, perhaps a hybrid method that mimics the existing BT regime with certain enhancements may be more practical. A system that closely resembles the existing regime, but improves on certain inefficiencies could be easier to implement.

Given these observations, perhaps the following hybrid method that combines the exemption and simplified methods is more suitable for the financial services sector in China:

- The simplified method could be adopted for traditional bank lending activities that earn guaranteed profit margins, thereby maintaining significant tax revenues to the government. The VAT rate could be revised in the event that interest rates become less regulated.
- The exemption method could be applied to financial intermediation services provided domestically, such as currency exchange, deposit-taking activities and trading in equities and derivatives. Exempting these financial intermediation services would be consistent with international practices adopted by numerous developed countries, and would help the Chinese financial services sector to be more competitive against other major financial service markets.
- All other financial services, such as advisory services, may be subject to the normal VAT method. These types of financial services are generally remunerated in the form of explicit fees, rather than margins from trading financial securities, and are therefore capable of having normal VAT principles apply. This approach is generally consistent with the methods adopted in countries such as Australia and South Africa.
- On cross-border transactions, imports of non-financial services (for example, IT services and advisory services) used by Chinese financial services providers could be sub-

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Chris has more than 25 years of experience. Before joining KPMG's Hong Kong office in 2003, he was the partner in charge of KPMG's New Zealand tax practice and chaired the New Zealand Institute of Chartered Accountants' tax committee. Chris leads KPMG's Asia Pacific financial services tax practice and is the ASPAC representative on the KPMG global financial services tax steering group.

He is the lead tax partner on a range of foreign financial institutions operating in Hong Kong. These include insurance companies, banks, securities companies and funds. A number of these organisations use Hong Kong as location for their ASPAC regional head office and Chris advises them on managing their tax affairs regionally. From his time practising and involvement with tax policy development in New Zealand, he is experienced in the application of that country's GST regime to financial services.

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ject to VAT (for example, via a reverse charge or withholding) to prevent a general preference for sourcing these services from outside China.

Imports of financial services (for example, traditional banking activities such as inter-bank lending) need to be exempt. Otherwise, it would encourage Chinese financial services providers to source within China and discourage the Chinese financial services sector from expanding globally.

Under the BT regime, traditional inter-bank lending activities are already exempted from BT. Exports of other financial services should be zero-rated to encourage the development of China as a global financial centre. If it is not practical to apply zero-rating on a transaction-by-transaction basis, the estimated effect of zero-rating could be incorporated into the VAT credit recovery rate, which is somewhat similar to Singapore.

The administrative burden from VAT invoicing under this hybrid approach would be significantly reduced. As a large volume of financial intermediation services would already be exempted from VAT or subject to the simplified VAT method, it would not be necessary for special VAT invoices to be issued or collected on every financial transaction.

Looking ahead

In the coming years, China will continue to make more changes to its tax regulations that will have a significant impact on taxpayers. There is usually no formal consultation process to seek feedback from businesses before the Chinese tax authorities implement change. Once the regulations are finalised, it is difficult to seek revisions even if some provisions create unintended consequences or cause uncertainties for certain industry sectors.

Companies in the Chinese financial services sector face unique challenges, both now and in the future as the regulatory environment continues to open up. Instead of taking a "wait-and-see" approach, taxpayers should proactively share their views with the MOF and the SAT.

The VAT methods(s) applied to financial services in China need to fit within the overall framework of the Chinese tax and regulatory systems, but it also needs to take account of experiences internationally given the global environment in which the financial services sector competes. Engaging industries in this debate could play a pivotal role in shaping future indirect tax policies for financial service providers in China.

Chinese Customs in uncertain times

Since the 2008 global financial crisis developed countries have been trying to repatriate manufacturing and labour-intensive industries in developing countries are facing mounting competition. Meanwhile, trade protectionism is regaining momentum in a number of jurisdictions. Lilly Li, Eric Zhou and Anthony Chau express the concern that these factors make it more complex to analyse and predict the trends of world trades.

China's trade policy is to maintain steady import and export growth. China also wants to shift focus from processing trades to dealings in products higher up value chains. In other words, It is aiming at a processing trade upgrade. The Chinese customs authority (China Customs) is the primary government organisation in charge of international trade in the People's Republic of China (PRC). Any adjustment in policy and administrative approach by China Customs may impact the trading and investment environment for businesses within and outside China.

Processing trade upgrade

Processing trade in China usually refers to:

- the business activity of importing all or part of the raw materials, parts and components, and accessories from abroad, in bonded or un-bonded form;
- performing prescribed manufacturing, assembling and processing procedures in China; and
- re-exporting the finished products.

The typical business arrangement in processing trade varies from industry to industry and can be broadly divided into tolling arrangements and contract manufacturing arrangements, depending on whether the foreign enterprises maintain ownership titles to the products under processing in China.

Statistics from the General Administration of Customs (GAC) put China's imports and exports in connection with processing trade at $1.3 trillion in 2011, accounting for 35.8% of China's total import and export value for the year.

While processing trade has contributed to the country's remarkable economic growth in the past, China realises the limitation of traditional processing trade.

In a tolling arrangement, though the trading volume is high, the profit margin left in China is generally low because the Chinese entities play limited roles in the overall value chain. Therefore, China is making active efforts to upgrade and transform its processing trade sectors. The specific actions of China Customs are discussed below.

Promoting the transformation of processing plants into corporate entities

Tax incentives for conversion

In a toll manufacturing arrangement, it is common for foreign enterprises to import certain manufacturing equipment into China for free to be used by the local processing plants. The equipment does not have price tags attached and the importation does not attract customs duty immediately as in normal import situations.

Instead, the equipment receives a special bonded status for customs duty purposes and will be under the supervision of China Customs for five years in general after entering China. Any unauthorised disposition of the equipment in China will trigger back-duties and import taxes plus interest charges that run from the time of the original importation. The ownership of the bonded equipment remains with the foreign enterprises during the supervisory period.

To encourage the conversion of tolling arrangements by foreign enterprises into legal entities in China, the authorities have announced customs incentives.

Specifically, if a foreign enterprise contributes the bonded equipment that has been used in tolling arrangements in China into a Chinese subsidiary, the customs back-duties and import taxes that would have been triggered by the equipment transfer can potentially be waived.

A recent circular issued by the GAC extends this preferential policy to December 31 2012. Foreign enterprises that carry out toll manufacturing with processing plants in China using bonded equipment may consider taking advantage of this temporary incentive.

Approval restriction for tolling arrangement

Though no national regulation officially prohibits tolling arrangement in China, the relevant authorities in some developed regions have, in principle, stopped approving new toll manufacturing projects.

Enterprises that conduct tolling arrangements in China may need to plan early to convert their operations to contract manufacturing or general trade models and should carefully evaluate the implications of such a conversion. For instance, a conversion of tolling arrangement may change the internal business process of a foreign enterprise as well as its agreements with its business partners throughout the supply chain. It may have an impact on a corporate group's global transfer pricing policy and shareholding structure, as well as its ultimate profitability.

Caution should be exercised when an existing toll manufacturing arrangement is converted into a contract manufacturing one. Though governments at various levels have released guidelines to facilitate conversions, businesses may still encounter difficulties on specific issues when applying the guidelines to their own cases.

Examples of issues that a foreign enterprise needs to pay special attention to include:

- how to inject the equipment used in a tolling arrangement into a new foreign investment enterprise;
- how to assess the value of the equipment; and
- how to smoothly transfer the equipment's ownership between relevant parties.

Encouraging processing trade enterprises to develop the domestic market

Relaxed exporting requirement

Under existing policies, when a foreign investment enterprise operating in a permitted industry category imports equipment to make products solely for export, it can potentially obtain a refund of the customs duty and import taxes previously incurred on the equipment importation during a five-year supervisory period.

Similarly, domestic manufacturers can potentially import equipment to be used in processing trade on a bonded basis if at least 70% of the finished goods so manufactured will be exported, among other requirements. Failure to meet the prescribed export percentage thresholds can result in not only customs duty and import taxes, but also penalties in serious cases.

These policies were issued years ago to encourage exports and are no longer consistent with the drive to grow China's domestic markets. It is likely that the GAC will relax the exporting requirements in the rules, though the timing and details of any new rules are unclear at the moment.

Expedited customs clearance

Before bonded goods can be sold within China, the back-due customs duties and import taxes must be made up and paid to the customs authorities first, as part of customs clearance process. This additional step of customs clearance creates an administrative inconvenience for domestic sales of bonded goods, which are driven by market demand and are often time sensitive.

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Lilly Li became a partner at KPMG China in 2005. Before joining the firm, she worked at the China Tax Bureau and the Australian Taxation Office in the areas of international tax administration, tax audit and transfer pricing. Lilly specialises in China tax, transfer pricing and customs advisory services. She provides business and tax advisory services to numerous multinationals as well as Chinese domestic companies on their M&A, corporate restructuring, cross-border transfer pricing, outbound investment, supply chain integration, and initial public offering (IPO) activities.

In the area of customs and trade advisory, Lilly has assisted many clients in reviewing and improving their customs-related processes and compliance of processing trade. She has also provided support to clients regarding their customs valuation audit defence. Lilly has also actively led and participated in the technical interflows with the respective customs offices in the areas of related-party transfer pricing and customs verification audit.

China Customs has started a centralised tax payment process under which qualified enterprises can deliver bonded goods to domestic customers first and then settle tax payments with customs authorities on a consolidated basis at the end of each month. At present, this measure is only available to enterprises participating in the Computer Networked Surveillance (CNS) system or having good customs credit ratings (mainly AA Class and A Class). The next step may see the GAC expand the measure to a wider range of enterprises.

Chinese companies that sell bonded goods in the domestic market should consult with the customs authorities in charge and monitor the local practice.

Promulgation of computer networked surveillance

China Customs may further promulgate the CNS model for the supervision of processing trade. CNS is an internet-based network system used by China Customs to remotely monitor businesses in processing trade and ensure compliance with customs requirements.

Through the electronic logbook and electronic handbook sub-systems, the CNS model allows an enterprise to transform its internal control process for customs from a manual process to an electronic one.

The CNS model can also help an enterprise reduce errors in customs declarations and improve operational efficiency. A successful implementation of the model generally requires that an enterprise make good preparations to:

- organise internal data flows;
- streamline business processes; and
- integrate the CNS model

with any enterprise resource planning (ERP) system that it may have in place.

Encouraging transition from low-end processing to high-end manufacturing

To promote the transition from low-end processing to high-end manufacturing, China Customs will probably provide additional tax incentives for equipment importation by Chinese companies that conduct R&D activities in China.

And the GAC may revise the Catalogue of Commodities Prohibited or Restricted for Processing Trade, and work with other government branches to modify the Industry Catalogue for Foreign Investment to help upgrade processing trade from low-end assembly to high-end manufacturing.

These revisions, if implemented, will affect areas such as:

- foreign investors' strategic plans;
- functional profiles;
- transfer pricing policies;
- profit allocations;
- effective tax burdens; and
- net profitability.

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Eric Zhou worked with China Customs for more than nine years before joining KPMG China in 2004.

Eric specialises in cross-border customs advisory/defence services such as HS (Harmonised System) codes determination, customs valuation and processing trade management concerning multinational enterprises in industrial markets and consumer markets. He also has extensive experience with corporate income tax, VAT and transfer pricing, which are closely linked to customs issues.

Multinational corporations with processing trade arrangements in China should re-evaluate their supply chain models in view of such potential regulatory changes.

Special supervisory customs zones

At the end of 2011, China had more than 100 Special Supervisory Customs Zones (SSCZ) with different functions. It is improving its regulatory system to encourage processing enterprises outside SSCZs expand their operations in these zones.

To promote a greater role for SSCZs in processing trade, China Customs may issue new regulations to:

- enhance the functions of various SSCZs;
- provide further preferential treatment for enterprises inside SSCZs; and
- strengthen the supervision of processing trade conducted outside the zones.

These measures are expected to further highlight the advantages of conducting processing trade in SSCZs.

Customs valuations

China Customs is responsible for levying tariffs, import VAT and consumption tax on the import and export of goods.

Except for certain commodities, customs duty is levied in the form of *ad valorem* tax. The tax amount is determined based on the value of goods and the applicable tax rate. Therefore, the customs authorities pay close attention to the valuation of goods to determine the dutiable price, and have established a specialised functional unit to deal with valuation cases. In practice, most businesses have been questioned or challenged by the customs authorities on valuations.

Valuation of related-party transactions

Many multinational enterprises sell goods or materials to related companies in China. China Customs scrutinises such related transactions closely to ensure that they are conducted in accordance with the arm's-length principle, that is the transaction price is not affected by the intercompany nature of the transaction.

If China Customs determines that the transaction price deviates from the arm's-length principle, it can adjust the transaction price and assess additional tariff and import taxes as a result.

China Customs has set up an internal database, which is updated periodically. By comparing the transaction prices of identical or similar goods available in the database and analysing the records of actual import and export transactions, officials can evaluate whether the price of a related-party transaction is reasonable.

Customs regulations state that the authorities are empowered to challenge the transaction prices set by enterprises. Once a challenge is raised, the burden is on the enterprises to prove the transaction prices are reasonable.

Investigation process

China Customs usually conducts a valuation investigation in two steps to determine whether the transaction price is affected by intercompany relationships.

1. it will investigate the nature of the related transaction in question (for example, sales terms and conditions) to understand:
   - how the contract value was determined;
   - whether there was a price negotiation process between the buyer and seller; and
   - whether the relevant process is in line with the general practice of the industry.

   Such investigations are based on the written explanations and evidence provided by the importer.
2. China Customs will request the importing enterprise to test the transaction price and provide supporting evidence that the transaction price adopted is similar to one of the these three prices:
   - the transaction price at which identical or similar goods are sold to an unrelated party;
   - the dutiable value of identical or similar goods determined using the subtractive method as specified in the customs regulations; or
   - the dutiable value of identical or similar goods determined using the "sum of components" method as prescribed in the customs regulations.

If the importer does not provide proof or if the proof provided is not accepted, customs authorities are entitled to revise the transaction price for customs declaration purposes using its own valuation methods.

In general, the customs-reassessed price for imported goods will result in higher tariffs and import taxes. Therefore, it is essential that the importer gathers sufficient evidence to prove that the transaction price reflects fair market value and is not affected by the related-party relationship.

Guarantee deposit

During a valuation investigation, China Customs may detain the imported goods temporarily or release the goods upon payment of a guarantee deposit by the enterprise. The enterprise in question may pay the deposit based on the full amount of tariff and import taxes reassessed by China Customs if no taxes have been paid, or the excess of that full amount over any taxes that have already been settled.

The guarantee deposit paid by the importer based on a customs valuation will be valid for six months and can be extended by application. In a case where the deposit expires without prior application for an extension, the deposit will be treated as the final amount of tariff and import taxes imposed.

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Anthony Chau started his tax advisory career in 1999 in the corporate tax department of KPMG Sydney. Upon returning to Hong Kong in 2000, he started practising in the areas of PRC taxation, customs duty and business advisory matters. He was based in Guangzhou and Chengdu before relocating to KPMG in Shanghai in July 2010. Besides his tax related roles in Shanghai, he manages the tax practice for KPMG in Chengdu and also leads the trade and customs practice for Central China.

Over the years, Anthony has advised multinational clients regarding their expansion plans, holding structures, and operational and related cross-border transactions as well as their restructuring matters from both a taxation and business regulatory perspective. He has also assisted numerous clients negotiate with the PRC tax/customs authorities on their daily compliance and audit matters.

Anthony is also a regular speaker in public seminars on taxation, customs and business advisory matters.

Cross-border payment for non-trade items

In recent years, China Customs has been strengthening examinations of non-trade payments such as royalty and service charges to determine if such payments should be included in the dutiable value of the imported goods for tariff and import tax purposes.

In general, during the customs declaration process, if any non-trade payment is identified by customs authorities, the importer must provide an explanation statement as to why the non-trade payment is not related to the imported goods and hence not subject to customs duty and import taxes. If the importer is unable to provide an explanation statement or the statement provided is not acceptable to the customs officials, the non-trade payment will be included into the dutiable value of the goods.

Royalty

Under the customs regulations, royalties paid by the buyer of the imported goods to the seller or another party concerned shall be included in the dutiable value of the imported goods, except under the these circumstances:

- Such royalties are unrelated to the imported goods (Circumstance 1)
- The payment of such royalties by the importer does not constitute a prerequisite for the importer to sell the imported goods in China (Circumstance 2).

When a Chinese enterprise makes a payment for both the importation of goods and royalties, it is obligated to demonstrate that either Circumstance 1 or Circumstance 2 applies to the royalty payment. Otherwise the royalties would be subject to customs duty and import taxes.

In practice, it is often difficult for an importer to prove that the royalty payment falls under Circumstance 2. Depending on the type of intangible asset that the royalty payment relates to (for example, trade marks, patents, technologies or distribution rights), there are different strategies for taxpayers to argue that the royalty payment is unrelated to the tangible goods being imported and therefore it fits into Circumstance 1. Detailed discussion of these strategies is beyond the scope of this article.

Service fees

Existing customs regulations do not state whether the service fees are subject to customs duty. In practice, customs officials generally determine if the service charge relates to the production, R&D, and distribution of the imported goods by reviewing the relevant service agreement and identifying the nature of the service.

If the service charge is deemed to relate to the imported goods, customs officials will include the service charge in the dutiable value of the imported goods for tax purposes. If not, the service fees are not subject to customs duty and import taxes.

Advance valuation review

In 2011, the GAC promulgated a circular requiring that all PRC customs authorities implement an Advance Valuation Review system for imported goods by January 2012.

An Advance Valuation Review is a process by which an enterprise applies to Chinese Customs in the destination port of importation for a review of the dutiable values of the goods before importation begins. When the goods are actually declared for importation, the local customs authority may compute and levy customs duty based on the previously reviewed dutiable values.

Not all enterprises can apply for an Advance Valuation Review. Only companies with good customs ratings (that is, Class AA and Class A) are entitled to this procedure. The commodities eligible for Advance Valuation Review are mainly those that are difficult for the customs authorities to value on site. Each customs authority under the GAC may set out the scope or conditions of the commodities qualified for Advance Valuation Review in the local jurisdiction.

The Advance Valuation Review is an important step to improve the efficiency of Chinese customs clearance for enterprises.Though some uncertainties remain in practice, such a mechanism helps reduce the likelihood of dispute about dutiable values between taxpayers and Chinese Customs.

By applying for the Advance Valuation Review, an enterprise may:

- anticipate all the elements to be included into the dutiable price of the goods;
- estimate the cost of the importation; and
- enhance the predictability of its commercial deals.

Customs investigation

During 2011, China Customs recovered underpaid customs duty of Rmb2.5 billion ($397 million) from various investigations, representing a 12% increase over 2010. The outcome is consistent with the objective of the customs investigation reform initiated by the GAC in 2011.

Before the reform, some departments within the GAC other than the investigation department audited various customs-related issues separately, such as the compliance status of equipment or materials that were imported on a bonded basis or subject to reduced customs duty and indirect taxes upon importation.

After the reform, all authorities to conduct customs-related audits were consolidated into the investigation department of the GAC. This consolidation of power increases the efficiency and effectiveness of the GAC in identifying and pursuing irregularities in the customs area.

The major developments in customs investigations in 2012 include:

- the revision of the Regulations on PRC Customs Investigation;

- the introduction of third-party intermediary agents in customs investigations;
- the strengthening of international cooperation; and
- the simplification of audit procedures for medium and large-scale enterprises with good compliance records.

It is understood that the revised Regulations on PRC Customs Investigation will allow businesses to:

- conduct self-audits and perform self-reporting;
- explicitly define the roles of third-party intermediary agents in customs audits; and
- simplify customs investigation procedures for enterprises with good credit ratings.

All of these measures are intended to address chronic issues that have troubled customs investigation for years.

Self-audits

Customs self-audits were in widespread use during the financial crisis in 2009 as a way to overcome resource shortages within the customs investigation department.

The practice has abated somewhat over the last couple of years because in theory, any delinquencies discovered during a self-audit can still be subject to the same level of punitive measures as those identified in regular investigations conducted by customs officials. This put a dampener on voluntary disclosure of errors in self-audit.

The revised Regulations on PRC Customs Investigation may provide legal support for reducing penalties on issues uncovered during a self-audit. Such a new policy is consistent with international practices in Europe, North America and Japan, and could serve to encourage expanded use of customs self-audit in China.

Third-party intermediaries

In 2012, the GAC will release the Administrative Measures for the Introduction of Intermediary Agent in Customs Investigations. These measures will clarify the status of third-party intermediary agents in customs audits, and will allow enterprises to apply to the relevant customs authorities to have qualified third-party agents assist with customs investigations.

Third-party agents can be engaged by the customs authorities or by the applying enterprises. The agents would:

- conduct audits for the customs authorities;
- verify the compliance status of the businesses; and
- issue audit reports to the customs authorities to describe the detected issues.

The implementation of such a measure, if successful, could alleviate the resource shortages within local customs investigation authorities.

Simplified audit procedures

China Customs is simplifying investigation procedures for creditworthy medium and large-scale enterprises and multinationals.

The investigation department of the GAC is launching the AEO (Authorised Economic Operator) certification programme. Chinese enterprises can be accredited by China Customs as an AEO when they prove to have high-quality internal processes that facilitate compliance with customs regulations.

If a Chinese enterprise obtains the AEO status, China Customs will have a higher level of trust towards the enterprise and perform fewer or no inspections on goods imported or exported by or via the AEO. Should an enterprise obtain the highest level of AEO status, that is, Class AA, it may simultaneously satisfy the trade security standards of the EU, Korea, Japan and Singapore and be recognised in these jurisdictions as AEOs too.

The China–U.S. trade security joint validation process (that is, the C-TPAT certification in the US) is also moving forward steadily. Even so, an enterprise with AEO status can be downgraded and lose the preferential treatment accorded by China Customs if the quality of its internal control process deteriorates.

Looking ahead

In 2011, the tax revenue collected by China Customs amounted to more than Rmb1.62 trillion, accounting for 18% of China's total tax revenue. While China is trying to mitigate the negative impact of the financial crisis on its economy, the government has placed great emphasis on the preservation of tax revenue from tariffs and a crackdown on customs irregularities.

In 2012, the GAC is carrying out a robust campaign called the National Gatekeeper. The campaign is conducted by various departments within China Customs and focuses on examining the classification of commodities, valuation fraud, and supervision over goods that have received preferential tax treatment previously.

The campaign requires the investigation department and anti-smuggling department to strengthen their cooperation and act in unison. Any clue relating to non-compliance will be reported to the anti-smuggling department for assessment. As a result, enterprises importing and exporting in China will probably face unprecedented pressure to manage their customs matters properly.

To reduce audit adjustment risks, companies concerned should pay close attention to new regulations from the GAC and maintain close communication with the customs authorities in charge to understand local practices.

Chinese businesses engaged in cross-border trade should also design and implement internal control systems related to various customs requirements to ensure that the appropriate action items are embedded in their normal business processes.

And companies should develop appropriate documentation to support the key positions adopted to prepare for potential challenges by the customs authorities.

Road to a comprehensive IIT system

The State Council has indicated that a key mechanism of reforming the income distribution regime is to refine the Chinese individual income tax (IIT) system. Vincent Pang and Michelle Zhou examine how this will be done and look at the permanent establishment (PE) implications of cross-border secondment and implication of social security contributions for foreign employees and employers.

Since 2004, we have seen discussions about reforming China's income distribution regime, which, in Chinese terminology, consists of initial distribution and secondary distribution.

The initial distribution primarily relies on market mechanisms to reward the participants (for example, enterprises, employees and investors) in the economy with financial compensations based on their contributions.

During the secondary distribution, government uses fiscal, tax and social policies to re-distribute income among the participants in the economy. The purpose of the reform is to improve efficiency in the initial distribution and enhance equality in the secondary distribution.

The specific measures mentioned in article 32 of the 5YP include:

- adjustment of the IIT tax base;
- revision of the progressive rate schedule;
- higher personal exemption for salaries;
- lower IIT burden for mid-to-low income earners;
- larger IIT collections from high-income individuals; and
- the establishment of an individual property tax system.

In short, the scope of IIT reform contemplated in 5YP was extensive.

Considering that the 2008 reforms in Chinese corporate income tax (CIT) took many years to prepare and implement, many were wondering how long it would take for the same degree of transformation in Chinese IIT to happen.

Encouragingly, over the last 18 months, clear actions were witnessed to address the objectives set out in the 5YP for reforming Chinese IIT. For instance, the standing committee of the National People's Congress (NPC) issued the Order of the President of the People's Republic of China No 48 on June 30 2011 (Order 48), which increased the personal exemption for salaried workers from Rmb2,000 ($318) a month to Rmb3,500 ($556) a month, and reduced the IIT liability for mid-to-low salary earners through adjustment of the tax rate schedule. These changes took effect on September 1 2011.

Order 48 marks a significant step forward for the Chinese government on IIT reform. Despite several increases in the personal exemption since the enactment of the Chinese IIT Law in 1980, the IIT rates for salaried workers have remained relatively unchanged for more than three decades. The adjustment of the tax rate schedule in conjunction with the increase in the personal exemption reflects the government's intention to accelerate the IIT reform.

Impact of Order 48

Since the introduction of the new IIT rates and the increased personal exemption for salaried workers in September 2011, the weight of IIT collection within the total tax revenue has decreased. The IIT collection amount in the first eight months of 2012 shrunk by 8.4% compared with the comparable figure for the same period of 2011. This result shows the effects of the IIT reduction for low and medium-income individuals and the monthly personal exemption increase from Rmb2,000 to Rmb3,500.

Before Order 48, a foreign national working in China was eligible to a personal exemption of Rmb4,800 a month; in contrast, a personal exemption of Rmb2,000 of was available to Chinese salaried workers.

The increase in the personal exemption threshold for Chinese salaried workers from Rmb2,000 to Rmb3,500 a month under Order 48 did not lead to any adjustment for foreign nationals working in China. In effect, Order 48 narrowed the difference between the personal exemptions for local and foreign employees. This may be an indication that in the long run, the same level of personal exemption may be employed across the board, irrespective of nationality.

Considering the CIT reform in 2008 unified the income tax rules for foreign investment enterprises and domestic enterprises, it would not be surprising if in the future the State Administration of Taxation (SAT) revisits IIT concessions for housing benefits, children's education and other allowances, which are available to foreign employees only, if they are considered to violate the principle of equity.

Despite the positive significance, measures in Order 48 only represent a marginal improvement of the existing IIT system, and certainly do not satisfy the appetite of many Chinese salaried workers who want more comprehensive IIT reform and more equitable distribution of IIT costs in the overall population.

In a report dated March 9 2012, the Standing Committee of the NPC reiterated the need for the country to:

- establish a comprehensive IIT system in China; and
- effectively regulate income redistribution in China through taxation.

Is China ready for a new IIT system?

Under the existing IIT system, individual income is divided into categories. Each category has a separate tax rate or rate schedule as well as its own personal exemption. Different categories are not consolidated for computing an individual's annual IIT liability, even though, for years, reformists have advocated a comprehensive IIT system that follows a mixture of the consolidated and the categorised approaches. Such a proposal has outlived three 5YPs since the 1990s and was adopted again into the 12th 5YP. However, as of now, no clear agenda for implementation is in sight.

Why is it difficult to adopt a comprehensive IIT system? The conversion into such an IIT system requires sophisticated tax collection and administration mechanisms to support it. These would involve:

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Vincent Pang is the China country leader of the international executive services practice and has been involved in providing Chinese individual income tax-related services to both multinational companies and Chinese domestic companies since 1998. He started his career with professional accounting firms in Canada in 1991 and has experience in various disciplines including tax, auditing and consulting. Due to the complexity of the China environment, Vincent's experience in corporate tax, foreign exchange regulations and other investment regulatory areas allows him to provide more comprehensive and professional views when providing clients with mobility-related advice.

- setting up individual taxpayer accounts;
- effective management of cash transactions;
- building up a complete social credit system; and
- establishing a centralised database that links an individual's tax filing status with his or her credit rating, education/employment profile, and social welfare status.

Furthermore, tougher enforcement of tax regulations and severe penalties for breaching regulations are also necessary to guide taxpayers' behaviour. China does not have the systems in place to support a comprehensive IIT arrangement. It will take some time before the necessary infrastructure and tools become available, as was pointed out by a senior official of the SAT in a recent media interview.

Besides the income consolidation issue, discussions about reforming the Chinese IIT system also concern whether IIT should be collected based on the family unit or the individual unit. Yet again, adoption of family-based reporting units may not be feasible in China at this juncture, because it would require a sophisticated system, which is not in place.

Determining tax exemptions and tax rates under a family-based joint-filing system would require collection, collation, and testing of demographic data from various sources, a process that could take a few years to complete.

From January 1 2006, individuals in China with an annual income of more than Rmb120,000 are required to file annual PRC IIT returns with their local tax authorities before March 31 of the year after the tax reporting year. Through this mandatory annual filing process for a selected group of indi-

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Michelle Zhou joined the KPMG international executive services practice in Sydney in 2001, relocating to the firm in China in 2005. She is in Shanghai now.

Michelle has more than 10 years of experience assisting multinational clients across a broad spectrum of industries (including consumer markets, industrial markets, financial services and information, communication and entertainment) on personal income tax compliance and advisory services. In particular, she has experience of Australian, China and US expatriation taxation and has served on small, medium and large accounts during her career at KPMG. Over the years, she has expanded and maintained a large portfolio of prestigious clients, as well as established an internal executive services team at KPMG Shanghai.

Michelle is a regular speaker at public seminars on personal income tax related topics. She is also the author of numerous KPMG alerts on the latest trends and developments in personal income tax, the immigration and social security framework and regulatory updates in China.

viduals, Chinese tax authorities are building an IT system and database to prepare for IIT reform as the next step. Only targeting one segment of the population initially makes the implementation work easier and allows Chinese tax authorities to gather valuable experience and information for the program to expand to broader segments later on.

According to this historical pattern of tax reform, though a programme of filing IIT returns on a family unit basis or consolidated basis is likely to be the future direction of China's IIT reform, it is unlikely that such a programme will be rolled out to all taxpayers at once. A pilot programme may be initiated for a smaller group first, and eventually a formal programme may be promulgated to cover all individual taxpayers in China. Therefore, we do not expect a nationwide IIT reform towards a comprehensive system to happen in the next 12 months.

In the near term, the priority of the Chinese tax authorities will probably continue to be the enforcement of IIT compliance on high-income individuals to effectively regulate income redistribution through IIT.

What measures are taken to strengthen IIT compliance for high-income earners?

The IIT system is fairly effective in collecting IIT from salary income by requiring employers to be withholding agents. However, there are significant loopholes related to taxing individual income from high-earning executives, investors, and entrepreneurs. Senior business executives often derive significant portions of their incomes from bonuses, allowances, equity incentive plans and earnings received from overseas companies. Investors can realise large sums of income from disposals of property and other capital transactions. Entrepreneurs make sizeable business profits from their self-employment and independent labour services.

To strengthen the collection of IIT from senior business executives, we have learned that the SAT will focus on these areas in 2012:

- Continue to strictly enforce the requirement of annual IIT filings to be performed by individuals whose annual income is more than Rmb120,000
- Require that detailed monthly online filings be performed by the executives' employers
- Inspect individuals who receive wages and salaries from two or more sources and consolidate the details submitted by the employers
- Compare and cross-reference the salary expenses declared in the CIT return of the employer with the salary income declared in the monthly IIT withholding returns submitted by the employer
- Strengthen the tax collection and management of IIT on income derived by business executives from stock options, restricted stock units, and other equity incentive plans
- Investigate the IIT treatment of allowances and expense reimbursements received by business executives.

To improve the system in collecting IIT from investors and entrepreneurs, the SAT issued a circular in 2011 to strengthen IIT administration of the disposal of investment property.

For example, when an individual transfers an equity interest in a Chinese company, under the prevailing regulations, the ownership registration of the equity interest with the State Administration of Industry and Commerce or its local branches (AIC) should be updated to reflect the change in title.

When the AIC processes an application for amending the ownership registration because of a transfer of equity interest, the 2011 circular requires that the individual seller submit a tax clearance certificate in connection with the transfer to the AIC in charge. The tax clearance certificate is to prove that the individual seller has settled IIT on the property transfer. Without the tax clearance certificate, the AIC will not approve the application.

Capital transactions such as equity interest transfers by individual investors and entrepreneurs will continue to be the focus of the 2012 IIT administration and audit. The tax authorities will collect information from various government authorities on equity transactions related to listed and non-listed companies, as well as transactions on real estate, mineral resources investments, private equity funds, trusts and other investments, to verify whether the individual investors and entrepreneurs have fulfilled their IIT obligations.

The SAT hopes that heightened enforcement will lead to an increase in IIT collection from capital transactions, which can partially make up for the reduction in IIT revenue because of the tax relief measures in Order 48.

What other areas do multinational companies need to consider when sending foreign workers to China?

Besides the reforms of the IIT system, China has issued regulations that technically do not relate to IIT, but have immediate tax implications for the prevalent practice of multinational companies (MNCs) sending expatriates to China as secondees.

Economic employer

It is common practice for MNCs to dispatch foreign employees to work in their Chinese affiliates under a secondment arrangement. Normally such an arrangement seeks to characterise the dispatching entity as the legal employer and the Chinese host entity as the economic employer. The PRC tax challenge is whether these intended objectives will be accepted by the Chinese tax authorities.

If the host entity is not considered as the economic employer or the "real" employer of the expatriates, extended stays of these expatriates in China will create an establishment under PRC domestic law or permanent establishment (PE) under PRC income tax treaties.

In the past, we have observed significant inconsistencies in how local Chinese tax authorities viewed this issue. The erratic positions taken by local tax officials called for the issuance of national guidelines to promote a uniform treatment, especially in the income tax treaty context.

In response to taxpayers' appeals, the SAT issued *Guoshuifa* [2010] No 75 (Circular 75) about two years ago, clarifying to some extent when a PE would be constituted in a cross-border secondment. While the circular puts across a clear message that a substance-over-form approach should be adopted in determining the real employer of a foreign secondee working in China, MNCs are still struggling with ambiguity in many cases as Circular 75 is limited to situations where the secondment is between the parent company and subsidiary.

We have learned that the SAT is evaluating a draft circular to provide further guidance on the subject after Circular 75. According to the draft circular, if the conditions below are met, expatriates assigned from an overseas company to a Chinese entity will be viewed as employees of the Chinese entity and thus no service PE of the overseas company would be created in China:

- Performance reviews and appraisals for the secondees will be done by the Chinese company solely, and the Chinese company shall be responsible for the result and risk associated with the performance of the secondees.
- The Chinese company shall determine the numbers, qualification requirements, compensation, and working places for these secondees.
- The Chinese company shall not pay any services fees or other considerations to the overseas company in relation to the secondment.
- The IIT returns for the secondees have been filed and the IIT liabilities have been settled.
- In case the overseas company pays certain salary and wages, social security and other expenses to the secondees, the Chinese company shall reimburse the overseas company without any mark up.

Though the draft circular is still not finalised, it sheds light on the factors that the PRC local authorities will probably scrutinise to decide whether the Chinese host entity is the real employer of the secondees. MNCs should pay close attention to these points in designing secondments to mitigate PE risks in China.

Social security

The Chinese Social Insurance Law, which came into effect on July 1 2011, establishes the basic social insurance framework for employees in China with the aim of standardising social insurance programmes in mainland China. It covers both Chinese and foreign employees.

On September 6 2011, the Ministry of Human Resources and Social Security (MHRSS) issued the Interim Measures to guide foreign employees to participate in China's social insurance scheme, which:

- describe the general implementation process:
- specify the consequences of non-compliance; and
- prescribe the national enforcement date.

On December 2 2011, the MHRSS released a circular to further clarify issues such as the effective date, the impact of totalisation agreements on foreign employees in China, and additional administrative details.

Since this announcement, some municipal governments, for example, Beijing, have circulated local guidelines and started to enforce the Chinese social security registration requirements for foreign employees.

These cities have also actively sought to collect social insurance from foreign employees and their Chinese employers. However, the roll-out is not happening across all of China. We have noticed that authorities in many cities such as Shanghai have not yet started the social insurance programme for foreign nationals or indicated when they will issue relevant local implementation guidelines.

Despite the inconsistent implementation status in various locations, the social insurance rules are here to stay.

Therefore, MNCs must take this additional cost into account when planning to second foreign employees into China in the future.

Some may argue it is unfair for China to levy social security on foreign nationals. Many foreign nationals are required or prefer to participate in social security schemes in their home countries, and mandatory contributions into the Chinese social insurance programme would result in duplicative social security payments.

From a policy perspective, asking foreign employees to make social security contributions in the local country where they work is not unique in China. Many developed countries have similar requirements. However, compared with these developed countries, China has a limited totalisation network, which allows foreign employees to apply for exemptions should they wish to continue making contributions to their home country's social security system. Therefore, the problem of duplicative contribution in China could potentially be more serious.

China has only entered into partial totalisation agreements with Germany and South Korea, which do not provide exemptions on all types of social security payments in China. China is in talks with more than a dozen countries including the US, Japan and Russia. However, the conclusion of a totalisation agreement is expected to take years. Therefore, most foreign employees working in China will probably experience double social security costs in the foreseeable future.

Keeping on top of changes

The Chinese central government once again identified income redistribution as a priority to complete in the most recent 5YP. IIT reform is instrumental to help achieve this objective. The NPC has issued Order 48 to start this reform process, but there is a still a long way to go.

To make the IIT system more effective in regulating secondary income distribution, China should migrate towards a comprehensive IIT system with features such as consolidated income reporting, and joint IIT filing on family basis. The SAT is preparing for the migration by building an information system for a selected group of the population and plans to make the transition following a phased approach.

Besides the transformation of the IIT system, the Chinese government has issued other circulars that may have tax implications for foreign employees working in China and their employers within and outside China.

Two examples discussed in this article are the economic employer issue in a cross-border secondment arrangement and the duplicative social security contribution issue for foreign employees in China. MNCs should follow these regulatory developments closely and take these additional costs into account when making plans for their PRC operations.

Will tax help save the Chinese environment?

Jean Ngan Li, Sunny Leung and Jessica Xie explain that Chinese government has introduced measures, including tax and financial incentives, to ensure that the breakneck economic growth in China can be sustained in the long-term and is not achieved by sacrificing the natural environment.

2011 marked the beginning of China's 12th Five-Year Plan (5YP), in which the Chinese government made a public commitment to enhance the protection of China's environment and conservation of natural resources.

Over the past year, the central government started implementing various measures to enhance the efficient utilisation of conventional energy and expand the exploration for natural gas and other energies. It has also continued to provide tax and financial incentives to encourage both domestic and foreign investment in unconventional energy sources such as shale gas and renewable energy.

To reduce dependency on resources and boost revenues for provincial authorities, the central government has reformed the previous Resource Tax (RT) regime primarily by imposing *ad valorem* RT on crude oil and natural gas, starting from November 1 2011 on a national basis.

The speculation is that coal is the next category in line to be subject to *ad valorem* RT. However, the central government is mindful of the fact that coal prices are soaring, and increasing tax costs for coal may create an additional burden for power companies that use coal for electricity generation.

Besides the RT reform, the Chinese government also plans to pass legislation to replace sewage charges with Environment Tax (ET). Such a measure is intended to increase the costs of polluters for causing environment damage.

Shale gas: a new source of energy

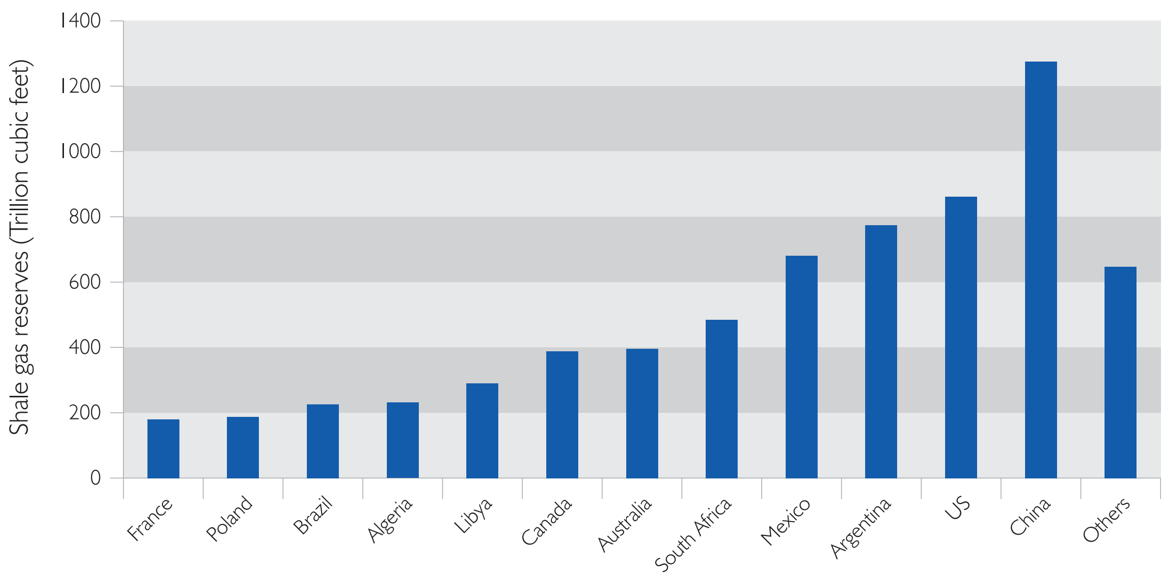
China has the largest shale gas reserves in the world, with more than 25 trillion cubic metres of deposits, which could well be China's largest onshore energy source (see Diagram 1). With such large reserves on hand, China is looking for ways to explore and use such a resource and decrease reliance on Russian and other foreign natural gas sources.

To recognise the great potential of shale gas to meet China's energy needs, the Ministry of Land and Resources (MOLAR) issued a notice in December 2011, classifying shale gas as a new and independent type of mineral and making it the 172nd type of mineral officially catalogued in China.

This is a key step towards recognising shale gas as an alternative energy source, separate from conventional oil and gas. And MOLAR has, in principle, also agreed on the "the Guideline for Administration of Shale Gas Resources (the Guideline)," which governs shale gas exploration in China. The final version of the Guideline is expected to come out soon.

To regulate the direction of foreign investment and monitor the foreign investment landscape in China, the Chinese government issued the Foreign Investment Industrial Guidance Catalogue and periodically released an updated version of the Catalogue.

Diagram 1: Technologically recoverable global shale gas reserve estimates



Source: World Shale Gas Resources: An Initial Assessment of 14 Regions Outside the United States, EIA, April 5 2011

In the most recent 2011 edition, which came into effect on January 30 2012, shale gas exploration and production is classified as an encouraged type of foreign investment. This means that foreign investment in the shale gas sector can enjoy a potentially easier administrative approval process and more favourable fiscal and tax policies than before. However, in terms of investment, foreign investment in shale gas is still limited to the form of Sino-foreign equity/cooperative joint ventures (JV) with Chinese partners rather than wholly foreign owned enterprises.

In the 12th 5YP, the Chinese government set a target of fulfilling most of the nation's energy needs from alternative sources by 2020. To reach this target, MOLAR, the National Development and Reform Commission (NDRC), the Ministry of Finance (MOF) and the National Energy Administration (NEA) jointly published the "The Development Plan for Shale Gas from 2011 to 2015" (the Plan) on March 16 2012. The Plan aims to convert the high expectations for shale gas into specific action steps for the industry.

The Plan states a goal of producing 6.5 billion cubic metres of shale gas in 2015, which is described by many foreign industry experts as aggressive. However, MOLAR officials consider this target to be achievable if the market is opened up to all industrial participants, including foreign and domestic private enterprises. Under the Plan, a market mechanism will be introduced so that future shale gas prices will be determined by supply and demand instead of being regulated by the Chinese government.

Entry threshold

Foreign companies are encouraged to participate in the exploration and development of shale gas, as the Chinese government is eager to acquire relevant experience and technology from foreign investors. However, as the Chinese shale gas industry is still in its infancy, there is no regulatory framework available to govern foreign participation in shale gas projects.

Shale gas exploration rights are granted through competitive bidding. The first round of bidding took place in June 2011, where various state-owned enterprises, including CNPC, CNOOC, Sinopec, China United Coal Bed Methane Company (CUCMB), Yanchang Petroleum and Henan Coal-bed Methane Gas, were invited to join.

The second round of bidding is expected to take place around October 2012. MOLAR officials have indicated that the exploration and mining rights shall be owned by Chinese entities and will not be allowed to be transferred to foreign investors under any arrangement or circumstance.

MOLAR officials advised that among the many requirements, bidders must have experience in gas exploration and meet certain financial requirements. A foreign investor may jointly bid together with a Chinese partner or form a joint venture (JV) with a Chinese company. The bidders must possess sufficient qualifications, and commit to making a significant amount of investment if they win the bid to prevent squatting behaviours. The bidders may need to obtain approvals from MOLAR, NDRC and the State Council to obtain the exploration rights.

The various breakthroughs in shale gas exploration and extraction made in the US have drawn close attention from China. However, China's shale gas deposits are geologically different than those in the US Many of China's shale gas deposits are deeply located in geological structures that are difficult to access. Besides, China's shale reserves often have unique physical compositions, which differ from those in other countries.

Therefore, MOLAR officials believe that the US methods of retrieving shale gas cannot be simply duplicated in China. By leveraging foreign technologies, MOLAR wants domestic enterprises and institutions to conduct joint research with their foreign partners and counterparts and develop core technologies for shale gas exploration and extraction that will adapt to China's unique geological requirements.

Fiscal and tax incentives

According to the Plan, a series of preferential policies will be published to provide incentives and encourage the exploration of shale gas and development of relevant technologies.

Various fiscal incentives are available for the coal-bed methane exploitation sector. For example, companies conducting exploration of coal-bed methane may be entitled to financial subsidies from the central government at Rmb0.2 per cubic metre by sales volume; local financial subsidies may also be granted. It is likely that the preferential fiscal policies available to investors in shale gas will resemble those for the coal-bed methane exploitation sector.

On the tax side, as the State has designated shale gas as a strategically important energy source and have accorded it with an independent mineral category status, the associated tax incentives are likely to be more generous than those available for coal-bed methane.

According to *Caishui* [2007] 16, general VAT taxpayers engaged in coal-bed methane exploitation can enjoy the preferential "levy first and refund later" VAT treatment, and the VAT refund is exempt from corporate income tax (CIT) if it is invested in the R&D of exploration technologies or the expansion of coal-bed methane production.

Furthermore, qualified taxpayers can use the accelerated depreciation method on certain exploration and extraction equipment, and take a 50% bonus deduction on R&D expenses that are incurred for incubating new technologies. Finally, qualified taxpayers are temporarily exempt from RT in connection with coal-bed methane exploitation.

The tax incentives above apply to the coal-bed methane sector and possibly also pertain to the shale gas sector when the final rules are issued. In addition, the Plan indicates that qualified enterprises in the shale gas sector may be eligible for customs duties and import VAT exemptions on the importation of equipment, instruments, parts and accessories, special tools, and embedded technologies that are necessary for shale gas exploration, but cannot be sourced domestically.

In general, the ownership rights of natural resources in China belong to the State, unless otherwise prescribed by the law. Therefore, enterprises that conduct exploration and mining activities on various types of natural resources in China normally need to pay royalties to the State to acquire the associated rights. However, as an incentive, the Plan suggests that an enterprise that obtains exploration or mining rights of shale gas may be exempt from royalties.

Other potential benefits, such as priority in granting land use rights to shale gas developers, are also mentioned in the Plan. Specific details have not yet been made public.

Nationwide resource tax reform

On October 28 2011, the MOF and the SAT issued Decree No 66 to revise the Implementation Rules for the Provisional Regulations of the PRC on Resource Tax issued in 1993 (Old Regulations). The revised Resource Tax Provisional Regulations and implementation rules (New Regulations) took effect from November 1 2011.

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Jean started practising China tax in 2001 and over the last seven years, she has been actively involved in organising roundtable meetings with Chinese government officials and major players in the oil and gas, mining, power and utilities and renewable energy sectors to discuss new tax regulations and policies. She is also the lead tax partner on projects pertaining to advice on renewable energy and Clean Development Mechanism (CDM) projects in China.

Jean also advises the Budget Affairs Commission of the PRC National People's Congress, the Ministry of Finance and the tax authorities about tax reforms, including the PRC VAT reform and the environmental tax legislation.

Compared with the Old Regulations, the RT on crude oil and natural gas was changed from a volume-based tax to an *ad valorem* one, which led to an increase in the tax burden for companies conducting mining activities in these areas. The change has significantly boosted the tax revenues of the provinces where crude oil and natural gas are produced. For example, the RT revenue collected by Xinjiang reached about Rmb4.5 billion ($715 million) in 2011, an increase of 77.37% from 2010.

Other types of taxable resources continue to be subject to volume-based RT, though the tax rates are different from under the Old Regulations. The MOF and the SAT jointly issued a circular to increase the tax rates of six volume-based mineral products such as tin and molybdenum from February 1 2012.

The trend for changing the tax base from volume to value may continue for other mineral products including coal and non-metallic materials. The initial round of RT reforms and the conversion of the tax base from volume to value has excluded coal so far. At the moment, 70% of China's energy generation is from coal. China is already facing a shortage in electricity, which is partly caused by rising price of coal as a raw material and, to a degree, caused by regulated sales price for electricity output.

Delay of the RT reform is intended to relieve the cost pressure on the major power companies. However, the transition of the tax base is a key objective of the RT reform. An *ad valorem* tax for coal will probably be instituted in the next five to 10 years when China's inflation pressure eases and a market pricing mechanism for electricity is well established.

Environment tax in controversy

Many nations are discussing a new international climate change regime after emission reduction targets set by the Kyoto Protocol expire in 2012. With the global economic downturn, China is facing immense challenges in dealing simultaneously with maintaining healthy economic growth and tackling environmental issues. The central government is keenly aware of the severity of industrial pollution and ecological degradation in China, and outlined primary measures in the 12th 5YP, including ET reform, to improve the situation.

Historically, China lacks an ET mechanism. While the Environment Protection Bureau (EPB) imposes sewage charges, these are administrative charges rather than taxes and are poorly enforced. Furthermore, they have limited application and the applicable rates are not significant enough to achieve the policy intent. Many social groups have been advocating a comprehensive ET system to the central government for years.

In a guideline issued in October 2011, the State Council stated that China will actively promote reforms in environment-related taxes and conduct research on imposing an ET that will replace the existing sewage charges. Traditional pollutants such as sulphur dioxide, waste water and solid waste will be subject to this tax and the tax base will be the actual emission amount.

In a more recent guideline, the State Council declared China will include environment protection in the government's annual budget and gradually increase investment in this area. In addition, China will speed up the establishment of a special funding mechanism to expand the scope of remuneration for ecological damage.

These measures are designed to pull China out of the environmental mire and position it as a responsible leader in the world economy after three decades of "filthy growth". However, the path of ET reform in China may not be a smooth one. For instance, some critics have voiced concerns that resource-hungry industries such as the steel, oil and cement sectors will have a hard time absorbing the new ET costs, considering that the ET reform may have already increased their tax burden directly or indirectly.

Tax policies shall be designed in a way to punish the behaviour of the polluters and to reward taxpayers who are prepared to invest in projects that enhance environmental protection. Following this principle, China is expected to reduce other taxes or grant tax incentives to ease the burden of qualified taxpayers when it introduces the ET in due course.

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Sunny Leung started her career in New York in 1997. She joined KPMG's New York office, specifically the federal tax practice, in 2000 and provided US tax compliance and advisory services to various multinational companies.

Sunny joined KPMG China's Shanghai tax team in 2005. Since then, she has been providing PRC tax advisory and compliance services to multinational companies in manufacturing and service industries. She has had extensive involvement in advising clients on setting up operations in China, M&A transactions and cross-border supply chain planning. She has also been providing tax due diligence and tax health check services in China.

In addition, the ET reforms may also face possible challenges from existing stakeholders. For example, the ET reform will transfer the government revenue source related to existing sewage charges away from the EPB and place it in the hands of the tax authorities. Suitable measures are needed to balance the economic interests of these two government branches.

And whether carbon dioxide emissions should be within the scope of ET remains controversial among industry specialists and policy makers. One school of thought is that carbon emissions should be included, as China is close to being the second largest producer of carbon emissions in the world. The other school of thought, however, is that China's economy is not developed enough and its technologies are not sufficiently mature for carbon emissions to be governed by the new ET regime. As such, the likely answer is that carbon dioxide emissions will not initially be included in the scope of the forthcoming ET regime, but may be incorporated later.

Importance of energy

Rapid economic growth in China depends on the continuous energy supply. Shortages in conventional energy sources will necessitate the development of alternative energy. As a result, investments in unconventional energy supplies such as shale gas will ramp up. We anticipate that implementation rules for financial and tax preferential policies will be published soon to encourage the exploration of shale gas. Meanwhile, the central government will probably issue accompanying environmental regulations to protect underground water and properly treat waste water during the shale gas extraction process to ensure that China will learn from mistakes of the US.

In addition, enterprises in the conventional energy exploitation sectors will probably incur higher tax costs when coal and other minerals are subject to *ad valorem* RT. Finally, China will seek to cut down environmental pollution by upgrading sewage charges to a more comprehensive ET system. In conjunction with the new ET, the central government will probably provide tax incentives and preferential policies for renewable energy projects and will use a carrot and stick approach to enforce environmental protection in China.

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Jessica Xie specialises in advising clients on tax issues concerning the energy and natural resources industry as well the manufacturing industry.

Jessica has also been active in assisting many foreign companies in designing their corporate and operational structures in China to meet their business objectives. She also focuses on providing M&A tax services to foreign companies and assists in tax due diligence, transaction structuring, post-acquisition structuring as well as setting up various forms of legal entities for acquisition or operational purposes.

Jessica also provides advice to multinational companies in the areas of company regulations, foreign exchange and customs issues.

Property tax: Where does it go from here?

For years, some policy advisers have advocated the use of property tax as a mechanism to cool down the real estate market. Part of the rationale is that a greater amount of supply would help drive down the market price. But would it? Jennifer Weng, Tracy Zhang and Jean Jin Li examine the impact that tax will have on the property market in China.

The Chinese real estate market has experienced phenomenal growth over the past five years. Housing prices in Beijing and Shanghai have surged by more than 110% since 2007. Today, a high-end home in prime areas of Beijing and Shanghai can cost upwards of $20,000 per square metre.

However, skyrocketing real property prices have raised concerns about a housing bubble in China due to excessive speculation by investors. Fears of an asset bubble have led the central government to announce several administrative measures over the last two years to try and temper breakaway housing prices. These include:

- tightening eligibility criteria for multiple home purchases (property purchase limit);
- raising central bank reserve requirements for commercial banks and;
- hiking borrowing rates.

In a 2010 proposal on China's 12th Five-Year Plan (5YP), the Chinese Communist Party suggested that one of the tax reform areas is to study and promulgate a property tax system in China. The rationale of some policy advisers in using property tax as a mechanism to cool down the real estate market in China is that it would increase the costs of holding real estate inventory and force investors to push more unoccupied real estate properties to the market for sale.

It was contemplated that property tax reform would start in selected regions first and if successful, would be expanded to other parts of the country. On January 28 2011, Shanghai and Chongqing began trial measures to collect property tax from individual residents for the residential properties they owned in these cities. The trial measures in Shanghai and Chongqing have been in place for more than a year.

Scope of taxable properties under the trial measures

The property tax reform measures in Shanghai and Chongqing were prepared and issued by the municipal governments there and therefore differ from each other in their specific provisions. The key terms for each city are summarised below.

Shanghai

In Shanghai, property tax is levied on individual owners of residential properties located in Shanghai if either of these two situations applies:

- Residential property (including second-hand property and newly constructed property) is purchased by a resident household of Shanghai after January 28 2011. Before the purchase of this property, the Shanghai resident household already owns at least one residential property in Shanghai (Situation 1)
- Residential property is purchased by a non-resident household of Shanghai after January 28 2011 (Situation 2).

In Situation 1, the resident household may be partially or fully exempt from property tax on the new purchase if the following applies: after dividing the total living space of the household in Shanghai, taking into account the newly purchased property and the pre-existing residential properties in Shanghai by the number of people in the household, the average living space per person in the household is no more than 60 square metres. If the average living space per household is more than 60 square metres, the portion of the aggregate excess that is caused by the purchase of the new property is subject to Shanghai property tax. The living space here refers to the construction space, a term used by Chinese real estate developers in measuring the size of real properties in China.

If Shanghai property tax applies, the applicable tax rate is as follows:

- If the transaction price of the property per-square-metre is less than two times the average selling price of all newly built properties in Shanghai in the preceding year, the applicable tax rate is 0.4%.
- In all other cases, the applicable tax rate is 0.6%.

Chongqing

In Chongqing, the property tax measures are implemented in nine districts in the metropolitan area (the nine districts). Property tax will be levied on individuals purchasing or owning these types of properties in Chongqing:

- Detached houses that are owned by individuals.
- High-end residential property (including second-hand property and newly constructed property) is purchased by an individual after January 28 2011. A property is high-end if its transaction price per-square-metre is at least two times the average selling price of all newly built properties in the nine districts in the preceding two years.
- A property purchased by a non-resident after January 28 2011, if before this purchase, a non-resident owns at least one real property in Chongqing. A non-resident is an individual who is not registered as a resident in Chongqing, who does not own a business in Chongqing, or who is not employed in Chongqing.

If Chongqing property tax applies, the applicable tax rate is as follows:

- If the property is priced lower than three times the average price of all newly constructed properties on a per square metre basis in the nine districts during the two preceding years, the tax rate is 0.5%.
- If the price of the property is between three times and four times the average price of all newly constructed properties in the nine districts during the two preceding years, the tax rate is 1%.
- In all other circumstances, the tax rate is 1.2%.

Initial results of the trial measures

The results published by market research institutions show that in Chongqing, the number of potential buyers for high-end residential properties has dropped 30% to50%; the prices of taxable properties have also decreased 10.48% since the trial measures took effect. Data released by the Shanghai Statistics Bureaus suggest that the average price of newly constructed residential properties has decreased 5.4% to Rmb13,448 ($2,137) per square metre in 2011.

However, the scope of the property tax pilot programme is quite limited and as such, a broad range of properties is not subject to property tax. For example, 90% of residential properties in Chongqing are ordinary properties, which fall outside the scope of the trial measures.

In addition, the amount of property tax revenue collected to date is insubstantial compared with the overall fiscal revenue in the two cities. And other policies besides property tax, such as the property purchase limit in Shanghai and the rising borrowing rates in Chongqing, may have also contributed to the price declines.

In economic centres such as Shanghai and Chongqing, increasing fiscal revenue is not the main goal of imposing property tax. Instead, a property tax is regarded as more of an economic balancing tool in controlling the overheated residential property market, especially for the high-end residential property market. So far, the trial measures have to some degree, depressed transaction volumes and the prices of high-end residential properties in Shanghai and Chongqing.

Though the scope of the reforms on taxable properties is somewhat limited, the property tax trial measures have had an impact on the decisions of real estate investors and had some effect in containing speculative activities. Potential

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Jennifer had been seconded to the international corporate tax group of the KPMG New York office for one year to assist with US companies focusing on various international tax projects for US companies.

investors now may need to take into consideration the holding costs when they make investments in residential properties and the likelihood that such tax costs might increase in the future when tougher and more comprehensive property tax regulations are issued.

Future expansion of the trial measures

The central government has explicitly expressed its intention to ask more cities (three to five) to adopt property tax trial measures in 2012. However, it is not prepared to expand the property tax programme nationwide yet.

It is anticipated that Shenzhen and Guangzhou could be the most likely cities to follow Shanghai and Chongqing and implement a property tax system on individual real estate owners. The real estate markets are quite mature in those cities, so the local tax authorities are better-positioned to begin the trial.

Hubei and Hunan provinces are also prepared to operate property tax programmes. Beijing was initially reluctant to authorise a pilot programme last year. However, it has recently changed its attitude and publicly expressed its intent to make property tax reform a priority. The property tax pilot programmes in these cities will heavily incorporate the experience gained from the trials in Shanghai and Chongqing.

Future trends of property tax reform

Taxation of existing properties

Under the trial measures in Shanghai and Chongqing, the imposition of property tax only applies to newly purchased properties (with the exception of owners of detached houses in Chongqing, who also need to pay property tax).

This policy of targeting newly acquired properties rather than existing properties is inconsistent with the principle of fairness in taxation. In general, a property tax should apply to all property owners regardless of whether the properties are newly bought versus existing, or high-end versus ordinary. The principle of fairness, however, is not violated if certain exemptions are accorded to properties that meet the basic needs of living spaces for the owners.

The Chinese government is setting up a monitoring system that links key information on real properties in 40 cities. Once the system is up and running, it would be feasible to examine the real estate assets owned by individuals in different cities by name and national ID number and retrieve the title certificates as well as the purchase agreements. Such a system will be integrated with IT platforms from the fiscal, tax, banking and public security authorities and will facilitate the implementation of property tax for both newly purchased and existing properties in the future.

Valuation

According to article 4 of the Shanghai property tax trial measures, the tax base to compute property tax will initially be the transaction price. After the initial phase of the reform, a valuation figure approximating to the market price of the property should be used as the tax base and will be subject to periodic adjustment for the same property. Chongqing also adopts a similar approach.

The transaction price method is vulnerable to manipulation. In the past, even among unrelated parties, it was common that individuals prepared more than one contract. Besides the real contract, one shadow contract with an artificially low transaction value was often executed between the parties for tax purposes. Therefore, to ensure the property tax system achieves its policy objective, the pilot programmes should move to the fair market value method as soon as possible.

However, property valuation in China is still at a nascent stage. The standards and the expertise of property appraisers still require substantial refinement. The challenge in the future is to develop a government regulated real estate appraisal system that can effectively support the property tax regimes.

Tax exemption

Tax exemptions are provided for in the trial measures in Shanghai and Chongqing. The exemptions are granted depending on:

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Tracy Zhang joined KPMG China's Beijing office in 1996. In 2006, she was seconded to the Qingdao office and was the head of the local tax practice. From April 2007 until July 2008, she worked with both the international corporate tax practice in KPMG New York as well as the financial services practice in KPMG London, respectively.

Tracy is a PRC regulatory and tax specialist on China investment related issues. Since 2004, she has been functioning as one of the leaders of the financial services tax team in KPMG Beijing, looking after domestic and foreign financial services, private equity and real estate clients. She has also been involved in:

- developing structures for foreign investments into China;
- tax due diligence reviews in connection with M&A transactions;
- and advising on cross-border transactions.

- when the purchase was made (that is, purchased before or after the implementation of the trial measures);
- what type of property was bought (for example, detached houses and high-end residential properties in Chongqing); and
- what the average living space for the purchasing household is (for example, the 60 square metre per person threshold in Shanghai).

China has travelled a tough road in pushing property tax reform thus far. The key argument raised by the opponents of the reform is that a blanket property tax without considering the size of a household unfairly taxes low-income families. In addition, retiring home-owners with fixed stipend are also concerned that property tax would create additional expenses for them without granting them the corresponding benefits.

For the property tax reform to proceed smoothly, it is important to design an exemption system that waives property tax for minimum living space. For example, regardless of whether a new home purchase is made, if the average residential space of a household in a particular city is within a threshold limit, no property tax should be imposed. Such a policy would help gather the support for a nationwide implementation of the property tax in the future, and more accurately aim the intended targets of property tax, that is, speculative real estate investors who often own scores of properties in one city for future resale.

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Jean Jin Li has more than 10 years of experience in the China tax practice and has worked in the US, Shanghai and Shenzhen, where she works now.

Jean has extensive experience in China tax consultancy. With her strong accounting, auditing, taxation and legal background, she advises clients on their investment and development plans, business structures, M&A transactions, share transfers, liquidation processes and transfer pricing strategies, as well as the customs and foreign exchange aspects of business operations. Jean also maintains good relationships with both tax and investment related authorities.

Jean is a certified public accountant and the holder of a lawyer practitioner qualification in China.

Controversies

Double taxation

There are debates as to the fairness of collecting property tax from individual property owners. Land in China belongs to the State. When a real estate developer wants to build commercial or residential projects on a piece of land, it needs to pay a fee to acquire the land-usage rights over a specified period (for example, 40 years or 70 years) and pass the fee on to the property owners through the sale price. Such land usage fees constitute a critical part of many local governments' fiscal revenues, which explains why local government are extremely reluctant to take concrete actions that would dampen overheated local real estate markets. Some argue that since the government already collects a *de facto* property tax in the form of the land-usage right, asking individual homeowners to pay an annual property tax would create double taxation.

Legal basis

Property tax is not a new tax in mainland China. Under the Interim Regulation of the PRC on Real Estate Tax (the Interim Regulations), individual property owners in mainland China should be subject to property tax for properties used commercially.

However, real properties owned by individuals for self-use have been exempt from property tax. Technically, the property tax reform measures in Chongqing and Shanghai are not consistent with the Interim Regulations and therefore lacks legal basis. Work is now underway to modify the Interim Regulations. The final release date of the revised regulations is still unknown.

Impact on tenants

In China's tier-one cities such as Beijing and Shanghai, demand for rental properties usually outpaces supply. If property tax is applied to all real estate, including existing and newly purchased, the incremental costs arising from property tax on the owners may ultimately be passed on to the tenants. Therefore, the imposition of property tax may indirectly drive up rental costs and increase the financial burden of tenants, who may already be in a financially worse-off position than property owners.

Administration in collection

It is expected that when the property tax reform is launched nationwide, the tax will not only be imposed on newly purchased properties, but also on existing ones. Such a feature would present a tremendous challenge to tax administration and enforcement in mainland China. In contrast, the trial measures in Shanghai and Chongqing mainly seek to collect property tax from new purchase transactions.

Based on the capability of tax enforcement, it would be difficult to identify a mechanism to effectively collect tax on existing properties owned by individuals. An expansion and upgrade of the government's IT system and databases are in urgent need. In addition, each city may have its own unique problems to address. For instance, many residential real properties in Beijing are owned by government-invested enterprises and the Beijing government is grappling with the issue of whether to grant special relief to those properties without compromising the fairness of the property tax programme.

Looking ahead

As stated in the first section, the central government dropped a massive bomb in 2011 to hold back the rapid rise in real estate price, that is, the "property purchase limit" policy. Specifically, residents and non-residents in major cities are restricted from buying additional properties even if they have the financial means, unless they meet stringent qualification criteria. The property purchase limit policy is criticised for contravening the principle of the free market and only temporarily suppresses the underlying force that drives the real estate market.

A long-term solution is a more market-oriented approach such as a property tax regime to influence investment patterns in the Chinese real estate market. When the property tax system becomes well established, property tax should provide an important source of government revenue and serve to reduce local governments' reliance on land-usage fees. This will help put local governments in a relatively neutral position when it comes to regulating the Chinese real estate markets. Therefore, an appropriately designed and well-established property tax regime will play a positive role in fostering a healthy residential property market in mainland China.

New Hong Kong tax initiatives in the pipeline

The Hong Kong government and the Inland Revenue Department (IRD) have embarked on a series of initiatives aimed at enhancing Hong Kong's status as an international financial centre.

Ayesha Lau, Curtis Ng and John Timpany describe key recent developments including DTAs, Islamic finance, TIEAs and APAs.

Hong Kong's network of comprehensive DTAs

Through signing DTAs with Jersey, Malaysia, Mexico and Canada in February, April, June and November 2012 respectively, Hong Kong has now expanded its network to 26 tax treaties. Similar agreements with Spain and Indonesia entered into force in March 2012 and those with Portugal and Malta entered into force in June and July 2012 respectively, bringing the total DTAs in force to 20.

The Indonesian DTA is of particular interest as it offers attractive withholding tax rates on dividends, interest and royalties. When compared with Indonesia's other treaty partners, a new Hong Kong DTA is more favourable and should enhance Hong Kong's status as the location of choice for holding investments in Indonesia. Negotiations are underway with a further 12 jurisdictions including South Africa, Korea and India.

The development of Hong Kong's DTA network continues to enhance its position as a regional investment and trading hub. However, Hong Kong should keep prioritising DTAs with major trading partners such as Germany, the US, Australia and Taiwan, as well as countries in South America and Africa, which remain the focus of Chinese outbound investment.

Consultation on Islamic finance

In March 2012, the government launched a two-month consultation on proposed amendments to the Inland Revenue Ordinance (IRO) and Stamp Duty Ordinance (SDO) to promote the development of an Islamic bond market in Hong Kong. This policy initiative was first articulated by the Hong Kong Chief Executive in his 2007 policy address; and most recently by the Financial Secretary in the 2012-2013 Hong Kong Budget. To complement its position as an international financial centre and asset management centre, the government understands the importance of supporting alternative financing arrangements such as Islamic finance.

Hong Kong is the leading financial services centre in the Asia-Pacific region. As a global and regional financial hub, it is committed to ensuring that it has a legal and tax framework to support the development of Islamic financing in the region. There is an ever-increasing demand for Islamic financing products from both investors and borrowers, and Hong Kong needs to provide a platform to promote this sector in the region. The introduction of Islamic finance in Hong Kong will help diversify its financial platform and add to the breadth and depth of its financial market by widening the spectrum of financial products and range of market participants. This will, in turn, reinforce Hong Kong's position as an international finance centre.

Islamic finance refers to financial activities that are in compliance with the requirements, restrictions and prohibitions imposed by Islamic law (Shariah) and has fast become part of the mainstream financial services industry around the globe.

Major financial markets such as the UK, Singapore, Japan, Australia and Ireland, have all been developing their Islamic finance offering. From a participant's perspective, the principal issue is to ensure that the tax treatment of an Islamic financing product is the same as a conventional financing arrangement.

The payment of interest is prohibited under Shariah law and returns are structured as distributions of profit or rental payments. Arrangements typically involve the issue of *Sukuk*, which are asset-based or asset-backed instruments representing *Sukuk*-holders' undivided ownership in the underlying asset and their right to receive profits generated by the asset.

The issue of *Sukuk* therefore typically involves more complex structures than conventional financing arrangements, such as setting up a special purpose vehicle (SPV) and multiple transfers of the underlying asset for the purpose of generating returns in the form of rental income, trading gains or profit sharing instead of interest. Such structures may attract additional profits tax, property tax and stamp duty charges which, in the absence of special rules, place *Sukuk* issues at a disadvantage compared with their conventional counterparts.

The existing tax regime is a major impediment to the development of a *Sukuk* market in Hong Kong. The main tax difficulties that arise in a Sukuk issuance are:

- When the underlying asset is Hong Kong immovable property or Hong Kong stock, additional stamp duty charges will be incurred as a result of the multiple transfers and lease of the underlying asset between the originator and the SPV, which would not have been implemented but for Shariah purposes
- Coupon payments made by the SPV to *Sukuk*-holders and certain periodic payments from the originator to the SPV are not deductible for profits tax purposes as they are not interest payments in legal form
- The originator of the *Sukuk* may cease to be entitled to depreciation allowances associated with the underlying asset since, in legal form, the asset has been transferred to the SPV during the term of the *Sukuk*
- The existing qualifying debt instrument (QDI) scheme does not cover *Sukuk* and the coupon payments and disposal gains derived from *Sukuk* cannot enjoy tax concessions/exemptions under the scheme even though the *Sukuk* can meet the relevant QDI conditions.

In addressing these tax issues, on March 12 2012, the government issued a consultation paper, proposing to adopt a prescriptive and religion-neutral approach similar to that adopted in common law jurisdictions such as the UK. The proposed legislation would not make any specific reference to Shariah, but would provide more certainty to market players and prevent disputes arising from different interpretations of Shariah principles by Shariah scholars.

The government suggested a phased implementation approach to initially cover the four most common Sukuk types in the legislative proposals, that is, *Ijarah*, *Musharakah*, *Mudarabah* and *Murabahah*. These four *Sukuk* types collectively represented almost 80% of global *Sukuk* issuances in 2011.

The consultation paper suggests that a new term be introduced known as an 'alternative bond scheme', which contains two arrangements – a 'bond arrangement' and an 'investment arrangement'.

A bond arrangement refers to the arrangement between the bond-issuer and the bond-holders, while an investment arrangement refers to the pact between the bond-issuer and

Biography

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Ayesha is a regular speaker and writer on tax and other matters and is the co-author of 'Hong Kong Taxation: Law and Practice' (Chinese University Press), a leading textbook on Hong Kong taxation.

Ayesha is the chairperson of the executive committee of the Taxation Faculty of the Hong Kong Institute of Certified Public Accountants and a member of the Joint Liaison Committee on Taxation.

She has been appointed by the Hong Kong SAR government as a member of various advisory bodies and has served on the Lump Sum Grant Independent Review Committee and the Taskforce on Economic Challenges. She is currently a member of:

- Women's Commission
- Financial Reporting Review Panel of the Financial Reporting Council
- Council and Court of Hong Kong University
- Independent Commission Against Corruption Advisory Committee on Corruption
- Hong Kong Trade Development Council
- Standing Committee on Judicial Salaries and Conditions of Service

In the December 2011 Election Committee subsector election, Ayesha was elected as a member of the Election Committee for the accountancy subsector.

the originator. In addition, the consultation paper identified three specific investment arrangements, that is, leaseback arrangement, profits-sharing arrangement, and purchase and sale arrangement, to target the aforementioned *Sukuk* types respectively.

A new part and a new schedule will be introduced into the IRO to cater for the new special tax regime for *Sukuk*. Specifically, they will provide for:

- The essential features of the alternative bond scheme, bond arrangement and investment arrangement.
- The specific features of the three specified investment arrangements.
- The conditions to be met for a bond arrangement and an investment arrangement to qualify for special tax treatment.
- The special tax treatment applicable to a qualified bond arrangement and a qualified investment arrangement.
- The obligations of the originator and bond-issuer after application of the special tax treatment.
- The circumstances under which a qualified bond arrangement or a qualified investment arrangement would be disqualified.
- The consequences of disqualification of a previously qualified bond arrangement and a previously qualified investment arrangement.
- The key miscellaneous amendments.

Similarly, a new part will also be introduced into the SDO, which will provide for:

- The conditions and requirements to be met for an instrument executed in relation to a bond arrangement and an investment arrangement to qualify for stamp duty treatment/relief.
- The stamp duty treatment/relief applicable to an instrument executed in relation to a qualified bond arrangement and a qualified investment arrangement that meets the conditions and requirements.
- The obligations of the originator and bond-issuer after granting the stamp duty relief.
- The circumstances under which a qualified bond arrangement or a qualified investment arrangement would be disqualified.
- The consequences of disqualification of a previously qualified bond arrangement and a previously qualified investment arrangement.
- The key miscellaneous amendments.The industry, bankers and the financial sector have welcomed this consultation process. However, the proposed legislative amendments the government has put forward will need to be critically assessed to ensure that they adequately address the requirements for Islamic finance to be viable in Hong Kong. The legislation should be flexible enough to cater for future developments in Islamic finance and avoid the need for further amendments.

Biography

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Curtis Ng joined KPMG's Hong Kong office in 1995 and is well versed in the complexities of delivering compliance and advisory services to multinational clients in various sectors. His experience includes a depth of experience in cross-border business activities and coordination and liaison with specialists to provide the most efficient and effective services.

Curtis received his BSSc degree in economics. He is an associate member of the Hong Kong Institute of Certified Public Accountants and an associate member of the Taxation Institute of Hong Kong.

Tax information exchange agreements (TIEAs)

In 2011, the OECD-run Global Forum for Transparency and Exchange of Information conducted a Phase 1 Peer Review of Hong Kong. The report examined Hong Kong's legal and regulatory framework for accessing and exchanging information with foreign tax authorities. Issued in October 2011, the report noted that Hong Kong has the necessary framework in place to exchange information, but there is room for improvement.

In particular, the Global Forum noted that Hong Kong's policy is to agree to exchange tax information only in the context of a DTA and not to enter into TIEAs. Given Hong Kong's importance as an international financial centre, the Global Forum considered it essential that Hong Kong enters into agreements (regardless of their form) that meet the international standard on exchanging information with all relevant partners.

The government's response to the OECD assessment has been positive. The government has indicated its intention to introduce legislation enabling Hong Kong to conclude TIEAs with all relevant partners and issued a public consultation paper about TIEAs in May 2012 seeking comments by June 29 2012. To date, the Government has not indicated how it will take this matter forward.

Advance pricing arrangements

On March 29 2012, the IRD released Departmental Interpretation Practice Note (DIPN) 48, APA, establishing the procedure for enterprises seeking an advance pricing arrangement (APA) in Hong Kong.

DIPN 48 builds on the IRD's transfer pricing guidelines, that is, DIPN 46: Transfer Pricing – Methodologies and Related Issues, released in December 2009. The DIPN establishes the opportunity for enterprises to attain certainty regarding the acceptability of their transfer prices with the IRD and one or more other tax authorities.

Specifically, an APA is an agreement between a taxpayer, the IRD, and the counterparty tax authorities on an appropriate set of criteria for determining the transfer price for its related-party transactions (controlled transactions) prospectively.

The benefits for both taxpayers and tax authorities from an effective APA programme are widely recognised internationally. This is evidenced by the number of jurisdictions that already have fully-functioning APA programmes and those in the Asia-Pacific region in the process of establishing such a programme. The IRD's introduction of an APA programme illustrates Hong Kong's alignment to other jurisdictions in developing a constructive transfer pricing compliance system for taxpayers.

The IRD states the objective of the APA process is to provide taxpayers with a voluntary alternative for resolving transfer pricing issues in a prospective manner. It provides certainty for taxpayers on an appropriate transfer pricing methodology and eliminates or reduces the risk of double taxation arising from controlled transactions. It also prevents costly and time consuming audits and litigation of transfer pricing issues covered by the APA.

DIPN 48 stipulates that the APA should fix arrangements according to the arm's-length principle for determining the transfer pricing for the future transactions in the APA. The key features of DIPN 48 include:

Scope

The APA programme is initially focused on the negotiation of bilateral and multilateral APAs in situations where Hong Kong has a DTA with the counterparty jurisdiction(s). Unilateral APAs are available to taxpayers only in cases where:

- the DTA partner(s) in a bilateral or multilateral process do not wish to participate or continue the process
- a bilateral or multilateral APA could not be agreed upon between the competent authorities
- a non-DTA state is prepared to give a unilateral APA regarding transactions, which are integrally linked to the controlled transactions covered by the bilateral or multilateral APA. In such a case, the government may consider granting a unilateral APA covering those linked transactions in the non-DTA state.

In DIPN 48, the IRD prescribes these general thresholds for an APA application in term of the size of the controlled transactions:

- If the controlled transactions involve the sale and purchase of goods, the threshold is HK$80 million ($10 million) for each year covered in the APA.

Biography

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John is a partner with KPMG China specialising in corporate tax. John's work involves providing a full range of tax assistance and advice to multinational companies across the Asia Pacific region and beyond. A number of John's clients use Hong Kong as location for their head office and John advises these organisations on managing their tax affairs regionally and globally.

His role involves advising on issues relevant to the establishment of investment holding and operating structures for companies operating in a diverse range of industries and countries. He has extensive international M&A experience and has played a major role in the provision of tax advice on due diligence engagements, contract negotiation, transaction restructuring and financing.

- If the application relates to services, the threshold is HK$40 million for each year covered in the APA.
- If the application relates to the use of intangible properties, the threshold is HK$20 million for each year covered in the APA.

However, the IRD notes that the relevance of the criteria will be reviewed on a case-by-case basis.

Five-stage process

DIPN 48 outlines a five-stage process for developing an APA:

- The pre-filing meeting stage, which allows parties to assess the likelihood of success for the APA. A pre-filing meeting can be conducted on an anonymous or named basis.
- The formal application stage, which details the scope of the APA and how any collateral issues identified in the pre-filing meeting stage will be addressed.
- The analysis and evaluation stage, which may involve independent experts in reviewing and evaluating the applying enterprise's proposed transfer pricing methodology.
- The negotiation and agreement stage, during which the applying enterprise submits an application for mutual agreement procedures and negotiations with DTA partner(s) are undertaken.
- The drafting, execution and monitoring stage, which addresses the content in the APA and outlines the requirements for an annual compliance report.

Renewals

DIPN 48 states that an APA may be renewed with the consent of all parties to it, including the DTA partner(s). The enterprise is required to seek renewal at least six months before the expiration of the existing APA.

Audits

DIPN 48 emphasises that the APA and audit processes are separate and will generally be resolved independently of each other. Furthermore, while the years covered in the APA may generally be subject to an audit, this will not involve a re-evaluation of the transfer pricing methodology agreed upon in the APA.

Rollbacks

DIPN 48 indicates that in the event that the finalisation of the APA is delayed and a later commencement date is specified, the IRD may seek to rollback the methodology agreed in the APA into those prior years intended to be covered in the original application. The approach of the IRD to rollback the transfer pricing methodology to prior years will depend on the circumstances of the case and whether prior-year assessments can be reopened under the provisions of the IRO and the relevant DTA. In addition, rollbacks will generally not be considered for unilateral APAs.

DIPN 48 further stipulates that where the provision of information for an APA results in an adjustment to a prior-year tax return, the adjustment will be treated as though the enterprise had made a voluntary disclosure, provided an audit has not already commenced or the IRD had not previously made contact with the enterprise about the prior-year returns.

In such a case, any additional tax for the enterprise in prior years will generally be calculated as if the enterprise makes a voluntary disclosure for each prior year. However, where an audit has commenced and the IRD has made contact with the enterprise, the normal penalty provisions apply to any adjustments made to prior years under an audit.

Miscellaneous

The appendices to DIPN 48 provide detailed guidance (and therefore are not prescriptive in nature) on:

- the pre-filing meeting agenda;
- the content of a model APA proposal;
- a model APA case plan;
- the formal application form for a bilateral/multilateral APA; and
- the information and documentation requirements for a bilateral/multilateral APA application.

The adoption of a formal APA programme in Hong Kong is clearly a positive step forward in the implementation of transfer pricing guidance by the IRD. The APA programme will enable multinational firms to prospectively lock in their corporate tax position both in Hong Kong and in the relevant counterparty jurisdictions of group entities in relation to transfer prices.

The scope of the APA programme (that is, focusing on bilateral and multilateral APAs where there is a DTA in place) highlights the importance of Hong Kong's continued expansion of its DTA network.

However, while the APA's programme's emphasis is on bilateral and multilateral APAs, a recent advance ruling by the IRD on an entity's transfer pricing methodology for controlled transactions demonstrates that there are other avenues for taxpayers to achieve transfer pricing certainty outside an APA.

In light of the scope of the APA programme, we believe this is particularly relevant to taxpayers in these situations:

- Taxpayers have experienced transfer pricing audits and/or adjustments on either side of their controlled transactions involving Hong Kong, and, as a result, have suffered from double taxation.
- Taxpayers are maintaining inadequate transfer pricing policies or are facing tax inefficiencies in Hong Kong. Therefore, they need to move to proper arm's-length policies or are considering restructuring their operations by migrating functions and/or risks across group entities.
- Taxpayers have traditionally managed their business largely from Hong Kong, but are increasing their presence and substance in other locations. As a result, they need to move to a new transfer pricing policy.

The IRD has indicated that it is likely to conclude initial APAs with mainland China, however, it will also be ready to initiate APAs with other jurisdictions in the near future.

Hong Kong's appeal increases

This article examines the latest legislative and regulatory developments in the Hong Kong tax field.

- The continuous expansion of Hong Kong's DTA and TIEA networks;
- The future enactment of the proposed legislation on Islamic financing; and
- The implementation of the new APA programme

will further enhance Hong Kong's status as an international finance centre.

Accordingly, Hong Kong and non-resident taxpayers, in particular those with transactions potentially affected by the subjects discussed above, are advised to closely monitor the developments, consider the possible impacts on their business operations, and take actions to benefit from these programs.

Garry Laird of KPMG China is an adviser on this chapter.