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China

Looking Ahead 4th edition

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China – Looking Ahead

INTERNATIONAL TAX REVIEW

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Editorial

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China's tax regime is changing fast as it seeks to create a world-class system.

As this fourth edition of KPMG's *China – Looking Ahead* guide shows, no aspect of the country's tax rules is escaping attention. Some areas, such as VAT and customs, are developing fast; others such as personal taxation are taking longer to catch up. And different sets of rules, for example, on the taxation of M&A, particularly the indirect transfer of shares, are unnerving investors. About others, they are relatively calm. The State Administration of Taxation (SAT), China's tax agency, is not getting, and will not get, everything right first time, but name another country that does. That is what new legislation is for: to amend or abolish something that is not working.

Internal and external influences are driving the reform efforts. The need to modernise the tax system of the biggest or second biggest economy in the world – depending on which statistics you follow – so it keeps bringing in enough revenue is a constant demand. So is the effort, perhaps futile in so large a country, to achieve consistency and uniformity of implementation throughout the country. This priority is one that interests multinationals greatly, as they seek to avoid being disadvantaged by their choice of investment location in a particular part of China.

The international influence comes from its keen interest in the base erosion and profit shifting (BEPS) project. China is a member of the G20, which commissioned the OECD in 2012 to undertake this work. The project has the potential to transform international tax rules and China is making clear where it agrees and disagrees with its direction. The need for economic substance in any transaction has quickly come to the fore as the dominant theme in these discussions. China, like other countries, wants to ensure that foreign direct investors do real work and have decision-makers in their jurisdiction before they can avail of any tax benefits.

What does this mean for taxpayers? Well, it means that China's tax system is developing fast and taking on many of the characteristics seen in other countries. Taxpayers would do well to make sure they keep in touch with progress and prepare for any changes that could affect them directly.

We hope the fourth edition of KPMG's *China – Looking Ahead* will be a valuable tool in helping corporations do this.

Foreword

As noted in last year's edition of China – Looking Ahead, the Third Plenum of the 18th Chinese Communist Party (CCP) Congress in November 2013 gave key priority to fiscal and tax reforms, which were raised to the prominent status of a 'national governance' issue for policy-making purposes. The subsequent Communiqué and Decision by the Central Committee of the CCP on "Deepening of Key Reforms" set principles and targets for tax reform, budget management, and the realignment of central versus local government revenue and obligations, with far reaching restructuring and modernisation of China's fiscal administrative system being pursued on an aggressive timeline.

As the Year of the Snake gave way to the Year of the Horse, key progress was made on the fiscal spending side of this equation, with the August 2014 amendment of the Budget Law, the October 2014 State Council "Decision on Deepening the Reform on Budget Management System", and the June 2014 Politburo approval for "The Plan to Deepen the Fiscal Reform", which also sets out key pillars of tax system reform in relation to value added tax (VAT), consumption tax and introduction of resource tax and environment protection tax.

Against a backdrop of the Chinese economy having solidified its place as the world's second largest, and with China-outbound foreign direct investment (FDI) set to overtake inbound FDI this year or next, the pace of tax changes has further quickened as the Year of the Horse turns towards the Year of the Sheep. In this edition of China – Looking Ahead, KPMG China's tax specialists examine recent developments and explore what the coming year may bring for foreign investors. We would note, however, that the content of this publication is not intended as predictions or forecasts of Chinese tax policies and should not be relied upon as such.

Of particular note has been the degree to which the Chinese State Administration of Taxation (SAT) has engaged with the G20/OECD Base Erosion and Profit Shifting (BEPS) global tax reform initiative. The support of China's top leadership for the SAT's contribution to the global tax reforms was confirmed by President Xi Jinping's November 16 address to the G20 Leaders' Summit in Brisbane, Australia, in which he indicated China's support for efforts to enhance global cooperation in collecting tax, cracking down on international tax evasion and helping developing and low-income countries to improve their tax collection capacity. This was notably the first time in history that a president of China specifically commented on tax matters at the G20.

The influence of the SAT in having key concepts in Chinese tax practice, most notably in the transfer pricing field, recognised by the global tax community comes through clearly in the September 2014 issued BEPS Deliverables Reports. The global tax reform coincides with the wider changes to the fiscal system being wrought in China, and is clearly catalysing regulatory and enforcement efforts in relation to China's international tax provisions, with a spate of relevant tax enforcement circulars recently having been issued.

The chapter "BEPS: China makes its mark on global tax rules and strengthens international tax enforcement":

- examines the OECD recommendations made in the 2014 BEPS Deliverables and their relevance for China;
- sets out the measures the SAT is taking to revise administrative guidance on transfer pricing and on anti-avoidance rules, including in relation to the general anti-avoidance rule (GAAR); and
- outlines enforcement measures being taken to put cross-border transactions, including treaty shopping, under greater scrutiny.

Certainly, such changes are only the first steps in the SAT's international tax work programme for the coming years. The SAT foresees a full-hearted cooperation in information exchange and tax collection with other tax administrations, through initiatives such as the OECD's Common Reporting Standard system, the US Foreign Account Tax Compliance Act (FATCA) system, and the Multilateral Convention on Tax Administrative Cooperation. Under the SAT work programme the BEPS-related domestic law changes to rules for TP, GAAR, and anti-treaty abuse are planned to be complemented by anti-mismatch rules, by a strengthened administration of outbound investment, and ultimately by a radically improved Law on Tax Collection and Administration. The SAT work programme, marked by increasingly deep participation in and alignment with the BEPS Action Plan, rolls out over three phases; year 1 as September 2013 to September 2014, year 2 running to September 2015, year 3 to September 2016.

These BEPS-related changes may come to herald radical new approaches in areas such as controlled foreign company and permanent establishment enforcement, previously outside the central focus of the Chinese tax authorities, as well as ever-increasing pressure on multinational enterprises (MNEs) in the more well-trodden enforcement fields of treaty shopping and, of course, transfer pricing.

Transfer pricing sits at the heart of BEPS. The chapter, "Rising to the occasion – Mounting transfer pricing activity shines spotlight on China":

- outlines how a significant ramp-up of audit pressure on designated transfer pricing areas is imminent, particularly for outbound royalty payments and service fees;
- details how, with OECD-BEPS endorsement of key Chinese tax concepts, and with new sources of information reporting and exchange available to the tax authorities, the rigour with which location specific advantages and Chinese concepts of value creation are to be pushed in tax enforcement is set for a significant step-up; and
- sets out anticipations for the forthcoming comprehensive new transfer pricing administration guidance, needed to deal with the greatly increased complexity of China's transfer pricing environment.

The pervasive effects of transfer pricing are also perceived in other fields of tax policy. As outlined in "Created in China: the fast pace of innovation, R&D incentives and economic development in the PRC", while a rapid escalation of Chinese R&D investment has been facilitated by the R&D Super Deduction and High New Technology Enterprise (HNTE) R&D programmes offered by the Chinese government, the focus of the tax authorities on transfer pricing profit attribution based on value-adding functions carried on in China, and the requirement to have such functions in China for HNTE qualification, may bring tension between MNEs' transfer pricing policies and their access to Chinese R&D incentives.

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Khoonming has worked throughout China, including in Beijing, Shanghai and southern China, and has built strong relationships with tax officials at both local and state levels. He 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).

In a similar manner to transfer pricing policy and practice, VAT reform in China is also at a crucial juncture, with the chapter, "VAT reforms in China – In the eye of the storm", considering how, while still grappling with the challenges of transitioning from Business Tax (BT) to VAT in relation to the modern services, transportation, media and postal sectors, in 2015 the tax authorities are set to take the plunge with the VAT transition of the real estate and construction, financial services, and the food, beverage, hospitality and entertainment sectors. These sectors are both the most financially significant for the government and the most challenging from a technical perspective. This ambitious reform could ultimately leave China with the world's leading VAT system given its unprecedented broad base.

The seismic changes occurring within China's transfer pricing and VAT systems are occurring in tandem with the wider modernisation of the fiscal system as envisaged at the time of the Third Plenum. In this regard the chapter, "Living in the present – The changing landscape of tax risk management in China", considers how the country's tax administration, adopting best practices from around the world and taking them further, has been moving towards a more sophisticated, collaborative relationship with large taxpayers. The administration:

- has been encouraging the adoption of tax risk control systems, particularly at SOEs [state-owned enterprises];
- has been building the capacity to audit these systems;
- has been entering into tax compliance agreements; and
- is looking towards the establishment of a centralised national risk management office.

A closer cooperation and understanding between taxpayers and the tax authorities is necessary and warranted, as the enforcement of increasingly complex tax measures with a greater degree of consistency and transparency is essential to avoid distorting economic activity while achieving compliance goals, as notably illustrated by the case of the indirect transfer rules in "M&A: Hopes for further clarification of Chinese indirect offshore disposal tax rules".

These changes are all occurring alongside noted progress in other tax fields, including attempts to achieve the right balance between trade facilitation and trade compliance, as set out in "China: Moving towards a world-class customs administration"*;* advances towards wider Individual Income Tax (IIT) reform, including ultimately an extension of anti-avoidance rules to cover the IIT Law, in "Stay tuned for IIT reform in China"*;* and ongoing refinements to the Hong Kong tax regime to enhance its captive insurance sector and facilitate Hong Kong's participation in the burgeoning global initiatives for greater exchange of tax information, as detailed in "Hong Kong increases its attractiveness as an international financial centre".

China's top policymakers recognise clearly that, given China's economic weight in the world and its new role as a net source of global capital flows, Chinese tax policy and administration now impacts the entire global community and are crafting China's revamped international tax rules with a view to supporting the architecture of the new global tax system. With numerous ground-breaking tax reform initiatives on the cards under the extensive SAT work programme, and broad-based enforcement initiatives getting underway, set against a backdrop of top-level political commitment to a thorough overhaul of China's entire fiscal apparatus and the most significant overhaul to global tax rules in nearly 100 years, the Year of the Sheep looks to be anything but tame.

BEPS: China makes its mark on global tax rules and strengthens international tax enforcement

The China implications of the BEPS 2014 deliverables, and the parallel development of other tools for firmer international tax enforcement, are the focus of this article by Chris Xing, Lewis Lu, Sam Fan and Vincent Pang of **KPMG China**.

China played an important consultative role in determining the outcomes of the first set of BEPS deliverables, which are expected to reinforce the trend of recent years towards firmer enforcement of transfer pricing rules.

The G20/OECD initiative for multilateral cooperation to address tax base erosion and profit shifting (BEPS) reached a milestone on September 16 2014 with the publication of the 2014 deliverables, setting out recommended changes to domestic laws/tax treaties for seven of the 15 Action Plan points, with a view to realigning jurisdictional taxing rights with the location of value creation and where business activities are actually conducted.

The wide reaching reform of the global tax framework through the BEPS initiative occurs against the backdrop of important changes in the global economy. Notably, China's outbound foreign direct investment (FDI), after a number of years of spectacular growth, is set to overtake inbound FDI into China either this year or next, according to a *Financial Times* article, "FDI into developing economies forecast to stall", on June 23 2014.

Consequently, the Chinese tax authorities' propensity to leverage off the outcomes of the BEPS process may be guided by two aims. Firstly, the BEPS initiative may be seen to support more rigorous enforcement of China's international tax rules on inbound investment, such as transfer pricing adjustments, to ensure that more of the profit in multinational enterprise (MNE) global value chains is allocated to China, and to support audit challenges to the deductibility of cross border intra-group payments. Secondly, the PRC tax authorities have also expressed an intent to bolster enforcement against outbound investment by Chinese MNEs, as these become the principal source of China's cross-border investment flows. BEPS-related tax law changes affecting both inbound and outbound investment are envisaged in the SAT's work programme for coming years.

During the last year, a number of new information reporting requirements and tax authority information collection initiatives, have been launched to further both of these aims. These together with draft refinements to key anti-avoidance tools such as the domestic law general anti-avoidance rule (GAAR) come in advance of anticipated and even more significant, regulatory and enforcement initiatives in the coming year.

The 2014 BEPS deliverables

To better understand the context in which Chinese tax enforcement action is evolving, it is worth first considering what recommendations have been made in the 2014 BEPS deliverables, insofar as they are relevant to China. The

Table 1

	Action	Deadline
1	Addressing the tax challenges of the digital economy	September 2014
2	Neutralise the effects of hybrid mismatch arrangements	September 2014
3	Strengthen CFC rules	September 2015
4	Limit base erosion via interest deductions/other financial payments	September/December 2015
5	Counter harmful tax practices more effectively taking into account transparency and substance	September 2014 & September/December 2015
6	Prevent treaty abuse	September 2014
7	Prevent the artificial avoidance of PE status	September 2015
8	Assure that TP outcomes are in line with value creation: intangibles	September 2014 & December 2015
9	Assure that TP outcomes are in line with value creation: risks/capital	September 2015
10	Assure that TP outcomes are in line with value creation: other high-risk transactions	September 2015
11	Establish methodologies to collect and analyse data on BEPS/actions to address it	September 2015
12	Require taxpayers to disclose their aggressive tax planning arrangements	September 2015
13	Re-examine TP documentation	September 2014
14	Make dispute resolution mechanisms more effective	September 2015
15	Develop a multilateral instrument	September 2014 & December 2015

article in last year's edition of "China Looking Ahead", "BEPS – what will it mean for China?", described the BEPS Action Plan set out by the OECD in August 2013 and subsequently approved by the G20 (see Table 1). The seven BEPS actions for which recommendations have now been made include the digital economy (Action 1), hybrid mismatches (Action 2), harmful tax practices (Action 5), treaty abuse (Action 6), as well as transfer pricing guidance for intangible assets (Action 8) and country-by-country (CbC) reporting (Action 13). Initial work on a multilateral instrument (Action 15) is also covered. The recommendations made were endorsed by G20 finance ministers at their September 20-21 2014 meeting.

Digital economy (Action 1)

This report does not make explicit recommendations for tax law and treaty changes, noting that digital economy concerns will be dealt with under other actions. However, it implies that the 2015 Action 7 on permanent establishment (PE) will look to modify tax treaty concepts to limit the "preparatory and auxiliary" activities exemption (including the warehousing exemption), and counter tax planning which uses contract signing outside the country of sale to avoid PE. The report also indicates that tackling the shifting of highly mobile e-commerce sales and services income may require that CFC rules be expanded to specifically capture it under action 3.

Hybrid mismatch arrangements (Action 2)

This report sets out proposals for domestic law and treaties to counter the effects of hybrid mismatches, including:

- restricting foreign tax credits where hybrid transfers are used;
- updating of controlled foreign company (CFC) rules to catch income from hybrid controlled entities;
- reporting requirements for hybrid entities in 'intermediate' countries to help application of CFC rules;
- denial of dividend participation exemption for payments deductible in the payer country; and
- rules restricting the transparency of entities where used as reverse hybrids.

These changes are to be accompanied by:

- linking, automatic rules, which align the tax treatment of a hybrid instrument or entity with the tax outcomes in the counterparty jurisdiction, through deduction denials and forced inclusions of income; and
- treaty changes to deal with dual residence situations and to facilitate the application of the domestic law anti-hybrid rules. Further rule refinements are planned for 2015.

Harmful tax practices (Action 5)

This report sets out a requirement for substantial activities to be performed in a jurisdiction as a condition for preferential tax treatment for income from intangible property (IP).

Expenditures incurred in developing the IP asset are used as a proxy for substantial activities. Only certain expenditures are taken into account, so limiting the permissible tax preferential treatment to income from substantive R&D activities which the taxpayer himself conducts. A review of preferential regimes across OECD/non-OECD countries, led by this substance approach, and modified to cover other (non-IP) preferential regimes (for example, shared services/finance companies), is to follow.

From October 28 2014 a system is to also apply for the inter-tax authority communication of rulings, related to preferential tax regimes and granted to a specific taxpayer, including advance tax clearances and advance pricing agreements (APAs).

Treaty abuse

This report recommends general treaty anti-abuse measures including:

- a provision to state explicitly that tax treaties are not intended to be used to create double non-taxation;
- a 'principal purpose' test focused on subjective tax motivations of a taxpayer; and
- a US-style limitation on benefits (LOB) provision.

The report also outlines targeted anti-abuse provisions dealing with, for example, treaty shopping for dividend withholding tax (WHT) relief through share transfers, and schemes to avoid capital gains tax on disposals of land-rich shares.

Transfer pricing for intangible assets (Action 8)

Revisions have been made to the OECD transfer pricing guidance for Chapter 1 (arm's-length principle), Chapter 2 (transfer pricing methods) and Chapter 6 (transfer pricing for intangibles), work which had been under way since 2010. Further refinements may follow the completion of the 2015 BEPS work on transfer pricing for risk, capital, high-risk payments, and hard-to-value intangibles, so certain changes remain in draft.

The guidelines on chapters 1 and 2 recognise the legitimacy, as transfer pricing analysis comparability factors, of location savings, assembled workforce and group synergies, as well as market features such as the growth of purchasing power and product preferences of households in a market.

The Chapter 6 guidelines downplay the significance of legal ownership of intangible assets (intangibles) in allocating profits to MNE group entities, instead emphasising:

- the actual conduct of parties in the control of intangibles development and maintenance functions;
- provision, use and exploitation of assets; and
- bearing/control of risks by MNE group members.

Whereas historically, residual returns from IP have often been allocated to the parties funding the development of intangibles, after compensating other group parties for their (routine) functions, the new guidance only assigns financiers a risk-adjusted rate of anticipated return, while residual returns are allocated to group entities which conduct key functions and which use and exploit assets. Legal owners of intangible assets are similarly entitled to returns for functions performed, assets used, and risks assumed, but not excess returns merely due to ownership alone.

And, to the extent that independent parties would have insisted upon protections for transactions involving intangibles with highly uncertain valuations, the guidance also envisages the use of hindsight (actual results) in certain contexts, and promises to give greater clarification and guidance for the use of profit splits. The guidance also foresees greater use of re-characterisation of legal transactions to tax transfers of intangibles, and broadens the intangibles definition to catch hidden transfers of intangibles.

Transfer pricing documentation and country-by-country (CbC) reporting (Action 13)

Revised standards for transfer pricing documentation demand the maintenance of master and local files; the master file gives a high level overview of the global enterprise, with information on MNE legal and ownership structures, supply chains, historic transactions, financing and IP arrangements and tax positions.

The common template for CbC reporting requires MNEs to provide information, by country, on revenues, profits, income taxes paid and accrued, capital and accumulated earnings, employees and tangibles assets, as well as entity information on business activities. The CbC matrix is intended to provide sufficient information for tax authorities to conduct risk assessment, to guide their allocation of resources for taxpayer scrutiny and audit. It may also facilitate tax authority evaluations of the contributions made by MNE group entities, across the entire value chain, with regard to value creation.

Multilateral instrument (Action 15)

The multilateral instrument, intended to be used to modify tax treaties en masse for BEPS recommendations is currently at an exploratory stage, though considered feasible.

How will the 2014 deliverables, and parallel State Administration of Taxation (SAT) initiatives affect China tax law and practice

The SAT is understood to have very positive expectations of the BEPS initiative. In particular, it gave key input into the BEPS work on intangibles and CbC reporting, and this is clearly reflected in the final 2014 deliverables.

On September 17 2014 the SAT, together with posting to their website Chinese language translations of the 2014 deliverables, issued a related announcement indicating the SAT's intent to improve China's regulations and bolster administrative capabilities to fully enforce its international tax rules in line with BEPS.

Specifically the SAT indicated that:

- Administrative guidance on anti-avoidance rules is being revised; and
- Greater scrutiny of cross-border transactions, including treaty abuses, would be forthcoming, together with increasing reliance on mechanisms of global cooperation.

Revisions to administrative guidance on anti-avoidance and transfer pricing rules

With regard to the revision of anti-avoidance guidance, the SAT had already issued a discussion draft of "Administrative Measures on the General Anti-Avoidance Rules" on July 3 2014 for public consultation, clarifying GAAR procedures and also potentially widening the circumstances in which the GAAR may be applied. It might be noted that in China the GAAR is principally used in relation to cross-border transactions.

GAAR provisions to be widened

While the Corporate Income Tax (CIT) Law's Detailed Implementation Rules (DIR) provided that the GAAR could apply to adjust arrangements that have the attainment of tax benefits as their 'primary purpose', the new measures, if made effective in their current form, could apply the GAAR to arrangements with tax benefits as 'one of their main purposes".

Lack of clarity concerning the appropriate manner of application of this new threshold has led to concern that local tax authorities could interpret it very broadly, applying it to a range of transactions which might otherwise be thought to be primarily driven by 'reasonable business purposes'. This concern is heightened by directions in the new measures, from the SAT to local tax authorities, to seek documentary support for GAAR enforcement actions from tax advisers directly and from 'overseas Chinese organisations', the latter potentially being outside the formal mechanisms and well defined parameters of tax treaty exchange of information articles and tax information exchange agreements.

In relation to the SAT's objective to clarify guidance on anti-avoidance rules, it is also understood that it is due to issue a substantial rewrite of the Circular of Implementing Measures for Special Tax Adjustments, *Guo Shui Fa* [2009] No 2 (Circular 2) by the end of 2014. The 2009 version of Circular 2 sets out the detailed administrative rules for "special tax adjustments" in relation to transfer pricing rules (including advance pricing agreements and cost sharing), CFC rules, thin capitalisation and the GAAR.

Additional transfer pricing guidance

In relation to transfer pricing, the redrafts will affect, for example:

- transfer pricing methods for related-party share transfers;
- transfer pricing documentation thresholds and disclosure requirements (including the Chinese version of CbC reporting); and

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- Location specific advantages (LSAs) and locally generated intangibles.

In making these updates the SAT will be able to leverage off the success it has had in having key transfer pricing concepts recognised in the proposed BEPS revisions to the OECD Model Tax Convention (MTC) Commentary on intangibles transfer pricing (Action 8). The recognition of LSAs as transfer pricing comparables was a key goal for China as these are increasingly incorporated into the Chinese transfer pricing paradigm, with the relevant SAT practice having been described in Section 10.3 China Country Practices in the UN Practical Manual on Transfer Pricing for Developing Countries, issued in June 2013.

The revised OECD transfer pricing guidance downplays the legal ownership and funding of intangibles in allocating profits *per se*, with residual returns allocated to MNE group entities which conduct key functions and which use and exploit assets, according with the position put forward by the SAT in the UN Practical Manual, as does the greater guidance being provided in the revised OECD transfer pricing guidance for the use of profit split methods.

These value attribution approaches require an understanding of contributions to, for example, intangibles' development, management and protection by multiple entities

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throughout the MNE value chain, moving away from the more commonly applied transactional net margin method, which is largely a 'one-sided' TP analysis. Such an analysis would be further supported by the CbC reporting template on the global deployment of MNE assets and allocation of profits, the introduction of the Circular 2 version being supported by the G20's approval of the OECD's template.

In addition to these substantive clarifications of law, the SAT has recently released a number of directives to local tax authorities, putting into effect the promised greater scrutiny of cross-border transactions, including treaty abuses. Efforts have also been stepped up in the collection of taxpayer information, with a view to greater policing of outbound investments as well as engagement in international information exchange. These efforts will receive further support with the SAT work programme's planned revision of the Law on Tax Collection and Administration, so that international tax matters can be better tackled from an administrative and procedural perspective, and complementary upgrade of tax authority IT systems to better analyse MNE profit attributions within value chains.

Administrative scrutiny of cross-border transactions and international cooperation

It is expected that the coming months will see more rigorous enforcement of China's international tax rules on inbound investment, such as transfer pricing adjustments to ensure that more of the profits in MNE global value chains are allocated to China and challenges to the deductibility of cross border intra-group payments. The authorities are also looking to draw support from the BEPS initiative for the enhancement of enforcement against outbound investment by Chinese MNEs.

MNE global profit allocations

In the future, business activities that create potentially valuable intangibles for taxpayers in China are likely to receive greater scrutiny from the tax authorities there, particularly where there are transactions with offshore entities that do not have commercial substance. What may be directly in the spotlight are PRC entities conducting activities that are viewed by the tax authorities as creating non-routine value (for example, certain R&D, brand building or market-penetrating activities), but which are allocated routine returns due to risks being removed by contract terms (for example, contract R&D and limited risk distribution).

With a focus on physical substance and functions performed, the Chinese tax authorities are likely to demand that a greater portion of the residual profits in the entire value chain be allocated to China. This was enunciated both in the SAT contribution to the UN TP Practical Manual, and in the Jiangsu Provincial Office of SAT International Tax Plan in April 2014, the previous principal official response of the Chinese tax authorities to BEPS.

The preferred approach of the Chinese tax authorities for transfer pricing adjustments is increasingly so-called taxpayer 'self adjustments', the 'voluntary' nature of which can result in double taxation where there is the absence of treaty relief. With the potential for greater numbers of transfer pricing disputes in future some MNEs may, on review of their arrangements, seek to forestall TP controversy by preemptively altering their transfer pricing approach and contractual arrangements in relation to China.

Cross border intra-group payments

The Chinese tax authorities are increasingly denying corporate tax deductions for outbound services/royalties payments made by Chinese entities in MNE groups, as the SAT leverages off the BEPS Action Plan's emphasis on value creation.

The SAT's April 2014 letter to the UN working group on transfer pricing issues sets out a firm stance on related-party services payments, calling for scrutiny of their benefits to the Chinese recipient, while the Jiangsu STB Plan calls for greater scrutiny of overseas service providers. Most recently, the SAT issued Directive 146 on July 29 2014, instructing local tax authorities to survey substantial payments of service fees and royalties made to overseas by Chinese entities between 2004 and 2013, with a view to launching extensive audits, placing particular focus on payments to low tax jurisdictions and on cases where foreign related parties conduct only limited, simple functions.

The OECD's specification of acceptable 'substantial activities' under Action 5 may support the Chinese tax authorities' questioning of the value-add provided by services and licences from overseas related entities. Though this definition is purposed for evaluating preferential IP tax regimes, the Chinese tax authorities are likely to leverage this definition of substance and the variants which the OECD plans to develop for non-IP preferential tax regimes, to challenge the value obtained by Chinese entities from payments to 'substance light', low-taxed, overseas related parties.

Challenges to outbound royalty payments, particularly where the IP is outmoded or the Chinese entity has also contributed to maintenance and enhancement of its value, is also supported by the Action 8 transfer pricing guidance. Ripe for potential challenge are foreign IP holding companies in low tax jurisdictions, to which patents and brand rights, for example, have been transferred.

The information provided to the Chinese tax authorities through the compulsory spontaneous rulings exchange system, taking effect from October 2014, and the OECD initiative on the establishment of an automatic information exchange platform, called the "Common Reporting Standard", will also inform the targeting of further audit action on outbound payments. China's involvement in the automatic information exchange platform was enabled when it signed up to the Multilateral Convention on Administrative Cooperation in Tax Matters in 2013, which sits alongside China's agreement with the US to cooperate with the Foreign Account Tax Compliance Act's (FATCA) information exchange arrangements through an Inter-governmental agreement, and China's own launch of "China FATCA" (SAFE Circular 642) at the start of 2014. These actions clearly demonstrate the SAT's commitment to enhance the channels of international information exchange, a key objective of the SAT's work programme for coming years.

While CbC reporting of related-party service fees, interest and royalties was not included in the OECD's BEPS template, China may possibly seek this information in the CbC filings of MNEs falling into the China tax net. Further support for the challenging of overseas payments is expected to be drawn from the 2015 BEPS Action 10 guidance on transfer pricing for high risk transactions, including head office expenses.

In light of these developments, more MNEs may well be evaluating the need to conduct reviews of the sustainability of their group recharge, IP holding strategy and shared service centre arrangements.

Enforcement against outbound investments

The BEPS hybrids and digital economy reports have indicated already some of the key features to be built into model CFC rules, to be more fully elaborated with the Action 3 deliverable in 2015. Key participants in the BEPS process have observed that CFC rules may well come to play a dominant role in the BEPS process, given that it is in part the weakness of CFC rules in the ultimate residence countries of MNEs that lead countries to push for unorthodox uses of transfer pricing rules to counter the resulting base erosion.

This BEPS focus on CFC rules intersects with an increased Chinese tax administrative focus on outbound investment, most notably with SAT Announcement 38 in July 2014 (effective September 1 2014). This requires detailed reporting on the interests of Chinese enterprises in CFCs. Updates to the CFC rule guidance (contained in Circular 2) are also expected to be issued in due course. The Jiangsu STB International Tax Plan, understood to reflect the SAT's views, sets out a variety of outbound transactions which the authorities would scrutinise, including establishment of offshore investment and financing structures, and the export of Chinese intangibles to overseas holding companies, as well as failures to report all information relevant to the application of CFC rules. China's MNEs should monitor developments carefully, particularly given the focus on outbound investment in the SAT's work programme for coming years, including updates to CFC rules and new hybrid rules, and consider the necessity for and implications of (re)structuring overseas investments.

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Vincent has also been active in assisting many foreign companies in designing their corporate and operational structures in China to meet their business objectives, as well as many Chinese domestic companies on their pre-IPO restructuring and outbound investments

Vincent has also been providing M&A tax services to both foreign and domestic companies and assistance in tax due diligence, transaction structuring, post-acquisition structuring, contract negotiation from the Chinese tax perspective as well as setting up various forms of legal entities for acquisition or operational purposes. Lastly, he also provides advice in the areas of company regulations, foreign exchange and customs issues.

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Continued rigorous policing of treaty shopping and a focus on permanent establishment (PE)

The Chinese tax authorities continue to rigorously assess double tax agreement (DTA) relief claims, with the commercial substance-focused factors set out in SAT Circular 601 [2009] being used to determine eligibility for relief from withholding tax (WHT) on dividends, interest and royalties, through the beneficial ownership assessment, and from WHT on capital gains, through a GAAR analysis. Given the success of the authorities with this approach, they may be less likely to favour the recommendation in the BEPS treaty abuse paper's for LOB inclusion in DTAs. The recommendations in the OECD's report on specific abuses, such as minimum holding periods for dividend WHT relief, and on the 'look-back' approach to determining land-rich shares, are already features of China treaty practice, so no further significant modifications may be considered necessary.

Nonetheless, the BEPS Action plan can be read in support of Chinese rules acting to counter "the insertion of third country 'shell companies that have little or no substance in terms of office space, tangible assets and employees' [that] strains existing bilateral treaty arrangements". The intensity of DTA relief challenges is in fact set to intensify; the issuance of *Shui Zong Han* [2014] No 317 (August 2014) launched the SAT's large scale examination of dividend DTA WHT relief claims.

Since the issuance of SAT Circular 103 (2009), which directed local tax authorities to scrutinise the secondment arrangements of non-resident enterprises to identify disguised service arrangements, service PEs have been a key focus in the enforcement of China's international tax rules. This was bolstered further by Announcement 19 (2013), which provided more detailed and consistent guidance. Up to now, challenges against agency and fixed place PEs have been less common. However, the BEPS Action 1 on the digital economy makes clear that the PE preparatory and auxiliary exemptions will be curtailed in the Action 7 work in 2015, and that tax planning which uses contract signing outside the country of sale to avoid PE will be countered.

The Chinese tax authorities may well try to seize the opportunity this provides to tighten up PE enforcement. Arrangements where a foreign company engages an agent to perform significant portions of commercial negotiations in China may be questioned, as may arrangements where the foreign enterprise sells into China and a local subsidiary provides crucial supporting services. Changes in the taxing approach may also result from the work of the SAT's dedicated task force on the digital economy which is examining, for example, taxing rights over cross-border consultancy services, an area seen as problematic by the Jiangsu International Tax Plan.

Into the future and recommendations

The wide sweep of the BEPS initiative, and the vigour with which the SAT is seizing the opportunity for upgrading its enforcement of China's international tax provisions, means that significant changes are coming for both foreign MNEs active in China and now, given the expansion of their overseas activities, also for Chinese MNEs. It is highly advisable for MNEs to monitor closely the rapid regulatory and enforcement developments, particularly as the BEPS project enters another phase in 2015, and make necessary plans to modify planning structures and arrangements.

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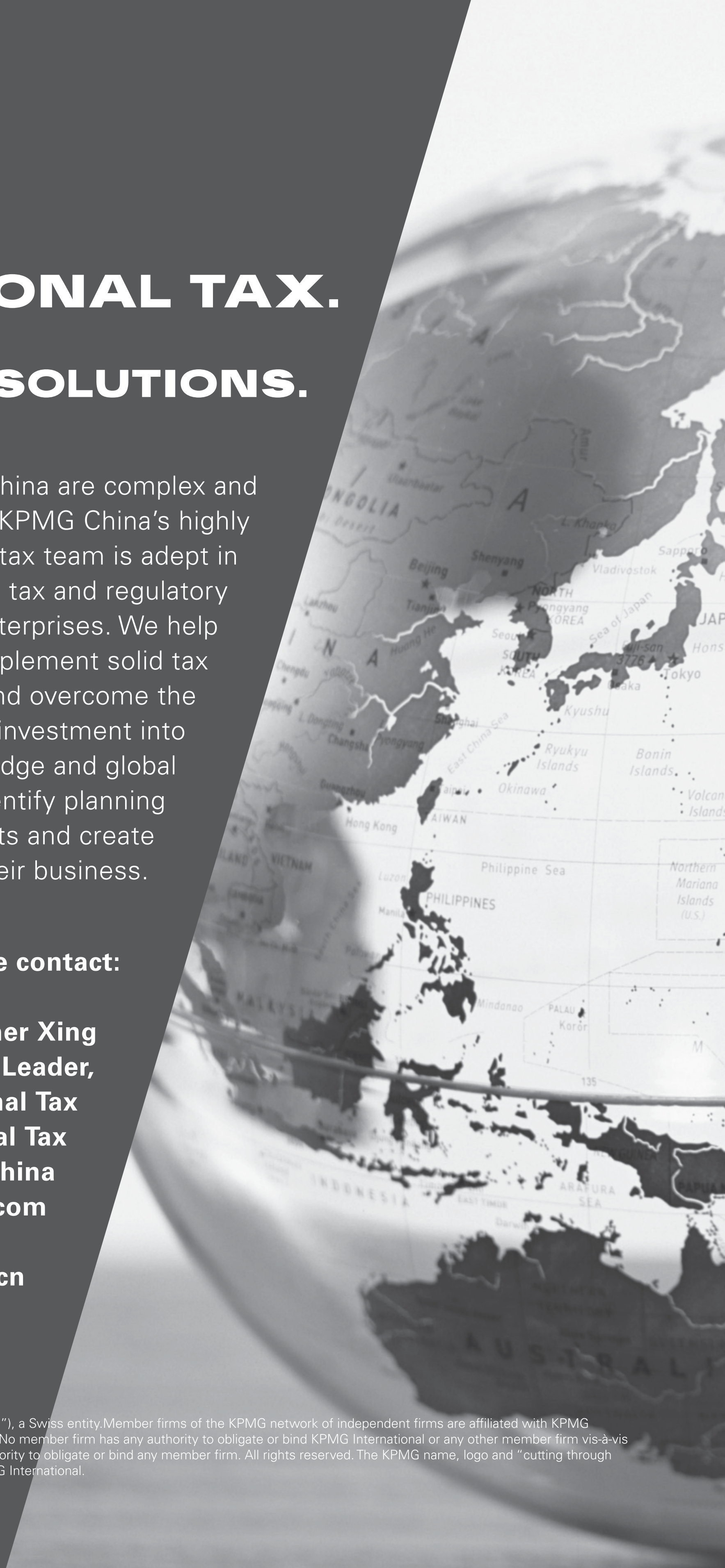
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Rising to the occasion – Mounting transfer pricing activity shines spotlight on China

The OECD's BEPS 2014 deliverables brought China's key transfer pricing issues to the centre of the international stage. Cheng Chi, Ho-Yin Leung, Kelly Liao and Simon Liu of **KPMG China** analyse how China is leveraging BEPS to support new transfer pricing measures, ramping up anti-avoidance efforts through targeted investigations and encouraging taxpayer self-adjustments.

The past year has marked a period of heightened activity in international tax, as persistent economic stagnation and recent OECD guidance aimed at addressing base erosion and profit shifting (BEPS) have brought transfer pricing issues to the forefront of the global discussion. Tax authorities in China face a unique set of challenges, as there is intense pressure to maintain or increase tax revenue, despite the overall slowing down of the Chinese national economy, which has led tax authorities to develop new strategies in an attempt to increase tax revenue gains. Against this backdrop, China continues to be a lead player in shaping transfer pricing administration, both locally and globally, and has thrust itself into the international spotlight.

In September 2014, the OECD released its first seven BEPS deliverables, which aim to enhance the integrity and fairness of the international tax system, and provide clarity on the alignment of taxing rights with value creation and global documentation. As a member of the OECD's Committee of Fiscal Affairs (BEPS committee) responsible for carrying out the BEPS Action Plan, China's State Administration of Taxation (SAT) has closely monitored the progress of the BEPS initiative and provided commentary on key items. The SAT's actions have clearly shaped the international transfer pricing framework, as the BEPS 2014 deliverables provide support for several key issues at the heart of new transfer pricing measures in China, such as those concerning location-specific advantages (LSAs) and value creation.

In this transfer pricing environment, the SAT is intensifying its scrutiny of target transfer pricing areas, particularly with respect to outbound royalty payments and service fees, overseas entities with little or no economic substance and payment for shareholder activities. Beyond simply implementing the BEPS 2014 deliverables, Chinese tax authorities have pursued a selective approach to the BEPS measures, leveraging BEPS guidance to apply a unilateral approach to key issues. This approach has been observed in recent audit cases in China, which centre on value creation through market-based intangibles and local R&D. The SAT also continues to enhance its investigative capabilities and strengthen its enforcement of transfer pricing administration through formal audits.

At the same time, the SAT maintains its emphasis on *ex ante* tax avoidance prevention (for example, self adjustments by taxpayers) as the preferred approach to achieve quick wins and alleviate the strain on the SAT's resources. In August 2014 the SAT issued its "Announcement of the State Administration of Taxation on Monitoring and Administration of Special

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In addition to lecturing at many national and local training events organised by the Chinese tax authorities, Cheng has provided technical advice on a number of recent transfer pricing legislative initiatives in China. He has been recommended as a leading transfer pricing adviser in China by the Legal Media Group.

Tax Adjustment [2014] No. 54" (Circular 54), which attempts to formalise the process of raising tax revenues through administration, formally encouraging multinational enterprises (MNEs) with operations in China to make self adjustments for non-compliant related-party transactions. According to our informed sources, the additional strain placed on the SAT's advance pricing agreement (APA) resources by enhanced investigation measures and the BEPS initiative has resulted in a temporary deferral of China's APA programme until early 2015.

Recent tax developments at both the local and international level have drastically increased the complexity of China's transfer pricing environment and significantly enhanced disclosure requirements for taxpayers. We expect the SAT to step up audit pressure in designated transfer pricing areas in the future, particularly for outbound royalty payments and service fees, while at the same time encourage taxpayers to perform self-adjustments. Multinational enterprises with operations in China will face even more rigorous compliance measures and need to balance disclosure requirements and transfer pricing risk. We also anticipate that the SAT will release a new draft circular for public discussion regarding the "Implementation Measures of Special Tax Adjustment (Provisional)" (Circular 2) by the end of 2014. The replacement for Circular 2 is expected to be finalised in 2015 and this is something that taxpayers will certainly want to be mindful of going forward, as it may affect various areas, including annual compliance.

Heightened scrutiny of intra-group service transactions

In April 2014, the SAT issued a letter to the UN working group on transfer pricing issues, marking the principal official response of the Chinese tax authorities to BEPS and understood to be an airing of the SAT's firm stance on related-party services payments. The SAT's comments set out a more stringent set of principles for payment and deductibility than those presented in the OECD guidelines, specifically highlighting several key issues at the core of any transfer pricing analysis assessing the deductibility of intra-group service charges in China:

- perspective of the service provider – when applying the benefit test, the analysis should be performed from the perspective of both the service provider and the service recipient;
- need for services – analyses should be made with regard to whether the services are required for the subsidiary's day-to-day operations;
- remuneration through existing transactions – it needs to be considered whether the provision of various services from a parent company to subsidiaries has already been remunerated through the transfer pricing policies of other related-party transactions.
- definition of shareholder services – the SAT argued that the definition of shareholder services in the OECD guidelines is too narrow, no longer including management or stewardship activities, effectively allowing parent companies to charge subsidiaries service fees relating to management and control that the subsidiaries can then deduct when calculating their taxable income.

Chinese tax officials have further stressed these views, including during one speech in particular delivered at a US transfer pricing conference given by the director general of the SAT's international taxation department. In the speech, the official outlined six specific tests to assess the reasonableness and deductibility of fees paid to related parties:

- benefit test – China applies a benefit test / price test for intra-group services. For example, when a parent provides strategic management services to a subsidiary, which are not classified as shareholder services, the services may be more beneficial to the parent, and such services should not be charged to the subsidiary.
- need test – this SAT official acknowledged that China is a manufacturing-based economy, and that simple manufacturing entities may not actually need certain headquarter services. Thus, Chinese subsidiaries should be able to go to the local market for services that can be outsourced.

- duplication test – in circumstances where management teams in subsidiaries perform management activities on their own with approvals from the parent, the intra-group management services are likely duplicative and, thus, should not be charged.
- value creation test – a service provides a benefit only if it directly results in, or can be reasonably anticipated to result in, identifiable economic and commercial value. As such, management services do not create economic benefit and are not considered beneficial.
- remuneration test – when analysing intra-group services, the SAT considers whether the provision of services from parent to subsidiary has already been remunerated through existing transfer pricing policy for related-party transactions, such as licensing of intangible property (IP) or buying-back finished goods processed from raw materials sold by the parent.
- authenticity test – it is difficult to verify the authenticity of intra-group services, as large groups can have thousands of intra-group transactions. Unless tax authorities can see the entire picture, it is impossible to judge the authenticity of intra-group service transactions and the reasonableness of cost allocation mechanisms.

The SAT has indicated that these tests are already being applied by certain local tax bureaus and are expected to be implemented throughout China in the near future. In July 2014, the SAT also issued Directive 146 (Circular 146), to provincial and local tax authorities calling on local tax bureaus to examine and report back on royalty payments and service fees made by companies to overseas related parties from 2004 to 2013, as these years are eligible for transfer pricing adjustments under the Chinese statute of limitations.

In Circular 146, the SAT focuses its attention on:

- royalty payments made to entities in tax haven jurisdictions;
- overseas related parties perceived to have little economic substance; and
- services relating to shareholder activities and supervision by headquarter companies.

The SAT is also challenging services that may be irrelevant to the Chinese recipient given its functional and risk profile or business operations and remuneration for provision of services that are duplicative, or already reflected in other transactions. In this light, taxpayers with outbound related-party non-trade payments, especially to tax haven jurisdictions, need to be prepared to provide convincing support for their transfer pricing positions to Chinese tax authorities. This could entail different layers of documentation and/or internal evidence to address the above-mentioned tests.

In the past, Chinese tax authorities placed their primary emphasis on the reasonableness of mark-up rates charged to Chinese affiliates by overseas related parties and whether segments of outbound service transactions needed to be adjusted in-line with the arm's-length principle. Now, compare that with the focus on whether or not entire transactions are without economic substance or represent shareholder activities and, thus, whether they should be deductible at all, and the implications for taxpayers have become much more substantial.

Against this background, the issuance of internal directives to scrutinise intra-group service and royalty transactions is a likely next step for the SAT. We expect that a significant number of transfer pricing investigations with a focus on royalties and service fees will be conducted throughout China. As the SAT steps up its intensity surrounding the investigation of intra-group service fee or royalty payments, taxpayers in China need to fully understand the nature and benefits of the

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services charged and address areas of potential controversy with the tax authorities. Taxpayers should also ensure that adequate evidence is in place to support their related-party arrangements, potentially through documentation and evidence from different perspectives.

China's tax authorities focus on value creation

Chinese tax authorities are also leveraging the value creation emphasis of the BEPS Action Plan. The BEPS initiative's focus on physical substance and functions performed in determining value creation echoes the SAT's stance previously presented in the 'China Country Practices' (CCP) chapter of the UN Practical Manual on Transfer Pricing for Developing Countries (UN manual). More recently, the Jiangsu Tax Bureau's (JTB) "2014-2015 Plan of the Jiangsu Provincial Office of the State Administration of Taxation for the Supervision of Taxpayer Compliance Regarding Matters in International Taxation" (the Plan), outlines the JTB's awareness of and views towards issues raised in the 2013 BEPS report, citing key issues such as:

- the need to consider fully the role of local enterprises in value creation (for example, local intangibles or R&D teams);
- the alignment of tax rights with the substance of economic activities; and
- increased transparency of transfer pricing documentation.

It is clear from the BEPS 2014 deliverables that key SAT input has helped shape the international transfer pricing discussion. In particular, Action 8 (transfer pricing of intangible assets) and Action 13 (CbC reporting) reflect an alignment of the BEPS Action Plan and recent transfer pricing measures enacted by the SAT. The Chapter 1 (arm's-length principle) and Chapter 2 (transfer pricing method) guidelines in Action 8 appear to recognise the legitimacy of location savings and assembled workforce, as well as market premiums. The Chapter 6 guidelines also downplay the significance of legal ownership of intangibles in allocating profits to MNE group entities, instead emphasising the functions, assets and risks involved.

The SAT also draws support from the BEPS 2014 deliverables for the application of the profit split method (PSM), as opposed to the more commonly applied transactional net margin method (TNMM), which the SAT views as largely one-sided, to the benefit of developed countries. For MNEs operating in China, it is conceivable that the Chinese tax authorities could use the PSM or formulary approach in transfer pricing audits to argue for additional profit attribution to the Chinese operations of MNEs, on the basis that such tax adjustments would be more in line with functions performed and assets assumed within China. This is evidenced in many of the transfer pricing audit cases we experienced.

Leveraging support from the BEPS guidance, we have observed Chinese tax authorities challenge royalty payments made by local affiliates that participate in on-the-ground efforts, including local marketing and promotional activities, to maintain relationships with local affiliates of global customers. In such cases, the Chinese tax authorities have asserted that the local affiliates create and own local customer-based intangibles that must be compensated, through partial or whole ownership of customer-based marketing intangibles, even if group customer relationships were developed at the overseas headquarters. Chinese tax authorities have also challenged cases in which Chinese affiliates of MNE groups are perceived to have created value through R&D activities but contractual arrangements do not accurately reflect these efforts. For example, if a Chinese affiliate's R&D team engages in significant R&D activities relating to technology licensed by an overseas related party (IP owner) that performs minimal activities (that is, "rubber stamp" approval), the Chinese tax authorities have challenged that the intercompany agreement has contractually shifted the legal IP rights overseas via royalty and R&D services fees and that such technology royalties are invalid.

Though it might be inferred that the SAT would have a positive outlook towards the BEPS Action Plan, the SAT is still critical of certain aspects of the OECD's guidance, preferring to apply the BEPS initiatives as support for its advantage. For instance, though it appears that both BEPS and the

Chinese tax authorities have taken similar views towards value creation, the interpretation of "key people function" is different. Instead of looking at the decision-making entity, the SAT contends that a greater emphasis needs to be placed on the actual execution of functions. The SAT maintains that even if the primary decision-makers are among a handful of employees located overseas, value creation relies on having a significant number of people to carry out the actual functions. The SAT also continues to compare local and group profit levels to assess whether local entities are earning less profit than they should be.

Chinese tax authorities are gathering momentum for enforcing transfer pricing concepts, such as value creation and LSAs, and we expect that taxpayers will face increased scrutiny in the near future. Due to China's unilateral and selective approach to transfer pricing administration, the SAT's arguments for adjustment are easy to make and difficult to refute, placing the burden of proof squarely on the taxpayer, with failure to provide sufficient supporting documentation resulting in non-deductibility of transactions. Therefore, taxpayers should periodically conduct tax health-checks to identify potential weaknesses and take necessary steps to mitigate transfer pricing risk, including realigning functions, assets and personnel within the group and preparing internal controls and working guidelines. And CbC reporting will increase the transparency of MNEs' global operations, so taxpayers should take a proactive role in understanding the BEPS development and establish a more centralised approach to transfer pricing.

SAT enhancing information collection and audit sophistication

In its commentary issued to the UN working group, the SAT admitted to the practical difficulties present in assessing the arm's-length nature of service charges due to the tremendous amount of information required, as well as difficulties in differentiating between the provision of services and the license or transfer of IP. Chinese tax authorities are developing and implementing comprehensive countermeasures to respond to taxation risks associated with the current transfer pricing environment and the OECD Guidelines. Based on information from knowledgeable sources, the SAT collected about RMB46.9 billion ($7.7 billion) of anti-avoidance tax revenue in 2013 through its 'three-dimensional efforts' (that is, administration, investigation and service), an increase of 35% year-on-year. According to our informed sources, the top five tax bureaus contributing to anti-avoidance tax revenue in 2013 were the Beijing, Jiangsu, Shanghai, Anhui and Guangdong branches of the SAT.

As the JTB Plan outlined, consistent with the BEPS initiative Chinese tax authorities are:

- increasing their focus on the global value chain;
- improving their information gathering; and
- developing better risk warning systems for identifying audit candidates.

Chinese tax authorities, including the JTB, are increasingly using information platforms to integrate various tax filing information, information from business databases and information from third parties (for example, customs offices, commerce administrations, industry and business administrations and other government departments). Chinese tax authorities plan to increase their use of data warehousing technology to determine risk indicators and categorise risks, and use this information to undertake risk screening processes and identify key targets for further review and investigation.

The Chinese tax authorities have also been active in developing new transfer pricing measures, such as the transfer pricing comprehensive indicator system, to:

- improve the efficiency of evaluating transfer pricing risks;
- encourage internal information sharing; and
- improve the quality of information in their internal database.

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The system was developed based on the internal database collected by the SAT over the past several years and can be applied not only to benchmarking studies across different industries, fiscal years and countries, but also to anti-avoidance models of specific industries to help strengthen transfer pricing management. During 2013, more than 1,000 taxpayers were prompted to change their transfer pricing mechanism or policy after review by the tax authorities, with more than RMB1 billion ($163 million) in extra tax revenue collected by local tax bureaus.

Based on these recent enhancements to their investigative capabilities, the Chinese tax authorities have been increasingly able to investigate and analyse complex transactions and transfer pricing arrangements. Specific anti-avoidance investigation organisations have been established at provincial and municipal levels, which consist of expert panels brought together to enhance the quality and strength of anti-avoidance investigations, including a broader scope of complex transaction arrangements (for example, profit shifting through the use of intangible assets or financial instruments). Chinese tax authorities also aim to expand international cooperation through information sharing under tax treaties, to further strengthen the monitoring of cross-border transactions.

In the future, transfer pricing documentation is expected to become a higher profile exercise from a company-wide risk compliance standpoint than in the past. The information provided to the Chinese tax authorities through the compulsory spontaneous rulings exchange system, taking effect from October 2014, and BEPS 'sister' initiative on the establishment of an automatic information exchange platform, will also inform the targeting of further audit action on outbound payments. In this complex environment, taxpayers in China should work together with their professional advisers early in the process to ensure the validity and compliance of transfer pricing strategies and be active in setting information collection and documentation strategies to better manage feasibility, risk exposure and resource management.

Self reporting and adjustment

The continuous efforts of Chinese tax authorities to collect more tax revenue amidst prevailing economic stagnation and the focus on recent BEPS deliverables, placing additional strain on SAT resources mean that the preferred approach of Chinese tax authorities for transfer pricing adjustments continues to be, and is increasingly, taxpayer self adjustments. These fall under the 'administration' aspect of the SAT's 'three-dimensional' anti-avoidance efforts, which also include service (APAs and mutual agreement procedure) and investigation (transfer pricing audit).

Though official statistics have not been released, our understanding is that Chinese authorities' anti-tax avoidance efforts have increased 2013 tax revenue by RMB12.3 billion ($2 billion) over the previous year, with about RMB9.4 billion generated by administration and RMB2.9 billion by service efforts and a minor increase in tax revenue through investigation.

Chinese tax authorities have an extensive monitoring and administration system in place at the local level, which is supervised by the SAT, used to address tax anti-avoidance issues in China in real time (effectively encouraging companies to make voluntary increases to taxes paid). As we discussed in previous editions of this publication, the SAT's administration programme continues to be increasingly viewed as a means to achieve quick wins for cases that might not otherwise be significant enough for formal audit, while at the same time, providing Chinese tax authorities with the flexibility to adjust their enforcement approach as necessary to fit the broader transfer pricing agenda.

The SAT's recently-issued Circular 54 provides further instructions in relation to the self-adjustment practice within SAT's monitoring and administration mechanism and, for the first time in writing, encourages taxpayers to make self adjustments, that is, voluntarily make an upward adjustment to the amount of income tax paid if related-party transactions were not carried out on reasonable terms. Previously, most guidance on the subject had been orally provided to taxpayers by the local tax bureaus, or in internal communications sent to local tax bureaus by the SAT.

Circular 54 also stipulates that the Chinese tax authorities retain the right to conduct audits and requires formal audits to be conducted when taxpayers require clarification of the reasonableness of their transfer pricing policies and methods. If this strategy is strictly implemented, taxpayers with less material adjustments who in the past may have passed under the audit radar may now receive more pressure to defend their positions.

Under Circular 54, taxpayers are permitted a brief window in which to submit relevant materials after a request (for example, a 20-day time limit to submit transfer pricing documentation). In the future, the additional 5% penalty interest stipulated by Circular 2 will not be charged on self adjustments, provided that transfer pricing documentation is provided as stipulated by law. However, interest should still be paid as stipulated by Circular 2 for tax adjustments. This is essentially to account for self adjustments being made after the fact (that is, late payment of tax), and formalizes the practice that some tax bureaus had already adopted.

While on the surface, Circular 54 does not appear to present anything particularly new, it is evidence of the SAT's resolution to formalise the self-adjustment programme, which is managed primarily at the local level with varied approaches to dealing with the same issue, such as whether and how to levy interest charges for the tax payments made as a result of self adjustment. With the SAT improving its enterprise monitoring capabilities and pushing for a unified approach across all tax jurisdictions, we expect that there will be more initiatives taken by the local bureaus to ask taxpayers to consider self adjustments in the future.

Taxpayers should note that performing a self adjustment may lead to double taxation, which is not eligible for treaty relief. Further difficulty also exists in dealing with other tax areas, such as VAT, export tax rebates, customs and foreign exchange issues. Self adjustment does not provide full protection from audit either; Circular 54 reaffirms that the tax authorities retain the right to conduct formal audits, even if a taxpayer chooses to make a self adjustment. Therefore, when considering initiating a self adjustment, taxpayers are advised to communicate with their professional adviser and thoroughly weigh the benefits of self assessment against the potential risks, which can potentially be very significant and undesirable.

If considering the self-adjustment approach, taxpayers should first consult their professional adviser, as taxpayers want to be careful not to send the wrong message that unreasonable transfer pricing practices are being carried out. And even if a company engages in self-adjustment, taxpayers will still need to plan ahead and be active in further minimising any transfer pricing audit risks on the same years. Taxpayers need to consider factors such as negotiating with tax authorities to ultimately apply for mutual agreement procedure (MAP) to obtain double taxation relief or using various other strategies to prolong self-adjustment cases.

2014 APA Programme in China

In China, APA applications need to be quality-checked and receive final sign-off from the SAT. Bilateral APAs are always conducted at the SAT level, with support from provincial and local tax authorities. Due to the new BEPS initiatives and targeted audit focus putting further strain on the SAT's limited resources for transfer pricing enforcement, China's APA resources are insufficient to proceed with any new APAs and there are a substantial number still in the pipeline. Multinational enterprises with operations in China should note that, though APAs are still a feasible and active risk mitigation strategy in China, the APA programme appears to have been temporarily put on hold until early 2015.

Looking ahead

The release of the first round of BEPS deliverables marked a defining moment in China's transfer pricing narrative, providing clear evidence of China's influence on the international transfer pricing discussion and offering implicit support for recent transfer pricing regulations implemented by the SAT. These latest transfer pricing developments will give the SAT new weapons to challenge MNEs in China and bring about complexity and enhanced documentation requirements for taxpayers. In this increasingly challenging environment, taxpayers need to revisit their transfer pricing methodologies, as what was defendable in the past may no longer be so in the future. Against this backdrop, the issuance of internal directives to scrutinise questionable transfer pricing arrangements is imminent and we expect a significant number of transfer pricing audits to be conducted across the country in the near future.

Specifically, the SAT is expected to:

- put a greater focus on outbound service fee and royalty transactions to determine whether services are necessary and beneficial, particularly through the lens of the six tests; and
- demand that taxpayers provide substantially more supporting evidence in order to remit money out of China at all.

This is a difficult exercise, as though some of the tests can be addressed using quantitative examples, the rest would be complicated (for example, need test and value creation test). Thus, taxpayers will need to increasingly consider preparing various levels of internal documentation and evidence to defend against potential audits or queries from tax authorities. There is no pre-set list for the necessary documentation, and taxpayers will need to determine this on a case-by-case basis. Therefore, taxpayers need to thoroughly understand their intra-group service transactions, as well as consult with their professional adviser to determine the necessary evidence.

Taxpayers having significant outbound non-trade payments should always have an audit defence mindset and, more importantly, a strategy to defend against any potential scrutiny by the tax authorities. Internal tax and finance teams should always be well-equipped with how to respond to the tax authorities' queries and requests. As an internal risk management strategy, communication protocol with tax officials should be in place so as to react to any future challenges quickly and appropriately.

BEPS is not a local legislation. Tax authorities around the globe will determine what should be included in their respective local tax and transfer pricing law and regulations. The same is expected for the SAT. Therefore, the BEPS initiative, which was originally intended to increase standardisation across different countries, could ultimately result in an increase in divergence. Different interpretations of the action plan may result in contradiction and ambiguity between different countries. For example, as discussed above, Chinese tax authorities interpret "key people function" as those who execute, rather than make, the key decisions. In light of this, MNEs should consistently reflect on whether they should always advocate global consistency or if, in reality, they should live with a certain level of deviations.

As MNEs with operations in China face the looming threat of transfer pricing disputes in an increasingly complex transfer pricing environment, Chinese tax authorities may also be banking on the investigative pressure in these targeted areas to lead taxpayers to pre-emptively alter their transfer pricing arrangements in China and seek self-adjustment as a means of forestalling transfer pricing controversy. The SAT continues to advance and formalise this programme aggressively and it is expected that there will be more initiative taken by the local bureaus to ask taxpayers to consider self adjustments.

However, the SAT has been clear that will maintain the right to conduct formal audits, so taxpayers will need to consider thoroughly the ramifications of a decision to self adjust.

On a broader scope, taxpayers need to be mindful of the continuously changing transfer pricing landscape in China. As the BEPS initiative progresses, we expect new approaches, such as the PSM, to continue to gain traction in China, which could pose new challenges for taxpayers in supporting their transfer pricing arrangements. Moreover, the SAT is expected to release a draft circular for public consultation regarding comprehensive revisions to Circular 2 before the end of 2014. While the SAT has been extremely secretive about the drafting process, we do expect the new transfer pricing regulations to account for the recent transfer pricing developments highlighted in this article. As such, MNEs in China should pay close attention to new developments, as this could have a far-reaching impact on their transfer pricing arrangements, as well as the annual compliance requirements in China. Once the draft version has been released for public consultation, MNEs should review and understand the new focuses and developments from the draft to reassess their transfer pricing arrangements and plan ahead. Though it is too early to give a precise date, this new circular is expected to be finalised in 2015.

The authors are grateful to Brett Norwood for his invaluable help with this article.

Created in China: The fast pace of innovation, R&D incentives and economic development

Though R&D tax incentives are attractive in China, multinational companies should remember that, in return, the authorities expect more than routine work to be carried out, explain Alan Garcia, Bin Yang, Josephine Jiang and William Zhang, of **KPMG China**.

China as global innovation leader

The Lunheng, written by Wang Chong (27 – c.100 AD) of the Han Dynasty, states "this instrument resembles a spoon and when it is placed on a plate on the ground, the handle points to the south" – and so we have a reference to a lodestone being the precursor to what we now know as the magnetic compass. In another Chinese innovation, it is recorded that a court eunuch (50AD – 121AD) invented the pulp papermaking process.

Fast forward to China today and we witness thousands of Chinese companies contributing to local and global development. For example, the State Nuclear Power Technology Corporation has developed a highly innovative third-generation nuclear power plant by working together with overseas partners. This technology is considered to have a higher safety and performance specification than those preceding it. XCMG, a construction industry company, has developed the largest crane in the world, which can be used to lift extremely heavy structures such as the shell of nuclear power plant.

China is once again becoming a global leader in innovation. Make no mistake, based on projections, China is on track to become a global leader in R&D spending and may overtake the US by 2024.

Innovation and technology are crucial to enhancing enterprise competiveness and boosting economic growth and R&D is a key factor in assessing a country's technology innovation capability.

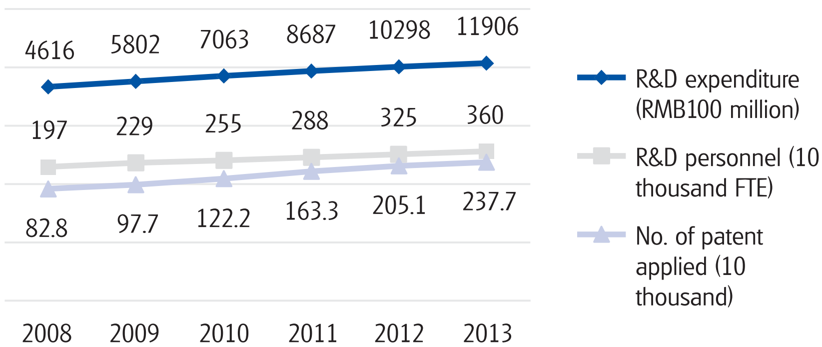
China's R&D spending grew rapidly from RMB461.6 billion ($75 billion) in 2008 to RMB1.19 trillion in 2013. In 2011, China surpassed Japan as the world's second highest R&D spender in the world. And in the same year China reported 525,000 patent filings, while the US reported 500,000.

Statistics show that R&D investment has increased year by year (see diagrams 1, 2 and 3).

In view of this, R&D expenditure increased continuously and as a proportion of GDP, with R&D expenditure as a proportion of GDP rising to 2.09% in 2013. The growth trends of R&D expenditure, R&D personnel and number of patent applications correlate, which reflects the impact of sustained R&D investment. R&D investment funded internally by companies accounted for the majority of R&D expenditure, which is between about 73% and76% from 2008 to 2013.

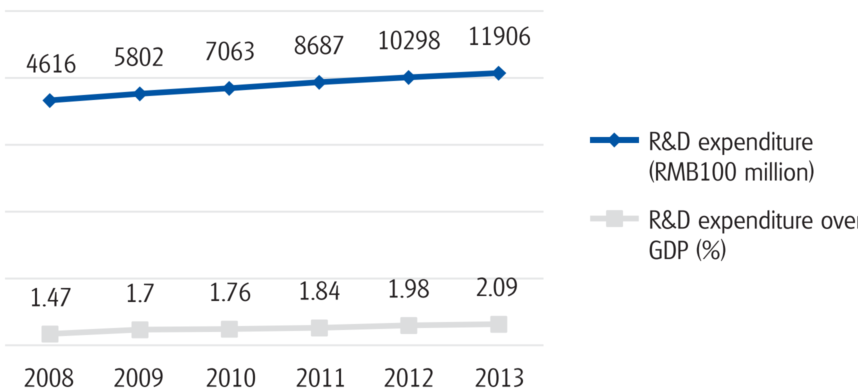
Today Chinese companies are keenly aware that while shrewd cost management will always be top of the agenda, such companies also appreciate that top and bottom-line growth can only be met with innovative technology and processes, market leading products and related services.

Diagram 1: R&D expenditure, R&D personnel and number of patent applications



Source data: 2014 China Science and Technology Statistics released by Chinese Academy of Science and Technology for Development

Diagram 2: R&D Expenditure over GDP



Source data: 2014 China Science and Technology Statistics released by Chinese Academy of Science and Technology for Development

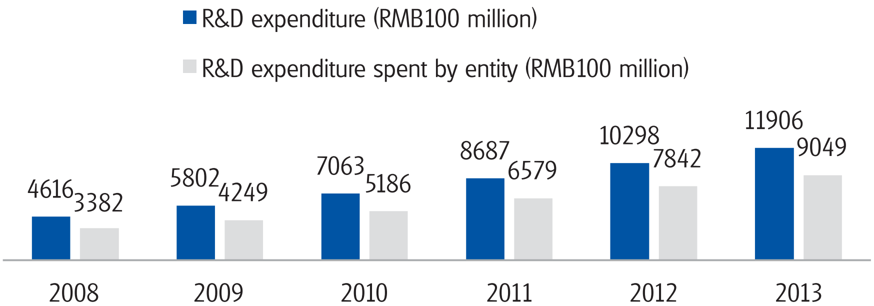
Big spending on R&D by sector – the top 10

Indeed, according to a Communiqué on National Expenditures on Science and Technology of China in 2012, the R&D expenditure of 10 industries was more than RMB20billion. The total R&D expenditure of these 10 industries took 73.9% of all industrial enterprises above a designated size.

Those 10 industries are:

- mining and quarrying;
- manufacture of chemical raw material and chemical products;
- manufacture of medicines;
- manufacture of general and special purpose machinery;
- manufacture of motor vehicles and railway locomotives;
- building of ships and boats;
- manufacture of air and spacecraft and other transportation;
- manufacture of electrical machinery and equipment;
- manufacture of communication and computer / electronic equipment;
- manufacture of measuring instruments and machinery for cultural activity and office work.

Diagram 3: Total R&D expenditure and R&D expenditure spent by entity



Source data: 2014 China Science and Technology Statistics released by Chinese Academy of Science and Technology for Development

R&D tax incentives

The Chinese government strongly supports eight high-technology areas according to *Guokefahuo* (2008) No. 172 – Administrative Measures on Accreditation of High-technology enterprises. More specifically, we list below the industry sectors that the R&D super deduction and High New Technology Enterprise (HNTE) Status tax incentives directly support:

1) electronic information technology
2) bioengineering and new medical technology
3) aeronautical and space technology
4) new material technology
5) high-tech service
6) new energy and energy saving technology
7) resource and environment technology; and
8) high technology to transform traditional industries.

China's rapid escalation in R&D expenditure and investment has been facilitated, in part, by the R&D Super Deduction and HNTE R&D programmemes offered by the Chinese government.

Decline in HNTE applications and re-applications out of step with R&D investment

The HNTE programme offers companies a reduction in total company tax payable to the revenue authority. If successful, such companies enjoy a tax rate of 15% as opposed to the standard 25% corporate tax rate. This is a significant saving for many HNTE recipients. However, the six eligibility criteria are tough to meet, especially if the company is increasing sales.

To be eligible as a HNTE, a company must satisfy these criteria:

- own the intellectual property (IP) for the key technologies of products;
- fall within one of the eight areas specified in 'High-New-Technology Areas with Key State Support';
- have sufficient R&D and science & technology personnel;
- perform R&D and incur sufficient R&D expenses;
- generate sufficient profits from High-New-Technology products; and
- meet the points calculation target.

HNTE recognition is performed by a committee comprising the science and technology bureau, tax authority and finance authority at the provincial level. The HNTE status is valid for three years but the tests need to be satisfied annually.

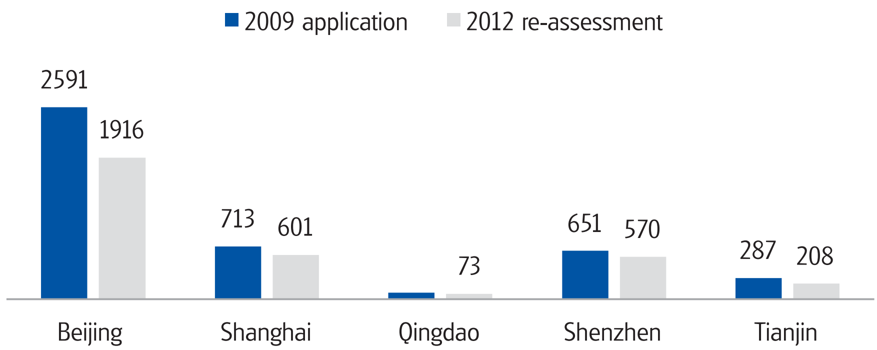
After six years of implementation, it seems the HNTE policy has supported the Chinese economy and facilitated increased investment in R&D by local and multinational companies. Many HNTEs are large global innovators or small start-ups looking to become the next Alibaba.

As R&D investment is a key eligibility test regarding HNTE qualification, an increase in gross R&D investment across China would potentially result in an increase in HNTE status applications and re-approvals across China. For example, an enterprise that previously obtained HNTE status would generally seek to achieve HNTE status every three years if the entity keeps increasing R&D investment. However, the data in diagrams 4 and 5 contradict this assumption.

As shown in the diagrams, for the five cities, the number of HNTEs which passed reassessment decreased between 2011 and 2013, and the total number of HNTE applications also declined. The average decline rate is about 22%.

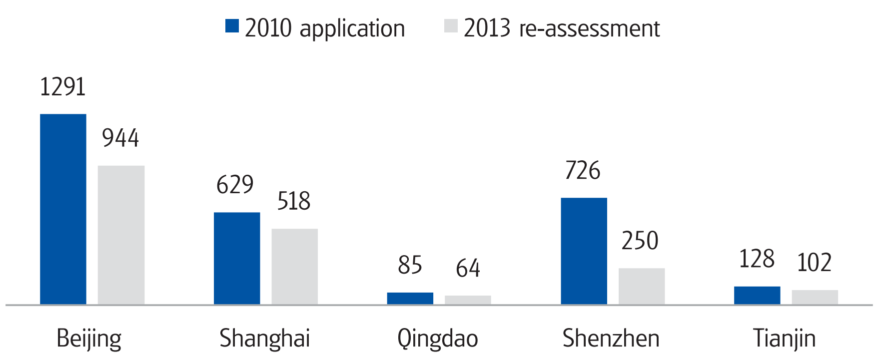
In summary, the HNTE status reassessment statistics do not correlate with the increase in gross R&D investment across the PRC.

Diagram 4: The comparison of application in 2009 and re-assessment in 2012



Source data: HNTE list released by Science and Technology Bureau of the five cities

Diagram 5: The comparison of application in 2010 and re-assessment in 2013



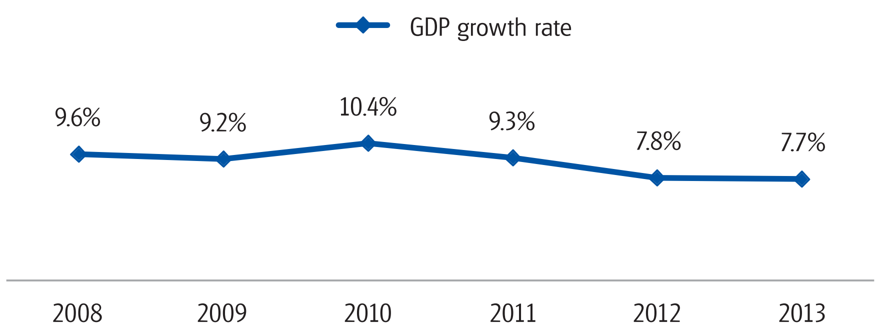
Source data: HNTE list released by Science and Technology Bureau of the five cities

A number of factors may be behind this, not the least of which is government strengthening of HNTE audit procedures in the context of tougher economic conditions. As shown in the chart below, the GDP growth rate in 2010 was 10.4%. However, from 2011, the GDP growth rate dropped annually and in 2013, it decreased to 7.7%. According to the most recent Government Work Report released by the State Council, the projected GDP growth rate for 2014 is 7.5% . While China still has a most competitive growth rate on a global scale, it is nonetheless a key issue affecting policy makers and tax officials. Recent international projections suggest China's growth could slow to under 4% in the near future (see Diagram 6).

A GDP slowdown typically increases pressure on budgets – resulting in tax leakage minimisation strategies by governments across the world. For example, as announced in *Guokefahuo* 2012 No. 1220, the Ministry of Science and Technology, Ministry of Finance and State Administration of Taxation jointly initiated the largest scale of inspections of HNTE status.

The aim of such audits is to deal with compliance better and clarify the interpretation of the six criteria described above. These audits have also triggered a policy review of the HNTE programme, with potential amendments to the HNTE programme anticipated in 2015. Specific items that may be modified include the rules about:

Diagram 6: GDP growth rate from 2008 to 2013



Source data: Government Work Report released by the State Council during 2009 to 2014

- R&D expense allocation;
- R&D expense as a percentage of turnover target;
- IP definitions and requirements; and
- HNTE revenue calculation.

Such potential changes to the regulations may make it more difficult for large companies to meet the relevant tests. As a result, existing HNTEs should carefully consider HNTE compliance and plan ahead for potential rassessment.

Inter-relationship between HNTE and transfer pricing

Moreover, the decline in HNTE applications and renewals may also be attributable to tax authorities stepping up their focus on transfer pricing issues, particularly involving R&D and value creation. Multinational companies that have obtained HNTE qualification are expected to perform substantial R&D activities and use key technology, resulting in the creation of IP for which they can claim legal ownership. As such, their subsidiaries in China need to demonstrate that their activities are not merely routine in nature – such local companies must demonstrate value-adding functions, and/or intangible asset creation owned locally. Chinese tax authorities may challenge the HNTE entity as either (1) performing 'additional' R&D functions, and assess an upward transfer pricing adjustment in-line with its valuable R&D contributions; or (2) the Chinese tax authorities might revoke the taxpayers' HNTE status due to lack of R&D activity and IP generation.

In this transfer pricing environment, it is crucial for MNCs to mitigate their transfer pricing exposure effectively and analyse these issues in a strategic fashion. Any inconsistency or contradictions between the HNTE application materials and the annual transfer pricing documentation could be attractive to tax authorities hoping to potentially minimise tax leakage.

R&D super deduction – a likely option to help fund R&D

The R&D super deduction is becoming a realistic option for many companies in China. This is because it has less eligibility criteria than the HNTE programme and focuses predominantly on R&D activities and eligible expenses, rather than R&D expenses as a percentage of turnover and revenue derivation calculations – these latter points are key HNTE compliance issues for large, successful companies.

The R&D super deduction offers companies a 150% tax deduction for eligible activities and associated expenses which results in additional tax savings of 12.5% for eligible expenses.

For example, if a company spends RMB10 million on eligible R&D expenses that involve new knowledge, improved products and/or processes and achieve an advancement in science and technology, such expenditure will generate a tax saving of RMB1.25 million. This definition is very broad and can include improvements to products and technologies in many industry sectors such as financial services (usually software development), IT, logistics, retail, food/beverage, agribusiness, manufacturing, engineering and mining – as well as more typical R&D industries such as pharmaceuticals and automotive.

Importantly, in 2014 a Government Work Report specifically stated that the R&D super deduction policy should be fully implemented in 2014 – a positive signal for companies to enjoy this benefit especially in view of the tightening of the HNTE audit processes by government agencies.

However, it is clear that many companies with operations in China fail to avail of the R&D super deduction. To successfully claim it, companies need to:

- identify the eligible activities;
- identify the eligible expenditure and track them to R&D expense category;

- describe the technical aspects of product or process development, new knowledge and technical development;
- substantiate the relevant activities and expenses with a documentation trail;
- submit the R&D Super Deduction claim with the STB and SAT;
- submit the annual income tax return; and
- receive the tax reduction after confirmation by the SAT.

Regarding eligible R&D expenses, these items would qualify if they relate to eligible R&D activities:

- new product design fees, new technique programming fees and direct expenses for technical materials and translation;
- direct costs of materials, fuels and powers;
- salary, bonus, and other allowances;
- depreciation or rental of equipment, expenses incurred for maintenance, tuning, inspection and repair of instruments and equipment used exclusively for R&D activities;
- amortisation of intangible assets including software, patent and non-patent technologies used exclusively for R&D activities;
- development and manufacturing costs of moulds and technical instruments used for interim test or trial production, expenses incurred for purchase of samples, prototypes and general testing items which do not constitute fixed assets; and
- on-site test expenses of mineral exploration technology and clinical trial expenses for development of new medicine.
- Demonstration, appraisal and recognition expenses of R&D outcome, expenses for evaluation of R&D results

The challenge for many companies is:

- Which activities are eligible R&D and how do you describe them?
- How do you calculate eligible R&D expenditure?
- Where do you collect relevant numbers?
- What is the claim process and how long does it take?
- What will happen when your claim is audited by the STB and SAT?
- What records are needed to substantiate a claim?

Such questions require careful consideration to ensure compliance with tax regulations to achieve the relevant tax saving – external assistance from an experienced and suitably qualified tax and scientific adviser may assist in this regard. Typical questions and investigations that can shed light on the scope of a potential R&D super deduction claim include:

- Did your engineers or scientists experience technical failures or prototype specification challenges during the project?
- Did the project take an unexpected course of direction because of a technical issue?
- Did the project run over time and over budget as a consequence of difficult technical specifications?
- Were highly qualified technical team members finding it difficult to deliver the project solutions?
- Did the company need to engage with a university or external specialist to achieve the results?

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Alan Garcia is a partner, R&D Tax, Asia Pacific Regional R&D leader & leader, Centre of Excellence, R&D Incentives, China. His ASPAC R&D regional role involves assisting companies to access and understand various R&D incentive programmes around Asia, including China, Singapore, Australia, Malaysia and Vietnam. He has more than 17 years R&D consulting experience with Big 4 firms.

Alan focuses on the R&D Super Deduction and HNTE / ATSE incentives in China. He deals with State Administration of Taxation (SAT) / Ministry of Finance (MOF) regulators regarding interpretation of R&D incentive rules and regulations and liaises with government regarding issues such as incentive policies and audit defence.

Across ASPAC, he has extensive experience in undertaking R&D reviews for global and local companies. In particular, Alan manages 'high value' R&D audits and inland revenue reviews and appeals and provides advice on legal R&D issues, including strategy and R&D planning.

Alan specialises in identifying all material R&D activities and associated R&D expenditure. This includes the provision of tailored knowledge transfer workshops and extensive analyses and processing of financial data – including understanding IP location issues, cross-charge/reimbursement across jurisdictions and associated financial risk.

Key areas of experience include the following: automotive, process and materials engineering; chemical engineering; banking and finance; information technology; energy and natural resources; manufacturing process, including automation; recycling process development; environmental sustainability projects; pharmaceuticals, and food and beverage development and processing efficiency.

Alan assists companies to identify potential government grant opportunities and preparation of competitive grant and subsidy applications. He has extensive experience in tracking the changing funding priorities of governments across Asia and assists companies to access appropriate funding opportunities, particularly for the innovation or commercialisation of new technologies and/or for projects that deliver environmental benefits.

He is actively involved in preparing KPMG's response to various government R&D incentive and clean energy strategies.

He has a bachelor of laws degree in accounting and a BA, is an affiliate of the Institute of Chartered Accountants.

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Bin Yang worked for the Guangdong government and a multinational foreign investment company for 14 years before he joined KPMG. When working for the government, he was responsible for regulations consultation and project management regarding the foreign investment to PRC.

Since joining KPMG in 2006, Bin has been mainly responsible for regulatory and company structuring advisory and implementation.

Bin is knowledgeable in business laws and regulations, and has a good understanding of enterprise investment practice; he is also familiar with the business environment in China. He has plenty of experience in enterprise set-up, advisory and implementation of corporate restructuring. He has successfully assisted many multinationals as well as medium and small companies from manufacturing, trading, property, and service industries to enter the PRC market and improve their company structure.

Bin also has in-depth knowledge of R&D incentives in China and has been actively assisting multinational companies as well as China domestic enterprises in R&D planning, R&D incentive application and R&D audits.

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Josephine Jiang is our Beijing based tax partner, focusing on R&D tax as well as M&A and international tax. She has been practising tax for more than 15 years.

Josephine has extensive background in Chinese domestic and international tax. She has served many large multinational companies, state-owned enterprises (SOEs), venture capital companies and private equity firms. She has significant experience in dealing with various tax issues including global tax minimisation, tax efficient financing, tax risk management, and domestic tax issues such as pre-IPO restructuring. She has worked extensively on M&A including due diligence, designing and implementing complex takeover transactions and reorganisations.

Being the Northern China R&D tax lead partner, Josephine has worked closely with her team to provide R&D tax services to clients across industries.

From 2008 to 2009, Josephine spent one year practising international tax in the New York office of another Big Four firm with a focus on China inbound investment by US multinationals.

Josephine also participated in the effort in providing commentary to China tax authority on their recent international tax and M&A related regulations.

- Was additional testing required to prove the project objectives?
- Did your team generate new knowledge as a consequence of undertaking the project?

If the answer is "yes" to some of these questions, it is likely your company has a claim. Of course, companies should also consider the transfer pricing matters described earlier to ensure a consistent approach is adopted.

Where does China sit on the scale of R&D incentives across the Asia Pacific?

Many countries in the Asia Pacific region promote R&D incentives as a method to encourage local and foreign direct investment in R&D. But it can be difficult to work out the net tax savings in each jurisdiction.

For example, Australia offers a R&D tax incentive or credit valued at 45% for small companies and 40% for large companies. In after tax terms, this translates to net tax saving of 15% and 10% respectively. Moreover, if the small company has tax losses, it can 'cash out' the tax deduction and receive a 45% cash refund. Overall, the system in Australia is mature, transparent, well managed by the regulators and often replicated by other governments around the world.

Malaysia offers a double deduction of 200% which translates to a net saving of 25% for eligible R&D expenditure. On paper this is one of the highest R&D benefits in the region, although it is important to note that companies must pre-register their intention to claim the R&D benefit and they will be thoroughly audited before receiving any potential benefit. Malaysia also offers tax exemption tax status to approved operational headquarters.

Singapore has managed to attract significant foreign direct investment over the past decade and has transformed itself into a financial and regional services hub. It offers a 400% R&D incentive on the first S$400,000 ($308,000) and a 150% benefit thereafter. It also offers enhanced benefits to small and medium sized enterprises. However, over the past 12 months in particular, the inland revenue authorities seem to have taken a more active involvement in auditing financial services R&D tax claims.

South Korea's R&D incentives are also very attractive, where the amount of tax credit for smaller companies is either 50% of the eligible expense amount more than the prior years average, or 25% of the eligible expense amount, whichever is larger. Medium companies can access 40% of the eligible expense amount above the three year average, or 8% of the eligible expense amount, whichever is larger. And finally, large companies can access 40% of eligible expenses more than the prior years average, or 4% of the eligible expense amount, whichever is larger. South Korea also offers various cash incentives and exemptions for setting up an R&D centre.

So we can see on the Asia Pacific scale of R&D incentives, China is quite good – not as generous as Malaysia's headline rate but higher than some other countries. To date, claiming the R&D super deduction in China has largely been reasonably efficient, although in some provinces the layers of review can occasionally slow things down.

China in the lead

In this modern world – often characterised by economic uncertainty, population growth, urbanisation, mobile technologies, environmental challenge, diseases such as Ebola and the ascendancy of the Asian economies – it is very likely China will once again take the R&D lead on a world scale. Today, however, it would probably use a GPS to lead the way rather than a "spoon handle pointing south".

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William is the practice leader for R&D tax and for international corporate tax in Central China. William has been providing PRC business, tax and legal consultation and planning ideas for various multinational companies since 1997. He has assisted many multinational companies in making investments in China and gathered extensive experience in serving a wide spectrum of clients in the industrial market. His experience covers the range, from assisting multinational companies in formulating expansion strategy 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 the clients.

In particular, William has assisted quite a number of multinational companies in industrial market in, for example, High and New Technology Enterprise (HNTE) application review assessment and R&D bonus deduction application.

William was seconded to the international corporate tax group of KPMG's London office for one year during which he was substantially involved in various international tax projects for European companies.

He is a member of the China Institute of Certified Public Accountants and the China Institute of Certified Tax Agents.

VAT reforms in China – In the eye of the storm

Modernisation, the ability for foreign entities to register for VAT and consolidation / grouping rules are just some of the things on the wish-list of Lachlan Wolfers, Shirley Shen, John Wang and Karmen Yeung, of **KPMG China**, as the VAT reforms continue to take shape.

In 2012 the Chinese government embarked upon an ambitious reform programme which was designed to replace Business Tax (BT) with a value added tax (VAT) throughout the services sector of the Chinese economy as part of the government's 12th Five Year Plan. These reforms were designed to overcome the problem of tax cascading arising whenever business-to-business (B2B) transactions took place under the BT system. The reforms were intended to overcome mismatches occurring whenever BT taxpayers purchased goods for which they were unable to claim input VAT credits, and similarly the problem of VAT taxpayers being unable to claim credits for the BT incurred on the services they purchased. From a tax policy perspective, these were entirely laudable aims.

Winding forward to late 2014, it feels as if we are in the eye of the storm. The VAT pilot programme has progressed from the modern services and transportation industry in Shanghai in 2012, to a national basis in 2013, and then further expanded to cover television, radio and film broadcasting services, also last year, and postal and telecommunications services in 2014. The main sectors yet to transition to VAT represent the most financially significant for the government, the most challenging from a technical perspective, and the most economically interdependent. Those sectors are the real and construction industry; the financial services and insurance industry; and 'lifestyle services', which comprises food and beverage, hospitality, entertainment and a general catch-all of all "other services". Though significant progress has already been made in expanding the VAT reforms, there is much work yet to be done.

There are several reasons why we are in the eye of the storm:

- one of the most challenging aspects of introducing a VAT is in managing the transition to VAT, more so than the business-as-usual;
- being partway through the implementation of VAT means there are still many BT taxpayers and therefore the VAT system is yet to exhibit its proper economic basis as a consumption tax collected by business but passed on to the end-consumer; and
- because there are several policy changes regularly being made to remedy unintended consequences or gaps arising from the rules initially released under earlier stages of the VAT pilot programme.

The experience in the implementation of VAT/GST in other countries suggests that things do settle down in time.

In last year's edition, we took a look at the likely implications of the expansion of the VAT reforms to telecommunications and e-commerce,

Table 1

Sector	Likely VAT rate	Likely time to transition to VAT	Brief comments
Lifestyle services	6%	2015	Uncertain how food and beverage will fit into this system – see comments below
Real estate and construction	11%	2015	Uncertain how VAT will collected, and if so at what rate, for second hand sales of residential properties
Financial services and insurance	6% or 11%	2015	Broad based VAT system expected. Insurance likely to be subject to VAT on premiums, but uncertain whether claims related costs will give rise to input credits

real estate and construction, financial services and insurance, and hospitality. Much of what was written about for the telecommunications sector proved true when VAT was implemented on June 1 2014, and much of what was written about for the remaining sectors would still be consistent with our expectations one year on – the proposals have simply been developed further and refined. At the time of writing this report, the policy-makers have informally indicated their intentions as outlined in Table 1.

Of course, between now and implementation of VAT, changes may occur. In this year's edition, we take a look at some of the specific issues affecting those sectors yet to transition to VAT, which gives some insight into the challenges which lie ahead.

Food and beverage industry

The food and beverage industry is likely to be included as part of the 'lifestyle services' sector, which is expected to transition to VAT at a rate of 6% from 2015.

The food and beverage services industry pays BT at the rate of 5% for 'food consumed on the spot', whereas sales of food items in places such as grocery stores constitute the sale of goods which is typically subject to either 17% VAT, or 3% simplified VAT for food sold by restaurants and hotels which is 'not consumed on the spot'. In practice, restaurants and hotels which sell both 'eat-in' and 'take-away' food typically characterise all of their transactions by reference to the predominant aspect of their business, and either pay VAT or BT accordingly. The transition to VAT for the services sector should largely remove this distinction. However, this distinction will remain to some extent if the VAT rate for food and beverage services is 6%, while the rate for sales of food items for take-away purposes is 17%. Only a single VAT rate for all goods and services would totally remove this distinction.

A further issue with the food and beverage industry is whether the threshold for registration as a general VAT taxpayer of RMB5 million ($814,000) a year will continue to apply. Smaller businesses below that threshold will presumably be treated as small scale VAT taxpayers who pay output VAT at the rate of 3%, but claim no input VAT credits. Even for those businesses exceeding the threshold, the question which remains is whether the government will want those businesses being able to claim input VAT credits for their expenses, especially when their revenue is predominantly from cash sales. The risk to the revenue would seem to be high.

In a similar vein, it remains to be seen whether businesses in the food and beverage industry will be able to issue special VAT invoices to their customers. This could result in business dining and entertainment services being potentially eligible for input VAT credits. How that policy may be monitored and audited would be a challenge for the tax officials, particularly given that there is a general exclusion on claiming input VAT credits for staff welfare and consumption activities.

And finally, if businesses in the food and beverage industry are to become general VAT taxpayers, they will have a strong incentive to obtain special VAT invoices (so as to claim input VAT credits) from their suppliers. The interconnectedness throughout the supply chain can readily be broken in China (in practice), especially when dealing with smaller operators, or when buying directly from farmers.

All of this suggests that the challenges for the food and beverage industry in transitioning to VAT are substantial. Inevitably, trade-offs will need to be made from a policy perspective between equity and simplicity.

Real estate and construction industry

The real estate and construction sector is expected to transition to VAT during the course of 2015 with a rate of 11%. While there has been some media speculation that the rate could be as high as 17%, that would seem to be unlikely given the potentially adverse impacts it may have on the property market in China. Indeed, one of the challenges in introducing a VAT for the property market is whether it will have an inflationary effect, or whether it will potentially have a detrimental impact on demand during a time when the market is already showing signs of coming off a high, at least in many of the larger cities.

The scope of VAT for the real estate and construction sector is expected to be among the broadest in the world. A key reason for this is that BT applies to virtually all real estate transactions at the rate of 5% – whether those transactions involve residential or commercial real estate, sales of new or second-hand real estate, and whether by developers or private individuals.

When it comes to sales by private individuals, it is expected that a form of simplified VAT method will apply. That is, private individuals will be unable to claim input VAT credits for their purchase, but equally they will pay a reduced rate of VAT (expected to be 3%) on a subsequent sale. A number of policy questions are raised by this approach, including:

- How will the payment of VAT be collected and enforced? Logically, collection will somehow need to be linked to the property title transfer system.
- Will VAT apply to the gross selling price, or the margin between the selling price and the purchase price?
- Will the simplified VAT method be restricted to private individuals selling their own home, or to passive investors, or to speculators too?

The experience with VAT/GST systems in other countries suggests that these are not easy problems to resolve and inevitably definitional problems will arise in practice.

Turning now to consider the position of developers, irrespective of whether we are dealing with residential property or commercial property developers, a key feature of what occurs in the marketplace is that many development projects take place in China through the purchase and subsequent sale of an equity interest in a development entity. In some cases, the equity interest may be held through a chain of entities, some of which are located offshore. The question which this feature raises from a VAT perspective is whether there will be look through rules which will effectively tax the underlying change of ownership or control of the real estate being developed. If so, how would that tax be calculated, disclosed and enforced?

A further issue is that in many cases, the equity in a development entity may be sold at a time when the development entity has a substantial input VAT credit balance arising from the works already completed. Absent any change of ownership or control rules which vitiate that credit balance, this is an asset of value which should commercially be taken into account by the parties in calculating the price. These issues rarely arise in other countries because refunds of excess VAT credits are routinely given.

Financial services and insurance industry

As noted above, the financial services and insurance industry is expected to transition to VAT from 2015, and the thinking is that the VAT rate will be either 6% or 11%. The Chinese

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Lachlan has led KPMG's efforts in relation to the VAT reform pilot programme in China. In the course of this, he has been asked to provide advice to the Ministry of Finance, the State Administration of Taxation and other government agencies in relation to several key aspects of the VAT reforms, including the application of VAT to financial services, insurance, transfers of a business, as well as other reforms relating to the introduction of advance rulings in China.

Lachlan has also led projects on the VAT reforms, and related business tax issues, for a large number of multinational clients, including assisting clients with seeking clarification of technical or contentious issues with the tax authorities. His clients come and have come from industries such as banking and insurance, automotive, consulting services, construction, consumer markets and technology.

Lachlan is formerly a director of The Tax Institute, which is the most prestigious tax professional association in Australia. In this role, he was frequently invited to consult with the Australian Taxation Office and Commonwealth Treasury on tax issues, as well as consulting with government officials from both China and the US about indirect tax reform of while he was in Australia.

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VAT system is expected to be among the first in the world to apply full VAT concepts to transactions in this sector.

The rationale for imposing VAT derives partly from the fact that BT applies to most financial services and insurance transactions at the rate of 5%, so a loss of revenue would arise if the more traditional approach of exemption were to apply. The proposed imposition of VAT on bank lending activities is being watched with considerable interest internationally and it will be fascinating to see if other countries follow this lead. From a pricing perspective, one question will be whether the banks will absorb all or part of the VAT into their interest rate pricing models, or whether they will simply pass it on. Clarity on this may take some time to emerge given that the introduction of VAT broadly coincides with the progressive relaxation of the regulated interest rate pricing mechanisms in China. One important consequence for business borrowers is that if the banks choose to absorb some or all of the VAT impost, then potentially those borrowers will benefit from a net reduction in their interest expenses after input VAT credits have been factored in.

For the insurance sector, recent proposals by the Ministry of Finance (MOF) suggest that VAT will apply at the rate of 6% to premiums for most forms of general insurance. From a claims perspective, it now seems less likely that the authorities will adopt models applicable in countries such as Australia, New Zealand, South Africa and Singapore under which input VAT credits (or equivalent) can arise from the cash settlement of certain insurance claims. Instead, recent proposals by the MOF suggest a move towards the adoption of a hybrid system where insurers' claims related costs are ineligible for input VAT credits, but non-claims related costs would be eligible for input VAT credits. Drawing that distinction in practice will be a challenge for both insurers and the tax authorities.

Looking beyond

Notwithstanding that calmer waters may lie ahead, the Chinese VAT system is already exhibiting some rare characteristics which depart from pure theories of a VAT. For example, many businesses raise concerns about the inability to claim input VAT credits for certain items of expenditure which do not bear VAT. A primary example is with property developers concerned that with the transition to VAT for the real estate and construction industry, they may be unable to claim input VAT credits for the purchase of land use rights from local government authorities – this can be a substantial part of their cost structure. While the purchase of land use rights is exempt from BT at present, it is widely anticipated that it will not be subject to VAT on the basis that the Chinese VAT system is unlikely to require corresponding output VAT to be remitted by local government authorities who grant those land use rights to developers. Pure economic theory would say that there is no need for developers to benefit from an input VAT credit given that the purchase does not bear VAT and is therefore reflected in a lower price. In other words, theory suggests that the developer paid only RMB100 for the land use rights without VAT but would have paid RMB111 if the grant of those land use rights was subject to VAT (assuming of course that the developer could benefit from a full input VAT credit).

Unfortunately though, this is where theory and reality seem to depart. The Chinese VAT system has some characteristics to it which can cloud the analysis. For example, the existence of multiple VAT rates means that the nature of what is purchased may influence the ultimate tax liability of the business making the purchase – in other words, some credits can be more valuable than others. The mindset of many businesses also sits part-way between BT concepts (which recognise the tax as a P&L – profit & loss – item), to modern principles of VAT (where the tax is intended to be passed on in the supply chain). The other major distortion is that businesses are generally ineligible to claim refunds of excess input VAT credits (except for certain exporters). As a consequence, issues that in other countries would give rise to minor timing concerns only, can cause timing differences lasting decades long.

The primary example where this is expected to arise is for property developers who lease the final product – substantial input VAT is incurred during development but the output VAT is generated over an extended period of time.

The real question is whether, in due course, the Chinese VAT system will exhibit more normal characteristics of a VAT system. Looking ahead to the future, the answer would seem to be yes. Over the course of the next few years, a number of changes are likely to take place which should ensure a more modern VAT system emerges. Those changes include:

- The reduction in the number of VAT rates used now (being 6%, 11%, 13% and 17%) towards a single VAT rate;
- The shift towards the most broadly based VAT system in the world, with few exemptions. The thinking is that VAT will be introduced for the financial services sector (including taxing interest income), and for residential property transactions, both new and second-hand properties will be taxed, irrespective of whether they are sold by developers, speculators or private individuals;
- The likely reduction in the threshold for registration as a general VAT taxpayer under the VAT pilot programme from RMB5 million annual turnover threshold ($814,000) to a lower threshold which is more consistent with international standards; and
- The eventual abolition of BT which should ensure that most outputs are taxed under a VAT, and therefore most inputs are creditable to business under a VAT.

Wish list

While the future looks bright, there are still some difficult structural issues the policy-makers in China need to overcome. They include:

- Allowing foreign entities to register for VAT, paying output VAT and claiming input VAT credits. The existing system precludes this from occurring in virtually all circumstances. Historically, this was because the VAT registration system was linked to the business licensing system in China, such that in the absence of being licensed to carry on business in China a business could not register for VAT purposes. Those systems were devised in a pre-digital economy age. Services should be able to be provided from outside China to consumers in China in such a way that the correct amount of VAT may be validly discharged in an administratively feasible way.
- The Chinese VAT system requires modernisation to deal with the challenges of the digital economy. In that regard, the OECD's September 2014 report entitled, "Addressing the Challenges of the Digital Economy", highlighted the "urgent" need for governments to introduce rules which facilitate the proper collection and remittance of indirect taxes on business-to-consumer (B2C) transactions involving the digital economy. A key recommendation from that report is to allow foreign providers of digitised services to register, collect and remit VAT in those locations in which its customers purchase services. This is integral to the implementation of the destination principle of VAT, under which VAT is accounted for in the location in which the services are consumed, rather than the location in which the supplier is based. Having partially implemented the destination principle in relation to exported services under the VAT pilot programme, the logical extension is to facilitate that principle being applied to the importation of services. After all, the existing limitations lead to a revenue shortfall for the government.
- Also on the theme of the destination principle, the VAT pilot programme introduced for the first time an exemption from VAT for many categories of exported services. While this was a step in the right direction, it still falls short of the OECD's recommended approach of zero rating exports with refunds of input taxes, as set out in the International VAT/GST Guidelines dated April 17 and 18 2014. It is hoped that in due course zero rating becomes the norm in China, rather than exemption.
- In terms of modernisation, a further feature of the Chinese system is its excessive reliance on paper-based invoicing. The Chinese Golden Tax System represents, in some respects, one of the most sophisticated data reporting tools used by tax authorities around the world. However, to keep pace with technological change, a monumental shift towards electronic invoicing needs to occur urgently. As more and more taxpayers join the VAT pilot programme,

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with ever greater volumes of transactions (for example, banks), the need for electronic invoicing becomes ever greater.
- Finally, a longstanding issue for larger corporate groups and multinational companies in China concerns the need for broad-based consolidation or grouping rules. Those concerns derive from two main factors – first, that registration for VAT purposes in China occurs at the branch level, such that each branch is effectively treated as being a separate taxpayer. As a consequence, a single legal entity in China may have multiple VAT registrations and associated compliance obligations. Second, there is generally no ability to claim refunds of excess VAT credits (except for certain exporters). This can result in one branch having output VAT liabilities which cannot be offset against the input VAT credit balance of another branch. While the framework for consolidation or grouping rules has been introduced into the VAT pilot programme already, the implementation of that framework is still very limited in practice.

Step in the right direction but…

The implementation of a VAT in China in substitution for BT is undoubtedly a step in the right direction. The policy-makers' focus to date has been on managing the transition as smoothly as possible, which has led to multiple VAT rates being applied and a staged implementation process. However, over the next few years the policy-makers will shift their focus to the longer-term and address aspects of the Chinese VAT system requiring modernisation or further development. The challenges of doing so are immense, but potentially China could be left with the world's leading VAT system given its unprecedented broad base. Right now, we are in the eye of the storm and whether further stormy waters, or relative calm lies on the horizon, will be awaited with interest.

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Living in the present – the changing landscape of tax risk management in China

Tracy Zhang, Eileen Sun, David Ling, Grace Xie and Adam Zhong, of **KPMG China**, discuss how taxpayers should respond to the efforts of the tax authorities to reform, particularly in the area of tax risk management.

The global landscape of tax risk management, from both the tax authority and taxpayer perspectives, is changing from living in the past, where the authorities focus their resources on detecting and penalising non-compliance, towards living in the present and dancing to the tune of future, where mutual tax authority-taxpayer engagement, based on improved taxpayer internal tax risk control, serves to prevent the crystallisation of non-compliance risks in the first instance.

The worldwide trend for increased tax authority scrutiny of taxpayer affairs in the context of the OECD/G20 Base Erosion and Profit Shifting (BEPS) initiative requires Chinese companies to manage the targeted risks in more organised and efficient ways. In China, the tax authorities are taking steps to reform the tax administrative system with a view to achieving better work efficiency. This is being pursued by encouraging large enterprise taxpayers to establish or improve their tax risk management capacity so that more tax administrative resources can be released from reviewing and approving routine transactions, and auditing low risk issues, to deal with high-risk accounts. From our observations, it appears that these released resources are set to be redirected by the tax authorities into the audit of those taxpayers which have not yet put a comprehensive tax risk management system in place.

A good illustration of the need for a sound taxpayer risk control system is the manner in which, as in *Shui Zong Fa* (2014) No 107, the tax treatment of some items which used to be subject to tax authority approval has now become solely a matter for taxpayers to evaluate and administer, in the first instance, for example, the VAT exemption for designated exported services, the deduction of asset losses and the R&D expenses bonus deduction. Under the revised rules, in the absence of recourse to tax authority approval and clearance, the taxpayer must bear the risk that the tax authorities will re-open and challenge the tax treatments adopted by the taxpayer, until the statute of limitations period lapses. Without a sound risk control system, the taxpayer will struggle to monitor and address adopted tax treatments which are prone to challenge, and consequently the certainty of its overall tax position will be diminished.

Given the macro environment, establishing or enhancing tax risk internal control systems has become a burning issue which has attracted attention from, and action by, both the tax authorities and taxpayers in China. From the tax authorities' perspective, some key milestones include:

In 2008, the State Administration of Taxation (SAT) in China set up a separate division for the purpose of managing and monitoring the tax

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Eileen has been providing tax advisory services to foreign investors in UK, Hong Kong and Shenzhen for about 20 years, and has extensive experience in VAT, transfer pricing, M&A and restructuring, tax planning, tax investigation and customs duty.

Eileen has been involved in the project of bilateral advance pricing in China, and her work has been recognised for its high quality in dealing with numerous transfer pricing investigation cases.

Eileen is currently responsible for tax in KPMG Southern China. She is experienced in IPO tax advisory services, having advised numerous listed companies in Southern China (including Hong Kong) on various tax issues arising from their IPOs.

affairs of large enterprises and developing an open and transparent working relationship between the tax authorities and the taxpayers.

In 2009 and 2012, the SAT issued two tax regulations, that is, *Guoshuifa* No 90 and *Guoshuifa* No 71, which provided guidance on best practice for the tax governance and risk control framework and these served as the foundation blocks for the new Chinese tax administration landscape.

In 2012, SAT concluded Tax Compliance Agreements (TCA) with three selected large enterprises. These are the Chinese equivalent of the cooperative compliance frameworks being put in place in many countries, such as the horizontal monitoring system prevailing in the Netherlands, which promotes the implementation of sound tax internal control systems and consequently minimises the need for inspection, by the tax authorities, of the taxpayers' reporting and compliance. It is a contract between the revenue authority and taxpayers, established on the basis of mutual respect and an open and transparent working relationship

From 2012, a number of local provincial level tax authorities followed in the footsteps of the SAT and started to take actions to fit the new era. Many provincial tax authorities have agreed TCAs with taxpayers with a good track record of high compliance. Some provincial/municipal tax authorities have adopted a practice of requesting selected large enterprises to establish or improve their internal tax risk management systems and evaluate the soundness of these systems on a regular basis. The evaluation result is then used to rank and score the taxpayer's risk prevention and minimisation capability.

In 2013, for selected large accounts, the SAT started to include the routine evaluation of tax risk management systems in the normal process for tax self-investigation. The respective taxpayers are required to self-evaluate the soundness of their tax risk management system against the criteria set by the SAT and score themselves. A low score will trigger more intervention and supervision from the tax authorities. Some local tax authorities have even rolled out a tax risk management evaluation regime where tax authorities will review and assess the soundness of the internal risk management system of the selected large accounts and issue certificates to those accounts passing all the tests. Those failing the tests will be required to improve their risk control up to the designated level within certain period of time.

Looking forward, it is understood that the SAT is contemplating a number of potential next steps to take tax risk management to the next level:

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David has extensive experience 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 in China. He has also accumulated years of experiences in assisting multinational clients from various industry sectors to operate in China.

David has extensive knowledge of the PRC customs regulations, foreign exchange control policies, and other regulations which may affect foreign companies' operations in China.

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Risk Management Office and National Key Tax Risk List for different industries: In September 2014 the SAT issued some new guidance to strengthen large enterprise tax risk management. It is understood that both the SAT and provincial level tax authorities intend to establish a Risk Management Office, which will be responsible for identifying the major tax risks of different industries and helping large enterprises better manage and mitigate their risks.

Large Enterprise Tax Risk Evaluation System: The SAT is understood to be working with the State-Owned Assets Supervision and Administration Commission (SASAC), the Chinese government body overseeing many of China's State-Owned Enterprises (SOE), with a view to potentially including tax risk management as part of SOEs' internal control supervision and evaluation systems. This could be viewed as a step towards transitioning SOEs' tax risk internal control systems from being voluntary to compulsory.

Tax Audit on Large Enterprises: As the Chinese tax authorities are still in the process of building up sufficient expertise and experience for the proper audit and evaluation of taxpayers' tax risk control systems their approach may not fully identify and address all of the systematic risks of large companies' risk controls To make the audit become full-fledged, and really help large companies to identify the root cause of their non-compliance, the SAT is taking action to establish the expertise and resources for proper risk control system assessment and evaluation. In the future, risk control assessment is likely to become part of a normal tax investigation and the failure of the system to meet the requisite standards may also lead to a failure to pass the overall investigation.

Working group on tax risk management: The SAT is understood to be considering the merits of drawing on expertise from the SAT, provincial tax authorities, and industry and professional firms, to form a tax risk management working group. The working group would be led by the SAT directly and meet regularly to discuss new developments in industry, emerging tax issues from new products or new markets, to help the SAT catch up with the industry developments on a real-time basis and eventually come up with regulatory guidance which better helps large enterprises to preempt any associated potential tax implications and risks.

All the existing and foreseeable developments in this area suggest that putting in place a sound tax risk control system is no longer something Chinese taxpayers can afford to wait and see about. Taxpayers need a reliable risk control system to identify, preempt, and minimise risks so that they do not have to live in the past and deal with the risks for many years down the road. A taxpayer with a sound tax risk control system can also be subject to less tax audit and receive better services from the tax authorities. In particular, technical guidance and, ultimately, advance rulings are more likely to be forthcoming to cooperative taxpayers. It is very likely that once the facility for advance rulings is finally implemented, the taxpayers with sound risk control systems will be the first to enjoy the benefits.

The construction of risk management systems is an evolving process. A sound tax risk management system should at least include the following measures. These are the must-have basic founding blocks. On top of these, companies can tailor their own risk management system based on the special features of their individual business operations.

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Major areas	Measures
Strategy, objectives and tax organisation	• Align tax strategy, mission and objectives group-wide • Standardise and establish written protocols to achieve the set strategy, mission and objectives • Design and put in place the most efficient tax organisation to realise the tax tasks
Tax risk identification and evaluation	• Regular tax compliance and tax reporting systematic health check to identify major risks • Establish major tax risk checklist • Evaluate and classify the risks into different categories for control purposes
Flow and control	• Establish tax manuals by tax, business or major tax issue • Establish protocols for tax filing procedures, define risk owner, responsibilities, and control points for each procedure • Streamline the information sharing and reporting flow group-wide
Monitor and test	• Conduct regular efficiency tests on the risk management system and modify to achieve higher efficiency

M&A: Hopes for further clarification of Chinese indirect offshore disposal tax rules

John Gu, Paul Ma, Chris Mak and Yvette Chan, of **KPMG China**, argue that lack of compliance is not the problem with the Circular 698 indirect offshore disposal tax rules, but the consistency and transparency with which the circular is applied throughout the country.

In the area of M&A, the greatest challenge in dealing with Chinese taxation rules, as noted by parties to M&A transactions in China, has been Circular 698, which was introduced by PRC tax authorities as a supplemental regulation to tackle perceived tax-avoidance transactions using offshore special purpose vehicles for dispositions. The tax authorities considered that these would effectively enable foreign sellers to avoid Chinese withholding tax liabilities, otherwise imposed on the direct disposal of PRC operating or asset holding companies.

Since the introduction of Circular 698 greater enforcement efforts have been made against offshore transactions. However, inconsistency in the enforcement of the rules among different tax authorities in China and the lack of guidance on certain aspects of the technical provisions have created compliance difficulties for participants in M&A transactions. This is due to different positions being taken by buyers and sellers based on different interpretations of the rules and varying local practices.

With a view to addressing the above issues and to eliminate inconsistency in the enforcement of the rules, as noted in last year's contribution to this publication, a supplementary circular to Circular 698 (Draft Supplementary Notice) was drafted and circulated for comment in 2013. This aims to clarify several aspects encountered in the enforcement of the rules governing the reporting and taxation of offshore indirect disposals of equity interests in Chinese enterprises.

The Draft Supplementary Notice has still not yet been finalised and no confirmed date of issuance has been announced yet. And it is still unclear in what form it will be finalized and issued. That being said, there have been indications that the finalised Supplementary Notice will be officially released by the end of 2014.

In this publication, we discuss the latest developments in the application and enforcement of Circular 698, and suggest how this rule should be further clarified and enforced with reference to the draft General Anti-Avoidance Rules (GAAR) administrative measures (GAAR Measures, which was released by the State Administration of Taxation (SAT) for public comment on July 3 2014), and then highlight the recent trends in the market and local tax authorities' practice.

Broadly, according to the draft GAAR Measures, the GAAR Measures will likely provide guidance on the following areas:

- when a tax avoidance scheme is in point;
- the internal tax authority protocols for selection of GAAR cases;
- the documentation which may be demanded from taxpayers; and

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- the manner in which tax adjustments for unwarranted tax benefits can be made.

'Reasonable business purposes' test and possible interaction with the GAAR Measures

The critical condition precedent to the application of the GAAR is the "reasonable business purpose" test. In the context of Circular 698 enforcement cases, the focus of the PRC tax authorities has been on the 'commercial substance' of the offshore intermediate holding companies which have been used. This is taken as the sole and dominant criterion for the determination of "reasonable business purpose", with other valid business purposes generally rejected or ignored in the assessment of the "reasonable business purpose" test.

This raises a question of whether the assessment criteria adopted for Circular 698 (noted above) are "objective" enough and whether they need to be modified to be consistent with the principles stated in the draft GAAR Measures. In this regard, it is noted that the draft GAAR Measures have reiterated that the "purpose" test is to be used as the objective test for "reasonable business purposes". This is in line with the guidance for the application of the GAAR under the Detailed Implementation Rules (DIR) to the Corporate Income Tax (CIT) Law, and this position has been clearly stated and noted in the Circular of Implementing Measures for Special Tax Adjustments, *Guoshuifa* [2009] No 2 (Circular 2). Therefore, to be consistent with the draft GAAR Measures, it is hoped that the "reasonable business purpose" test in the Draft Supplement Notice will be modified and expanded to explicitly incorporate the "purpose" test, and so require the PRC tax authorities to take into account such purposes in the application of Circular 698 rules.

It is also hoped that "safe harbour" rules will be introduced to exclude certain transactions (for example, post-IPO exchange traded transactions, and transactions with underlying China asset value lower than a particular threshold) from the application of Circular 698 to ensure efficient enforcement of the GAAR on a cost-benefit justified basis.

Limitation of tax basis – Recent practice of tax authorities in the determination of tax cost base

Under the Draft Supplementary Notice, there is an indication that the State Administration of Taxation (SAT) is intending to calculate and limit the tax base cost with reference to the registered capital of the underlying PRC company, rather than having regard to the consideration actually paid by the non-resident investor to acquire or invest in the offshore intermediate holding company. The only exception is where the

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previous vendor has complied with the Circular 698 reporting and tax payment requirements, in which case the consideration actually paid by the non-resident investor can be adopted as the tax cost base for Circular 698 purposes.

In practice, while the Draft Supplementary Notice has not yet taken legal effect, the local tax authorities have sought to apply the rules under the Draft Supplementary Notice by using the registered capital of the underlying PRC company to calculate the tax basis in the assessment of the tax liability of the non-resident sellers.

The imposition of a cap on the tax basis without taking into consideration the commercial reality that the offshore capital may be used for other commercial purposes raises a question of whether this proposed treatment is consistent with the spirit of the law that the seller should be taxed on the "economic gains" derived from the transaction under the GAAR. The limitation of the tax basis has the potential effect of causing non-resident sellers to bear a PRC tax liability higher than that on the economic gains derived, due to the loss of tax basis from the offshore equity interest acquired, effectively shifting the tax liability of the previous seller to the buyer.

To mitigate the above exposures, it is noted, as a matter of market practice, that the concern over "shifting tax liability" caused by the loss of tax basis under Circular 698 has driven many buyers to seek appropriate protections from the offshore vendor for the indirect transfer of PRC companies, using one or more of the following protections:

- requiring the offshore vendor to fully comply with the requirements under Circular 698, as a condition precedent in the share transfer transaction agreement (and obtaining records of the reporting thereto), by filing and settling the tax liability from the indirect transfers; this effectively has accelerated the crystallisation of the potential tax liabilities, which the vendor might have to settle on the indirect transfer transactions;
- withholding, from the sale proceeds, the expected PRC withholding tax (WHT) on the assessed gains arising for the offshore vendor from the transfer of shares of the offshore holding company to the buyer; and/or
- seeking an indemnity (to be included in the transaction document) to protect the tax base in the acquired shares of the offshore vendor from being disregarded in a future disposal transaction.

This has become one of the most important tax issues to address in the negotiation and closing of many offshore M&A transactions, with significant time and effort being spent by both the sellers and buyers of the Chinese companies offshore.

It is hoped that the cap on tax basis under the Draft Supplementary Notice will be modified and restricted to certain limited circumstances, such as where there is a clear avoidance motive for the buyers to assist the seller in the execution of the indirect transfer transactions.

Internal restructuring relief

The Draft Supplementary Notice has proposed an internal restructuring relief which exempts certain indirect offshore transfers from potential taxation. However, before the exemption can be taken, the internal restructuring must satisfy certain conditions, which include that (i) an 80% common ownership exists between the transferor and transferee; and (ii) the corporate income tax burden incurred on a future disposal of equity interests is unaffected by the restructuring.

While the business community has welcomed the internal restructuring relief, it is hoped that the conditions for the internal restructuring relief will be further relaxed to allow for contribution, mergers and in-specie distribution of equity interest to be covered by the exemption regardless of the ownership condition. Such transactions are commonly used in pre-IPO restructuring transactions and hopefully should be exempt from PRC income tax as they are supported by clear commercial purposes.

Other key issues yet to be clarified in the Supplementary Notice

While the Draft Supplementary Notice has clarified a number of uncertainties as discussed above, the Draft Supplementary Notice has still not yet addressed areas including (but not limited to):

- detailed implementation guidance for the local tax authorities on consolidated Circular 698 reporting and how the chosen local tax authorities should coordinate with the SAT and other relevant local tax authorities on the consolidated filing;
- clarification on the allocation basis of sales consideration and acquisition costs where there is more than one PRC (and offshore) entity being transferred; and
- whether tax treaty relief can be claimed by the seller if it is subject to PRC tax under Circular 698.

Consolidated Circular 698 filing

While technically the existing law permits consolidated filings for the indirect transfer of multiple PRC operating companies in one offshore transaction, the local tax authorities, in practice, have been generally unwilling to accept consolidated Circular 698 reporting at the local level. This is either because they have no experience in handling such consolidated filing and/or because they do not want to bear the burden/ responsibility of reviewing and assessing the Circular 698 case, including the necessity to report the case to the SAT on behalf of the other tax authorities in other provinces.

To address the above issues, it is hoped that clear guidance will be given in the final Supplementary Notice in relation to consolidated filings so that the local tax authorities will be willing to accept such filings and make the consolidated filings less burdensome for taxpayers/offshore sellers.

Allocation of sales consideration and acquisition cost for a portfolio of PRC (and offshore) entities being transferred for the calculation of the capital gains

In the case of an indirect transfer of multiple PRC companies, the existing tax law does not provide for clear guidance on how to allocate sales consideration and acquisition costs among a portfolio of PRC (and offshore) companies being transferred and how to calculate the capital gains if PRC tax is imposed on the indirect transfer of a group of PRC companies. However, in a precedent case, it appears that the following allocation bases and calculation method was accepted as the appropriate method for calculating the tax liability for each PRC company being transferred:

- allocating the sales consideration based on:
  - equity investment;
  - net asset value; and
  - operating income of the latest accounting period of each PRC company in comparison with the total of the group companies being transferred;

  and then
- calculating the capital gain for each PRC company being transferred by deducting the equity investment in the PRC company being indirectly transferred from the above-allocated sales consideration of each PRC company.

That said, no rules have been stated in the prevailing Circular 698 nor Draft Supplementary Notice about the calculation of capital gains in relation to transfer of a group of PRC (and offshore) companies.

To eliminate any inconsistency in the calculation of the tax liability for the transfer of a group of PRC (and offshore) companies, it is hoped that clear methods of calculating the PRC tax liability on the indirect group transfer of the PRC companies will be set out in the final Supplementary Notice, particularly in relation to the calculation of the PRC tax liability for each underlying PRC company.

Availability of tax treaty relief in the case of a 'look-through' under Circular 698

The rules under Circular 698 are silent on whether tax treaty relief can be claimed by the taxpayer in the event that an indirect transfer is determined to be taxable in the PRC. It is hoped that this will be clarified in the final Supplementary Notice.

Market trend towards Circular 698 filing

Notwithstanding the fact that many uncertainties exist about the application of Circular 698, reporting for offshore indirect disposition pursuant Circular 698 is increasing. This trend of increasing reporting is probably due to a combination of factors, including:

- many 'offshore buyers' now insisting on a condition precedent being included in an share and purchase agreement (SPA) to ensure that the Circular 698 filing obligation is fulfilled and/or a tax indemnity is obtained such that the offshore seller is 'underwriting' the Circular 698 tax risk;

Table 1

Published cases in 2014	Tax collected	Key features
Hangzhou, Zhejiang	RMB450 million ($73 million)	The tax authorities received an enquiry letter from the legal counsel of an offshore investor in relation to the tax treatment of the offshore indirect equity transfer of a PRC company. The tax authorities considered the case constituted 'an abuse of business structure', which results in PRC tax being avoided, and thus re-characterised the offshore indirect equity transfer of the Hangzhou company
Qingdao, Shandong	RMB10.28 million	Based on a Chinese media report, the tax authorities became aware of the indirect sale of a PRC company. After the investigation, the tax authorities concluded that the holding structure lacked 'business purposes' and involved abusive use of organisational forms, and thus disregarded the transferred intermediate holding company (that is, in the British Virgin Islands and Hong Kong) to treat the transaction as a direct disposal of the PRC company
Shantou, Guangdong	N/A	The Guangzhou State Tax Bureau publicly issued a notice to disregard the 'commercial substance' of the Hong Kong intermediate holding company being transferred, and re-characterise the transaction as direct disposal of the PRC company
Shekou, Shenzhen	RMB30 million	The tax authorities noted, during a business consultation, the offshore indirect equity transfer of a Shenzhen company by a Hong Kong company to another Shenzhen company for a consideration of RMB320 million. The tax authorities finally re-characterised the offshore indirect equity transfer of the Shenzhen company
Shekou, Shenzhen	RMB30 million	The tax authorities were informed through third-party information of the offshore indirect equity transfer of a Shenzhen company by two Hong Kong companies and a Hong Kong individual shareholder to a Hong Kong individual for a consideration of RMB450 million. The tax authorities finally re-characterised the offshore indirect equity transfer of the Shenzhen company and levied taxes on the two Hong Kong corporate sellers
Qidong, Jiangsu	RMB30 million	The tax authorities noted the indirect sale of the PRC companies from the public announcement of an offshore listed company. After investigation, the tax authorities disregarded the 'commercial substance' of the intermediate holding companies being transferred, and re-characterised the transaction as direct disposal of the PRC companies. As both of the buyer and seller are offshore parties, the tax authorities have communicated with the offshore seller/ payer and asked for its help in withholding the relevant taxes on behalf of the offshore seller before making payment
Ningbo, Zhejiang	RMB3.6 million	The tax authorities accidentally noticed the indirect sale of the PRC companies, and disregarded the 'commercial substance' of the Hong Kong intermediate holding company being transferred, and re-characterised the transaction as direct disposal of the Ningbo company

- increasing auditing and enforcement efforts from the PRC tax authorities to pursue indirect transfers noted from public information; and
- offshore sellers showing a greater tendency to conduct reporting voluntarily due to concerns over reputational risks and potential penalties.

Latest enforcement of Circular 698 cases

To show the increasing efforts to enforce Circular 698 against perceived tax avoidance transactions, the cases listed in Table 1 were published in 2014.

As noted above, in assessing the taxpayers to tax in the respective cases, greater focus has been placed by the PRC tax authorities on the economic substance of the offshore intermediate holding company being transferred, rather than the 'reasonable business purposes' of the offshore share transfer transaction. We expect that this position is likely to continue until further guidance is issued in the final Supplementary Notice.

Looking ahead

Given the state of application and enforcement of Circular 698 noted above, the issue at hand is not about ensuring taxpayers' compliance with the rules, but rather how to promote consistency and transparency in the enforcement of the rules under Circular 698. Based on our discussions with market participants, we understand that many taxpayers want to comply with the rules, but just cannot afford to be at a disadvantage due to the inconsistency of the enforcement that benefits certain taxpayers. In light of this, it is hoped that the SAT will finalise and issue the supplementary notice to Circular 698 soon, which will clarify the uncertainties and address the current challenges and inconsistency in the enforcement of the rules under the Circular 698.

Clarification of this tax uncertainty would certainly be in the spirit of other recent encouraging efforts by the SAT to clear up other longstanding areas of tax uncertainty for foreign investment into China. As recently as November 17 2014 the SAT has finally clarified the that, going forward, a temporary gains tax exemption will apply for Foreign Institutional Investors (QFIIs) and RMB Qualified Foreign Institutional Investors (RQFIIs) deriving gains from Chinese listed A-share investments (this was as part of a joint announcement also providing a temporary exemption from income tax on capital gains derived from the trading of A-shares under the new Shanghai-Hong Kong Stock Connect programme). Although the historic tax exposures for QFIIs and RQFIIs still require further clarification, this development shows the SAT's focus on clearer, better tax regulation and bodes well for the Circular 698 clarifications.

China: Moving towards a world-class customs administration

Eric Zhou, Helen Han, Dong Cheng and Melsson Yang, of **KPMG China**, discuss China Customs's reforms in areas such as enterprise classification and audits, and how these improvements will help taxpayers.

In the 3rd edition of *China Looking Ahead*, we discussed the gradual shift in the role of China Customs from that of a trade enforcer to more of a trade facilitator. Since then, the tenor of the more noteworthy regulations that the General Administration of Customs (GAC) has issued in the past year has been indicative of an even more resolve to move towards greater transparency and alignment with globally accepted best practices. Taking a brief snapshot of regulations issued in the past 12 months, one can readily appreciate the extensive coverage of the reforms (and proposed reforms) in the GAC's interaction with local businesses and the broader international community.

This article aims to provide a concise summary of recently issued customs regulations in China that allude to significant changes within its enforcement framework as these relate to the primary areas of:

- customs valuation;
- processing trade;
- the conduct of customs audits;
- e-commerce; and
- overall compliance.

One other interesting feature of these changes is that most, if not all of them were the result of extensive consultation with local and international stakeholders, having the same objective of advancing the modernisation of China's customs administration and bringing it on a par with other, more advanced jurisdictions.

Aligning customs valuation standards with WTO principles

In the area of customs valuation, the GAC released a series of measures which should lay the foundations for more transparent, standardised, and predictable means to appraise products for customs purposes and in accordance with WTO principles. A concern among importers and exporters is that, despite being a WTO member and therefore bound by the rules of the Customs Valuation Agreement, there are still many grey and arbitrary areas in how China Customs determines the dutiable value of goods. This has caused varying degrees of confusion and unpredictability for their overall duty and VAT costs.

The following regulations which came into effect on February 1 2014 respond to these concerns and more clearly reflect the basic principle of the WTO Customs Valuation Agreement in which transaction value is used as the primary basis of customs valuation:

- "Measures of the Customs of People's Republic of China for Assessment of Dutiable Price on Domestic Sale of Bonded Goods"

(GAC Order No. 211) – which provides more specific operational details on the assessment of the dutiable value of bonded goods sold domestically in accordance with WTO Customs Valuation Agreement, which upholds transaction value as the primary basis for customs valuation; and

- "Measures of the Customs of People's Republic of China for Assessment of Dutiable Price on Imports and Exports" (GAC Order No. 213) – which specifies that, if Customs confirms that a related-party price is consistent with common commercial practice, the relationship between the seller and the buyer should not be deemed as having influenced the transaction value.

These developments are expected to greatly improve China's cross-border trade environment. Moreover, they may reduce previous uncertainties about the actual duty and VAT cost of general trade imports and bonded domestic sales. As such, these developments are expected to enhance the overall business environment for China's general trade, processing trade and bonded logistics enterprises.

A good number of the revisions pertain to the valuation of bonded goods imported under processing trade arrangements which are ultimately sold to the domestic market. These include:

- Use of weighted average method – The basic principle of using the original transaction value of bonded raw material imports as the basis for customs duties still applies, but details are added to explain that if the original import transaction price of bonded raw materials is difficult to determine, the weighted average method can be applied to compute the dutiable price, whereas in the past, some local customs houses would compute using the highest of the raw material batch values as the basis for customs duties. The issuance of GAC Order No 211 may stop this adverse practice.
- Valuation of bonded materials sold in the local market – Previously, Customs determined the dutiable price based on the transaction values of identical or similar goods at or about the same time the domestic sale is made. Under GAC Orders 211 and 213, the actual transaction value of the domestic sale should be the basis on which to determine the dutiable value. This means that the new regulations are more aligned with market rules, and they make it more convenient for companies to provide documentary support for their declared price by simply presenting domestic sale contracts and the relevant payment documents.

It is worth noting that in 2013, more favourable pilot policies began to emerge. Processing trade enterprises located in the Hengqin New Area, Pingtan Comprehensive Experimental Zone and Shanghai Pilot Free Trade Zone can now choose to pay customs duties/VAT based on the original imported raw material or the status of the actual goods domestically sold. It remains to be seen whether GAC Order No 211 will take a similar path in the future.

- Treatment of related costs incurred within special customs zones – For those goods stored or undergoing other logistics processing in Special Customs Supervision Areas, the measures specify that the cost of insurance, storage, and transportation and related costs incurred within the Special Customs Supervision Areas, provided that these are itemised separately in the relevant commercial documents, can be excluded from the dutiable price, thus giving further tax cost reductions for companies.
- Valuation of bonded scrap sold in the domestic market – For scrap and manufacturing by-products, the domestic sale price will remain as the basis for determining the dutiable value. This domestic sale price is defined as the total amount actually paid or payable by the Chinese enterprise to the seller (that is, processing trade companies) for the purchase of the bonded scrap and by-products, excluding the custom duties and taxes. This clearer and more practical definition makes it simpler and more convenient for Customs to verify documentary proof provided by companies.

With regard to general trade importations, the revised regulations shed more light on the subject of related-party transactions and the treatment of transportation, and make these more consistent with WTO requirements that discourage arbitrary and notional valuation systems.

- Assessment of related-party transactions – A newly added article 18 brings China's customs valuation system into closer alignment with the principles of the WTO Customs Valuation Agreement. The article provides that if Customs is able to confirm that the pricing of the goods is consistent with common commercial practice after conducting a circumstances of sale test, this should be sufficient to conclude that the relationship between the buyer and the seller did not influence the transaction value.
- Transportation and relevant fees – Actual freight, transportation and other relevant logistics costs can now be used instead of benchmarks as previously required. The earlier rules provided that freight and insurance for goods transported through railways and highways be computed at 1% of the total goods value. Customs also previously did not specify whether the freight (rate) of the transportation industry in the corresponding period can be used as a reference if actual transportation fees of imported goods are undeterminable under GAC Order No 148. By contrast, the new GAC Order No 213 clarifies that Customs shall base its assessment on comparable transportation expenses at the time the goods are imported.

Simplified procedures for processing trade enterprises

Much of the revisions to the customs valuation regulations promulgated by GAC Measures 211 and 213 are related to the processing trade and, interestingly, a revamp of regulations specific to processing trade is also underway. China's imports and exports benefit significantly from the processing trade, but administrative requirements to operate a processing trade enterprise successfully have commonly been perceived to be tedious and time consuming. Slowly, long awaited reforms to simplify the tedious approval procedures are becoming a reality.

Recently, GAC made some amendments to the processing trade regulations that simplify and standardise daily procedures with regard to handbook set up and verification, bonded goods outsourcing and factory transfer. At the same time it also strengthens Customs' role in the actual supervision of relevant declaration data and the management of bonded goods. Processing trade companies should therefore review the impact of these new regulations on their daily customs operations and, as necessary, strive to enhance their trade compliance and internal control management capacity.

These changes are contained in a number of regulations recently issued by GAC which include:

- GAC Order No. 219, Measures of the Customs of the People's Republic of China on the Supervision of Processing Trade Goods;
- GAC Announcement 2014 No. 21, Announcement on Issues concerning the implementation of GAC Order 219;
- GAC Order No. 218, Decision of the General Administration of Customs on Amending Some Regulations, including amendments to the following processing trade regulations:
  - Administrative Measures of the Customs of the People's Republic of China on administration of Bonded Groups Engaged in Import Processing;
  - Measures of the Customs of the People's Republic of China on Administration of Processing Trade involving multiple locations;
  - Measures of the Customs of the People's Republic of China on Administration of Processing Trade Scrap, residual Material, Defective Goods, By-Products and Bonded Goods Affected in a Disaster;
  - Measures of the Customs of the People's Republic of China on Administration of Processing trade Unit Consumption; and
  - GAC Order No. 216, Decision of the General Administration of Customs Abolishing Some Regulations, including abolishing Administrative Measures of PRC Customs on factory Transfer of Bonded Goods between Customs districts.

The GAC has still retained the basic processing trade principles such as the requirement for accurate declarations in setting up customs handbooks, handbook verification based on actual information, accurate declarations of unit consumption and the separate management of bonded and non-bonded goods, but notable changes have been set in motion by these new regulations such as:

- Simplified procedures for bonded goods outsourcing, factory transfer, residual material carry-over, and other administrative steps for handbook approval and verification.
- Reduced restrictions on the supervision procedures for bonded goods outsourcing, while strengthening the company's legal responsibility for compliance.
- Removal of previous restrictions that limit material interchange between bonded and non-bonded materials to situations in which it is "urgently required to process the export goods orders" or where "non-bonded materials are required by technical necessity to complete the manufacturing process."
- Loosening the restrictions in the applications for collateral on processing trade goods, especially for long-term collateral;
- Allowing letters of guarantee issued by non-bank financial institutions as a legal means of collateral in the procedure of handbook setting and bonded goods outsourcing. (Previously, only letters of guarantee issued by banks were allowed);
- Exempting processing trade companies from submitting annual reports of operating activities; and
- Allowing the direct export of bonded raw materials imported via customs handbook for after-sales service.

Though the overall intention of the new regulations is positive and commendable, we still expect challenges down the road and it is advisable that companies still pay close attention to perennial issues such as determining whether or not the original import price is at arm's length when reviewing the dutiable price of domestically sold bonded goods between related parties; how these rules would interact with different valuation practices in different Special Customs Supervision Areas; and how this would affect factory transfer movements.

Revisions to Customs' audit regulations

The easing of restrictions on the processing trade and the granting of flexibility for companies to determine their customs value based on actual declared amounts, aim to gradually transfer Customs' primary function and resources from the border to the company's premises. Instead of holding goods at the port, the enforcement role of the Customs authority is being redefined as being a post-import/export auditor. This inevitably makes it incumbent upon companies to be more circumspect in their customs operations, thereby emphasising the need for better internal compliance or self-discipline measures which Customs itself is now striving to promote among companies.

In view of these considerations, Customs is once again revising its Customs Audit Regulations (under State Council Order No 209). To get as much input from the business sector as possible, the State Council recently released a draft (the Revision Draft) of the new regulations to the general public for comments. Briefly, the Revision Draft pushes the customs compliance function further up to the level of higher management, requiring them to adopt higher standards for risk management, credit management and overall enterprise self-discipline. To reduce bureaucratic barriers, Customs' role would be limited to ensuring that these standards are adhered to.

Some notable features of the Revision Draft are as follows:

Shifting the primary focus of customs audits

The Revision Draft gradually shifts the focus of customs audits from examination to management. Instead of making detailed examinations of company accounts, documents and goods, Customs will make an overall assessment of the company itself and its risk management capability. It will no longer rely exclusively on follow-up supervision but will take careful note of the company's capacity to pre-assess its imports/exports, credit status and risk status; and conduct post-import/export reviews to verify the accuracy and propriety of its import and export activities.

The following two aspects of the new customs audit guidelines are particularly relevant to enterprises:

- Establishing an enterprise "self-discipline" system – Article 11 of the Revision Draft provides that: A company under audit that is able to carry-out self-compliance management on their operations may report any instances of non-compliance to Customs and take prompt corrective action. In such cases, administrative penalties will be reduced or may be waived particularly for minor torts that are quickly corrected and do not result in any damages.
- Establishing an internal control system according to customs requirements – Article 9 provides that: 'The companies being audited should establish an import/export internal control system according to customs requirements and accept customs supervision and inspection.'

Protection of the legitimate rights and interests of auditees

The Revision Draft protects the legitimate rights and interests of companies being audited by standardising the notification and review procedures. Article 21 provides that: 'Customs should inform the auditees of the facts obtained through a customs audit before reaching an audit conclusion; companies who have factual objections should express their opinion to Customs within seven days from the date that the information is issued to them.' This provision protects the companies' right to know the legal basis for any administrative enforcement, as well their right to reply and prepare a defence. Furthermore, Article 22 provides that: 'Customs should review any facts that are questioned by the companies being audited and any reasonable explanation raised by the auditees should be accepted by Customs.'

Transforming Customs functions and improving management efficiency

The Revision Draft introduces a legal provision allowing third-party intermediaries to conduct customs audits. The notion of enlisting third-party intermediaries to assist in customs enforcement is not new. Third parties were already allowed when the Measures of the Customs of the People's Republic of China on Inspection of Bonded Zone Operations were issued by the GAC and took effect on June 1 2008. Since third party-intermediaries have a wealth of both domestic and international experience, local Customs authorities are seen to benefit from the former's involvement. We understand that Customs will publish the qualifications and management regulations regarding the third-party intermediaries at a later date.

With regard to the selection of auditees and the actual conduct of audits, Customs will rely on risk management and credit management. As a member of the World Customs Organisation (WCO), China Customs has also established an enterprise classification management system that follows principles similar to the Authorised Economic Operator (AEO) system (to be discussed in a later part of this article) whereby Customs identifies and grants cargo clearance benefits to enterprises with exceptional track records in compliance, credit, and cargo security. China Customs has been continually improving its enterprise credit and risk management systems and the Revision Draft aims to strengthen this further.

Article 4 of the Revision Draft provides that customs audits should be conducted more along the lines of enterprise credit management and import/export risk management. Instead of a one-size-fits-all approach, Customs will decide on the key audit areas based on the import/export credit status and risk status of the auditees, thereby improving the efficiency and effectiveness of the customs audit. Upon conclusion of the audit, Article 17 provides that Customs would have the right to adjust the company's enterprise credit records according to results and findings.

Introduction of self-disclosures

One defining characteristic of the upcoming Customs Audit Regulations is the introduction of an enterprise self-disclosure systemfor the first time. Under the existing system, Customs is not obliged to grant lenient treatment in any circumstances, which imposes a high-level compliance dilemma on the part of the enterprises. However, the enterprise self-disclosure system in the Revision Draft is rather vague since it does not offer specific solutions for different self-disclosure problems and does not define the conditions in which an enterprise would be precluded from leniency. The anticipated lack of detail in the upcoming Customs Audit Regulations may cause confusion and inconsistent standards being applied in different circumstances. While this is still a step forward, enterprises should be wary when making self-disclosures.

Some local Customs authorities have already adopted enterprise self-discipline practices. For example, Tianjin Customs has already introduced self-checking and self-reporting of royalties. And after GAC issued the Notice of the General Administration of Customs on Carrying Out the Enterprise Self-discipline

Management Pilot and Research Work (GAC Auditing Division [2014] No111), it began to organise self-discipline pilot programmes in 10 local Customs authorities: Beijing, Tianjin, Qingdao, Shanghai, Nanjing, Wuhan, Xiamen, Gongbei and Shenzhen. Similar pilot programmes are expected to be carried out all over the country soon. Thus, we would encourage enterprises to make early preparations

Since the upcoming Customs Audit Regulations require a higher standard of internal customs management, enterprises would be advised to enhance their internal management systems too, so as to meet these higher standards.

Enterprise classification and China's nascent AEO system

The benefits of the changes that China Customs is undertaking are expected to be enjoyed not only in China. Rather, these changes are geared at obtaining reciprocal customs benefits in other countries as well for Chinese exporters. This initiative of securing Authorised Economic Operator (AEO) status for Chinese companies to receive preferential customs clearance benefits in other countries dovetails with China Customs' adoption of its enterprise classification system, which is likewise undergoing changes.

The GAC first adopted an enterprise classification system in 1988 (Measures on Management of Trustworthy Enterprises), and has been refining it ever since. Constant changes in roles and responsibilities within China Customs have now made it necessary once again to revise these Administrative Measures to adapt them to commercial realities of the present day.

For the purpose of enacting this latest round of revisions, the GAC has prepared and circulated a draft of Provisional Measures of the PRC on Credit Management of Enterprises (Provisional Measures). The main reason for issuing these Provisional Measures is to keep the enterprise management system in line with international standards, particularly with regard to:

- the use of an AEO system that will provide differential customs treatment for enterprises with various credit levels, and
- alignment with the soon to be implemented Certification Criteria that conforms with WTO standards.

The Provisional Measures differ from the existing Administrative Measures in a number of ways. Some notable changes are described in the succeeding section.

Changes in enterprise classification measures

Companies in China that are certified as AEO (that is, advanced certified enterprises and generally certified enterprises) will be able to enjoy preferential customs clearance benefits in China and in countries with which China has mutual recognition agreements (for example, Korea and Singapore). However, instead of a one-time classification, enterprises of a high credit standing will be re-evaluated from time to time to manage potential customs risks better. Customs will also apply a credit rating system within the Certification Audit procedure to clarify administrative standards. These changes are summarised below:

- Simplified classification of enterprises. The current system that divides enterprises into five categories (AA, A, B, C and D) will be replaced by a simplified system with four category levels:
- Advanced Certified Enterprises (ACE),
- Generally Certified Enterprises (GCE),
- Regular Credit Enterprises (RCE); and
- Discredited Enterprises (DE).

ACE and GCE (Certified Enterprises or CE) will be considered as AEOs in China that can enjoy special customs clearance privileges in China and in countries with mutual recognition agreements with China.

- Establishment of a dynamic adjustment system. Article 15 of the Provisional Measures states that "Customs should review the qualifications of Advanced Certified Enterprises every three years and perform an assessment on Generally Certified Enterprises at random. Generally Certified Enterprises Companies who fail the general assessment, will lose their General Certification and will not be allowed to apply for certification within one year. Advanced Certified Enterprises who fail the advanced assessment but pass the general assessment would be referred to the management of Generally Certified Enterprises".
- Allow the involvement of agencies in customs administrative procedures. The Provisional Measures state that "Customs

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Helen worked as a project leader in the Customs authority and a trainer for nationwide Customs officials. She was sent by GAC to study post-clearance audit, price valuation, risk management and customs management abroad and also attended a few international customs academic seminars to discuss with World Customs Organisation experts on behalf of the PRC Customs. She was involved in writing and designing regulations and used to organise and was responsible for some important cases.

Since joining KPMG, Helen has been integrally involved in a wide range of customs projects such as consulting, compliance and defence, including customs valuation, processing trade, internal control implementation and related-party pricing. She provides services to many multinational corporations in various industries. She has also been a guest speaker at various customs seminars and training courses hosted by Customs authority.

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or enterprises can entrust qualified agencies to perform the customs assessment. The results can be taken as references for the credit assessment once recognised by Customs".

Clarification on the treatment of customs clearance for enterprises having different classifications

The Provisional Measures grant CEs preferential treatment during customs clearance and clarifies the supervision measures for discredited enterprises.

Preferential treatment granted to GCEs includes:

- A relatively low inspection rate on import/export goods;
- Simplified document review of import/export goods;
- Prioritised clearance treatment of import/export goods; and
- Other administrative principles and treatments announced by the GAC.

On top of the preferential treatment granted to GCEs, ACEs shall enjoy the following administrative measures:

- Advanced release of import/export goods before the completion of customs clearance procedures, such as goods classification, valuation and country of origin;
- Assignment of a dedicated liaison officer for the enterprises;
- Bank deposit account system would not be required for enterprises engaged in processing trade;
- Preferential clearance benefits in countries that have signed AEO Mutual Recognition Arrangements with China.

Management principles and measures for regular credit enterprises will include:

- An average inspection rate on its import/export of goods;
- General document review of its import/export operations;
- A sequential, chronological clearance procedure for the import/export of goods;
- Other administrative principles and treatments announced by the GAC.

Finally, the management principles and measures for discredited enterprises will be the following:

- A relatively high inspection rate on its import/export of goods.
- Intensive document review of its import/export operations;
- Key supervision on processing trade and other businesses;
- Other administrative principles and treatments announced by the GAC.

Innovations in customs management measures

The Provisional Measures introduces a system of managing the credit / reputation of companies based on their levels of customs management. For the first time, Customs will publicise the enterprise credit rankings of companies which is indicative of China Customs becoming more transparent. This also encourages companies to improve their compliance and strive for smoother clearance options to maintain their image and reputation. These Measures can also be considered a breakthrough in the development of China Customs' enterprise classification system, and is expected to be of significant benefit for both Customs and the business community. In preparation for these changes, enterprises will have to pay close attention to the following:

- As far as we understand, during the transition, enterprises can still apply for advanced certified level before the new certification criteria comes into effect on December 1 2014. Depending on the local customs administrations, enterprises with AA or A ratings will be directly reclassified as ACE or GCE.
- The Provisional Measures operate within a dynamic adjustment system. Customs will perform re-assessments on the advanced certified enterprises every three years and re-assess

the generally certified enterprises on a random basis, which would demand a higher level of customs management.
- Whereas the Audit Department conducts the existing assessment and classification procedures, it is likely that after the implementation of the Provisional Measures, the Enterprises Administration Department of local customs will be responsible for assessment and classification. Customs will also further involve qualified agencies to assist with classification assessments.

E-commerce

Another sign of the times that Customs will need to adjust to is the prevalence of cross-border e-commerce transactions, which will enable Chinese companies or individuals who either purchase from or sell to overseas entities or individuals in relatively smaller volumes but higher frequencies. This poses a challenge to traditional customs enforcement that is more often accustomed to inspecting and levying duties on large volume and regular shipments. Under the direction of Customs, different customs ports in China are conducting experimental projects in different ways to explore how to address this concern.

For example, last September Guangzhou introduced a direct purchase model that allows e-commerce companies to pre-register their overseas orders with China Customs to facilitate customs clearance and the payment of duties and taxes based on the legal provisions and rates pertinent to personal items. This is an innovation from previous practices of using domestic agents which could potentially take time because shipments would first have to be consolidated before these are processed. Under the new programme, Customs needs to review the online purchase orders, payment receipts and logistics data which are transmitted electronically to Customs before the release of the shipments. It is expected that this new system will lower the customs duty, as well as reduce lead times. Other customs ports, such as Shanghai, Ningbo and Zhengzhou have experimented with similar measures earlier this year.

These measures come on the heels of State Council Notice No 89 [2013] issued last year that recognised the importance of e-commerce to China's economy. This Notice demonstrates the general policy direction of the Chinese government to adapt to present realities by formulating measures that will help develop cross-border e-commerce, particularly for business to consumer (B2C) export transactions. In the process, the following have been identified as key areas that would require further reforms: customs administration, quality inspection, taxes, foreign exchange, payment and credit. Since the concept of cross-border e-commerce and its implications spans multiple government agencies, we can expect more improvements and changes not only in customs regulations, but in other administrative bodies as well such as the China Inspection and Quarantine CIQ) and the State Administration of Foreign Exchange (SAFE).

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Looking to the future

The last 12 months witnessed not a few significant milestones for China Customs in moving towards its goal of being recognised as a world-class agency that can reasonably balance the conflicting demands of trade facilitation and trade compliance. As a measure of how important and far reaching these changes are, these reforms and proposed reforms directly address contentious issues that the business community has long been seeking clarification on. Nearly all companies engaged in cross-border transactions involving China can relate to the uncertainty and ambiguity in dealing with issues surrounding customs valuation, processing trade management, audits and e-commerce. The benefits of enterprise classification, and the objective of expedited cargo clearance and reduced customs scrutiny for better managed and highly compliant organisations have also not been fully realised, partly because of the uncertainties around the conduct of customs validation or certification audits that are a prerequisite to qualify for an upgrade.

The new regulations that have recently been introduced and the draft regulations being circulated for comments can be expected to go a long way to providing some degree of relief for companies, assuring them that more transparency and predictability in customs enforcement are in the offing. Multinationals that are used to AEO systems and risk-based approaches in the selection of audit subjects may particularly be encouraged by the prospect of China adopting more business-friendly standards similar to those used in other advanced economies.

Nonetheless, it will still take time and a lot of fine-tuning before the touted benefits of these reforms can be appreciably felt. Given the sheer size of the customs bureaucracy in China, we can expect tangible results starting in various ports and pockets where pilot programmes are to be launched. These should slowly spread to the rest of the other more challenging, remote, and less equipped port administrations. A strong training complement should also accompany these programmes, preferably with the continued involvement of the business sector to leverage the latter's experience and knowledge of how similar reforms are being implemented in other countries. It would be exciting to see how these will all take shape in the next few years as China Customs turns another page in its decades-long efforts to forge an effective partnership with the private sector and the international community at large.

The authors wish to thank Raphael Madarang for his key contribution to this chapter

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Stay tuned for IIT reform in China

Taxpayers should make sure they are compliant with rules on equity-based incentive plans and frequent business travellers as the individual income system moves towards comprehensive reform, explain Michelle Zhou, Chris Ho and Barbara Forrest of **KPMG China**.

Major obstacle to push for IIT reform

Despite the intent and efforts made to reform the Chinese individual income tax (IIT) system, the progress thus far has been somewhat slow. The IIT was the first set of tax law enacted in China and has been around for more than 30 years. Given the rapid social and economic changes seen in China in the last three decades, the system will be inadequate to serve its purpose to achieve secondary distribution among participants in the economy. Thus, reform will be critical to enhance equality in this secondary distribution, and although we do not expect a reform to happen under the Chinese government's series of social and economic development policies in the 12th 5 Year Plan (5YP) period (2011 to 2015), it is well on the radar screen of the authorities and progress is likely to be expedited in the 13th 5YP period (2016 to 2020). While discussions on the specific measures for the IIT reform continue to revolve around adjustments to the existing IIT tax base and IIT rates among other things, according to Chinese officials, one major obstacle at present to push for an IIT reform is the lack of comprehensive data (which will enable the formulation of an equitable basis for a new personal taxation system in China).

Obstacle or catalyst?

The move from an IIT system which taxes individuals on a categorised-income basis towards a comprehensive system where tax will be imposed on a consolidated income basis and based on the family unit has been the focus of Chinese IIT reformers over the last few decades. However, without comprehensive data on the nation's existing and future taxpayers' tax payment history, family size, credit rating, education/employment profile, social welfare status, for example, the decision on whether a comprehensive IIT system is the right system for China will undoubtedly be a difficult one for the reformers. Unfortunately, at this juncture, the system does not capture the data necessary for pushing the reform along.

For years, tax authorities across China have attempted to establish city/province-based databases to capture individual taxpayer information via employers. While the outcome of such efforts is unknown, one is not convinced that the conversion to a comprehensive IIT system can be achieved without the support of sophisticated tax collection and administration mechanisms. The 'one nationwide platform', which the "Golden Tax Project Phase III" aims to establish, is an evident move by the authorities to expand, strengthen and develop the existing mechanisms into a nationwide platform for capturing the data necessary for analytical and tax administration purposes. It is understood the platform will be established as part of a pilot programme in a few cities first before being rolled out nationwide.

In the meantime, while we have to acknowledge that reforming the Chinese IIT system is going to be a long journey, one should not overlook the efforts of the Chinese tax authorities to strengthen IIT collection and administration (in particular for high-income earners), as it is and will always be on their agenda. Although we have not seen any specific tax circulars issued on this in the last 12 months, apart from the periodic routine tax audits, there also appears to be a tendency for authorities to enquire about employee equity-based incentive plans and on some occasions to establish local systems to track the vesting of the awards and other details.

Equity based incentive plans

In recent years, the use of employee equity-based incentive plans as a long-term reward scheme has proven to be popular among Chinese employers (in particular for those with a publicly listed foreign parent). These awards can be taxed preferentially in China while there are also additional compliance requirements for the employer. To put it in simple terms, where the underlying equity award is publicly listed, the employer should undertake to register the plan, with other relevant details, with the local tax authority throughout the lifecycle of the award. Failing to comply with the registration requirement will not only lead to the employee being denied application of preferential tax treatment to income related to the equity award, but also a fine could be imposed on the employer.

Equity-based incentive plans could also be subject to foreign exchange rules in China where the underlying awards are publicly listed overseas, as the outward remittance of funds required for the acquisition of awards by employees and the inward remittance of funds to employees after the disposal of awards are all regulated by the State Administration of Foreign Exchange.

Companies that implement equity-based incentive plans in China should not overlook the compliance requirements in China as it could potentially undermine the benefit of these awards and adversely impact on the tax credit rating of the company in China.

Frequent business traveler (FBT) – a trend?

Based on recent studies, the airports in Beijing, Guangzhou and Shanghai have been climbing up the ladder of the world's busiest airports by passenger traffic in recent years. In particular, Beijing is the second busiest airport in the world based on statistics released in early 2014. While we have not observed a significant increase in the number of resident foreigners in China over the past few years, the increase in traffic at Chinese airports could be interpreted as a trend of an increasing flow of business travellers into China, as well as other visitors. This trend could also be explained by the fact that the cost of long-term assignments is becoming increasingly expensive given that living standards in major cities of China are on the rise and that cross-border projects of a short-term nature are becoming more prevalent in today's business environment.

From a personal tax compliance point of view, the Chinese domestic rules and the relevant tax treaty provisions should be reviewed to determine whether FBTs are eligible for tax relief in China. Where the FBT is not domiciled in China and derives employment income from the provision of services in China, he could be exempt from IIT in China if he meets all of the following conditions:

- He is in China for no more than 90 days in a calendar year;
- His remuneration is paid by, or on behalf of, an employer who is not a resident of China; and
- His remuneration is not borne by a permanent establishment (PE) or a fixed base which the employer has in China.

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Over the years, she has undertaken speaking engagements at events held by the American Chamber of Commerce, Australian Chamber of Commerce, Canada Business Council and EU Chamber of Commerce to update their members on the latest regulatory developments and trends in Chinese individual income tax, as well as topics on remuneration packaging; equity based compensation structuring; and others. Michelle has also delivered lectures to students in the finance discipline of Fudan University on expatriation taxation. In recent years, Michelle and her team have successfully assisted clients in the tax and foreign exchange registration of equity-based plans in China since the introduction of the relevant regulations in China. She has also actively participated in various projects relating to design, implement and roll-out of employee incentive plans, including equity-based compensation plans.

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Barbara has extensive experience in dealing with equity-based employee compensation, both interpreting the tax treatment of offshore arrangements in Hong Kong and using equity compensation as a tax planning and employee retention tool. Her clients have included JP Morgan Chase, UBS and BNP Paribas, in financial services, PMI and Mattel, in consumer services, and Cathay Pacific, in property and infrastructure. She is a regular speaker at KPMG-sponsored events and has published articles on taxation and international human resource matters and policies in various trade publications.

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If the FBT concerned is a tax resident of a country with which China has a double tax agreement (DTA), the period of 90 days could be extended to 183 days (although it could be measured over the relevant tax year or any 12-month period, depending on the provision of the relevant tax treaty).

Unless the FBT is relieved from Chinese IIT by virtue of the Chinese domestic rules, there are compliance requirements to consider. Where the FBT is determined to be exempt from Chinese IIT by virtue of the relevant DTA, he should undertake to comply with an one-off "put-on-record" treaty filing with the Chinese tax authority, as failing to do so could result in his treaty relief being denied by the Chinese tax authority. Otherwise, the FBT will need to comply with tax reporting requirements in China.

Management of FBTs in China could lead to a few more issues for employers other than meeting personal tax compliance requirements. One of these considerations is whether the presence and activities of the FBTs will create, for corporate tax purposes, a Chinese establishment under PRC domestic law or permanent establishment (PE) under PRC income tax treaties for the foreign enterprise for whom the FBT works.

After the issuance of *Guoshuifa* [2010] No 75 (Circular 75), the State Administration of Taxation (SAT) issued Announcement 19 [2013] (Announcement 19) which offered additional guidance on the assessment of PE. Specifically, the "fundamental criterion" for the sending foreign entity to be regarded as providing services through its employees in China, and thus having a taxable establishment or place of business in China, is whether:

- the sending entity bears all or part of the responsibilities and risks in relation to the work products of the employees, and
- it is the sending entity that normally reviews and appraises the job performance of the employees.

Beyond the "fundamental criterion," Announcement 19 also prescribes the following factors (reference factors) in deciding whether the employees are in substance the employees of the sending entity:

- The host entity in China pays the sending entity management fees or makes payments in the nature of service fees;
- The payment to the sending entity from the host entity is more than the employees' wages, salaries, social security

contributions, and other expenses borne by the sending entity;

- The sending entity does not pass on all the related payments made by the sending entity to the employees; instead, the sending entity retains a certain amount of such payments;
- PRC Individual Income Tax (IIT) is not paid on the full amount of the employees' wages and salaries borne by the sending entity.

Above and beyond these factors, Chinese tax authorities would also determine the 183-day threshold for service PE assessment by counting from the date on which the first employee arrives in China to provide services for the same project or a connected project, and end on the date on which the services are completed. Thus, multinational companies (MNCs) who are sending FBTs to work on projects in China should pay close attention to these points in their planning to manage the FBTs' personal tax and associated PE risks adequately.

Keep up to date

MNCs that have operations in China and those high income earners should continue to follow closely the regulatory and practice development on the Chinese tax authorities' efforts to strengthen the enforcement of IIT compliance. In particular, given the recently indicated intent of the SAT, as part of their work programme for the years ahead, to introduce IIT avoidance rules, a keen understanding of the latest developments is needed to ensure that proper advice is sought to effectively manage IIT exposure.

Hong Kong increases its attractiveness as an international financial centre

Ayesha Lau, Darren Bowdern, Justin Pearce and Michael Olesnicky of **KPMG China** explain how the Hong Kong government has changed tax rules in areas such as captive insurance and expense deductibility for payments to overseas companies to maintain its position as an attractive international financial centre in the Asia Pacific region.

As a leading global financial centre and important gateway to China, Hong Kong continues to see growth in inward investment while continually seeking ways to enhance its value as a financial centre. In one such initiative, in 2014 legislation was introduced allowing captive insurers a 50% reduction in the profits tax on their insurance business of offshore risks.

Captive insurance is a commonly used risk management tool in developed economies, with more than 6,000 captive insurers worldwide, the majority domiciled in Bermuda and the Cayman Islands. Attracting enterprises to set up captive insurers in Hong Kong helps the development of related businesses, such as reinsurance, legal and actuarial services; makes Hong Kong's risk management services more diversified; and reinforces Hong Kong's status as a regional insurance hub. Hong Kong's robust regulatory regime and pool of professional talent makes the territory an attractive domicile for a captive insurer. The tax concession aims to attract more enterprises to establish their captive insurers in Hong Kong.

With its proximity to the mainland, Hong Kong will benefit from the anticipated growth in the use of captive insurance by mainland enterprises. To date, at least three of them have set up captive insurers to underwrite their own risks. As these enterprises become more international and sophisticated, there is an expectation that they will increasingly use captive insurance for reducing insurance costs and better risk management. This tax incentive together with Central government encouragement for mainland enterprises to establish captive insurers in Hong Kong should provide the impetus for those enterprises to seriously consider doing so.

Apart from new tax policies for captive insurance, there were also announcements of other initiatives, aimed at enhancing Hong Kong's standing as a major provider of financial services, in the 2014/15 budget. Firstly, the Financial Secretary announced that the rules for expense deductibility for interest paid to overseas companies would be reassessed. The existing deductibility rules may discourage the establishment of group treasury companies in Hong Kong and this measure may attract more treasury activities to the territory.

Secondly, and further to the proposals contained in the 2013/14 budget on profits tax exemptions for offshore funds being extended to private equity funds, the Financial Secretary advised that work on the relevant legislation would commence in 2014. To attract more traditional mutual funds and hedge funds to Hong Kong, the regulatory frameworks for introducing an open-ended fund company structure have been drawn up and consultation began in March.

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

Ayesha was the chairman of the executive committee of the Hong Kong Institute of Certified Public Accountants' Taxation Faculty and its former taxation committee. She has been elected to be a member of the 2011 Election Committee for the Accountancy subsector.

Ayesha is passionate about community service and has been appointed by the Hong Kong SAR government as a member of various advisory bodies, including the Lump Sum Grant Independent Review Committee, the Taskforce on Economic Challenges, the Women's Commission and the Financial Reporting Review Panel of the Financial Reporting Council. She is a member of the Council of the Hong Kong University, the Independent Commission Against Corruption Advisory Committee on Corruption, the Hong Kong Trade Development Council, the Standing Committee on Judicial Salaries and Conditions of Service, the Market Development Committee of the Financial Services Development Council, the Harbourfront Commission, the Aviation Development Advisory Committee and the Financial Infrastructure Sub-Committee of the Exchange Fund advisory Committee.

Ayesha was appointed as a justice of the peace on July 1 2013. She is a member of the HKICPA and the Institute of Chartered Accountants in England and Wales.

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Darren Bowdern is a partner in corporate tax. For more than 19 years, he has been involved in developing appropriate structures for investing into the Asia Pacific region, tax due diligence reviews in connection with M&A transactions and advising on cross-border transactions. Many of these projects comprise tax effective regional planning including consideration of direct and indirect taxes, capital and stamp duties, withholding taxes and the effective use of double taxation agreements. He also advises on establishing direct investment, private equity and other investment funds in Hong Kong.

Finally, a proposal to extend the stamp duty concession for exchange traded funds (ETFs) was announced by the Financial Secretary. Previously the extension only applied to ETF tracking indices comprising not more than 40% of Hong Kong stocks. This will now be extended to the trading of all ETFs and should promote the development, management and trading of ETFs in Hong Kong.

During 2014 Hong Kong increased its network of double tax agreements (DTA) to 31, with the conclusion of agreements with South Korea and South Africa. Negotiations continue with more than a dozen jurisdictions including Germany, India and Russia.

The further development of Hong Kong's DTAs will enhance its position as a regional investment and trading centre. The Hong Kong government has reiterated its policy to conclude further DTAs and is prioritising its major trading partners and jurisdictions that are the focus of mainland Chinese outbound investment.

Exchange of information

In February 2014 the OECD released details of the Common Reporting Standard, which is to be the global standard for the automatic exchange of financial information.

Hong Kong has diligently complied with OECD initiatives while at the same time dealing with stakeholder concerns about administration and privacy issues, as well as the threat of possible capital withdrawal and potential impact on its competitive advantage in Asia.

In July 2014 the OECD published the first edition of the Standard for Automatic Exchange of Financial Account

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Information in Tax Matters (the Standard). It comprises three parts and seven annexes, and includes commentary and guidance for the effective implementation of the Standard by governments and financial institutions, detailed model agreements, as well as standards for technical and information technology solutions.

The first edition of the Standard complements the draft model in February 2014 and provides for the annual automatic exchange of financial account information between governments, including balances, interest, dividends and sales proceeds from financial assets, reported to governments by financial institutions. It also covers accounts held by individuals and entities, including trusts and foundations. The standard was endorsed by the G20's finance ministers at their meeting in Cairns, Australia in September 2014, asking financial centres to commit themselves to the exchange of information automatically by the end of 2018.

Hong Kong government supplies tax information on request only either under the equivalent of article 26 of the OECD Model Tax Convention in its DTAs or through tax information exchange agreements, the first of which was concluded with the US in 2014.

The political support for the Standard and Hong Kong's commitment to transparency led, not unsurprisingly, to the commitment in September 2014 to implement it.

As mentioned earlier, legislation in Hong Kong only allows the exchange of information on request so, to comply with the Standard, amending legislation will be required. The government has indicated that it will consult stakeholders with a view to introducing the necessary legislation within a two year target period.

For Hong Kong to implement the standard it will need to deal with the following:

- It will have to incorporate the Standard into domestic legislation. This will require rules requiring financial institutions to report information and follow prescribed due diligence requirements.
  It is anticipated that this legislation will be relatively complex with legislative proposals expected in the coming legislative session and consultations with industry and business groups commencing beforehand.
- Hong Kong will have to adopt a legal basis for the exchange of information in the form of legal instruments that permit automatic exchange of information under the Standard. In this regard, countries may use bilateral double tax treaties (using article 26 of the OECD Model Tax Convention) or the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (the Multilateral Convention). It is unlikely that Hong Kong will become a signatory to the Multilateral Convention and therefore it is expected that double tax treaties will be the legal foundation for Hong Kong's automatic exchange of information.
  Hong Kong will also have to conclude separate agreements between competent authorities of counterparties to activate and operationalise the automatic exchange. These agreements will specify the information to be exchanged and deal with practical issues such as the time and format of the exchange and a model competent authority agreement has been provided for this purpose.

- Before concluding any competent authority agreement, Hong Kong will need to have an administrative and information technology infrastructure in place to collect and exchange information. It will also have to ensure that systems are in place to protect confidentiality and safeguard data and that the rules contained in the Standard in this regard are fully adhered to.

Implementing automatic exchange of information by the end of 2018 will require the smooth passage of the necessary legislation before the end of the legislature's tenure in 2016. It is expected that the government will work to a strict timeframe to ensure it is able to meet its commitment of exchanging information in 2018. Specific administrative resources will also be required for the effective and practical implementation of the Standard and it is likely that legislators and stakeholders will raise concerns over privacy and appropriate use of information.

The coming year will see Hong Kong moving towards complying with its commitment to meeting the global standard of exchange of information, while we expect to see Hong Kong paying particular attention to the recommendations arising from the BEPS project and how these will affect Hong Kong taxpayers and the tax administration. As mentioned earlier, we also foresee further legislation during the coming year that will maintain and increase the attractiveness of Hong Kong as an international financial centre.


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