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China

Looking Ahead 6th edition

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China – Looking Ahead

INTERNATIONAL TAX REVIEW

Editorial

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International Tax Review

China has been busy refining its tax system and strengthening its tax policies over the past year, laying the foundations to advance fiscal policies.

The sixth edition of KPMG's *China – Looking Ahead* guide highlights how the country has transitioned from the business tax regime to VAT, implemented several recommendations under the OECD's BEPS Project and prepared itself for the common reporting standard. It also looks at the developments that will influence business decisions in 2017 and beyond.

The progress made in 2016 has allowed China to take the lead in driving forward global tax reform. Not only was it the host of the G20 Summit and the Forum on Tax Administration in 2016, but China has continued its economic expansion with its booming outbound direct investment. While the focus for organisations and governments has been on aligning international tax laws, China's tax reform measures have been about spurring investment and cross-border trade. Like its new indirect tax system, it aims to create world-leading policies.

China has adjusted its policies to align with its economic and strategic plan and therefore develop a model that focuses on services, consumption and the high-tech industry, particularly with the aim of driving its outbound investments along the One Belt, One Road. New customs regulations, including the release of the Customs Audit Regulations, and further guidance to improve the legislative framework for cross-border e-commerce are part of the wide-spread changes to drive China's economic transformation. In addition, incentive supply side programmes such as the high and new-technology enterprise scheme and 150% super deduction are expected to boost industry and service-consumption. The State Administration of Taxation (SAT), China's tax agency, has also worked on tax treaty policy, which is creating a new generation of double taxation agreements to keep pace with changing business practices.

Overall, China has developed a springboard for action and further international collaboration in the years ahead. Multinational enterprises looking to understand China's changing tax landscape will not have to look any further than this guide, as KPMG's tax specialists in China provide a digestible breakdown of the most prominent changes and offer a glimpse of the year ahead.

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Foreword

China's Year of the Monkey will soon give way to the Year of the Rooster, which will see the closing of another economically and fiscally progressive chapter in China's ongoing development.

Throughout the past year, a lot of groundwork has been laid for a series of key fiscal policy advances, which are anticipated to come to fruition in 2017. This chimes with the characterisation of the Year of the Rooster as being a period that calls for confident and courageous action.

Since 2014, China has overtaken the US as the world's largest economy in purchasing power parity terms. It has continued its steady expansion with a GDP growth of 6.7% in the first three quarters of 2016. Chinese outbound direct investment (ODI) overtook foreign direct investment (FDI) in 2015, with ODI at $146 billion and FDI at $136 billion, making China a net exporter of capital. This trend accelerated in 2016, with ODI for the first six months alone standing at $99 billion and projected to hit a record $170 billion for the whole year. This outbound push by Chinese multinational enterprises (MNEs), alongside the substantial acquisitions of foreign brands and technology, is seen as integral to the retooling of China's economy towards a service, consumption, and high-tech industry-driven model. This transition towards wholesale economic transformation is now having a perceptible effect on Chinese tax policy.

An overarching framework for Chinese fiscal reform was provided in the 15th chapter of the 13th Five Year Plan for Socio-Economic Development, which was issued in March 2016.

During 2016, many of the plan's objectives have been put into effect, including the finalisation of the business tax (BT) to VAT reforms, resource tax reforms, and the issuance of a draft of the planned environmental protection tax.

In 2017 and beyond, substantial reforms are planned to the Individual Income Tax (IIT) Law, real estate taxation, and consumption taxation. This is alongside a restructuring of the way in which tax revenues and collection responsibilities are shared between the central and local governments within China, and a move to put tax regulations and guidance on a statutory basis, further formalising and reinforcing Chinese tax law.

While China makes these major changes in 2016 and 2017, it is also transposing most of the G20/OECD BEPS agenda into Chinese tax regulations and guidance. In 2016, the China State Administration of Taxation (SAT) put mechanisms in place to enable Chinese participation in the OECD's common reporting standard (CRS) for the automatic exchange of information (AEOI), which goes live in China from 2018.

The fact that China is at the forefront of implementing these measures should come as no surprise. China's hosting of the G20 and the Forum on Tax Administration (FTA) in 2016 saw the SAT and China's Ministry of Finance (MOF) take leading roles in driving forward the global tax reforms.

In this, the 6th edition of *China – Looking Ahead*, these recent developments will be examined by KPMG China's tax experts as they explore what the Year of the Rooster may bring for foreign investors in China, and for Chinese MNEs investing overseas. It should be noted, 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.

The first chapter, *BEPS in China – multi-track developments*, breaks down the development of China's cross-border taxation policies and practices into three dimensions. The chapter looks at the steps already taken to embed the 2015 BEPS deliverables into Chinese law, alongside efforts to roll out other global cooperative initiatives, such as the OECD's CRS. It discusses in detail how Chinese enforcement of cross-border tax rules is becoming more vigorous, driven by the exchange of information and the use of big data analysis. At the same time, the chapter also highlights other notable developments, including the first significant tax court cases and the increased use of private tax rulings, which could allow taxpayers to gain greater tax certainty over time. Lastly, the chapter discusses the rapid development of China's external tax policy, looking at the rigorous enforcement of controlled foreign corporation (CFC) rules and how the tax authorities assist Chinese MNEs in their tax disputes overseas through the use of the mutual agreement procedure (MAP). This outline of China's external tax policy is rounded out with a summary of China's efforts to improve its tax treaty network, particularly with the One Belt, One Road project countries, and its assistance to developing countries to improve their tax capacity. This builds on a key commitment among all nations that attended the FTA meeting, held in Beijing in May 2016.

At the core of the BEPS initiative is a radical overhaul of transfer pricing (TP) rules. Another chapter in this guide, *China transfer pricing – first mover on BEPS*, captures the key changes in China's TP regulations during the past year. In 2016, the SAT clarified China's TP documentation requirements and the administrative procedures for advance pricing agreements (APAs), thus implementing China's BEPS TP documentation commitments. At the same time, the new SAT circulars support the use of China's long-standing TP practices. These practices have been successfully embedded by the SAT into the updated BEPS TP guidance in the course of the BEPS process.

Although much attention has been focussed on policy development in the direct tax space, the most significant China tax policy change of 2016 was in indirect taxation, with the transition from BT to VAT being completed.

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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 various government consultation projects about the ongoing VAT reforms.

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).

Through BEPS, China may be increasingly taking a leading role in global direct tax reform, but it may be leading the world to an even more profound extent with the updated VAT rules and administration regime. Other countries may, in time, adopt some of the innovative features from the upgraded Chinese VAT system. In this regard, the chapter, *Post VAT reform in China – what's next?*, sets out a number of key world-leading dimensions of China's new VAT system.

Moving from a policy-led focus to a more practice-driven focus, the chapter, *M&A tax in China – practical challenges*, provides a step-by-step walk through the merger and acquisition (M&A) tax due diligence and structuring processes. It highlights pitfalls for the unwary and offers best practice advice to conclude a successful transaction in the context of heightened enforcement by the Chinese tax authorities.

Increasing tax enforcement effectiveness is indeed the overarching narrative of the chapter *China tax – big data and beyond*. The chapter considers how more efficient and effective tax authority work is being driven by the better use of big data analysis and tax information pooling, in part from overseas exchange of information sources. Improved data analysis is being combined with more effective arrangements for collaboration between tax authorities throughout China, and further supported by initiatives for enhanced taxpayer-tax authority collaboration, such as the One Thousand Enterprises initiative.

The theme of improving tax policies to drive economic transformation, alongside more data-driven and rigorous tax enforcement approaches, is also present in other chapters. The chapter, *IIT in China – moving with the times*, details the new preferential tax regime for staff equity incentives, which is designed to help align management and staff incentives and efforts. At the same time, the chapter details how the authorities are making greater use of data and analytics in IIT enforcement.

Similarly, the chapter, *China Customs – pushing the boundaries*, clarifies how the new framework for cross-border e-commerce into China has been designed to stimulate the further development of China's already burgeoning digital economy. In parallel, the chapter highlights how far more detailed customs reporting, particularly on royalties and related party transactions, and the use of taxpayer risk ratings, are driving more targeted customs enforcement.

Equally, the chapter, *Tax to the aid of innovation and entrepreneurship in China*, details how continued refinements to Chinese innovation incentives are accompanied by increasingly finely tuned compliance requirements.

These chapters are rounded off with a look at developments in specific industries and locations. China's crucial healthcare system reforms, a key focus of the 13th Five Year Plan, and their tax implications are explored in the chapter *Challenges of the two invoices system for China's pharmaceutical industry*.

The chapter, *Hong Kong: A tax boost to the international investment hub*, highlights enhancements to Hong Kong's tax regime through clarifications made on the taxation of reorganisations and the operation of the corporate treasury centre regime. The improvements were made at the same time as Hong Kong made moves to start adopting BEPS changes.

Finally, the chapter, *Taiwan: tax changes towards growth and progress*, looks at how Taiwan is becoming more attractive as an investment hub, with its steady expansion of double tax agreements and a tougher, BEPS-driven, upgrade to its anti-avoidance rules.

On the whole, it can be seen that many of the reforms in the Year of the Monkey involved China getting ready for significant changes in the Year of the Rooster and beyond.

For companies operating in China, the following themes will be explored throughout the chapters:

- The BEPS TP rules and documentation should be largely in place by the end of 2016: how will the new rules work and be applied when the new TP reporting requirements enter into effect from 2017?
- The VAT reforms were rolled out in mid-2016: how will they fare in practice as businesses get used to them in 2017?
- The OECD BEPS multilateral instrument was concluded in November 2016: how will it change China's tax treaty network and what will be the implications for taxpayers?
- The CRS implementation guidance has been issued in draft for public consultation in 2016: when CRS is implemented from 2018, will the Chinese tax authorities be in a position to effectively use the mass of new tax information they receive?
- Big data analysis has been put at the centre of China's new tax enforcement approach, with new systems (e.g. Golden Tax III, etc.) being rolled out in 2016: now that the new systems are in place, what will they be able to achieve in 2017 and beyond?

Quite significantly, 2017 is the Year of the Red Fire Rooster. This means that it will be a period of meaningful advancements that can provide a clear picture of how the future will unfold. Given the rapid pace of developments in China's tax system, this is certainly to be hoped for in the coming year.

Checklist of hot China tax issues for MNEs in 2017

In 2017, multinational enterprises (MNEs) should in particular be alert to the following anticipated China tax developments.

- **Country-by-country reporting (CbCR)** – From 2017 onwards, MNEs around the world will begin filing, and countries will begin exchanging, CbC reports detailing MNE global operations, as envisaged in the OECD Base Erosion and Profit Shifting (BEPS) Action 13 work stream. With this information, the State Administration of Taxation (SAT) and other tax authorities can assess the impact of transfer pricing on an MNE's profitability in each jurisdiction, meaning that taxpayers must be prepared to explain any anomalies in the data presented.

- **Advanced pricing arrangements (APAs)** – From 2017, under newly effective guidance, China APA applications will require more detailed analysis and more thorough preparation work to be conducted at the early stages of the process in order for the APA application to be successful. Consequently, MNEs must adopt a more strategic approach when they consider entering into unilateral, bilateral or multilateral APAs.

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- **Multilateral instrument (MLI)** – In November 2016 more than 100 countries around the world agreed on the final terms of the BEPS Action 15 MLI, providing for simultaneous updates to thousands of bilateral tax treaties around the world to take place in 2017 and subsequent years. The BEPS anti-treaty abuse rules and the expansive new BEPS permanent establishment (PE) definition are expected to be integrated into many of China's existing tax treaties. MNEs must monitor these updates closely and be prepared to update documentation/protocols, and adapt investment and operational structures, where necessary.

- **Common reporting standard (CRS)** – 2018 will see the commencement of the automatic exchange of information (AEOI) by China under the OECD CRS framework. From 2017, China's financial institutions will need, under SAT guidance currently at draft stage, to conduct thorough due diligence and to prepare to fulfil their reporting requirements. Many countries around the world will be already commencing CRS exchanges from 2017 and taxpayers will need to be aware of sharply heightened enforcement going forward.

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- **Scoping merger and acquisition (M&A) tax due diligence (TDD)** – In 2017, M&A investors will continue to need to finely balance their time/budget constraints and increasingly rigorous tax enforcement when scoping TDD. The challenges of the indirect transfer rules in SAT Announcement 7 will continue to be a focus area and timely transaction reporting, as well as the negotiation of indemnities/escrow arrangements, will be key.

- **Preserving tax treaty benefits** – Anticipated BEPS updates to China's anti-treaty abuse rules in 2017, and ongoing administrative challenges in obtaining tax treaty relief, mean that investors into China will need to proactively manage risks of denied treaty relief under legacy investment structures. Resource needs to be committed to developing arguable positions to support the commercial rationale of existing structures, and to strategically align commercial substance in holding entities with treaty access requirements.

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- **VAT, data and analytics** – Electronic invoicing is expected to become more widespread in 2017 as further enhancements are made to the Golden Tax System. Businesses will embrace tax technology with increased usage of data and analytic tools for VAT to assist in managing compliance and risk.

- **Increasing VAT enforcement rigour** – While clarifications and refinements to the new VAT rules will be a regular feature during 2017, the tax authorities will simultaneously be strengthening their enforcement efforts. This will leave many businesses exposed because, despite their best efforts, the time period for implementation of the VAT reforms was too short and errors occurred. Businesses will need to manage risk in a complex environment where tax authority interpretations at a local level may conflict, and interpretations may remain unclear.

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- **Customs scrutiny for related-party transactions (RPTs) and royalties** – New customs declaration forms for RPTs and royalties, together with the linking of customs inspections to customs credit ratings and the formalisation of voluntary disclosure practices under the new Customs Audit Regulations, will demand careful management of customs challenges in 2017.

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- **Research and development (R&D) super deduction rule changes** – In 2017, taxpayers must consider whether they: (i) fall into the 'negative list' exclusion, (ii) can gain additional benefits under the expanded eligible scope, and (iii) are up-to-date with the streamlined 'self-assessment' registration process.

- **High and new-technology enterprise (HNTE) opportunities** – In 2017, taxpayers must consider whether the enterprise: (i) owns the intellectual property (IP) that technically plays a core role in relation to its main products (services), (ii) falls into the updated HNTE 'positive list' categories, (iii) meets the new innovation ability assessment criteria scorecard, and (iv) is ready for the new annual documentation submission procedures.

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- **Tax management technology solutions** – In 2017, the Chinese tax authorities will use ever more IT technology to identify risks and monitor the tax compliance of the taxpayers. Consequently, large enterprises in China will deploy, to an ever greater extent, tax administration and risk management IT solutions to standardise tax work flows and control procedures, with a view to mitigating risks and improving overall efficiency.

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- **Individual income tax (IIT) audit and investigation** – In 2017, the Chinese tax authorities will make greater use of big data analysis on information collected through the enhanced online tax filing system and conduct more frequent and in-depth tax audits. This will require employers to ensure that mechanisms and systems, to vouchsafe employee tax compliance, are properly implemented. Individuals should ensure that in light of the CRS roll-out they play an active role in managing their personal tax affairs and seek professional advice where necessary.

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BEPS in China – multi-track developments

China's progress in rolling out the 2015 BEPS recommendations, key cross-border tax enforcement trends in 2016, and the development of China's external tax policy are the focus of this chapter by Khoonming Ho, Chris Xing, Lilly Li and Conrad Turley.

Introduction

Over the past few years, the international tax chapter of this guide has looked in-depth at the 15 action items under the G20/OECD BEPS Action Plan, and their outputs, which were finalised in October 2015. This chapter details the Chinese State Administration of Taxation's (SAT) initial moves to roll out a number of these action items in proposed new Chinese rules and guidance.

In contrast to the extremely active tax policy agenda of 2015, the Chinese authorities have, so far this year, issued relatively fewer new cross-border direct tax rules than many people expected. Nevertheless, there has been no let-up in the rigorous enforcement of China's cross-border direct tax rules. China served as host of both the G20 and the OECD Forum on Tax Administration (FTA) in 2016, and this has driven the significant strides made by China in defining and advancing its external tax policy in the course of the year. We foresee that the relative lull in the issuance of new cross-border direct tax rules and guidance is solely temporary in nature. A raft of new rules is set to be released over the next year.

This chapter looks at this year's BEPS developments in three parts:

1) The latest state of play with China's 'localisation' of domestic rules in relation to BEPS and other OECD tax initiatives;
2) The key enforcement trends in the application of China's cross-border tax rules. This includes the rigorous policing of the treaty shopping and permanent establishment (PE) rules, and increased use of the exchange of information (EOI) and big data to target tax audits; and
3) The rapid development of Chinese external tax policy. In this regard, tax assistance to outbound investing enterprises, and an emerging One Belt, One Road-focused external tax policy, sit alongside more rigorous tax enforcement for Chinese multinationals enterprises (MNEs).

China's localisation of BEPS and other OECD initiatives

In the lead up to the 5th edition of this publication and during the course of 2015, the SAT had issued a large number of new and proposed cross-border tax rules. These included new double tax agreement (DTA) relief administrative rules, new offshore indirect disposal rules, as well as a new general-anti avoidance rule (GAAR) administrative measures.

In September 2015, the SAT issued a public discussion draft of the circular on special tax adjustments, proposing updates to controlled foreign corporations (CFC) rules, thin capitalisation rules, GAAR interpretation rules and, most importantly, setting out how China proposed to localise the BEPS transfer pricing (TP) rules and BEPS TP documentation requirements.

This occurred alongside a general update to many of China's key tax treaties, particularly with major EU jurisdictions, to include upgraded anti-abuse measures and exchange of information (EOI) rules. It also occurred alongside China's commitment to the global EOI initiatives, for example China's adherence to the common reporting standard (CRS) multilateral competent authority agreement (MCAA), which China signed up to in December 2015.

China's upgrades to its tax rules and international agreements were also accompanied by generally heightened enforcement of China's cross-border tax rules. This included tax matters that had already been under intense scrutiny for many years, such as the DTA relief, indirect transfers, as well as fields of tax policy seeing a new level of enforcement focus, such as CFC rules and deductions for outbound royalty/service payments, among others.

While 2016 saw a deceleration in the issuance of new SAT rules and guidance, and the revamping of several pieces of guidance proposed in 2015, there was an emergence during the year of a new collaborative approach between the Ministry of Finance (MOF) and the SAT on formulating cross-border tax rules. With the new collaborative arrangement now in place, the pace of finalising the rules picked up again in the second half of 2016.

This chapter runs, briefly, through the BEPS actions which have a relevance for China, apart from Actions 11 and 12 which do not have significant implications for China and are not detailed here.

Digital economy (Action 1)

China has not, so far, indicated an intent to introduce any novel digital economy corporate income tax (CIT) nexus rules. This is in contrast to other countries, such as India, Israel, or Saudi Arabia.

However, with Circular 18 (2016), released jointly by the MOF, SAT and the General Administration of Customs (GAC) in March 2016, China has adopted the recommendations in the BEPS Action 1 report to leverage online shopping platforms and express couriers to collect indirect taxes (as well as customs duty) on cross-border inbound e-commerce transactions. See the chapter, *China Customs – pushing the boundaries*, for further details.

At the same time, the OECD's VAT recommendations on digital imports have not yet been adopted by China. This is in contrast to the wide adoption of these proposals across other countries, such as EU member states, Australia, and South Korea.

A host of direct and indirect issues will need to be resolved in the future for those new China business models that are seeing explosive cross-border growth, such as cloud services and mobile payment services. See the chapter, *Post VAT reform in China – what's next?*, for further insights.

Hybrid mismatches (Action 2)

The OECD have supplemented their 2015 hybrid mismatch recommendations with additional proposed rules on branch mismatches, issued as a discussion draft in August 2016. Looking at the uptake of the OECD proposals across countries, the UK and Australia, for instance, have already legislated for rollout of the OECD's proposed hybrid rules. The EU Anti-Tax Avoidance Directive would see an EU-wide roll out of hybrid rules, though the precise provisions have yet to be clarified. While the SAT had earlier signalled an interest in rolling out anti-hybrid mismatch rules in China by late 2016, no firm details on this, or on China's position in relation to the branch mismatch rules, are as yet available.

CFC rules (Action 3)

China's proposed revamped CFC rules, contained in the 2015 draft special tax adjustments circular, have not yet been finalised because the content of that circular has been revised and is now being progressively issued as a series of separate circulars.

It is anticipated that CFC rules will be issued sometime in 2017, but the final form that these rules may take is as yet unknown.

Interest deductions (Action 4)

China has not expressed any intention of implementing the recommended BEPS rule that links interest deduction limitations to earnings before interest, tax, depreciation and amortisation (EBITDA).

Harmful tax practices (Action 5)

The SAT Announcement 64 (2016) on advance pricing agreements (APAs) puts taxpayers on notice that their APAs will be subject to spontaneous, compulsory exchange with other countries' tax authorities in line with the BEPS Action 5 requirements. See the chapter, *China transfer pricing – first mover on BEPS*, for further detail.

Treaty abuse (Action 6)

Recent DTAs entered into by China, including the new DTA with Chile that was signed in May 2015, and the updated Russia treaty, which entered into force in April 2016, have included limitation on benefits (LOB) provisions based on the Action 6 recommendations.

The Chile treaty went even further, adopting the Action 6 principal purposes test (PPT) and triangular PE rules. However, other treaties signed by China since late 2015 (for example, Zimbabwe and Romania) and protocols to existing treaties (for example, Bahrain, Macau, and Pakistan) have not sought to implement the Action 6 proposals.

China has committed to adopting Action 6 anti-abuse rules in its DTAs as a BEPS minimum standard and may look to achieve this through the Action 15 multilateral instrument (MLI). The MLI was finalised by the OECD in November 2016 and, up until the formal signing in June 2017, countries around the world, including China, will be considering which DTAs to nominate for update through the MLI.

At the time of writing, it is not yet apparent which of the Action 6 rules China will adopt through the MLI, and which of China's DTAs will ultimately be affected.

PE (Action 7)

China was quick to initiate the adoption of the new BEPS PE standard. The DTA with Chile even included the draft BEPS PE language before it was finalised by the OECD in October 2015. Since then, however, none of China's new DTAs, or new protocols that amend existing DTAs, have adopted the BEPS PE wording. The SAT had earlier indicated interest in the adoption of the BEPS PE standards. However, with the MLI having made adoption of the BEPS PE rules voluntary, China is likely to consider the positions taken by other major countries on adoption before making any decision itself.

Two key adoption patterns stand out:

- The Inclusive Framework for BEPS implementation, which was inaugurated in June 2016, has expanded the number of jurisdictions making BEPS commitments to 85, with a further 19 to sign up by the end of 2016. Most importantly for China, these include Singapore and Hong Kong. Popular OECD "hub" countries (e.g. Luxembourg, Netherlands, and Ireland) were already committed to the BEPS updates. This means that, if all of these jurisdictions and China were to opt for the BEPS PE DTA updates through the MLI, then the main platforms for investing into/operating cross-border into China would all, in principle, incorporate the new BEPS PE wording in their DTAs with China;
- However, it is understood that many significant countries (e.g. US and Germany) are lukewarm on the BEPS PE changes. The OECD has consequently built a degree of flexibility into the MLI, allowing countries to forego adopting part or all of the BEPS PE wording. As such, it could eventuate that some of China's DTAs are (partly/fully) updated for the BEPS PE changes through the MLI, while others are not. This would clearly have an impact on the manner in which cross-border operations and investments into China are structured in the future, and the jurisdictions from which they are structured. Ultimately, whether this situation arises would depend, in the first instance, on whether China itself opts for the BEPS PE changes.

The OECD is working on updated PE profit attribution guidance and a draft was issued in July 2016. It may be that this work will not be concluded until after the DTA BEPS PE changes have been made through the MLI. In light of the potential for PE challenges to proliferate globally as a consequence of the BEPS PE changes, PE profit attribution is a pressing concern. This is certainly true for China where a deemed profits approach is generally used for PE income attribution. Officials at the SAT have repeatedly indicated a determination to continue applying the deemed profit approaches, but it remains to be seen how far China is willing to move in the direction of the authorised OECD approach (AOA) to PE profit attribution, when it issues anticipated revised PE profit attribution guidance.

Indeed the risks of PE for enterprises operating in China, and the degree to which business and investment structures will need to be adapted, will only become apparent when the SAT issues its guidance on PE recognition and profit attribution, which is expected in 2017, and the enforcement approaches taken by the authorities in practice begin to be observed.

TP (Actions 8, 9, 10, 13)

A detailed overview of China's TP developments and their inter-relationship with the OECD's TP work under the BEPS project is provided in the chapter, *China transfer pricing – first mover on BEPS*.

In short, the comprehensive TP guidance in the special tax adjustments SAT draft circular of September 2015 has been set aside in favour of a series of TP-related circulars. At the time of writing, these include:

- SAT Announcement 42 (2016), providing guidance on TP documentation; and
- SAT Announcement 64 (2016), providing administrative guidance on APAs.

Both of these measures are strongly informed by the BEPS TP work. The TP documentation follows the BEPS Action 13 master file, local file and CBC reporting structure. BEPS Action 14 on improving dispute resolution highlights the importance of APAs to mitigate disputes in the first instance. In line with this, China's new APA guidance, along with a planned increase in the number of staff at the SAT focused on APAs and MAP, shows China's proactive approach to limiting and resolving disputes.

At the same time, the new China guidance is strongly influenced by long-standing priorities in China's TP approach. The China local file requirements are more expansive than the OECD's recommendations. It demands that a Chinese entity that is part of a MNE group includes a value chain analysis in its local file. This is to provide quantitative details on the profits attributed to group entities in each country into which the China-relevant MNE value chain(s) extend. This, together with a required analysis of the contribution of China location specific advantages (LSAs) to group profit generation, provides fuel for China's existing TP practices. China's well known TP approach pushes for profit adjustments for China-based MNE group entities based on the creation of local intangibles and contributions to the value of group intangibles, and based on the contribution of LSAs. It might be noted that China successfully pushed for amendments to the OECD TP guidance in the course of BEPS Actions 8-10 work to lend support to its existing practices.

In addition, the new Chinese TP documentation guidance significantly bulks up the related party transaction filing forms with much greater detail on cross-border payments and on their tax treatment in recipient countries. This provides strong support to the Chinese tax authority's ongoing campaign to challenge tax deductions on outbound related party payments of royalties and service fees. These bulked up filings sit alongside the additional data being derived by the Chinese tax authorities through new national and international EOI initiatives, which are discussed below.

The new China APA guidance lends further support to these special Chinese TP approaches. Preferential admission into the APA programme is given to taxpayers who provide in-depth value chain analysis and who give full consideration to the contribution of LSAs to value creation. The APA guidance also gives a neat illustration of how the SAT is putting its new taxpayer risk-targeted enforcement approach at the centre of its tax administrative efforts. Only taxpayers with an "A" rating under the SAT's taxpayer credit rating system are granted access to the APA programme. See the chapter, *China tax – big data and beyond*, for further insight on how the taxpayer rating system is also being linked to various other tax and administrative incentives and treatments.

As at the time of writing, the highly anticipated SAT circular on TP adjustments, which would roll out the BEPS guidance on intangible asset transactions into Chinese guidance, had not been published. China's ultimate position on the BEPS work on risk and intangibles in Actions 8-10 and its position on the OECD work on profit splits, will have a major impact on how Chinese TP rules interact with those of other countries. It will therefore be crucial in framing the extent to which MNEs in China can successfully manage their TP risks.

Improving dispute resolution (Action 14)

As the host of the 10th annual plenary meeting of the OECD FTA in May 2016, the SAT played a key role in pushing forward the establishment of the Action 14 peer review mechanism. Under this, the FTA MAP Forum will review the fulfilment by countries, including China, of the 17 minimum standard commitments contained in Action 14.

On October 20 2016, the OECD publicly issued the relevant framework documents for the launch of peer review. As noted above, China's revised APA guidance and the ramp up of the APA/MAP staffing resources makes a major contribution from the Chinese side to the Action 14 agenda.

MLI (Action 15)

China worked closely with more than 100 countries on developing the MLI, which was finalised and released by the OECD in November 2016. As noted above this may see updates to China's DTAs with many treaty partners in relation to treaty anti-abuse and PE provisions, and the upgrade of DTA MAP articles. The MLI also allows for the insertion, into Chinese DTAs, of a new transparency clause in relation to the tax treatment of non-residents including partnerships, trusts, etc., which give rise to uncertainties in practice.

The MLI is a highly complex document which allows a great deal of flexibility and options to the participants in relation to how they wish to update their DTAs. Jurisdictions nominate the participants in the MLI, with which they wish to make DTA updates. After that they indicate preferences, from a closed set of alternatives, in respect of each of the update matters (i.e. treaty abuse, PE, hybrids, MAP), and set out the manner in which they wish to make the DTA updates.

A complex "matching" process then follows. If jurisdictions have made the same preference selections then updates are made in that manner; if jurisdictions have chosen differing options then special resolution rules and procedures take effect to determine if an update happens at all, and what form it takes.

In the run up to the formal MLI signing date in June 2017 there is likely to be intensive activity amongst national tax policymakers, across countries, to determine which updates they want to make. This would probably be accompanied by consultation/negotiation with their counterparts in other countries to find out, and influence, what the end effect of their selections will be. For China, as for other countries, the next six months will consequently be a crucial period in determining the new architecture of China's DTA network.

EOI initiatives

Apart from China's BEPS collaboration, China is also preparing for the launch of the automatic exchange of information (AEOI) platform under the OECD's CRS programme from 2018. As noted above, China signed the CRS MCAA in December 2015 to facilitate these exchanges, but China still needs to identify with which of the other 84 CRS MCAA signatories it wishes to exchange information.

On October 14 2016, the SAT took a major step when it opened a public consultation on a discussion draft setting out China's CRS implementation measures, entitled "Administrative Measures on Due Diligence of Tax-related Financial Account Information of Non-residents".

The draft sets out details of the financial account information to be reported by financial institutions to the Chinese authorities for exchange with other countries. It also sets out the details and timeframes for the due diligence to be conducted by these institutions up to the end of 2017. It is notable that it was at the Beijing FTA meeting in May that the concrete basis for CRS, the common transmission system (CTS) was unveiled.

The activation of CRS from 2018 promises a sea-change in the effectiveness of Chinese tax enforcement. EOI through CRS sits alongside:

- China's commitment to FATCA with the US;
- China's commitment to CBC exchanges through the CBC MCAA (signed by China at the Beijing FTA meeting);
- Tax intelligence sharing through JITSIC (the reform of which was announced at the Beijing FTA meeting);
- Tax information exchange agreements (TIEAs) with the 10 main China-relevant offshore centres; and
- Ongoing upgrades of EOI articles in China's DTAs in line with the 2005 OECD standard.

Information obtained through these channels is starting to be put to effective use, as discussed in our look at 2015/16 China tax enforcement cases. See further information below.

Enforcement of cross-border taxation is leveraging information exchange and big data

While the SAT may have issued relatively fewer new circulars with a direct tax impact in the year to-date in 2016, there has been a continued increase in the intensity with which existing Chinese cross-border tax rules are enforced.

Offshore indirect transfer cases, which can be subject to tax pursuant to SAT Announcement 7 (2015), continue to be a key enforcement focus area in 2016, and further detail is supplied in the chapter, *M&A tax in China – practical challenges*.

In addition, there have also been a multitude of cases in the TP space. Particularly noteworthy is the continuing national campaign, which started in 2014, that challenges tax deductions for outbound royalty and service payments. This is discussed in more detail in the chapter, *China transfer pricing – first mover on BEPS*.

In this chapter we highlight the key DTA and PE cases that should be noted, as well as cases where EOI and big data have driven enforcement efforts during the year.

Treaty abuse cases

Following the entry into effect of new DTA relief administrative procedures in November 2015 with SAT Announcement 60 (2015), the tax authorities have maintained a strong focus on treaty shopping throughout 2016.

The new procedures abolished the previous tax authority pre-approval system for treaty relief. They replaced it with a system under which withholding tax (WHT) agents would, on receipt of completed forms and supporting materials from a non-resident and following a cursory review, withhold tax in line with the DTA WHT rates and file the relevant documentation with the tax authorities. The tax authorities would then examine the information in the filings and use follow up procedures to claw back the DTA relief if they considered it to be inappropriate or abusive. This is part of the broader move by the Chinese administrative authorities away from cumbersome pre-approvals towards more data-driven, targeted follow up audit procedures. Although this trend extends beyond the tax sphere, the tax element is discussed in further detail in the chapter, *China tax – big data and beyond*.

The roll out of the new approach across China has been uneven in some cases, causing complications in obtaining relief in certain localities. At the same time, certain overseas jurisdictions, popularly used to establish holding structures to invest into China (e.g. Hong Kong), have become more conservative in issuing tax residence certificates, which is complicating the DTA relief process in China. This is further discussed in the chapter, *M&A tax in China – practical challenges*.

PE enforcement cases

Another keenly observed enforcement area is PE. The SAT has stated on numerous occasions that it would boost its PE enforcement, most notably in the October 2015 SAT seminar where the Chinese versions of the 2015 BEPS reports were released. The SAT indicated that national systems for information exchange and data analysis would play a key role in the identification and targeting of PE cases. Given the widened scope of agency PE in the BEPS work and the fact that Chinese enforcement of agency PE has, in general, not been overly aggressive in the past, taxpayers have focused their attentions on enhanced agency PE risk. Foreign enterprises have accordingly been contemplating adjustments to their cross-border sales and procurement structures into China to limit agency PE exposures. However, in 2016 the more notable publicised PE cases were in the historically already vigorously enforced service PE space.

A notable service PE case, publicised by the SAT on their WeChat news feed in August 2016, which has become one of the key channels for public communication by the Chinese tax authorities, involved the simultaneous assertion by the authorities of 19 separate service PEs. As is typical for Chinese tax enforcement cases, the information available on the technical aspects of the case is limited because the main source of publicly disclosed details is generally the media or the tax authorities themselves. It appears that between 2009 and 2014 a foreign enterprise dispatched numerous staff to China to work on separate projects to provide various technical guidance and after-sale services. The relevant DTA with the country of the foreign enterprise required the presence of staff on a given service project to exceed 183 days for service PE to be asserted. Leveraging this, the tax authorities took the position that the various staff activities in China collectively constituted the same or connected projects, and that the time threshold had been exceeded.

Service PE has long been a problematic area for foreign enterprises active in China. Since 2009 there has been a national campaign to investigate and assert service PEs arising from secondments of staff into China. SAT Announcement

19 (2013) provided detailed guidance that allowed for these risks to be better managed. However, as is clear from the 2016 PE case, the tax authorities are becoming more effective at monitoring and aggregating the short term presence of visiting staff in China for asserting service PE. Looking ahead, a greater number of PEs are expected to be asserted due to greater coordination of geographically separate tax authorities in China among themselves, including sharing of intelligence, joint investigations and enforcement.

A notable policy development that may have a further impact in this space in future is the BEPS PE contract splitting rule. Intended by the OECD to deal with the splitting of construction projects into separate contracts to fall under the construction PE time threshold, this rule aggregates the time spent by the staff of separate foreign and domestic entities on a given construction project to determine whether the time threshold has been exceeded. The China-Chile DTA of May 2015 modified this rule so that it could be used in relation to service PE. If China chose to introduce this novel rule across its DTA network through the MLI then this would lead to a significant heightening of China service PE risk.

A further notable China service PE matter relates to digital cross-border service supplies. In 2013, at a meeting of the UN committee of tax experts, which maintains the UN model tax convention (MTC), China and India collectively put forward the novel concept that service PE might be asserted even where there are no staff in the country of a customer. This reasoning was based on the wording of the service PE provision, which asserts that a PE exists where services are "furnished within the source state", and this could occur digitally without a local physical presence. While China and India did not push this concept further at the time, in 2015 Saudi Arabia and Kuwait explicitly introduced this very concept into law. As noted above, China has not yet signalled an intent to roll out any novel CIT nexus concepts for digital economy businesses, but given China's role as a progenitor of this concept, this matter merits continued monitoring.

As can readily be seen, service PE in China is a field rich in current and potential future developments, quite apart from the increase in agency PE risk and fixed PE risk anticipated with the forthcoming roll out of the BEPS PE changes.

EOI and big data

What comes through in many of the tax enforcement cases publicised in 2016, is the increasing use of EOI, big data, and taxpayer risk ratings to drive more targeted audit activity. The tax authorities' extensive use of WeChat to publicise these cases also makes clear that the authorities wish to notify taxpayers that these tools are being used to tackle aggressive tax practices and avoidance. China's adherence to ever more international multilateral and bilateral initiatives for information exchange has been highlighted above. Information obtained through these channels is being pooled with information obtained by tax authorities around China, both by local and state tax bureaus and other government bodies such as forex authorities, administrations of industry and commerce, etc., using new national data systems. For example, EOI cases highlighted in a publication issued in October 2015 by the SAT's international tax department include the following:

- An investigation concluded in 2013 of a Chinese company paying service fees to a foreign related party. Documentation supporting the fees was considered insufficient to properly evidence whether the service fee was excessive when compared to the substance of the services in question. The EOI was initiated to obtain foreign tax authority information on the service fee and adjust downwards the tax deduction;
- An investigation concluded in 2014 of a Chinese company buying machine tools from a foreign related party. It was suspected that the company had overpaid for the equipment and was claiming excessive tax depreciation. The EOI with the foreign tax authority helped to confirm this with details of the original cost of the machine tools; and

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- An investigation of a China representative office whose procurement activities exceeded the preparatory and auxiliary threshold protected from PE challenge under the relevant tax treaty. The EOI provided the Chinese authorities with the information required to assert a PE.

The improvements in the mechanisms and systems for using the EOI and big data are explored further in the chapter, *China tax – big data and beyond*.

Certainty for cross-border tax – increasing court cases and advance rulings

Historically, the courts system has played a very minor role in the interpretation of Chinese tax law and in the resolution of tax disputes. Courts did make decisions on procedural tax matters, but the courts generally declined to opine on the substantive meaning of tax law provisions, considering that the SAT was the more appropriate authority in this regard. Furthermore, taxpayers were generally reluctant to take matters to court because they were keen to preserve good relations with local tax authorities and resolve matters through negotiation. However, recent years have seen a greater formalisation of local tax authority work due to reforms in how taxpayers are selected for audit, and greater higher level tax authority scrutiny of procedural compliance by local tax authorities and their retention of complete on-file documentation. Against this backdrop of greater formality, and the monetary significance of some of the cross-border tax issues coming to a head, taxpayers have become more willing to open formal review procedures for cases, even to the extent of going to court.

Several tax court cases that were concluded in late 2015 were publicised in 2016. *The Children's Investment (TCI) fund* case, heard by the Zhejiang Province People's High Court in December 2015, which followed on from earlier lower court hearings, was the first case in China concerning the application of the GAAR to an indirect offshore transfer of a China investment by a UK managed investment fund – the decision was ultimately in favour of the tax authorities. The second case related to the application of the CIT reorganisation relief provisions to a cross-border restructuring of the China investment arrangements of Illva Saronno Holding SPA. The Shandong Province Zhifu District People's Court decided on the case in December 2015, with the decision in favour of the tax authorities. A further decision, made by the Guangdong Province People's Intermediate Court in November 2015, was the first case in China to deal with the IIT implications of dual employment arrangements into China. The case, involving a US tax resident and concerning the interpretation of the China-US DTA, was decided in favour of the tax authorities.

While the decisions in these cases ultimately went against the taxpayers in question, this emerging new trend for tax cases to be brought to court has the potential to bolster taxpayer certainty with cross-border transactions. Over time, this should generate court interpretations that were previously lacking in Chinese tax law. It should also provide a path for taxpayers to resolve disputes in individual cases beyond informal negotiations with the tax authorities.

In relation to obtaining greater certainty for taxpayers on cross-border transactions, another emerging trend is for tax authorities to grant private tax rulings on cross-border transactions. In November 2015, a municipal state tax bureau in the Jiangsu province issued a private tax ruling, in relation to the application of reorganisation relief on the merger of two non-resident holding companies that involved a change in the registered owner of equity in a Chinese enterprise. The extension of private tax rulings to cross-border transactions (local tax authorities have, with SAT encouragement, been granting these to purely domestic transactions for several years) is important in the context of the 2015 abolition of tax authority pre-approvals for most transactions. A greater expansion of private tax rulings is envisaged from 2017 when the new Tax Collection and Administration Law, which includes specific provisions on rulings, is expected to be finalised. These court and administrative developments, which enhance taxpayer certainty for cross-border transactions, are explored further in the chapter *China tax – big data and beyond*.

Rapid development in China's external tax policy

In the first six months of 2016 China's outbound direct investment amounted to $99 billion. This was a 50% increase on the year before. For the year as a whole a total of $170 billion is anticipated, a historic high that would significant outstrip foreign direct investment into China for the year. In tandem with this, 2016 saw further significant advances in the development of China's outbound investment tax policy. There are three dimensions to this policy:

- China has been taking steps to increase its scrutiny of Chinese enterprises and individuals investing overseas, and to enforce tax more effectively;
- At the same time, tax policy and administration has sought to encourage and support outbound investment, in particular along the One Belt, One Road; and
- These initiatives dovetail with China's increased engagement with G20 nations and the OECD on initiatives to build tax capacity in less developed countries.

Increased tax enforcement rigour in relation to outbound investment

With regard to enforcement, and as discussed in last year's edition, in 2015 extensive publicity was given to the first reported applications of the Chinese CFC rules in the Shandong and Hainan cases. Both of these cases involved the disposal of equity in Chinese enterprises by Chinese investors through the interposition of layers of offshore companies to enable offshore disposals. These cases, focusing as they did on "round-tripping" arrangements, did not really involve a departure from the historic focus of the Chinese tax authorities on Chinese tax base erosion in inbound investment cases – enforcement in these cases could also conceivably have been by way of the inbound investment-focused indirect disposal rules.

However, 2016 saw crucial advances on this position, with reports being released of truly "outbound"-focused CFC enforcement cases. A case pursued by Urumqi STB in the Xinjiang province (and concluded in 2015) involved a local company that established an overseas subsidiary in a low tax jurisdiction. The overseas subsidiary received largely passive income and the authorities concluded that it did not have a reasonable commercial need to defer repatriation of its earnings to China, which is the principal let-out under the Chinese CFC rules. The CFC rules were applied and the company was charged RMB 2.7 million ($390,000) in taxes, plus penalties and interest. Such cases are likely to make Chinese outbound investing companies that are entering into new markets more cautious about how they manage their operations to ensure they do not to fall foul of the CFC rules.

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The Chinese tax residency rules could equally be used to tax outbound investing Chinese companies. However, the reported cases have focused on tackling base erosion in relation to inbound investment, which has been the traditional focus of the Chinese tax authorities. The noted cases involved the Chinese tax residence rules being used by the tax authorities to bring foreign incorporated listing vehicles for Chinese enterprises into the tax net as tax residents. This was in order to tax foreign companies investing in these listing vehicles on their China sourced gains.

These cases included a 2011 case concerning Vodafone's sale of a stake in China Mobile's Cayman-incorporated, Hong Kong-listed holding company for Chinese operating companies, and a further 2013 case involving the sale by a US private equity fund of, similarly, a stake in a Cayman-incorporated, Hong Kong-listed holding company for Chinese operating companies. In both cases the Chinese tax authorities asserted that the Cayman companies were

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Chinese tax residents on the basis that effective management was exercised from China. The enforcement action was taken to ensure foreign investors did not avoid taxation in China when exiting from Chinese investments. Looking ahead, as with the new *Urumqi* case for CFC rules, it is anticipated that the Chinese tax residence rules will be used more vigorously to tax genuine outbound investment.

The various new international EOI initiatives entered into by China, together with the 2014 enhancements to CFC reporting in SAT Announcement 38 (2014), and the commencement of CbCR from 2018, mean that outbound investment will be under tax authority scrutiny like never before.

China tax policy promotes outbound investment

The more notable tax policy developments in 2015 and 2016 have been focused on facilitating outbound investment. The SAT has instructed tax authorities at all levels to promote understanding among taxpayers of the benefits of DTAs and to encourage outbound investors to consider putting a bilateral APA in place. Nationwide promotional campaigns in relation to tax administration support for enterprises investing along the One Belt, One Road have been run, and a special tax authority hotline (12366) service has been established to provide guidance on outbound investment tax issues. In addition, a range of detailed tax guides on foreign tax systems, and tax issues typically encountered overseas by Chinese enterprises, have been published by the authorities.

A trend has also emerged for China to enter into particularly preferential tax treaties with jurisdictions along the One Belt, One Road. On August 8 2016, China signed a new tax treaty with Romania that will offer some of the best WHT rates to-date in a Chinese tax treaty. Dividends, interest and royalties are all subject to a 3% WHT rate, while a 0% WHT rate is available for dividends and interest in certain cases. The DTA provision on capital gains is also preferential in comparison to most other Chinese tax treaties.

While Romania is a relatively minor trading partner for China, the signing of the new Romania treaty comes hot on the heels of the entry into force of the new China-Russia treaty, which itself is among the most attractive Chinese treaties, with a 0% WHT rate on interest.

This new generation of tax treaties are significantly more beneficial than the previous 'bests', such as China's tax arrangements with Hong Kong and Singapore. Whether this heralds a new approach underpinning Chinese tax treaty policy going forward, with a preferential leaning towards countries along the Belt and Road, remains to be seen.

In addition, real assistance is being provided by the SAT to Chinese companies encountering tax issues abroad. In line with the SAT's efforts to raise awareness of the assistance that can be rendered to outbound investing companies, MAP cases have been reported with ever increasing frequency throughout 2015 and 2016. However, the details tend to be somewhat limited, being whatever the tax authorities are willing to disclose. For example:

- In a case publicised in June 2015 on the SAT official website, a Yantai City, Shandong province-based, listed company was refused royalties WHT relief under the China-Kazakh DTA. The WHT, imposed at a domestic rate of 20%, had been applied to payments made by a Kazakh subsidiary of Yantai Jierui Petroleum Services Joint Stock Company in respect of the lease from the Chinese parent to the subsidiary of certain equipment. The SAT reported that after the MAP process was initiated by the Yantai company with the Yantai STB, who elevated the matter so that discussions took place between the SAT and their Kazakh counterparts, the DTA WHT rate of 10% was ultimately secured. The SAT reported that a tax refund amounting to RMB 1.5 million was achieved;
- In a case publicised in August 2016 on the Beijing STB website, an overseas subsidiary of a Chinese enterprise had

been denied DTA WHT relief on an interest payment made on a loan received from the China Development Bank (CDB). The foreign tax authority focused on the DTA provision which indicated that loans guaranteed by a foreign government could benefit from a 0% WHT rate on interest and disputed that the loan met the terms of the DTA. The Chinese enterprise's position, supported by the SAT in the MAP discussions, was that as CDB was a wholly-owned Chinese government institution and therefore a separate provision of the DTA should in any case grant DTA relief. When the case was concluded in the Chinese enterprise's favour in February 2015 it had taken just 36 days to be resolved and a tax reduction of in excess of $5 million was secured;

- A further 2015 MAP case highlighted by Beijing STB on its website involved a dispute over the attribution of profits to a PE of a Chinese enterprise in a treaty partner state. The Chinese enterprise had entered into a contract for the design and construction of, and related procurement associated with, a power plant project in the treaty partner state. A local project office established by the Chinese enterprise to facilitate the project work, overseeing supplies and conducting certain service activities, constituted a local PE. The dispute related to the attribution of profits to the PE by the local tax authorities. The Chinese enterprise argued that the activities associated with the supply of equipment occurred wholly in China and not in the country of the power plant project and that, consequently, no profits from the supply of equipment should be attributed to the PE. The Chinese enterprise initiated the MAP and the case was resolved by the SAT with their overseas counterpart, with the latter agreeing that the equipment supply profits should not be attributed to the local PE, achieving a tax saving of RMB 10 million; and
- Another case publicised in June 2015 on the SAT's website involved a MAP case with India. Shandong Electric Power Construction Corporation was engaged in a number of power plant construction projects under contracts with the Indian government, some of which were contracts with local Indian entities of the Chinese group and some of which were contracts with the Chinese company itself. The Indian tax authorities sought to treat the contracts collectively, resulting in an additional 2013 tax demand of $38 million. While the SAT has made efforts to resolve the matter through the MAP, the case was reported as being complex and not yet resolved as at the time of the SAT's web posting.

The rapid growth trends for Chinese outbound investments and overseas economic activity are already seeing Chinese enterprises engaged in an increasing number of high profile tax disputes overseas, many of which have ended up in foreign courts. For example, in 2016 in India, ZTE faced a challenge over PE profit attribution for its telecommunication equipment supplies (*ZTE Corporation v ADIT, ITA 5870/Del/12 & ors)*. Zhenhua Port Machinery faced a PE recognition challenge in relation to a port construction project in *Gujarat Pipavav Port Limited v. ITO* (ITA No. 7878/Mum/2010). Haier, Shanghai Electric, Huawei and Dongfang Electric have similarly all been engaged in high profile Indian tax disputes. This is in India alone, but with Chinese investment ranging over the whole world the tax complexity to be managed is becoming immense.

In the context of the broad upswing in outbound activity associated with the Belt and Road initiative, reliance by Chinese enterprises on APAs and the MAP will become ever greater. Furthermore, Chinese MNEs are buying into existing overseas structures with acquisitions of groups in Europe and elsewhere. The BEPS tax changes overseas will invalidate many of the existing structures, demanding restructuring and potentially entangling Chinese MNEs in further overseas tax disputes in the future. China's overseas investments and operations will also demand, reciprocally, a clarification of Chinese tax law in relation to foreign tax credits.

China's tax capacity in building assistance to developing countries

A third leg of China's outbound tax policy relates to providing enhanced tax capacity building assistance to developing countries. The May 2016 FTA meeting in Beijing moved forward with global initiatives in this space by establishing a Knowledge Sharing Platform and a Capacity Building Network to coordinate assistance from multiple international organisations and national governments to developing countries. Progress on toolkits to guide developing countries in upgrading their cross-border tax rules, which are being developed by the OECD, IMF, UN and World Bank in light of BEPS, was also outlined at the Beijing FTA meeting.

Interlinking with these initiatives, China has implemented 12 bilateral and multilateral cooperation programmes with developing countries, particularly those along the Belt and Road. Under these, the SAT has been providing tax training courses, expert support, experience sharing and technical assistance in building tax capacity. In this regard, workshops on tax administration and taxpayer service were provided to 82 tax officials from 18 African, Asian and Latin American countries in 2015, facilitating further cooperation between those countries and China. In another example, a delegation was sent to Ethiopia in 2015 to help build up its tax administrative capacity and business environment. China also announced the establishment of an OECD-SAT multilateral tax centre in Yangzhou in March 2016 to provide tax-related training for developing countries. This sits alongside the announcement by the G20 following its February meeting that the Chinese Ministry of Finance would establish an international tax research centre in Beijing to generate cutting edge thought leadership in the international tax space.

These efforts may eventually constitute a key pillar of Chinese outbound investment policy. Tax assistance is being channelled in particular at Belt and Road countries such that China is helping to enhance and potentially influence the tax administration of countries in which Chinese businesses will invest and operate. China's more intensive interaction with the tax administrations of such countries, and the manner in which China is interlinking its efforts with those of the international tax organisations, such as the OECD with respect to BEPS and other governments as regards to the CRS, may result in China having greater influence on the overall shape of global tax policy and administration.

China transfer pricing – first mover on BEPS

In July 2016, China's State Administration of Taxation (SAT) released Announcement 42, outlining the updated Chinese requirements for contemporaneous documentation. In October, it released Announcement 64, containing revisions to the guidance on the administration of advance pricing arrangements. Chi Cheng, Xiaoyue Wang, Simon Liu, Kelly Liao and Mimi Wang explore the implications.

Introduction

Against the backdrop of the OECD's Base Erosion and Profit Shifting (BEPS) initiative, tax reform in China over the past few years has maintained a rapid pace, taking observers along on a breath-taking ride while keeping them on the edge of their seats as to what will happen next.

Underlying the recent flurry of activity, as noted in a paper written by Dr Liao Tizhong, director of the international tax division of the SAT, following the 2016 G20 Hangzhou Summit, is China's increasing eagerness to become an active participant in the international tax reform process. At the same time, the updated regulations also reflect the SAT's genuine interest in updating and modernising its practices in the tax administration process, making it more systematic, efficient and service oriented. In less than a decade, China has come a long way from having a dearth of transfer pricing (TP) regulations to now being one of the earliest adopters of the OECD's BEPS Project on the global stage.

The SAT's public consultation draft guidance, issued in September 2015, to provide for the implementation measures of "special tax adjustments" (the discussion draft), outlines the SAT's conceptual approach to adopting the BEPS proposals. It addresses those areas that were already of particular importance from the Chinese TP perspective, such as value creation and location specific advantages (LSA). Effectively, the discussion draft has set the foundation and provided direction for future regulatory updates.

A little over a year since the discussion draft was published, the public release of the Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation (Announcement 42) on July 13 2016 marked the first of a series of official regulatory reforms by the SAT in the area of TP. This was followed closely by the public release of the Announcement on the Enhancement of Administration of Advance Pricing Arrangements (APAs) (Announcement 64) on October 18 2016, with future announcements certain to be forthcoming.

Regulatory reform in China has also cascaded down to the local level with provincial tax administrations quick to integrate BEPS-driven international tax reforms as part of their *modus operandi*. In particular, the Jiangsu provincial office of the SAT (Jiangsu Office) issued a 2016-18 Compliance Plan on International Tax Administration (Jiangsu Compliance Plan), in which specific references are made to enhancing the quality of BEPS documentation and taxpayers are encouraged to use value chain based transfer pricing methods, such as the value chain apportionment method proposed in the discussion draft. It is clear that taxpayers will face increased pressure to demonstrate that their TP practices are consistent with the compliance requirements as set out by the SAT. They will therefore be challenged to balance compliance requirements with the administrative costs of doing so.

Announcement 42 integrates BEPS principles with Chinese focus

Announcement 42 demonstrates the SAT's intention to align its contemporaneous documentation requirements with those in other OECD countries, while incorporating a special focus, into the Chinese standards, on those areas that have traditionally been important to the Chinese tax authorities. Moreover, the compliance requirements introduced in Announcement 42 are emphasised by Announcement 64, demonstrating the SAT's holistic and integrated approach in drafting the new regulatory guidelines.

The most pronounced structural change to contemporaneous documentation requirements under Announcement 42 is the formal adoption of the three-tiered documentation approach as envisaged by BEPS Action 13. This supersedes the previous single report approach under Chapters 2, 3 and Articles 74 and 89 of the SAT Circular on Implementation Measures for Special Tax Adjustments (Trial Implementation), Guoshuifa (2009) No. 2 (Circular 2). Looking ahead, multinational enterprises (MNEs) meeting specific reporting criteria must prepare the master file, the local file, and the country-by-country (CbC) report. The latter report must be submitted as a part of the related party transaction forms filed with the annual corporate tax return.

Master file

While the requirements for the master file under Announcement 42 broadly follow the guidelines in the BEPS Action 13 report, one of the more notable areas where the SAT seeks additional information through the master file is with respect to an MNE's research and development (R&D) activities. This is an area that the SAT has historically emphasised in relation to the concept of value creation.

Announcement 42 requires disclosure of detailed information of activities, including functions, risks, assets and personnel associated with principal facilities performing and managing R&D, in addition to disclosure of where these facilities are located. This allows the Chinese tax authorities to better understand whether the R&D entities are actually responsible for performing the principal work, and where eventual profits should reside.

New requirements for the master file provide the SAT with more information about the taxpayer's restructuring activities during the year. Underlying this is the SAT's increased scrutiny of both direct and indirect related-party equity transfers.

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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 Euromoney Legal Media Group since 2009 and as a tax controversy leader by *International Tax Review*.

This theme is also carried over to the local file reporting requirements. The SAT would like to understand the nature of the MNE's legal reorganisations during the year, such as debt restructuring, equity acquisitions, mergers and acquisitions, and divestitures, in addition to its business restructuring activities, including activities that involve adjustments of its industrial structure, and transfers of functions, risks and assets.

Although the BEPS Action 13 report only requires disclosure of unilateral APAs, Announcement 42 goes beyond this and requires disclosure of bilateral APAs entered into by all entities of the MNE. Furthermore, the entity filing the CbC report on behalf of the group and its location must be disclosed. As such, MNEs must pay additional attention when preparing the master file to ensure that its contents meet the Chinese requirements.

The updated guidelines under Announcement 42 provide MNEs with considerable flexibility in deciding how to best structure and present their master file. However, within this greater latitude taxpayers must think more strategically about the level of disclosure made not only within the master file,

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but also between the master file, the local file and the CbC report. A balance must be struck between providing sufficient information to the tax authorities and confining disclosure solely to information that is pertinent. Taxpayers also need to think about and anticipate who the potential readers of the document may be and whether the document is shared with different tax authorities, some of which are more experienced in dealing with TP issues than others.

Local file

Over the past several years, in tandem with China's economic development and the movement away from being purely a routine manufacturing or services centre, the SAT is increasingly emphatic about ensuring that China receives its "fair share" of an MNE's total profits, proportionate to the functions performed, risks borne and assets utilised by local Chinese entities. Hence, one of the most pronounced areas where Announcement 42's requirements extend beyond the BEPS Action 13 report, and indeed beyond the old Circular 2 guidance, is the new value chain analysis that must be included in the local file. Specifically, taxpayers are asked to provide a wide array of information including an overview of the attribution of the MNE's global profits to the different countries within the MNE's value chain, based on how profits are allocated across the value chain and the actual amounts of profit earned by each value chain participant. In addition, quantification and attribution of profits arising from LSA factors must also be disclosed in detail, to the extent that location savings and market premiums impact the pricing of related party transactions (RPTs). Information on the company's contribution to the overall profits or excess profits of a MNE must also be included in the local file submission, regardless of the choice of TP method, along with standalone and consolidated financial statements. Finally, the transactions, goods and funds flows, within each value chain in the MNE group, must be clearly explained, beginning with initial design and development of goods through to production, marketing, delivery, after-sales service and recycling. These requirements represent a fairly ambitious wish list by the SAT. To the extent that this information is available and can be provided by the taxpayer, the SAT will be able to better assess whether MNEs are paying their fair share of profits in China. However, it remains to be seen as to whether taxpayers will be able to provide this detailed level of information.

Requirements for entities to prepare the local file under Announcement 42 are more rigorous compared to the thresholds set under Circular 2. In addition to requiring entities, whose RPTs involving transfer of tangible assets exceeding RMB 200 million ($29 million) or other RPTs totalling more than RMB 40 million, to prepare local files, entities with transfers of financial assets exceeding RMB 100 million or transfers of ownership of intangible assets that are greater than RMB 100 million are also required to prepare documentation. This further reflects the significance of these types of transactions in the eyes of the SAT. Given the relatively low thresholds set for transfers of financial assets and intangible assets, more entities are likely to have to meet the criteria for preparing documentation, than was the case in the past.

One area where Announcement 42 specifically diverges from the OECD's BEPS requirements is the SAT's decision not to adopt the requirement for simplified documentation for low value-added intragroup services. This reinforces the SAT's long-standing position that all services transactions are considered to be potentially high risk, capable of shifting profits out of China. Clearly, as with the master file, the requirements for the local file under Announcement 42 reflect the SAT's desire to adapt and tailor BEPS Action 13 initiatives to China's unique circumstances.

Country-by-Country reporting

The SAT has eagerly awaited the opportunity to obtain the type of information contained in the CbC report, as it has long stressed the importance of being able to obtain information on MNE businesses on a global basis. With the introduction of the CbC reporting (CbCR), tax authorities are now able to assess the impact of TP on an MNE's profitability in each jurisdiction in which it operates. Reportable items in the CbC report such as revenue generated through transactions with third parties as well as related parties, profit (or loss) before income tax, income taxes accrued and taxes paid, stated capital, number of employees, etc. allow tax authorities to understand how functions performed correspond to returns generated and potentially relevant tax positions of the entities in the relevant jurisdictions and, equally importantly, across the value chain.

Many MNEs have spent the past year conducting CbCR "dry-runs" using 2015 data before the deadline for submitting the 2016 data, the first taxation year in which CbCR applies. Early evidence from a number of the larger MNEs indicate that the May 31 filing deadline represents a fairly aggressive target for large organisations to meet, given that final year-end data are typically not available until February or March of the following year at the earliest. Therefore, one of the most crucial aspects of CbCR is for companies to map out and implement a systematic process for data collection, aggregation, review and reporting. Involvement of the systems IT personnel early on in the process can be beneficial, especially for organisations that anticipate significant enhancements to their IT systems.

Discussions with taxpayers also indicate that there is some flexibility in the interpretation of certain reportable items. For example, there is some discussion as to whether stated capital should be consolidated within the same tax jurisdiction. While MNEs can interpret the wording in BEPS Action 13 to represent a simple aggregation of all stated capital, in reality simply adding together all stated capital may potentially enlarge the total to a multiple of its actual level, depending on the number of consolidation levels and therefore, grossly over-represent the total stated capital. The same issue of whether or not to consolidate also extends to the related-party revenues within the same jurisdiction. We have seen some MNEs consider an approach that consolidates intra-country related-party revenue to make certain ratio analyses more meaningful. To this end, taxpayers may want to retain the flexibility to adopt the interpretation that is the most consistent with the economic substance of their operations.

The CbC report provides a high level summary of an MNE's activity in each jurisdiction at a high-level and is not meant to replace the more rigorous TP analysis of functions, risks and assets as contained in the local file. Moreover, as the basis for CbCR is on a jurisdictional rather than on an entity level, the master file and the local file must be reviewed in conjunction with the CbC report for the tax authorities to identify potential investigation targets.

Related-party relationships and transactions

Adopting the principles set out in the discussion draft, Announcement 42 provides clarification regarding when related-party relationships are deemed to exist. In addition to the most commonly observed direct and indirect ownership criteria, entities may be deemed to be related through their:

- Financing activities;
- Rights to access and use intangible assets belonging to one of the parties;
- Through common familial relationship at the ownership level; or
- When one entity exercises substantive control over another entity's business operations.

Notably, the updated definitions are more comprehensive compared to what was previously outlined under Circular 2, consequently expanding the scope of related-party relationships.

In addition to related-party relationships, the SAT has also incorporated financial asset transfers into the fold of RPTs, which can be seen as a clear signal of the SAT's growing attention to this area. Related-party financing and related-party services transactions are also defined in further detail. Therefore, the taxpayer burden for disclosing information has notably increased.

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Simon has been actively involved in advising clients on various issues such as M&A, corporate restructuring and market entry feasibilities, based on Chinese state regulations and special local rules, policies and practices. He is experienced in delivering creative and practical solutions, and planning ideas which not only cover tax but also regulatory, customs, and foreign exchange issues. He also has extensive experience in transfer pricing and of cost sharing arrangements.

His technical expertise covers transfer pricing documentation, planning, and investigation defence; cross-border tax structuring; tax-efficient supply chain management and economic valuation for intra-group restructuring.

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Annual reporting forms of related-party transactions

The revamped related-party transaction reporting forms under Announcement 42 represent both an increase in the quantity of forms – up to 22 forms from the nine forms under the previous Circular 114 – and the level of detail required to be disclosed.

The SAT's focus on the key areas of interest is also evident through the design of the forms. For example, there are now two forms related to intangible assets, one related to the transfers of ownership of intangible assets and a separate form related to the transfers of rights to use intangible assets, replacing the previous Intangible Asset Transaction Form under the previous Circular 2. A separate form is also required to disclose financial assets transactions such as:

- Accounts payable;
- Accounts receivable;
- Other payables:
- Equity investments;
- Bond investments;
- Assets from derivative instruments; and
- Other financial assets.

The CbCR forms, making up six out of the 22 forms, in English and in Chinese, line up with each of the three template CbCR tables presented in the BEPS Action 13 guidelines.

Summary

Underlying the changes in reporting requirements, as outlined under Announcement 42, are the principles that the SAT has always been promoting:

- Contribution to value creation of intangibles should be properly remunerated, performance of activities that relate to the creation of intangible assets should also be considered in addition to the ownership of intangible assets;
- Local specific advantages in the form of location savings and market premium should be considered;
- Contractual mismatching of functions and risk, such as in the case of low cost-plus return on key R&D activities, should be avoided; and
- All services transactions are considered to be potentially high risk and therefore should be examined in detail.

With the formal adoption of these principles into SAT guidance, it becomes the taxpayer's responsibility to demonstrate and prove that their TP practices are in line with the principles outlined by the SAT.

Jiangsu Tax Office and the 2016-18 Compliance Plan

Shortly after the release of Announcement 42, the Jiangsu provincial office of the SAT issued its 2016-18 Compliance Plan on International Tax Administration.

Although this plan aligns closely with the areas of focus outlined under Announcement 42, the Jiangsu Compliance Plan further stresses, in unequivocal terms, the importance of improving the overall quality of TP documentation, effectively raising the compliance bar for taxpayers. Taxpayers are also encouraged to use value chain based transfer pricing methods such as the value chain apportionment method proposed in the discussion draft.

Also explicitly noted in the plan is a requirement for tax intermediaries to apply their professional skills to help enterprises improve the overall quality of the documentation. Interestingly enough, it is noted that "for those intermediaries and their employees engaging in the preparation of documents which exhibit poor quality, the tax authorities will make them known". Ultimately, those taxpayers whose documentation is considered to be of poor quality will be attributed with a higher risk rating by the tax authorities for the purpose of identifying potential audit targets. By highlighting the role of the professional intermediary, the Jiangsu Compliance Plan brings the interests of the taxpayer, their professional advisers, and the SAT closer in line.

Announcement 64 reflects SAT's objective of transparency

In the decade between 2005 and 2014, over 100 successful APAs were signed by the SAT with unilateral APAs accounting for approximately 70% of the total, and bilateral APAs making up the remaining 30%. Announcement 64 incorporates the experience accumulated, technical experience gained and systematic processes developed by the SAT since the release and implementation of Circular 2. These updated regulations also reflect the SAT's aspiration to develop and refine a more systematic and transparent approach to APAs and more robust administrative procedures for their implementation. At the same time, these regulations embody the key transparency principle underlying the BEPS Action Plan, in which China has actively participated since the beginning. With these updated requirements, there is general consensus that the threshold for the successful acceptance of an APA is higher and more rigorous compared with those under Circular 2.

The updated Announcement 64 follows a six-stage process, with the stages of:

- Pre-filing;
- Intention;
- Analysis and evaluation;
- Formal application;
- Negotiation; and
- Signing and supervision of implementation.

Notably, the analysis and evaluation stage has been brought forward before the formal application stage. The new six-stage process is generally consistent with what takes place in practice for unilateral APAs. However, it does raise some challenges for bilateral and multilateral APAs given that the other competent tax authorities may or may not start their detailed analysis and evaluation work until an APA application has been formally accepted. This means that, going forward, taxpayers who are interested in bilateral or multilateral APAs involving China must engage in detailed discussions with all competent tax authorities early on in the process to make sure that their negotiation positions are well managed, in order to avoid situations where agreements reached with the SAT are considered unacceptable to other competent tax authorities.

The frontloading of the analysis and evaluation stage demonstrates the SAT's push for additional preparation work to be performed before the formal application stage, and requires taxpayers to adopt a more efficient and accurate approach at the outset. Materials that would have been required to be submitted at a later stage under the current system will be fast-tracked to the initial stages. For example, the APA pre-filing application in the initial stage requires inclusion of:

- An extensive and detailed description of the transactions involved and the years to be covered under the APA;
- A description of the businesses' operations and the most recent three to five years of contemporaneous documentation;
- An explanation of the functional analysis associated with the transactions to be covered; and
- A description of market conditions, including any LSAs that may exist.

Successful continuation of the application past the initial stage sets the groundwork for the submission of an APA Letter of Intention and APA Application Draft.

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Mimi has managed many multi-jurisdictional planning studies, documentation and has participated in the negotiation of unilateral and bilateral advance pricing agreements and audit assessments. She has experience in a wide range of transfer pricing issues, including tangibles, intangibles, intra-group services, intra-group financing, business restructurings, etc. Mimi also has significant experience in business and intellectual property (IP) valuations.

As a member of KPMG China's BEPS centre of excellence, Mimi is also responsible for analysing BEPS implications to clients with operations in China. She has delivered training to tax officials and participated in discussions with senior State Administration of Taxation (SAT) officials on topical transfer pricing issues.

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The Application Draft will require the taxpayer to disclose the TP methodology and calculation method proposed under the APA, functional and risk analysis, as well as comparability analysis along with any assumptions used in devising the methodology applied. A detailed value chain or supply chain analysis will be presented at this stage along with information on the business scale including forecasts and business plans for the period covered by the APA. By frontloading these requirements, the submission of the Formal Application Letter and Report will become a procedural formality.

It is obvious that there are consistent themes across both Announcement 42 and Announcement 64. This reflects the SAT's systematic and integrated approach when designing these new standards to raise the level of sophistication of updated tax regulations. For example, taxpayers are asked to discuss any relevant LSAs, including location savings and market premiums, at the pre-filing stage of the APA application and to provide value chain or supply chain analysis later on in the analysis and appraisal stage.

Furthermore, Announcement 64 notes that if the applicant has not filed their contemporaneous documentation or annual reporting forms for related parties that satisfy the criteria under Announcement 42, their application may be denied on this basis. As such, Announcement 64 mutually reinforces and upholds the requirements set out under Announcement 42.

It is also particularly interesting to note that, under the new administrative mechanism in Announcement 64, the tax authorities will issue a Notice of Additional Taxes to be Paid/Tax Refund calculated for the years covered or retroactively applied under the APA. This is the first time the SAT has opened the door for refunds to be granted arising from TP adjustments. Indeed, if applied in practice, this would make China an exception among the global tax authorities in allowing adjustments of this type. However, it remains to be seen whether these adjustments will be observed in practice going forward.

China Country Practices

The United Nations Practical Manual on Transfer Pricing for Developing Countries (the Manual) was first issued in 2013, with the SAT then contributing a section on China Country Practices. In October 2016 the SAT updated this document, setting out what it perceives as the TP opportunities and challenges for developing countries in the post-BEPS era.

The SAT has been consistently under-resourced. In response to the increased workload related to TP audits and bilateral negotiations in the post-BEPS era, the SAT has set up three anti-avoidance divisions in its headquarters. Sixteen people were recruited in 2016, with 26 more expected to join the team in the next two years. Eventually a 50-person team dedicated to transfer pricing will be working in the SAT headquarters. This significant increase in personnel at the SAT headquarters will have a profound impact on TP audits and bilateral negotiations over the coming years. In particular, it is likely that there will be more nationwide audits led or coordinated by the SAT, as well as greater consistency in the assessment of similar cases.

The SAT, in the same manner as in the previous version of the China Country Practices document, emphasised the difficulties encountered when applying the arm's-length principle in developing countries, in particular due to a lack of reliable comparables. The SAT also stressed the need to perform comparability adjustments when companies in developed countries are used as comparables for companies in developing countries. The SAT again emphasised factoring in the impact of location-specific advantages, such as the so-called "location savings" and "market premium", in performing TP analyses in developing countries.

While not challenging the overarching role of the arm's-length principle in TP, the SAT states clearly that China's TP regime has drawn on some other internationally recognised rules besides the arm's-length principle. Indeed, the SAT encourages research to be conducted to explore better alternatives to the arm's-length principle. The value chain apportionment method, proposed in the discussion draft, is considered by many to be a departure from the arm's-length principle. It will be interesting to see if the value chain apportionment method will be sanctioned as a formal TP method in one of the additional TP regulations that the SAT is expected to release in forthcoming months.

Conclusion and look-ahead

With the release of Announcement 42 and Announcement 64, it is widely anticipated that additional guidance on TP investigations and audits will be forthcoming in the coming months. Based on the guidance provided in the discussion draft, the SAT is likely to adopt a more sophisticated approach to examining taxpayer internal control procedures in the context of conducting tax audits, providing impetus for taxpayers to develop a more robust tax risk management system. The SAT has also hinted that it will implement a risk based approach in identifying target enterprises as well as increasing its reliance on the use of "self-investigations" by the taxpayer.

As the SAT continues to release additional regulations in the forthcoming months, taxpayers will need to vigilantly monitor these changes and carefully balance their approach to meeting the new compliance requirements, while managing the administrative burdens associated with compliance.

In the course of the past decade, China has transformed itself from having virtually no formal TP requirements until 2008, to now being one of the first countries to formally adopt the OECD's BEPS Action Plan into local rules. This demonstrates China's eagerness to become an active and integral part in transforming the global tax system. Undoubtedly, more changes are ahead for China in this age of international tax reform.

Post VAT reform in China – what's next?

China's indirect tax system underwent a major overhaul when its new VAT reforms were rolled out. Lachlan Wolfers, Shirley Shen, John Wang, and Jean Li take a look at the new indirect tax model and discuss how China has moved away from a bifurcated system.

Introduction

For the past five editions of *China – Looking Ahead*, we have plotted the expected path of China's value added tax (VAT) reforms, while waiting with bated breath for their actual implementation.

On May 1 2016, the wait ended with the final stage of the VAT reform programme commencing. This marked the day that the business tax (BT) ceased across all industries nationwide, and all sales and importations of both goods and services into, within, or from, China fell within the scope of a single indirect tax system, being VAT.

While the period between the government's formal release of the VAT reform policies and their implementation was spectacularly short by international standards, approximately five weeks, business did not come to a grinding halt and the government's famed "Golden Tax System" did not buckle under the weight of user overload. Frankly, people in China did what they are accustomed to doing in many other aspects of their life – they set about adapting and implementing change as best they could.

The experience gained from the VAT reforms should serve as a valuable case study in tax implementation to treasury officials and tax authorities around the world. The policies were carefully considered, the major impacts had been largely predicted, taxpayer support was rolled out with phenomenal speed, and businesses and consumers alike responded well.

To put these changes into context, the total number of new VAT taxpayers is approximately 10 million. The reforms resulted in a fundamental shift in the system of tax collection and administration from local governments to the central government, and the last stage of the reforms introduced the world's leading policies to address previously intractable problems. This is not to suggest that all taxpayers were happy, nor is it to suggest that the reforms were implemented flawlessly. Rather, what was observed was a tax authority willing to listen, adapt and make changes where needed in response to concerns, and where the macroeconomic focus remained on producing a more efficient tax system as a whole, while recognising that not all taxpayers would necessarily have a reduced tax burden.

During the implementation of China's VAT reforms, we saw on display two truisms of tax reform that apply the world over. The first being that change will always be implemented in accordance with the formula of one day less than the maximum available timeframe given, however long that may be. And the second being that the extent of clarity and certainty sought by taxpayers, and their advisers, may always be plotted on a graph that approaches infinity. In simple terms, tax reform can actually be implemented quickly because people will actually meet the challenge and adapt, and the quest for certainty and clarity is insatiable.

Given that the title for this publication focuses on "China – Looking Ahead", it begs the obvious question, so what now?

When answering that question, let us divert for a moment with a small aside. Upon passing the May 1 2016 deadline, and then the completion of the first VAT reform filing period, a number of people were heard asking: "what are you going to do now?" Their question presupposed that having implemented VAT in China over the past five years, there would be no further VAT work required. The response was to ask them why most companies still have corporate tax managers seeing as though corporate income tax (CIT) had been introduced in China many years ago? The point being, why do we equate the implementation of a relatively new tax such as a VAT with finality, but yet we would never contemplate the same idea with more traditional taxes such as CIT? The obvious answer is that we are not at the end of a road, but rather, at the start of a new journey. In this edition of *China – Looking Ahead*, let us explore this new journey that lies ahead.

The framework through which we will explore the journey ahead is firstly by looking at those aspects of the China VAT system which, in the authors' opinion, will lead the world. That is, where the changes implemented in China will serve as the model for other countries to follow. Secondly, we will look at those aspects of the China VAT system that will respond to developments occurring internationally.

World's leading policies

China's VAT system contains three key features which, in the authors' view, represent breakthrough policies among VAT/GST systems around the world. Again, this is not to suggest that other countries will rigidly follow these changes verbatim, but rather that they form the backbone of new developments upon which future improvements and enhancements will be made. To use an analogy, they are the equivalent to the development of the first Apple iPhone, but in time subsequent models will be introduced that are better, faster and more powerful.

Application of VAT to the financial services sector

The first key feature is the application of VAT to the financial services sector.

Historically, most VAT/GST systems around the world have exempted financial services from the tax, primarily because of the difficulties in measuring the value added on a transaction-by-transaction basis. However, exemption raises its own problems, with issues such as cascading liabilities in business-to-business (B2B) financial services, the bias against outsourcing, and the reduced tax base arising from the non-taxation of profit and labour of financial intermediaries. More recently, industry developments such as Fintech, virtual currencies, new payment systems, and peer-to-peer lending have also highlighted practical difficulties in terms of where to draw the line between exempt financial services and other taxable services – a problem which is likely to suggest that the model of VAT exemption is inapt in a modern financial services world.

Countries such as New Zealand made some inroads into trying to tax certain financial services by applying GST to

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Shirley is a key member of KPMG's indirect tax centre of excellence and is leading the VAT team in KPMG's Beijing office. She has been involved in many VAT reform projects for multinational enterprises and state-owned enterprises and provides a full range of services relating to VAT implementation.

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general insurance policies, effectively by adopting a cash-flow basis of taxation. Then others, such as South Africa, Singapore, Australia and Malaysia, followed by taxing financial services that are remunerated on a fee or commission basis. New Zealand chimed in again by zero-rating B2B financial services to remove the cascading effect. Meanwhile, in Australia, the use of reduced input credit intends to offset the bias against outsourcing.

Where China's VAT system has made a huge leap forward is in the introduction of a model where the default position is the taxation of financial services. More specifically:

- Interest income is subject to VAT;
- Fee and commission-based income is subject to VAT;
- Net gains from trading in financial products are subject to VAT; and
- General insurance products are subject to VAT.

Critics may point to aspects of the Chinese VAT treatment of financial services which are impure or imperfect, such as the inability to claim input VAT credits for interest expense, the inability to claim input VAT credits for losses from trading in financial products, and the inability to claim input VAT credits for cash settlements of general insurance claims, and argue that China's VAT system for financial services is not, in substance, a true VAT. Certainly, aspects of these policies depart from pure VAT principles and in reality, can start to resemble aspects of the former BT system, or even a capital gains tax in their application. However, what this overlooks is that the VAT rate for financial services is 6%. This is a far cry from the general VAT rate in China of 17%, and therefore it may be contended that the reduced rates act as a kind of proxy or estimate to counteract the effect of a disallowance of certain input VAT credits.

The early experience with these policies highlight that although it is certainly possible to apply VAT to the financial services sector, and indeed, to apply it to most types of financial services, the quest for equity, efficiency and certainty will still continue, albeit with new policy challenges arising. The well-known inequities associated with exempting financial services are replaced with new inequities associated with taxing financial services, but with the difference now being that the tax base is broader. Some of the new policy dilemmas that have been highlighted by taxing financial services are:

- The need to provide exemptions for 'wholesale' funding to prevent a cascading of VAT liabilities arising from an inability to claim input VAT credits for interest expenses. This problem was highlighted early and largely rectified quickly with the release of Circular Caishui (2016) 70 (Circular 70). Having said that, the ultimate goal should be to allow a credit for interest expense in all B2B transactions, which would remove both the cascading effect and any real need for interbank exemptions, although practical invoicing issues would still need to be resolved;
- The differential treatment of debt versus equity, and even differences in VAT treatment between varying types of debt and equity. Typically, interest paid on debt is subject to VAT, though many types of bond trading activities are now exempted under Circular 70. Trading in financial products that includes stocks and other derivatives is subject to VAT on the gain, whereas trading in equity interests, such as shares in unlisted companies, is exempt;
- The inability to claim input VAT credits for claims settlement pay-outs in the form of cash, but the seeming ability to claim input VAT credits for the purchase of goods or services used in settling claims. Given that most goods

attract a VAT rate of 17%, this creates an obvious incentive for insurers to structure claims settlements by providing goods in kind, rather than cash upon which the insured buys new goods; and
- The lack of any general exemption or zero rating for exported financial services. At present, there is a very limited form of exemption for exported financial consulting services only, but for the most part, exports of financial services bear VAT. The absence of any exclusion from output VAT runs contrary to the OECD's International VAT/GST Guidelines, and it has the propensity to cause double taxation, given that the export of the financial service from China may well be taxed in the place of importation, usually on a reverse charge basis, and especially so for many types of fee-based financial services. This lacks international competitiveness.

In time, it would not be a surprise if many of these problems are rectified, recognising that what we have now is VAT version 1.0. Similarly, it would not be a surprise to see governments around the world studying the Chinese experience and attempting their own VAT version 2.0.

In some respects, China's experience with imposing VAT on financial services operates as a useful test case. The financial services sector in China is heavily dominated by state owned enterprises and there is a heavier concentration of revenue from financial services drawn from relatively simple lending activities as compared with other markets. In addition, the general regulatory environment is in some respects more tightly controlled, except perhaps for shadow banking, with a greater ability to influence outcomes through government intervention. So in conclusion, even though the application of VAT to financial services in China is modified, impure and perhaps imperfect in some respect, the experience in China shows that it is certainly possible.

Taxation of B2B, B2C and even C2C transactions

Virtually all major VAT/GST systems around the world share certain common features:
- They define what constitutes a supply (i.e. goods, services, or rights);
- They require the place of supply to occur in that jurisdiction as a precondition to the imposition of VAT/GST;
- They calculate the VAT/GST based on the consideration payable for that supply; and
- They impose the obligation to collect and remit the VAT/GST on entities in respect of "commercial activities".

For the most part, this means that businesses collect and remit the VAT/GST, and then depending on the jurisdiction, they either include or exclude from the scope of the VAT/GST activities of passive investors (e.g. property landlords), one-off traders and speculative investors (e.g. those carrying on an adventure or concern in the nature of trade), as well as charities and governments.

What makes the Chinese system unique is that the distinction between "commercial activities" and "non-commercial activities" is almost never drawn. Instead, the distinction is more often drawn on the basis of turnover thresholds (e.g. paying VAT on a simplified basis at 3% if the annual turnover from services that have recently transitioned from BT to VAT is less than RMB 5 million ($723,000)) or between "individuals" and "non-individuals".

In the authors' view, drawing distinctions between commercial activities and non-commercial activities is a concept that will gradually become an historical anecdote in other VAT/GST systems around the world. The birth of the sharing economy, in areas such as accommodation and travel with companies such as AirBnB, Uber and Didi Kuaidi, highlights the increased mobility in which business can be carried on. The growth of online platforms such as Etsy, which can allow an 80-year old grandmother to sell her art and craft wares to an international market, the dominance in China of Alibaba's B2B and business-to-consumer (B2C) T'Mall platform and its B2C and consumer-to-consumer (C2C) Taobao platforms, coupled with the growth of peer-to-peer (P2P) lending, all show the rise of the intermediary in facilitating transactions between active buyers and willing sellers.

China's VAT system is believed to be among the first to impose VAT on C2C transactions, including in the real estate sector. With effect from May 1 2016, transactions involving not only commercial real estate but also residential real estate attract VAT. In addition, transactions involving not only newly developed real estate assets but also

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

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Jean specialises in China corporate tax and indirect tax. She has rich and extensive experience in providing tax and business advisory services for the significant business activities of large state-owned enterprises, for example, investment, outbound, restructuring and M&A deals.

Jean is also actively involved in the China VAT reform and has extensive experience in serving many well-known companies in real estate and finance industries. Jean has also actively contributed her insights on the VAT reform from an industry perspective to various tax authorities and government departments, including the China Ministry of Finance.

Jean is a certified public accountant and a holder of the lawyer practitioner qualification in China. With her strong accounting, auditing, taxation and legal background, Jean is well known as a China tax expert and is frequently invited as speaker by professional associations (for example, ACCA) and many universities across China.

second-hand real estate assets attract VAT, and transactions involving not only B2B and B2C, but also C2C attract VAT. While the VAT rates can vary depending on some of these features, and some exemptions do apply, the simple point is that the tax base in China for VAT *prima facie* includes C2C transactions. That appears to be a world first. After all, provided the taxpayer has met the requisite turnover threshold and has added value, should it really matter whether the label on the type of activity is that of a "commercial activity" or not?

The challenge for governments around the world is to ask whether their VAT/GST systems are fit for the modern way in which consumers will buy goods and services, and whether there is anything in China's system that may serve as a blueprint to help them meet that challenge.

China's Golden Tax System

The final, and perhaps most controversial feature, is China's Golden Tax System. This is the hardware and software system upon which invoices are issued and received (or validated), and where transactional data is stored for later transmittal to the tax authorities. The importance of China's Golden Tax System to VAT and to the economy generally simply cannot be understated. It is often joked that the first words that a foreign businessperson learns upon arriving in China is not *ni hao* but is instead *fapiao*, meaning invoice.

Most countries' VAT/GST systems place considerable importance on invoicing in the operation of their system, but few place as much importance as the Chinese. Invoices in most countries serve the purpose of providing persuasive evidence that a transaction has occurred and the way in which it has occurred. However, in China, the *fapiao* virtually fulfils the role of being determinative evidence.

The controversial aspect is that despite multiple anti-counterfeit features of China's Golden Tax System, according to certain OECD studies, the VAT gap (being the difference between VAT revenues that should be collected and what is actually collected) in China is exceptionally high by international standards. The OECD has estimated that the VAT gap in China represents around 55% of all VAT revenue. While estimations of the VAT gap are by definition difficult to verify, it has been said by some international experts that by placing the invoice or *fapiao* at the core of its tax system, this perversely creates a system which rewards 'off record' transactions or even fraudulent invoices. Put simply, if the *fapiao* was not all that important, then the production of fraudulent invoices would become less useful. Similarly, if the issuance of a *fapiao* did not result in a transaction record being conveyed to the tax authorities, the failure to issue a *fapiao* would not create the perception that tax can be evaded. This does not mean to suggest that VAT may be avoided by the failure to issue a *fapiao*. The Chinese VAT rules make very clear that VAT is payable irrespective of this. Rather, the common perception in the general community is that this is the case.

These arguments, while reasonably valid, overlook three key points. First, until May 1 2016 there was a significant gap in the system, whereby transactions involving either a liability to BT, or to a BT taxpayer, resulted in no VAT *fapiao* being issued. However, that has now changed. The chain of invoices is now intact because all taxpayers are under the VAT system. It is expected that the VAT gap should therefore reduce considerably.

Second, it overlooks technological developments. China's Golden Tax System is moving in the direction of a fully electronic era. Electronic invoicing is gradually being introduced and should be widespread within the next two years and the system itself is automatically uploading importation records to enable the importer to claim an input VAT credit. In addition, the previous system, requiring manual verification of invoices, is similarly becoming automated with the taxpayer scanning and loading invoices for which it is claiming input VAT credits and the tax authority's approved software is automatically verifying them. Put simply, China has the hardware in place upon which it can make upgrades into the future. It is not difficult to foresee when VAT will be collected and remitted at the point of sale, and similarly credited automatically in B2B transactions. Compare that to (most) governments without any form of government authorised or mandated hardware in place.

Third, data and analytics is increasingly becoming the tool of trade for 21st century tax administrations. China's Golden Tax System means that the government has the data, but they just need to learn how to analyse it. Compare that to, again, (most) governments that have neither the systems nor resources in place to obtain the data, except in response to the detection of risks or following a specific request.

In 2016, KPMG launched the "Tax Intelligence Solution" in China, which is a data and analytics solution that allows businesses to obtain key insights into data from their enterprise resource planning (ERP) systems. At the click of a button they can obtain reports that highlight anomalies such as domestic sales without VAT, multiple tax codes used by the same supplier, transactions in which no tax codes have been assigned, a virtual toolbox of over 60 data and analytics tests specifically designed or adapted for China's VAT system, which help businesses to detect tax risks and to identify opportunities. Now, imagine such a tool in the hands of the tax authorities, and especially where they already have the data.

Policies that will respond to international developments

While this chapter has so far concentrated on how China's VAT system will lead developments internationally, it would be unbalanced not to point out those aspects of the system that will respond to international developments. In that respect, it must be remembered that China is still, in many respects, a developing economy, and its fully fledged VAT system is still in its infancy.

The following represents key areas where change is expected, or perhaps is hoped for, over the coming few years.

B2B 'wash' sales

The principle of fiscal neutrality, which is embedded in the OECD's international VAT/GST Guidelines (the guidelines), recognises that VAT is not intended to be a cost on business. According to guideline 2.1, "the burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation". The guidelines then seek to provide examples where exceptions may apply, such as for the denial of input tax arising from exempt activities, or non-business activities.

A number of countries implement the fiscal neutrality principle in such a way that typically seeks to ensure the amount of output tax payable by a business supplying a good or a service in any given transaction equals the amount of input tax claimable by a business purchasing that good or service for use in their taxable business activities. The principle of fiscal neutrality can be called in aid of taxpayers in a range of situations, including:

- Where the VAT treatment adopted by the supplier and the recipient in the first instance was zero-rated or exempt, but the tax authorities later asserted the transaction should have been subject to VAT. The principle of fiscal neutrality may be called in aid to ensure that if the supplier must still remit the output tax at a later point of time, the recipient can still claim the resulting input tax credit;
- Where the recipient loses the tax invoice, or fails to obtain it, or simply fails to include the input VAT credit in its correct VAT return, then the principle of fiscal neutrality could be used to correct the anomaly of the supplier's output VAT not being matched by the recipient's input VAT credit, where they are carrying on taxable business activities. Most countries provide some latitude or leniency in terms of alternative evidence used to support the recipient's input VAT credit where in substance they would be eligible for such a credit;
- In transactions where there are post-sale price adjustments, such as volume rebates, or third party price adjustments (e.g. manufacturers giving cashbacks to consumers), or even in complex loyalty reward schemes. The VAT/GST systems in many countries recognise that VAT should only ever be imposed on the true 'value added', see for example *Elida Gibbs Ltd v Customs & Excise Commissioners* (1997), and therefore allow later period adjustments to the supplier's output VAT and the recipient's input VAT; and
- In transactions where there is a gift or free giveaway between arm's length parties. The principle of fiscal neutrality would suggest that the imposition of output tax is inappropriate from a policy perspective because the value of the gift is already priced in to the goods or services which the consumer actually pays for.

In each of these cases, China's VAT system would not always achieve an equitable policy outcome. In some respects, this is for historical reasons that reflect a certain 'impurity' to China's VAT regime. For example, before 2009 China's VAT rules precluded input tax being claimed on fixed assets, and until recently the impact of a dual indirect tax system resulted in BT taxpayers being denied input tax for their purchases of goods, and VAT taxpayers being denied input tax for purchases of many services.

With the 2016 shift to a single integrated VAT system in China, it is hoped that in time the recognition of the principles of fiscal neutrality will be more fully implemented.

Exports and imports of services

The VAT position for exports and imports of services in China may be briefly summarised as follows:

- Exports of services are typically exempt from VAT where the service is consumed outside of China, though there are some limited categories of zero-rated services; and
- Imports of services are subject to VAT with the VAT being collected by the domestic recipient on a withholding basis.

There are two key elements where China's VAT system needs to respond to international developments, as well as to technological developments. They are:

1) The OECD's International VAT/GST Guidelines, which adopt the destination principle of taxation. This is the principle under which VAT/GST should be collected in the destination where the service is consumed, not the place where the service originates. China's VAT rules in Circular Caishui (2016) 36 (Circular 36) fall short of the full implementation of the destination principle. They fall short because they merely exempt most services from VAT – they do not zero rate most services. This means that VAT is effectively still borne by the domestic supplier on their inputs. Furthermore, the categories of exemption in Circular 36 do not 'cover the field'. As mentioned previously, this means that services such as many types of exported financial services bear VAT at 6%, which is internationally uncompetitive. Finally, China's VAT system does not allow foreign businesses to register for VAT and similarly does not allow them to claim refunds, so unlike other countries, there is no viable option to relieve the burden of VAT where exemption or zero rating is not satisfied. This runs counter to guideline 2.4 of the OECD's guidelines.

   On a more positive note, it must be remembered that China's previous BT system contained no general category of exemption for exported services, so the VAT system already represents an improvement. Additionally, in November 2015 the categories of zero rating were expanded to include offshore outsourcing services (see Circular Caishui (2015) 118, but now embedded in Circular 36) and it is therefore hoped that this is the start of a more general shift to convert exemptions into zero rating treatment.
2) Increasingly, consumers are purchasing services in a digitised form, which can entail services being provided by offshore suppliers without a physical presence in China. This raises significant problems from a VAT compliance perspective.

   Put simply, the VAT system in China is ill-equipped to deal with this phenomenon. In reality, individual consumers bear the responsibility to account for the VAT on a withholding basis, yet in practice they are unlikely to do so because offshore suppliers are not able to effectively register for VAT purposes in China and account for the VAT on behalf of individual consumers. A position that has been made more difficult since the release of Circular 36, which now precludes offshore suppliers from appointing a local agent to collect the VAT on their behalf, and yet the liability for a failure to withhold the VAT is a joint and several liability of both the offshore supplier and the domestic recipient.

   The OECD's and G20's report on the digital economy, released as part of the BEPS initiatives, recommends that countries amend their VAT/GST systems to allow offshore suppliers to register and account for VAT/GST, and to allow them to do so in a way that is both efficient and effective administratively. Already several jurisdictions in the Asia Pacific region such as Australia, New Zealand, India, Taiwan, Japan, Thailand and South Korea have either implemented, or are taking active steps to implement, the recommendations of the OECD/G20 report. They have a strong self-interest in doing so, because their tax bases will be detrimentally affected until they do so. For China, the day is fast approaching where similar steps need to be taken, especially given the enormous growth in the use of technology in buying and selling services in China.

   While the VAT position in China with respect to exports and imports of services may lag behind international developments in certain respects, the flipside is that China's VAT treatment for imported goods may well be ahead of the pack. In early 2016, China introduced Circular Cai Guan Shui (2016) 18, which effectively applied a 30% discount to the liability to VAT and consumption taxes due on imported goods. It also introduced certain low value thresholds for imported parcels (consistent with OECD recommendations), and it further had the effect of encouraging e-commerce platforms in China.

Single rate VAT system

China's VAT system uses a number of different VAT rates, with 3%, 6%, 11% and 17% in common usage. Even then, the conclusion that there are four general VAT rates in application is itself strictly inaccurate. There are instances where other rates are commonly used too, such as 1.5%, 2%, 5% and 13% to name just a few.

The shift from the previous BT system to the VAT system resulted in an increase in the number of VAT rates. The explanation for the multiple VAT rate system is that the government officials adopted a preference for policies and rates that would preserve, and in some cases reduce, the tax burden impact in the transition from BT to VAT, over policies that would rationalise the number of VAT rates.

The obvious impact of a multiple VAT rate system is that it increases complexity. Take the simple example of a customer choosing to stay at a hotel in China. They may incur:

- A 6% VAT on the hotel booking fee;
- A 11% or 5% VAT on car parking if they drive themselves;

- A 6% VAT on the hotel accommodation and food and beverage;
- A 11% VAT for a room hire booking in the business centre;
- A 17% VAT on the spa products they consume;
- A 11% VAT on the use of the telephone;
- A 6% VAT for the use of the internet; and
- A 17% VAT when they buy something from the gift shop.

Plainly, a system that adopts a single rate across a broad base is simpler, more efficient and promotes equity between taxpayers. Countries such as New Zealand are known to have one of the broadest based VAT/GST systems in the world, achieved with a single VAT/GST rate.

It is expected that China will take steps to reduce the number of VAT rates over the next few years, as the new VAT system matures and perhaps is accompanied by the enactment of formal VAT legislation.

Conclusions

China's VAT system has the potential to be among the leading VAT/GST systems around the world. It has three key pillars or foundations in place that should prove resilient to technological change and innovation, being:

1) The taxation of financial services;
2) A broad base of taxation that also includes C2C transactions; and
3) The hardware in place to obtain transactional level data through the Golden Tax System, with improvements likely to result in real time data transfers in the near future.

What is needed now is to build on those pillars or foundations by adopting international developments relating to cross-border services, applying the principle of fiscal neutrality, and rationalising the number of VAT rates in effect. Once it has done so, China's VAT system can then be regarded as truly the world's leading indirect tax system.

M&A tax in China – practical challenges

John Gu, Yvette Chan and Chris Mak share their insights on encountering practical uncertainties and resolving contentious tax issues when working with clients on merger and acquisition (M&A) transactions in China. They look at how the rapidly changing global tax environment will impact future M&A transactions in China.

Introduction

In the past year, global M&A activities have experienced reasonable growth and it is expected that the volume of these activities will continue to grow into 2017. As many M&A transactions are completed in China and the number of outbound M&A transactions undertaken by Chinese enterprises continue to increase at a fast pace, the importance of tax throughout the M&A process should be taken seriously. This is true, in particular, at the early stage to ensure that contentious tax issues are identified as much as possible and resolved as soon as possible before closing. Practically, the identification of contentious tax issues is not a simple task during a tax due diligence (TDD) review. In particular, the Chinese tax rules and the application of these rules by the local tax authorities are often inconsistent between different locations in China. In this article, we will discuss the practicalities of tackling tax-related uncertainties during an M&A transaction in China and how these uncertainties and identified tax issues can be overcome and resolved through an adequate level of planning and the use of appropriate solutions.

For any multinational enterprise (MNE), institutional investor, private equity fund, etc. (collectively referred to as "investors" throughout this article) undertaking M&A transactions, thorough tax planning before making the right investment is often the key to maximising returns through steady income streams (e.g. dividends), or capital gains upon divestment. As most investors would probably agree, planning at the pre-M&A transaction stage is often a challenge.

The art of scoping the TDD review

For investors involved in an M&A transaction in China, the process of going through the entire transaction, especially the due diligence and subsequent transaction agreement negotiations, is often challenging. Due diligence, which mainly includes legal, commercial, financial, tax, human resources, and where applicable, technical due diligence, is an essential and paramount procedure of every M&A transaction in China. The due diligence findings can often influence the decision of the investors to buy, or not to buy, into the investment. Such findings also dictate what protections should be sought and included in the relevant transaction sales and purchase agreement (SPA).

The investors wish to confirm that the target or target group of companies (the target) are fully tax compliant. If the target is not tax compliant, the investors at least wish to confirm that the exposures are manageable, that they have identified all material contentious tax issues through a TDD, and that the issues can be addressed. However, in practice, given the more challenging economy nowadays, investors, particular Chinese investors, are facing increasing budget and time constraints to perform TDD. This can result in the scope of work of the TDD review by M&A tax advisers being tailored to be more limited. This may increase the risk of contentious tax issues at the target level because they have not been properly identified and quantified.

Bearing in mind the tight budget and time constraints faced by the investors, it is important to work with M&A tax advisers, who have the relevant industry experience to assist the investors to identify the key potential tax risk areas in the specific relevant industry of the target. This can help the investors to tailor the right scope of work to focus the TDD review on the industry specific contentious tax issues and key tax risk areas. This allows the M&A tax advisers to perform the TDD work within the investors' budget and time constraints.

In terms of best practice, having an appropriately scoped TDD review should be viewed as advantageous because the identified tax exposures can potentially be used as a very powerful negotiation tool with the vendors, as further discussed below.

Contentious tax issues commonly identified during a TDD review

Contentious tax issues in M&A transactions in China are very common. These could arise for various reasons. Some are a result of target company management intent, while some are simply due to their negligence. This may include the target's responsible tax personnel lacking understanding of the tax rules and compliance requirements to be aware of any tax related issues, or lacking the resources and knowledge to deal with any contentious tax issues. It may also result from the target tax personnel lacking timely communications with the business personnel of their overseas travel or business expansions to adequately deal with any potential overseas tax risks. Some typical examples of contentious tax issues in China that are often observed in practice include:

- Transfer pricing (TP) risk on local and cross-border related party transactions due to the lack of a proper TP policy, benchmarking study, and TP documentation;
- Permanent establishment (PE) risk outside China, or in China for the non-Chinese targets with business operations in China created through the physical provision of services by the target's personnel over a certain period, having a fixed place of business, or the negotiation and conclusion of a contract overseas/in China;
- Non-compliance with tax requirements, such as not registering, filing or paying taxes on time. Another example is not reporting gains arising from an internal restructuring (such as under the Chinese Announcement 7 (2015) on issues relating to corporate income tax on gains from the indirect transfer of assets by non-resident enterprises, which is discussed later in this article) to the local tax authority. This may be due to the lack of adequate understanding of the tax rules or an inability to keep up with the constant changes in tax rules; and/or
- Tax deduction risks as a result of the necessary evidentiary document, such as an invoice, payment records and an agreement, not being properly maintained.

The above examples can generally be detected through a documentation review or a management interview during a TDD review. The resolution is generally not difficult, such as putting a set of proper TP policies in place, conducting internal trainings to raise tax compliance and PE awareness, and maintaining proper supporting documents for tax deductions/tax credits.

However, if the M&A tax advisers' TDD scope of work is greatly reduced, there is a risk that they may not be able to uncover those contentious tax issues that have been concealed by the target's management for the purpose of tax avoidance or minimisation during a TDD review. Some typical examples in China, in practice, include:

- Maintaining multiple sets of books prepared by the target, which show less profits for tax reporting purposes, but higher profits for management reporting purposes, resulting in no/minimal tax paid;
- Deliberately declaring a lower value on assets/goods imported into China to underpay the relevant import duties such as VAT, consumption tax and customs duties, etc.;
- Accessing tax incentives by fabricating supporting documents and false declarations of eligibility to the local tax authorities; and/or
- Establishing trading, service and/or intellectual property (IP) holding companies in tax haven/low tax jurisdictions to channel the target's profits without proper TP support that may have resulted in a very low effective tax rate for the target.

In the above situations, it would be even more important to ensure the TDD review is appropriately scoped and sufficiently detailed to be able to identify these contentious tax issues. Without performing a properly scoped and thorough TDD review (at least on the key tax risk areas), it would almost certainly be impossible to identify some of the above tax issues, particularly if management has an intention to hide the relevant evidence and misrepresent matters at the management interview.

Having considered the contentious tax issues identified, the next step is to seek a resolution for these issues.

Resolving the identified contentious tax issues

In practice, the resolution of the contentious tax issues identified during the TDD review is typically achieved through the drafting of the SPA. Investors can successfully use the results of the TDD review to request the vendors to:

- Reduce the purchase price;
- Provide a tax warranty and/or indemnity in the SPA;
- Modify the deal structure (i.e. from a share deal to an asset deal); and/or
- Suspend the deal until the contentious tax issues are reasonably resolved by the vendors.

The above actions are common remedial tools adopted by investors for M&A transactions in China, where the identified tax exposures and issues are within their tax tolerance level to proceed with the acquisition. However, an investor would need a level of protection from the vendors to insure against unwanted tax consequences that may unexpectedly occur in the future.

While an adjustment to the purchase price is ideal, this is only possible if the investors can accurately estimate the potential tax exposure. Furthermore, this is subject to the agreement of the vendors. However, in practice this can be difficult in China. This is particularly the case for those China-based vendors who often adopt the mind-set that a tax exposure/risk can only be recognised as such when only the local tax authority detects it. It may also be the case that there is a significant inconsistency between the tax rules and local practice on a certain tax exposure which the vendor might use as a reason to reject the tax exposure raised by the investors.

Therefore, it is more common in practice for investors to use a warranty and/or indemnity to insure against any identified or undetected potential tax exposures. The decision to use either a warranty or indemnity is contingent on the specific circumstances of the tax issues(s) and the tax position of the target.

Escrow – where money is held by a third-party on behalf of transacting parties – is also a common tool used in the marketplace by investors to resolve tax related issues with vendors. Under this, a portion of the consideration is held in a trust account until certain conditions are met, or the tax statute of limitation lapses. The funds held in escrow are used to compensate for any tax related damages or to settle tax liabilities in case the agreed tax related conditions or procedures are not met/dealt with, or where a tax liability arises as a result of settling a tax audit. In practice, escrow is commonly and effectively used for M&A transactions in China involving offshore indirect transfers of Chinese assets where Announcement 7 obligations are involved at pre-closing and Chinese tax liabilities may arise post-closing. This is further discussed in the next section.

Realistically, investors would not be able to gain a complete knowledge of the target's contentious tax issues during the limited timeframe of the TDD process. The level of difficulty would also substantially increase for foreign investors investing into China who are inexperienced with the local business and tax practice. Hence, it is important for all investors completing M&A transactions in China to sufficiently cover themselves with a warranty or indemnity and/or enter into escrow arrangement(s) with the vendors before committing to complete the acquisition.

In the worst case scenario, where the identified tax issues are so significant and the investors and vendors could not mutually agree to a resolution via the SPA, the investors can always terminate the deal. This can avoid any unwanted litigation with the vendors in the future and avoid incurrence of further time and other costs required to resolve the tax issues. While rare, tax-related deal breakers do exist in the Chinese marketplace.

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Pre-closing dilemmas

Having identified the contentious tax issues and agreed to a resolution with the vendors, the investors may face more dilemmas at the pre-closing stage in terms of what to do next. At this stage, investors generally face a number of dilemmas including the following:

- The acquisition and holding structure to be used for acquiring the target group of companies in China. This should consider the impact on the future taxes throughout the investment lifecycle, from tax exposures on dividend, interest and/or royalty payments during the holding period, to capital gains upon exit. It should also be considered whether treaty benefits under an applicable double tax treaty with China would be available and how this would impact the tax assumptions in the financial model;
- Whether any tax incentives/attributes being obtained by the target would still be available post-acquisition as a result of a change of ownership of the target, and if so, how to ensure the tax incentives/attributes can be sustained;

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- Where pre-closing restructuring will be undertaken by the vendor, whether any tax relief (say, in the form of a deferral of tax on the gain from the restructure under Caishui (2009) Notice 59) applied on the restructuring is sustainable at closing and post-acquisition, and if not, what measures or protections should be sought from the vendors; and
- How to sustain the investment cost base and minimise tax upon a future exit, including whether to model, and how to manage, any potential taxes arising on future indirect transfers of the underlying investments at an offshore level, such as Chinese tax under Announcement 7 for indirect transfers of Chinese taxable assets.

How to deal with Announcement 7 issues?

Another dilemma investors commonly face in deals involving the offshore indirect transfer of Chinese taxable assets is the fulfilment of obligations under Announcement 7.

While the vendor is the ultimate taxpayer, the investor (as the buyer) is obligated to withhold any Chinese tax arising from the indirect transfer of Chinese taxable assets. Failure to do so would result in the investor being hit with a penalty imposed by the Chinese tax authorities. Accordingly, the investor and vendor have to agree on whether the indirect transfer of Chinese taxable assets will be reported to the Chinese tax authorities, and if so, who will perform the reporting. In practice, conflict between the vendors and investors is not uncommon due to the vendors not willing to report, or not willing to allow the investors to report, the indirect transfer to the Chinese tax authorities. Such disagreement on reporting has in fact resulted in deal breakers in practice where the quantum of the potential Chinese tax exposure, as well as the potential penalty and interest under Announcement 7, is too significant for the investors to bear.

In practice, even if the vendors refuse to report the transaction to the Chinese tax authorities, they have generally agreed to provide an indemnity to the investors, which means that any tax arising under Announcement 7 is reasonably compensated by the vendors to the investors. Where the investors agree that the risk of tax being imposed under Announcement 7 is not high in their specific circumstances, they have often accepted such resolutions for the matter.

In certain cases, particularly where the risk of Chinese tax being imposed is high, the vendors may also agree to setting up an escrow account. An estimate of the Chinese tax will be held in the account until either the Chinese tax authorities confirm no tax is payable, or a number of years have lapsed (a period of three to five years is common in the marketplace).

However, due to the uncertainty as to how the Chinese tax should be calculated under Announcement 7, there are often disagreements between the investors and vendors on the amount to be withheld in the escrow account to cover the potential Chinese tax. For example, the vendors and investors may disagree on whether the consideration, for the purpose of calculating the indirect transfer gain under Announcement 7, should include the vendors' shareholder's loan. They may also disagree on whether any negative net asset value of overseas holding companies should be adjusted from the consideration. Furthermore, the vendors and investors may disagree on the investment cost base that should be used for calculating the Chinese tax. Given that the amount of Chinese tax payable will not be known until after closing, which is when the tax obligation technically arises, it is ultimately a commercial negotiation between the vendors and investors, and possibly their M&A tax advisers, as to the appropriate amount to be withheld and agreed in the SPA.

What protections should be sought in the SPA?

A noteworthy point to consider at pre-closing is for the investors' M&A tax advisers to review the tax clauses in the SPA to ensure the provisions are properly drafted to protect the investors on the identified and unidentified tax exposures. This is actually becoming an essential part of the contract drafting and execution process. A common practice is for the M&A tax advisers to negotiate with the vendors and/or their legal and tax representatives on the tax clauses on behalf of, and for the benefit of, the investors. The increasing need for a tax clause review is a direct result of the increasing complexity and severity of tax impositions related to M&A transactions. It is also a consequence of the unique characteristics of the Chinese tax environment, where M&A tax advisers' knowledge of local tax rules and practice can offer creative solutions to the issues faced. Ultimately, agreeing to the tax clauses in the SPA relies on intensive commercial negotiation between the vendors and investors, where the results are quite often driven by the bargaining power of either parties.

All in all, the contributions made by the M&A tax advisers in a SPA review can often lead to a beneficial outcome for the investors. This is by contractually shifting any identified/unidentified tax liabilities to the vendors, or at a minimum, by both vendors and investors mutually agreeing on how the contentious and unidentified tax issues can be satisfactorily resolved between both parties. This would at least allow the investors to decide whether to take the risk if no protection can be offered by the vendors under the SPA.

Post-acquisition dilemmas

At the post-acquisition stage of the M&A transaction, the dilemmas do not necessarily end for the investors. Quite often, the investors may face risks that the projected values for the target will deviate from the actual values, due to a lack of tax-related awareness post-acquisition.

Is the holding structure sustainable?

After an acquisition, it could occur to the investors that the structure they used to invest into the Chinese target can no longer sustain any treaty benefits. This may be due to the constantly changing and inconsistent assessment practice of the tax authorities in various locations in China. As a result, the tax costs may increase substantially on the distributions flowing through the structure from China back to the investors. This situation is starting to become common in the Chinese marketplace. China is taking a more stringent approach in granting treaty benefits to overseas treaty claimants. At the same time, treaty claimant countries are also becoming more stringent in reviewing and granting tax resident certificates (TRCs) to treaty claimants so they are not regarded as tax haven countries. Without a TRC, the treaty claimants would no longer be able to access treaty benefits in China.

As an example, take investors using a Hong Kong holding company to invest into China. Completing and filing the relevant paperwork with, and responding to rounds of enquiries from, the Hong Kong Inland Revenue Department (IRD) is now a daunting process because the IRD has stepped up its efforts in making in-depth enquiries into the applicant's business status. It is now becoming more common to see the IRD reject the grant of, or prolonging the process for granting, TRCs to applicants where there are only limited business operations in Hong Kong. Hence, the use of Hong Kong as an investment platform for the dominant purpose of achieving treaty benefits, such as reduced withholding tax rates on dividends distributed from China to the Hong Kong holding company, should be reconsidered by investors. This renewed approach from the IRD has particularly impacted those investment structures where Hong Kong has historically been used as the holding jurisdiction for investments into China.

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Should investments be made to improve the target's tax profile?

Another dilemma is whether the investors should further invest into the target for the purpose of improving its overall tax profile. This might be, for example, by resolving any previous tax non-compliance issues identified during the TDD review, implementing proper TP policies in light of the OECD Base Erosion and Profit Shifting (BEPS) Project related to tax changes, or improving for any tax inefficiencies of the target's existing operational and/or holding structure. However, the investors would need to consider whether such changes in tax policies/corrections for previous non-compliance practice could result in the Chinese tax authorities performing a tax audit/investigation on the historical open tax period. They would need to consider whether any tax liabilities arising from the historical period (pre-acquisition) could be indemnified by the vendors under the SPA.

Subject to reservations expressed above in relation to the risk of triggering tax audits, improving the tax profile of the target may bring benefits over the longer term. Improving the tax profile of the target not only maximises its after-tax returns, but having a cleaner tax record would also reduce the possibility that future investors might seek to leverage contentious tax issues as a bargaining tool. It may also, where applicable, increase the chance of passing a future initial public offering (IPO) audit. One benefit is that companies in China with excellent tax compliance records may be awarded a "Class A" taxpayer status by the in-charge tax authorities. This recognition not only adds to the tax credentials of the investment companies in China, which may be of benefit to the investors' future disposal plans, but also demonstrates to the general public that the current investors of the award-winning companies in China are managing their investments well.

As for the non-tax reasons, the investors investing more to improve the Chinese tax profile of the target allows the investors to demonstrate their commitment to the target. It shows that the investors are investing in the target's future to improve its after-tax earnings for the benefit of all the stakeholders, and may also enhance the business relationship between the investors and the target's management team.

Uncertainties in the international tax environment impacting on M&A transactions in China

In light of the constantly changing tax environment, it is worth singling out the BEPS Action Plan introduced by the OECD and consider its impact on M&A transactions in China.

BEPS has prompted many organisations' boards to take tax risks seriously as the BEPS changes could greatly impact an organisation's business model and investment structure.

With China taking a very active stance in localising BEPS into its tax rules, we foresee that the following areas of M&A transactions in China could seriously be impacted by BEPS in the future. This is in addition to the BEPS influence on TP, which clearly impacts the identification of TP risks during the TDD and the need to improve TP policies post-M&A. The risks include:

- Investment structuring and treaty shopping – with Chinese tax authorities increasing their efforts to combat tax avoidance and adopting BEPS measures, a low substance investment structure may be much less likely to achieve the treaty benefits on distributions through the structure from China to offshore. Consequently, this may impact the investors' returns; and
- The use of hybrid financial instruments (FIs), such as convertible bonds, which exhibit both the characteristics of a debt and equity, in financing an M&A transaction – such hybrid FIs may result in a mismatch in tax treatment by tax authorities in two different jurisdictions. This could arise where the FI-holder in one jurisdiction, say China, can obtain a tax deduction on the expense while the FI-issuer in another jurisdiction, say Hong Kong, is not taxed on that income. BEPS initiatives are seeking to negate the aforesaid tax advantage through the introduction of "co-ordination rules". Future changes in tax treatment for hybrid FIs would therefore impact how the financing of M&A transactions should be structured in China.

In view of what has been discussed throughout this article, investors will go a long way with their investments in or out of China if they can find a balance between having a properly scoped TDD review, seeking proper protections during the SPA negotiation process, and putting in place a tax efficient and sustainable operational, financing and investment structure that can legitimately maximise after-tax earnings and minimise tax leakage on divestment.

Also, from a non-tax perspective, understanding the Chinese business culture and local practice can often make a difference for the investors in meeting their investment objectives in China.

The authors would like to thank Winson Chan for his contribution to this chapter.

China tax – big data and beyond

Enhanced use of tax technology by the Chinese tax authorities, more sophisticated targeting of taxpayers, and heightened engagement between China and overseas tax authorities are the focus of this article by Tracy Zhang, Marianne Dong, David Ling and Karmen Yeung.

Introduction

In May 2016, the Chinese State Administration of Taxation (SAT) hosted the 10th plenary meeting of the OECD Forum on Tax Administration (FTA) in Beijing. At this event, the tax commissioners of 44 tax authorities from the leading global economies came together to share best practices in relation to tax administrative practices. As the host, the SAT took the opportunity to provide a detailed explanation on the strides that China has made in recent years in upgrading its tax administration and, indeed, the SAT had a great deal to tell.

As discussed in last year's *China Looking – Ahead* in the chapter, *New challenges to tax risk management in China*, advances are being made on many fronts in relation to Chinese tax administration. This includes, among many other changes, improved tax rule-making processes, new arrangements for collaboration between state tax bureaus (STBs) and local tax bureaus (LTBs), and new tax administrative processes that replace cumbersome tax pre-approvals with data-driven, follow-up tax audit procedures.

These measures to enhance taxpayer certainty, improve the usage of tax authority resources, and ensure better tax compliance are being driven by massive investment in technology. For example, the radical China VAT reform of 2016 would have been inconceivable without the real-time information collection, cross-checking and sharing permitted by the Golden Tax Project III and the new VAT Invoice Processing System. The drive being made to get taxpayers to conduct all their interactions with the tax authorities through the internet, apart from decreasing compliance costs and limiting opportunities for corruption, also provides the electronic data 'fuel' for ramped-up big data analysis for tax audit targeting and for taxpayer risk rating. More "fuel" will come on tap shortly, with the activation of China's new arrangements for the international automatic exchange of tax information (AEOI) under the OECD's common reporting standard (CRS).

This chapter will clarify how the SAT has moved quickly in 2016 to consolidate the improvements arising from the numerous tax administrative reforms undertaken in 2015, which were detailed in last year's chapter. It will look at the initiatives likely to have a major impact in 2017 and beyond, and the implications for taxpayers.

Building on 2015 developments towards greater tax certainty

Last year's chapter explained, in detail, how the SAT had made great efforts to improve the clarity of the tax law and the consistency of tax enforcement. These efforts continued in 2016.

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Tracy is national leader of the tax transformation service line. She has been seconded to KPMG Holland to study the Dutch horizontal monitoring system and has extensive knowledge of the tax risk control framework in many countries. She has led the professional team and assisted a number of state-owned enterprises to establish or improve their tax risk control systems.

Ever-increasing numbers of enforcement cases are being publicised through tax authority information platforms, in particular through the WeChat mobile messaging service. This grants taxpayers and advisers an enhanced view of the types of tax issues being focused on by the authorities, and clarifies how information exchange and big data analysis are increasingly driving case identification. Continuing the trend observed in last year's chapter, guidance on new tax regulations is becoming ever more detailed and the SAT response time to emerging issues is becoming quicker. The manner and speed with which detailed and voluminous VAT guidance was issued in the wake of the May 2016 VAT reforms is testament to this. At the national level alone, 33 SAT Circulars have been issued between May and October 2016 to clarify specific VAT reform matters, with many more issued at the provincial and local levels.

A highly significant new development, with major implications for improved clarity in Chinese tax law and for the manner in which tax law is enforced by the authorities, has been the recent hearings given by the Chinese courts to cases addressing the substantive interpretation of Chinese tax law. As discussed in the chapter, *BEPS in China – multi-track developments*, a case heard by the Zhejiang Province People's High Court in December 2015, concerning The Children's Investment (TCI) fund, was the first Chinese court case to consider the application of the Chinese general anti-avoidance rule (GAAR) to an indirect offshore transfer. A second case heard by the Court of Zhifu District of Yantai City in Shandong Province in December 2015, related to the application of the corporate income tax (CIT) reorganisation relief provisions to a cross-border restructuring of a China investment. A third case, heard by the Guangdong Province People's Intermediate Court, considered the individual income tax (IIT) implications of dual employment arrangements and the application of the China-US double taxation agreement (DTA).

The emerging new trend for cases to be brought to court holds out the potential for enhancing taxpayer certainty with respect to cross-border transactions. This is firstly, by generating, over time, a body of court interpretations that were previously lacking in Chinese tax law, and secondly by providing a path for taxpayers to resolve disputes in individual cases beyond traditional informal negotiations with the local tax authorities. This being said, in many parts of the country local tax authorities may still not be keen for cases to go to court, given the potential for loss of face. Consequently, the transition towards greater court involvement in China taxation will likely differ in degree and pace across the nation.

In relation to obtaining greater certainty for taxpayers, the new trend for tax authorities to grant private tax rulings for cross-border transactions is also significant. Local tax authorities have, with the SAT's encouragement, been granting such rulings for purely domestic transactions for several years. In this regard, a municipal state tax bureau in Jiangsu Province issued a private tax ruling in November 2015 regarding the application of reorganisation relief to the merger of two non-resident holding companies, involving a change in the registered owner of equity in a Chinese enterprise. This received extensive publicity in the Chinese tax media.

Last year's chapter detailed how, in 2014 and 2015 the SAT had abolished almost all of the tax authority pre-approvals that used to be required for a wide range of tax treatments. These ranged from the granting of tax incentives, to the use of tax treaty reliefs, and even to routine matters such as the recognition of tax losses realised on asset disposals. In February 2016, in SAT Announcement 11 (2016), the SAT outlined that just seven matters will be retained as pre-approval items going forward. These related to minor administrative matters, such extensions of tax payment or filing deadlines, but they do not concern substantive tax treatments for tax computation purposes.

As such, the extension of private tax rulings to cross-border transactions, flagged by the November 2015 Jiangsu ruling, is very important. To explain, abolition of pre-approvals frees up both taxpayer and tax authority resources, by releasing both from having to engage in the pre-approval filing and examination process. But, at the same time, it diminishes taxpayer certainty by leaving open whether the tax authorities would accept the taxpayer position on an audit.

However, this gap is being bridged by the progressive introduction of a system of private tax rulings, together with measures to clarify tax laws and ensure consistent enforcement. This is reinforced by improved taxpayer internal tax risk management control systems that are being progressively put in place, particularly by larger and more sophisticated taxpayers. As mentioned in last year's chapter, a greater expansion of private tax rulings is envisaged from 2017 when the new Tax Collection and Administration (TCA) Law, which includes specific provisions on rulings, is expected to be finalised.

Also of direct relevance to greater taxpayer certainty, and as discussed in the chapter, *China transfer pricing – first mover on BEPS,* is how the SAT is actioning plans to rapidly ramp-up the resources committed to their advance pricing agreement (APA) and mutual agreement procedure (MAP) programmes. It has also issued new guidance on APA administration in SAT Announcement 64 (2016) in October 2016. These steps support China's commitment to the BEPS Action 14 minimum standards for "Making Dispute Resolution Mechanisms More Effective", for which APAs and the MAP both form a crucial part. As explained in the chapter, *BEPS in China – multi-track developments*, the SAT views these programmes as having a particularly important role in obtaining more tax certainty for outbound investing Chinese multinational enterprises (MNEs). The tax authorities are encouraging such enterprises to open APA processes with the SAT. Numerous MAP cases have also been reported, in which the SAT intervened decisively on the part of Chinese MNEs engaged in tax disputes with overseas tax authorities. However, it might be observed that with resources at the SAT still being limited prior to the planned ramp-up, APA applicants are more likely to get a positive reception where the APA is being sought for new types of related party transactions or for new counterparty authority country locations, thus helping the SAT to expand their experience and knowledge in the APA space.

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Advanced targeting of taxpayers and issues – the central role of tax data

The remaking of Chinese tax administration has, at its core, new approaches to targeting taxpayers and tax issues. The more efficient use of tax authority audit resources, directed towards taxpayers who constitute a credible risk of loss of tax revenue, is the complement of other efficiency enhancing measures mentioned in this chapter (e.g. the abolition of pre-approvals, digitisation of taxpayer filings and automation of invoice checking).

This enhanced targeting consists of a number of strands, including:

- New institutional and operational arrangements for conducting tax audits;
- Close collaboration with the largest enterprises in the enhancement of their tax control systems; and
- Tax risk rating (referred to as tax credit rating) of the population of taxpayers, which accompanies other data-driven audit targeting approaches.

For tax audits, a more targeted and somewhat less aggressive approach is progressively being deployed. In the past, the audit bureau of local tax offices could select pretty much any taxpayer at random and launch into audits in a sometimes quite aggressive manner. The new approach is for much of the early taxpayer engagement to be handled by the tax collection bureau, within a local tax office, as assisted by the policy bureau. Based on tax risk assessment, the tax collection bureau will identify particular taxpayers from which further clarifications are needed. Further information will be requested and, if the information confirms that the taxpayer is a risk case, then the tax audit division will become involved. Taxpayer experience of the new approach, where it has been rolled out, is that it is less often as 'hard-edged' as the earlier approach.

Even for tax audit initiatives handled in the first instance by the audit bureau, their work is increasingly defined by national campaigns spearheaded by the SAT, for example in the real estate industry and for cross-border payments. The SAT conducts extensive industry analysis in advance and, therefore, the taxpayers pursued by the audit bureau are those who have high risk tax risk indicators. Data is drawn from a wide variety of sources, including information from other government authorities such as the State Administration of Foreign

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Exchange (SAFE), so that a far more scientific approach is taken to selecting audit targets. The more sophisticated approach, by being less likely to fall upon taxpayers with no outstanding tax issues at random, and by being more measured, is seen to be conducive to reducing the potential for confrontation and disputes.

Closer collaboration with the largest taxpayers is also a key focus of the SAT's new approach. The SAT launched the "1,000 Enterprises Initiative" in July 2015. This programme covers about 1,000 representative large enterprises from different industries, including MNEs, state-owned enterprises and private enterprises. The chosen companies are given priority access to tax officials at provincial and state level. The idea is that these enterprises can reach beyond the lower level tax authorities, formally responsible for their affairs, and resolve matters at the provincial level. There has been a focus on building up services at the provincial level, with tax authorities encouraged to grant rulings to large enterprises on request, and to assist them with improving their tax control systems. On the whole, it is hoped that this approach will result in more effective tax management and lower disputes. The *quid pro quo* is that covered enterprises must provide not only tax return and financial statement data, but also information on electronic accounting ledgers and vouchers. This data becomes a key input into tax authority risk analysis models with risk indicators for different industries.

The 1,000 Enterprises Initiative complements initiatives established by the SAT in earlier years, such as the tax compliance agreements (TCA) programme, orchestrated through the SAT large enterprise taxation department. This seeks to leverage the sound internal control through the tax risk management (TRM) systems of the enterprises participating in the programme to minimise the need for inspection of taxpayers' tax reporting and compliance.

Better audit targeting is ultimately driven by data analytics. Pooled data streams, including information on taxpayer TRM systems and historic compliance, as well as business and transactional information, are being harnessed for the tax risk classification of taxpayers. The metric developed is referred to as a 'tax credit rating'. The information on which tax credit ratings are based include internal tax information held by the tax authority, such as records of decisions/conclusions in the tax administration system of tax assessments, tax audits on large enterprises, tax anti-avoidance and tax investigations, as well as external information. The tax credit rating system has been progressively developed through a range of SAT circulars. These include SAT Announcement (2014) no. 40, SAT Announcement (2015) no. 48, and SAT Announcement (2015) no. 85, with further guidance in SAT Public Consultation Draft Circular on Special Tax Adjustments (2015).

As with the schemes increasingly used in Western countries, the tax credit ratings are intended to facilitate the concentration of audit resources on risky taxpayer segments, with low risk taxpayers commensurately accorded a lower level of scrutiny and audit. Credit ratings, A being the best to D being the riskiest, are to be awarded to taxpayers and are to be publicised by the tax authorities. The supervising tax authorities are responsible for the tax credit assessment, determination and announcement of the results. The upper tax authorities shall publicise the results on a consolidated basis.

Importantly, the tax credit rating of taxpayers is now being linked to the availability of preferred treatments. In order to foster the creation of incentives for compliant tax behaviour, 29 Chinese regulatory authorities signed a cooperation memorandum in July 2016, providing for 41 incentive measures, issued as National Development and Reform Commission (NDRC), People's Bank of China (PBOC), SAT Circular (2016) no. 1467. These include:

- Expedited arrangements for obtaining special and ordinary VAT invoices. Businesses generally obtain blocks of invoices to cover a month of their estimated needs from the tax authorities. Class A rated taxpayers can obtain three month blocks and replenish readily if VAT invoices are exhausted;
- Green lane access (i.e. a special service window at tax service halls) for Class A rated taxpayers;
- Priority handling of export VAT refunds for Class A rated taxpayers;
- No need for Class A rated taxpayers to have their invoices scanned for verification by the tax authorities. Class A rated taxpayers need simply to log on to their online account and confirm that the VAT invoice information on the tax authorities' systems is correct;
- Priority export and import clearance processing from the customs authorities for Class A rated taxpayers;
- PBOC and China Banking Regulatory Commission (CBRC) instructions to banks to take into account tax credit ratings when granting loans to enterprises. This policy is going nationwide after earlier being piloted in some of the free trade zones (FTZs) under SAT Circular (2015) no. 208; and
- Expedited processing times for Class A rated taxpayers from NDRC and Ministry of Commerce (MOFCOM) on approvals for industrial and engineering projects, company establishment, M&A transactions, etc.

These preferential treatments exist alongside other types of incentives for enterprises with good tax risk ratings. The following incentives have been piloted in the FTZs and may be expanded nationwide at a later point:

- Class A rated software exporters based in the Shanghai national innovation demonstration zone may file VAT returns on a quarterly rather than monthly basis; and
- The FTZs have launched a policy under which private tax rulings may be granted to taxpayers having a sound TRM system and a Class A rating.

As can readily be appreciated, giving effect to such novel arrangements requires far better drawn arrangements for cooperation between tax authorities and other government agencies, vast sources of information, and high end systems for data storage and processing. China's recent advances in relation to all three of these dimensions are set out in the next three sections.

Updated tax authority institutional arrangements for a new era of tax enforcement

A core initiative in the reform of China's tax administration in 2016 was launched on December 24 2015 with the issuance of the plan on deepening the reform of state and local tax collection and administration systems by the general office of the State Council and the Central Committee of the Communist Party of China. This was followed by a battery of circulars issued over the course of the year that intended to achieve a new intensity of structured cooperation between STBs and LTBs at all levels of government in China. At the May 2016 FTA meeting in Beijing, the SAT placed particular emphasis on this initiative in its outline of Chinese tax administrative reforms to the collected tax commissioners from around the world.

Measures taken to more systematically allocate tasks between STBs and LTBs, and foster collaboration in tax administration include, *inter alia*:

- The SAT Guidelines on STB-LTB cooperation, at version 3.0 from July 2016, which provide a number of key collaborative measures. These include the sharing of tax service halls to limit taxpayers having to shuttle between locations, and establishing a unified mobile online systems for tax services;
- Unified standards between LTBs and STBs in relation to the documentation that must be filed in regarding tax incentives are being pursued; and
- LTBs and STBs are to jointly draw up lists of major taxpayers and identify tax risk areas relating to this pool of taxpayers requiring explicit follow up (e.g. incentives, losses, and restructurings). Detailed guidance for joint audits by LTBs and STBs is directed at ensuring effective

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information sharing and collective planning/execution of audits to increase effectiveness and limit the duplication of efforts;

With regards to the latter point, the SAT has provided guidance, in SAT Circular 71 (2016) of May 2016, on exactly which of the abundant new data sources are to be used for the selection of targets for tax inspection. Tax audit relevant information from these preferred data sources will be stored on individual taxpayer files based on their tax identification numbers (TINs) for use by tax inspection bureaus. The guidance also sets out protocols for the latter to follow in selecting and pursuing cases.

This is coupled with the SAT guidance for provincial tax authorities on drawing up lists of key tax audit targets. The conduct of this list-making process rests heavily on data from the tax credit rating system, on information obtained from other government agencies regarding enterprises delinquent in other aspects of their corporate compliance (e.g. social security affairs), and on the lists of taxpayers with high risk features as collectively identified by LTBs and STBs. These enterprises will be grouped with the lists prepared by the SAT on key SOEs and large companies with operations spanning different tax districts in China to establish final lists of local key audit targets. Rolling inspections of key audit targets will have each key enterprise audited at least once every five years. For non-key enterprises a different approach will apply and approximately 3% of the non-key enterprises will be audited annually on a random basis, as provided for in the SAT Circulars 73 and 74 of 2016.

These efforts to get LTBs and STBs working together in a more coordinated, effective fashion will be accompanied, going forward, by steps to clarify the framework under which the LTBs and STBs may mutually collect taxes for each other. Future plans also include setting out comprehensive updated arrangements for the sharing of revenues from national taxes between central and local levels of government.

To take, for example, the May 2016 reform of transitioning business tax (BT) to VAT, the SAT has clarified in what circumstances the LTBs are entrusted by the STBs to accept VAT returns and issue VAT invoices. Before BT was abolished, LTBs administered the tax because the revenues from the levy accrued to the local levels of government in China. Even though VAT is generally administered by STBs and VAT revenues accrue largely to central government (historically split 75% to central government and 25% to local government), LTBs are still being given a role in VAT collection because of their historic experience of collecting BT on the transitioned tax objects. As an interim arrangement until 2018-19, to compensate for the loss of BT revenues, the local governments' share of VAT will be increased to 50%, pending a more permanent settlement to be put in place at that time.

All of the existing STB-LTB arrangements for mutual collection of taxes and tax revenue sharing can be seen to be in transition, and a new, more systematic set of arrangements is set to emerge in due course. The SAT has planned a fundamental modernisation of Chinese tax administration by 2020. This includes, *inter alia*, moves to put existing tax regulations on a statutory basis and the Spring Breeze project to improve taxpayer services.

A key initiative facilitating the LTBs and STBs to work closer together, and with other government agencies, is the move to unify five enterprise certifications, with five different government authorities, into a single certification. Three licences, the business license, tax registration and organisation code certificate, were initially unified in the 'three certificates into one' reform in 2015. These are now being coupled with the social insurance and statistics registration licenses for a 'five certificates into one' certification. Moreover, an enterprise will now get a unified social credit code upon its business registration to supersede different identification numbers issued by different authorities in the past. This is the so-called 'one license with one code' business registration regime. It might be noted that one key improvement from this system is that newly established enterprises will no longer need to register with the tax authorities separately, as the initial registration with the administration of industry and commerce automatically registers the enterprise for tax.

This integrated and coordinated cooperation of Chinese local tax authorities with each other, and with other agencies of state, is a crucial pre-requisite for the increasing streams of tax data to be collected, pooled, analysed and used effectively.

Tax information – swiftly coming on tap

The fuel for China's new approaches to tax administration is vastly expanded volumes of tax data. The SAT is engaged in a whole series of initiatives that maximise tax data resources, including:

- Moving taxpayers in the direction of completely digitised dealings with the tax authorities, thereby rendering tax data in an electronic form susceptible to pooling and analysis;
- Pooling domestic data from across domestic tax authorities and other government agencies; and
- The international exchange of information (EOI) initiatives.

Under the government's "Internet + Tax" action plan, the Chinese tax authorities progressively facilitate the conduct, by taxpayers, of all their interactions with the tax authorities (e.g. tax filings, electronic invoice management, enquiries, etc.), through the internet and in digital form. This initiative was a particular focus in SAT presentations to global tax commissioners at the May 2016 Beijing FTA meeting. Key individual initiatives include:

- Online tax handling. The transition to online tax handling is being spearheaded by certain cities and regions, in line with the 'pilot city' approach, which is typical of Chinese tax reforms. So, for example, the Beijing STB in 2016 is piloting paperless management of export refunds of VAT.

Under Beijing STB Announcement 13 (2016), a declaration for an export VAT refund or exemption has to be made online, with paper documents not submitted but simply kept on file by the taxpayer for future inspection. As noted above, there are efforts in the context of the State Council's plan on deepening the reform of state and local tax collection and administration systems, for STBs and LTBs to provide joint online and mobile platforms for tax registration, invoice handling, filing, payment and other functions, and to provide LTB and STB tax services at the same physical locations;

- Paperless tax administration. The move online is also linked, as noted above, to efforts to handle all tax matters, where practical, digitally and reduce the use of paper forms and other documents. A nationwide move from paper to digital VAT invoices was initiated by SAT Announcement 84 (2015) in November 2015 for roll out in 2016. This has even gone so far that some Chinese tax authorities are starting to make the issuance of electronic ordinary VAT invoices mandatory, thus disallowing the issuance of printed invoices. This is the case in Beijing with respect to telecommunications service providers, as provided in Beijing STB Announcement (2016) no. 16. This is paralleled by the move to digital customs declarations, with paperless customs having been expanded nationwide in February 2016, under the MOFCOM, GAC Announcement 5 (2016). Customs is indeed at the forefront of the digital transition in China, with a dedicated data exchange interface between taxpayer internal customs records and the customs authority's data systems being launched in 2016 under GAC Announcement 16 (2016);
- Online pre-approvals. To the limited extent that some pre-approvals are to be retained by the tax authorities, following on from the mass abolition of pre-approvals in 2015, these are being shifted to online platforms. The SAT has directed, in SAT Circular 142 (2015), that all of the remaining non-abolished tax pre-approval items will be facilitated for online approval; and
- Tailored online and mobile tax information services**.** Significant resources are being invested in online, mobile phone (e.g. WeChat) and telephone information facilities for taxpayers. Taxpayers will be able to access information online that the tax authority retains on them. Services are also being tailored for specific sets of encouraged enterprises, such as 'go global' Chinese enterprises operating in One Belt, One Road jurisdictions.

Apart from the efficiency advantages of these developments, and the reductions in personal interactions between authorities and taxpayers that cut opportunities for corruption, the fact that this information is in a digital form provides tremendous amounts of data for the tax authority to analyse. Data received in the appropriate electronic format can then be pooled with other data sources.

In this regard, China is getting more efficient at pooling the data from domestic sources, and therefore existing tax reporting requirements are becoming ever more detailed.

- Information sharing between government agencies: The 5-in-1 certification system for businesses, mentioned above, allows for enhanced information sharing between different government agencies. This sits alongside numerous other initiatives to pool, together with tax information, data from Customs, MOFCOM, the Ministry of Finance, SAIC, public security bureaus, social welfare authorities, and other bodies. Various inter-agency memoranda of cooperation provide the basis for this data pooling, such as the SAT's memorandum of joint action against tax evasion with the SAIC and CSRC, and dedicated information sharing platforms that facilitate the electronic dissemination of the information itself.
- More detailed taxpayer filings: Taxpayer filings are also getting more in-depth on many fronts. The 2015 move in China from tax authority pre-approvals to taxpayer self-assessment has been complemented by taxpayer filings (e.g. for treaty relief), becoming much more detailed. The transfer pricing documentation enhancements under SAT Announcement 42 (2016) have also radically upgraded contemporaneous documentation through the local and master files, and related party transaction filings have been significantly expanded, including the addition of the country-by-country (CbC) report. The local file alone requires an extensive value chain analysis, a decomposition of income streams by business line and by product, and extensive new detail on outbound service payments, equity transactions, and outbound investments, which is also mirrored in the related party transaction filings. Enhanced CFC reporting is also provided for under SAT Announcement (2014) no. 38.

All of this data will, in line with the broad move to online tax compliance, ultimately be input by taxpayers online or otherwise supplied in a digital format.

The Chinese tax authorities are also radically enhancing the information they collect on taxpayers' TRM systems. Originally carried out on an ad-hoc basis, reviews of such TRM systems has become a steadily more standardised component of routine tax audit work, as well as in taxpayer 'self-investigations'.

Once the new Tax Collection and Administration (TCA) Law is in place from 2017, financial intermediaries and e-commerce platforms will become key sources of tax authority information. Financial institutions will record taxpayer identification numbers (TINs) in the bank accounts of taxpayers and where business-related payments exceed certain thresholds then these details, together with the TIN of the payee, must be provided to the tax authorities. Obligations for using TINs with all sorts of contracts will put the tax authorities in a position to better match transactions. E-commerce platforms will also be obliged, under the TCA Law, to provide information on online trader transactions. In parallel, it should be noted that the requirement, in MOF, GAC, SAT, Circular 18 (2016), for e-commerce platforms and couriers to supply B2C import information directly to the customs authorities, has already brought significant cross-border e-commerce information on an ongoing basis in this regard.

Finally, beyond the transition to online filing and digitisation, which allows for better capture of taxpayer data, the enhanced details within filings and the new mechanisms for domestic data pooling, China has significantly enhanced its capacity for cross-border tax information exchange, particularly through:

- Enhancements to the EOI articles in China's treaties and entering into Tax Information Exchange Agreements with 10 major tax haven jurisdictions;
- The FATCA-related intergovernmental agreement with the US for AEOI;
- The AEOI under the OECD's CRS system, supported by China's adherence to the CRS Multilateral Competent Authority Agreement (MCAA) from 2018. Formal Chinese regulations to support CRS were issued as a public consultation discussion draft on October 14 2016, setting out details of the financial account information to be reported by financial institutions to the Chinese authorities for exchange with other countries, and the details and timeframes for the due diligence to be conducted by these institutions up to the end of 2017;
- The CbC report exchanges under the CbC MCAA from 2018; and
- The multilateral exchange of intelligence on aggressive tax planning strategies through the OECD FTA and the Joint International Tax Shelter Information Centre (JITSIC).

The SAT are keen to emphasise the message to taxpayers that they are actively using these new resources. Many of the increased number of tax enforcement cases, reported through WeChat, highlight that big data analysis drove the 'red flagging' of the taxpayer case in the first instance, and that an EOI request to a foreign tax authority provided information on which the enforcement action could be brought forward.

Investment in infrastructure – systems to support an upgraded tax administration

In order to facilitate the new data-driven tax enforcement approaches, the Chinese authorities continue to push the construction and expansion of information platforms.

China is investing in enhanced data warehousing capacity for storing and manipulating huge quantities of tax-relevant data. The sophistication and capacity of these data warehousing systems will become crucial for the Chinese tax authorities in future years as they turn on of the data 'tap', particularly with the planned developments in the new TCA Law and CRS, which will demand capacity to match billions of transactions each year. As noted, the move to online filing and use of digital tax documents facilitates the direct channelling of tax information into big data analysis. Such systems are also necessary to handle the data streams generated from other new tax technologies, such as the 'web crawler' technology used to collect tax-related public information on indirect offshore transfers from the internet. The new national tax authority IT system, referred to as the Golden Tax III project that provides for the centralised collection of national tax data, is crucial in the regard.

Progress has been made towards rolling out the Golden Tax III project to all provinces in China by the end of 2016. The project is running in parallel to other new IT systems projects, such as a new VAT invoice system rolled out in 2016 to allow for real time cross-checking of each VAT invoice. This builds on earlier successes such as the core China taxation administration information system (CTAIS), which integrated all STBs with each other and with other key government institutions for tax data storage, exchange and analysis, and the Golden Tax II project of the late 1990s/early 2000s, which originally standardised national VAT administration.

The Golden Tax III project aims to achieve consistent nationwide tax administration backed by information technology and the processing of tax data in a highly efficient manner. As such, it will not only transform the tax authority's operating system, but will consequently change taxpayers' compliance procedures as well. Once implemented, the improved system and optimised procedure will help the tax authorities to tighten their administration of taxpayers. The Golden Tax III system will automatically detect tax risks that were being ignored before and will result in penalties, as well as impacting the taxpayer's credit on tax collection.

These systems were the centrepieces of the SAT's presentations to global tax commissioners at the May 2016 Beijing FTA meeting.

Sharing insights – tax administrative assistance to developing countries

Finally, it might be noted that China has recently been leveraging its own achievements, with the upgrade to its tax administration processes and systems, to assist developing countries with "tax capacity building".

Capacity building was a centrepiece of the May 2016 Beijing FTA meeting. The FTA meeting communique outlined:

- A G20-mandated, joint initiative between the OECD, International Monetary Fund, UN and World Bank group to develop detailed guidance for improving technical assistance to developing country tax administrations;
- The establishment of a knowledge sharing platform; and
- The setup of a capacity building network to coordinate assistance, from multiple international organisations and national governments, to developing countries.

China's capacity building efforts intersect with the global initiatives and are conducted through a number of channels.

China has implemented 12 bilateral and multilateral cooperation programmes with developing countries, particularly those along the Belt and Road. Under these, the SAT has been providing tax training courses, expert support, experience sharing and technical assistance in building tax capacity. In this regard, workshops on tax administration and taxpayer service were provided to 82 tax officials from 18 African, Asian and Latin American countries in 2015, facilitating further cooperation between those countries and China. As another example, a delegation was sent to Ethiopia in 2015 to help build up its tax administrative capacity and business environment. China also announced in March 2016 the establishment of an OECD-SAT multilateral tax centre to provide tax-related training for developing countries.

Looking to the future, China's assistance to developing countries to upgrade their tax administration systems may come to constitute a key pillar of China's outbound investment policy. Much of China's assistance is directed at the Belt and Road countries so that China is helping to enhance and shape the tax administration of countries in which Chinese businesses will invest and operate. China's more intensive interaction with the tax administrations of such countries, and the manner in which China is interlinking its efforts with those of the international tax organisations, such as the OECD, may give China greater influence on the overall shape of global tax policy and administration. As such, looking ahead, the development of tax administration in China is not just significant for taxpayer activity in China itself, but has a significance for the wider world.

The authors would like to thank Conrad Turley for his contribution to this chapter.

IIT in China – moving with the times

Although China's individual income tax (IIT) reform is still being incubated and there have been no changes to the IIT Law during the past couple of years, the future of IIT presents both opportunities and challenges. Michelle Zhou, Chris Ho, Vincent Pang, Angie Ho and Jason Jiang look at the future intended changes to the IIT system.

New IIT developments are intended by the government to support national mass entrepreneurship and innovation and promote economic structural transformation. This will provide more IIT planning opportunities in certain encouraged areas and industries. At the same time, the Chinese tax authorities are continuously strengthening their efforts in relation to the administration and the collection of IIT, which will bring more challenges affecting both employees and employers in China.

Preferential tax treatments for equity incentives

On September 22 2016, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) jointly issued Circular 101 (2016). This circular clarifies the IIT preferential treatments applying to employee equity incentives and the use of rights in technology as capital contributions to Chinese resident enterprises. It also sets out the incentive qualifying criteria and is supplemented by SAT Announcement 62 of September 28 2016, which provides for the administrative guidelines and detailed implementation rules. Both circulars are effective from September 1 2016 and underpin governmental support for national mass entrepreneurship and innovation to promote economic structural transformation. The preferential tax treatments apply solely to unlisted domestic resident enterprises, which should stimulate interest of those private companies and pre-Shanghai and Shenzhen Stock Exchange initial public offering (IPO) companies in the market for wider deployment of equity awards.

Since the SAT Circular 1030 (2007), concerning the IIT treatment of share options granted by unlisted companies, was annulled in January 2011, there has been no national tax policies offering guidance in this area, leading to inconsistent application of tax treatment across the nation. The promulgation of Announcement 62 and Circular 101 fills this gap and should act as a stimulus to promote the use of equity awards among unlisted companies as a tool to align employee interest and behaviour. In particular, the new policy allows the deferral of taxation of equity awards until the point of disposal, and reduces the marginal tax rate from 45% (top marginal tax rate applicable to employment related income) to 20%.

To illustrate the potential reduction in the tax burden with a numerical example, before the new rules came out, an employee with equity awards vested at the value of RMB 200,000 ($29,000) could be taxed at 45% (the marginal tax rate), resulting in a tax payable of RMB 90,000 on vesting. The shares would also be subject to a further 20% capital gains tax if sold at a premium later on. With an assumed capital gain of RMB 100,000 on disposal, another RMB 20,000 tax liability is due, which results in a total tax bill of RMB 110,000. Under the new rules, and assuming the facts remain the same, taxation of the equity awards would be deferred to the point of share disposal which relieves the employee from cash flow strain at vesting. The total gain realised from the share disposal should be taxed at 20%, which results in a total tax liability of only RMB 60,000, translating to a reduction of RMB 50,000 in the total tax bill compared to the tax treatment under the old system.

With the rollout of the new rules, the IIT preferential treatment is now available to equity awards granted by both listed and unlisted companies and the degree of tax benefit largely depends on the design of the plan.

Emerging trend of tax audits and investigations from data and analytics

Notwithstanding the fact that implementation of the Golden Tax III project since early 2016 has experienced some teething problems, the revamped nationwide online tax lodgment system should ultimately enhance the collection of tax data for ongoing monitoring of tax compliance by businesses. The new lodgment system is one of the many measures that the SAT has developed to curb tax avoidance and strengthen the collection of tax revenue.

Enhanced IT systems to facilitate information gathering and data analysis

In February 2016, the Shanghai tax authority launched a new IIT filing system, which is a part of the third project of the Golden Tax System (Golden Tax III).

An enhanced version of Golden Tax III, which covers all tax filings, has been launched in major cities across China including Beijing, Shenzhen and Guangzhou. According to the current plans, the Golden Tax III project will be rolled out in all locations across China by the end of 2016.

The Golden Tax III system aims to achieve consistent nationwide tax administration backed by information technology and processing of tax data in an efficient manner. For tax lodgement via the Golden Tax III system, in addition to requiring taxpayer details to be submitted in a standardised and consistent format, additional details on income are required to be declared. For example, the Golden Tax III system requires an employer to disclose each type of tax-exempt employment income of its employees on a monthly basis in addition to the regular monthly withholding tax reporting. The collection of standardised and additional information under the Golden Tax III system nationwide should provide the tax authorities with sufficient data to support benchmarking exercises and formulate new tax policies.

Furthermore, the Golden Tax III system will unify the national tax administration standards for data, compliance and penalties, establish an effective system for tax information exchange, and facilitate centralised processing and analysis of multiple data sources from the state and provincial levels.

Risk management divisions established to identify non-compliance

With the amount of tax-related data being collected with the assistance of the Golden Tax III system, the SAT and various local tax authorities are making efforts to improve how the data is shared and pooled across tax authorities. Most of the municipal tax authorities have established a risk management division to identify major tax risk areas as their basis for conducting in-depth tax audits or investigations.

Pooled data, including information from the taxpayer tax risk management systems and information on historic compliance, as well as business and transactional information, is then to be harnessed for the tax risk classification of taxpayers, referred to as a "tax credit rating". This allows for the concentration of audit resources on risky segments, with low risk taxpayers commensurately accorded a lower level of scrutiny and audit.

More frequent data and analytics-based tax audit and investigations performed

Based on the information gathered from the tax filing system and major tax risk areas identified via the tax risk management systems, more frequent tax audits and investigations could be performed by the local tax authorities.

Recently, more and more companies are being subject to tax investigations by the local tax authorities on tax exempted benefits provided to expatriate employees. Among other things, these investigations look at:

- Whether proper contractual and supporting documentation is in place for the provision of IIT exempted benefits to the expatriate employees;
- Whether the IIT exempted benefits provided are reasonable;
- Whether such benefits can be substantiated by valid tax invoices; and
- Whether the filing is performed where required by the local tax authority.

The disclosure of more information on IIT-exempted benefits by the withholding agent/taxpayer via IIT filings through the Golden Tax III system enables tax authorities to set risk control standards on the reasonableness of tax exempted benefits. This information is them assessed to determine whether the tax exempted amount is within a reasonable range. If not, the tax risk management system would push the case to the tax investigation department to arrange a tax audit or investigation.

Furthermore, certain tax bureaus in northern China are performing tax investigations on taxpayers who have abnormal IIT filing records. Specifically, individuals who have performed "nil filings" are being required by the local tax

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authorities to provide explanations on the technical basis for the nil filing position adopted.

Given the extensive number of sources that the Chinese tax authorities are beginning to utilise to collect and exchange information for tax enforcement, it is imperative for companies to conduct regular reviews of their IIT positions to effectively manage their IIT exposures.

CRS and the Chinese IIT impact

China, as one of the countries committed to adopting the OECD's common reporting standard (CRS), is now focusing on CRS.

On October 14 2016, the SAT released draft management measures on tax-related information due diligence for non-resident financial accounts, which requires financial institutions to commence conducting customer due diligence. This includes:

- Reviewing for reasonableness the self-certifications and other declaration documentation provided by customers; and
- Gathering details of their account holders' tax related information.

Due diligence work will commence from January 1 2017 and it is intended to facilitate China to undertake the first exchange of information with other countries in September 2018.

CRS provides a common global approach for jurisdictions to obtain financial information from their financial institu-

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tions and to automatically exchange that information with multiple jurisdictions on an annual basis. After implementation of the CRS, from a Chinese IIT perspective, the following individuals who are subject to the IIT on their worldwide income would be impacted:

- Individuals who are domiciled in China; and
- Individuals who are not domiciled in China but are a tax resident of China for five full consecutive years and deemed a tax resident of China in the year concerned.

Generally speaking, an individual, who is domiciled in China, is subject to China's IIT on his worldwide income. An individual who is domiciled in China is defined as an individual who, by reason of his household registration, family or economic interests, habitually resides in China. An individual with a Chinese passport or a '*hukou*' (household registration) is generally deemed to be domiciled in China.

An individual, who is not domiciled in China, is taxed in accordance with the length of their residence in China. They would be deemed to be a resident of China if they have not been physically away from China for more than 30 continuous days or 90 cumulative days in a calendar year.

An individual, who is not domiciled in China, but is a resident of China for five years or less, is taxed on income derived within China only.

An individual, who is not domiciled in China, but is a resident of China for five full consecutive years, would be taxed on their worldwide income in China, if they are deemed a tax resident in any of the years thereafter.

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- Formulating tax-optimised remuneration packages for globally mobile employees;
- Foreign exchange implications for international assignees in general;
- Addressing Chinese foreign exchange and tax implications for MNEs rolling out global equity compensation plans to participants in China; and
- Identifying tax risks through conducting health checks and devising plans to address deficiencies in existing operations.

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The above tax rules were introduced in 1994 and are still valid. However, the taxation of overseas income was not strictly enforced in the past. This was due to the lack of tax authority resources and difficulties for the tax authorities in gathering information on individual personal income derived from overseas. After the implementation of CRS, a China tax resident's income information from an account in a CRS participating country will be automatically transmitted to the Chinese tax authorities. This will facilitate the tax authorities to monitor the tax status of the overseas income.

It is imperative for individual taxpayers to periodically review their tax residency status in China and plan their financial and tax arrangements accordingly. If it is determined that an individual is subject to Chinese IIT on worldwide income, the individual should comply with the Chinese IIT filing requirements to avoid any penalties being imposed on noncompliance.

Increased efforts to conclude social security totalisation agreements with other countries

China's Social Insurance Law requires employers and their employees to participate in the Chinese social security system by contributing towards social insurance schemes, including pensions, medical, unemployment, maternity insurance, and work-related injury insurance. While all five types of schemes are mandated for employers, employees are required to contribute to three of these schemes.

Since October 15 2011, expatriate employees lawfully working in China are also required to participate in the social security system in China.

Generally speaking, the mandatory social insurance contribution basis is determined on the basis of the employee's average wage in the prior year. The social insurance contribution calculation basis is subject to a ceiling of 300% of a city's annual average wage of workers in the prior year, but cannot be lower than 60% of a city's annual average wage of workers in the prior year. As the mandatory contribution basis and rates vary by city, social security contributions are location specific.

- Among the categories of contributions in China, the contributions required to be made to the pension scheme create the greatest burden. According to the current pension contribution rate and base for 2016-17, the monthly contribution required to be made to pension schemes by employers and employees, respectively, in Beijing and Guangzhou are as follows: Monthly maximum social security contributions in Beijing:
  - Employer: RMB 4,039
  - Employee: RMB 1,701
- Monthly maximum social security contributions in Guangzhou:
  - Employer: RMB 2,321
  - Employee: RMB 1,326

To mitigate duplicate contributions of social security by cross-border employees, the Chinese government has concluded – or is in the process of concluding – social security totalisation agreements with the countries listed in Table 1.

At this juncture, the Chinese government is negotiating with a few other countries on entering into totalisation agreements. It is anticipated that the conclusion of these totalisation agreements will encourage cross-border business operations and promote global mobilisation of employees.

Table 1

Countries	Status	In force by
Belgium	Under negotiation	Not in force
Canada	Concluded on April 2 2015	Not in force
Denmark	Concluded on December 9 2013	May 14 2014
Finland	Concluded on September 22 2014	Not in force
France	Concluded on October 31 2016	Not in force
Germany	July 12 2001	April 4 2002
Japan	Under negotiation	
Korea (Rep.)	Concluded on October 29 2012	January 16 2013
Romania	Under negotiation	
Serbia	Under negotiation	
Spain	Under negotiation	
Switzerland	Concluded on September 30 2015	Not in force
The Netherlands	Concluded on September 12 2016	Not in force

China Customs – pushing the boundaries

For China's customs reform, 2016 has been an important year with quite a few new pieces of customs regulation and guidance having been issued. Eric Zhou, Helen Han, Dong Cheng, Philip Xia and Melsson Yang highlight the changes.

Introduction

China has publicised the Customs Audit Regulations to improve the existing legal basis for customs audits. This adds, to the existing regulations, specific clauses pertaining to third-party audits, authorised economic operators (AEOs) and voluntary disclosure practices (VDPs), among other important changes.

China has also announced a series of laws and regulations concerning cross-border e-commerce business in an effort to set up a clearer and more uniform legal framework for conducting this mode of business cross-border with China.

Moreover, China's customs authority also announced guidelines on filling in the customs declaration form for import and export goods to strengthen scrutiny and supervision over royalty payments and transfer pricing between related parties. This chapter of *China Looking – Ahead* will share insights on these three key topics.

Formal release of the new Customs Audit Regulations

To stay current with the changing business and global economic environments, the old version of Customs Audit Regulations enacted about 20 years ago, has been revised in State Council Decree 670 (2016).

Over the past two decades, China has become one of the most important economies in the world. The old version of the law had difficulty keeping up with the demanding requirements of business, the development of business self-governance, the challenging economic climate for global supply chains, as well as the modernisation of global customs practices. The new version of the Customs Audit Regulation has several key features, discussed below.

Formal introduction of VDPs

Voluntary disclosure practices are a prevailing customs practice in most developed countries. The intention of a VDP is to provide an opportunity for businesses to proactively identify and report non-compliance and breaches of the law to the relevant authorities before enforcement becomes necessary. A possible consequence of a VDP is that the enforcement authorities may approve lenient treatment on non-compliance and breaches of law.

According to the latest Customs Audit Regulations, China's customs authority permits VDP by businesses and may grant lenient treatment on disclosed non-compliance in the form of waiving late-payment surcharges, reducing or waiving penalties, maintaining credit ratings, or alleviating or exempting criminal charges, among others.

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Helen Han worked for China Customs more than 10 years in various departments such as the Investigation Bureau and Post-Clearance-Audit Section in both GAC, Guangdong Sub-Administration and Huangpu Customs. She also worked for local government and has overseas study experience, having pursued a master's degree in art in Paris before joining KPMG in China.

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 China 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 enterprises in various industries. She has also been a guest speaker at various customs seminars and training courses hosted by Customs authority.

Helen has a master's degree in economics.

However, there is currently a lack of clarity on the appropriate VDP operational procedures. Operational-level customs officials understand this concept, but have not received the operational guidelines on how to handle VDPs. Businesses are recommended to continue paying close attention to the development of VDP processes. For non-compliance discovered before the issuing of more detailed procedures, business operators can initiate dialogue with the customs authority on a case-by-case basis. If necessary, they can seek support from professional firms.

Linking inspection practices to credit ratings

China customs authority categorises business operators into the following four categories according to their performance and a thorough risk management analysis, namely:

- Senior certified enterprises;
- General certified enterprises;
- General enterprises; and
- Discredited enterprises.

The new Customs Audit Regulation stipulates that credit ratings must be considered when the customs authority decides whether to inspect a given cargo and investigate certain business operators. The better the rating, the lower the inspection rate.

To qualify for a higher credit rating, business operators must have solid internal control procedures in place to ensure legal compliance, to oversee the proper operation of logistics and supply chain processes, and to monitor financial performance.

China facilitates third-party firm involvement in the customs audit process

Since 2008, the customs authority has been conducting trials directed at involving third-party intermediaries in customs

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Before joining KPMG in January 2004, Dong Cheng served as the director of policy research in the Shanghai Customs from September 1991 to December 2003. During his tenure, his role was to research complex customs issues from the various local customs units in the Shanghai region and advise them on the appropriate treatment. In addition, he was involved in the drafting of a number of China customs regulations. Over the years, Dong Cheng has developed excellent relationships with senior customs officials throughout China.

Since joining KPMG, Dong Cheng has been integrally involved in the analysis and development of resolution strategies for multiple trade and customs issues, including customs valuation, import tariff classification and related-party pricing.

Dong Cheng gained extensive knowledge and experience in all major areas of customs duty activities, such as valuation, duty reduction and exemption, duty collection methodology and customs policy implementation study, through providing services to many multinational corporations in various industries, including automobile, chemical and luxury goods. These services comprise strategic planning, duty saving and industry-specific analysis. He has also assisted many multinational companies to cooperate with customs audits on various issues, such as smuggling and the false declaration of import goods.

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In KPMG, he has been actively involved in a wide range of customs projects such as customs valuation, compliance review and internal control improvement. He has advised multinational clients on various customs cost-saving opportunities, such as duty-free equipment and processing trade practice. He has also assisted his clients in audit defence and customs operation setup issues.

His clients include manufacturing, logistics and trading companies. Industries involved include electronics, chemicals, machinery, aeroplane repairing, luxury consumables and foods.

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audit activities. This either involves customs contracting with the third parties, or businesses themselves engaging the third parties.

During this trial period, both the customs authority and businesses have been frustrated in their efforts, from time to time, due to a lack of solid legal support for this initiative. With the introduction of a legal clause in the new version of the Customs Audit Regulation, utilising qualified third parties has become a formal legal process. According to this regulation, the third-party intermediaries will generally be auditing firms, tax firms and other qualified agencies with pertinent accounting and tax competency.

Businesses may consider taking advantage of the strength and resources of qualified professional firms in reviewing/auditing day-to-day business operations, while focusing on their core business processes.

Revised guidelines on completing the Customs Declaration Form in relation to royalties and related-party transfer pricing

Royalties and transfer pricing between related parties has been a focus of customs authorities worldwide.

The World Customs Organisation (WCO) issued customs valuation and transfer pricing guidelines in 2016.

Under the old Chinese guidelines, it was only stipulated that it is the liability of the business operator to declare related prices accurately and correctly. However, there was no concrete tool or operational mechanism for the business operators to assume this liability.

New guidelines are now in effect as the Guidelines on Filling in the Customs Declaration Form for Import and Export Goods in GAC Circular 20 (2016). With the new Chinese guidelines going into effect, business operators are required to declare and make a statement at the time of goods entering China regarding:

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Melsson has more than 20 years of professional experience of working in China Customs, commercial business and consulting. He advises multinational clients on handling logistics related projects, as well as taking care of consulting related to customs audit and investigation, processing trade management and tariff engineering.

Melsson started his career as an officer with China Customs, after graduating from a top customs school, then he moved to the private field, and was responsible for customs and logistics operations of a well-known telecommunications manufacturer. He also served at leading logistics and supply chain management companies as the regional customs & solution manager for southern China. Melsson is a member of the expert panel for the Guangzhou government and a licensed customs broker.

- Whether there is any royalty payment, and if so, whether the royalty is dutiable; and
- Whether there is related party relationship, and if so, whether the relationship affects the import price declared, etc.

This may have an impact on business operators that have related-party transaction arrangements. For operators who are planning to have related-party transactions, it is necessary to establish sound pricing practices that consider the implications from both the perspective of the customs and the tax authorities. For operators, which are operating under a related-party structure, it can prove helpful to conduct a self-assessment, make pricing practice improvements where necessary and document supporting material for future use.

With regard to identifying non-compliance or uncertain areas, it is useful to raise issues with the customs authority for clarification, confirmation, or remedial action. Failure to do so, if later detected by the authorities, could set the ground for heightened future customs investigations, late-payment surcharges and customs penalties.

According to China's Regulations on Import and Export Duties, where the customs authority discovers upon customs clearance that there has been a short payment of customs duty and taxes, customs will collect the amount due from the taxpayer within one year from the date of payment of customs duties, or customs clearance. Where such short payment was caused by a breach by the taxpayer, the customs authority may recover the customs duties for up to three years from the date of payment of customs duties, or customs clearance. Based on typical practice, the customs authority tends to collect three-year overdue tax on issues concerning customs valuation, especially for royalties.

Improving the legislative framework for cross-border e-commerce

China has 10 pilot cities for cross-border e-commerce, including Shanghai, Hangzhou, Ningbo, Zhengzhou, Chongqing, Guangzhou, Shenzhen, Tianjin, Fuzhou and Pingtan.

In order to further regulate this kind of business, the Chinese government announced a series of new policies for cross-border e-commerce and a list of cross-border e-commerce retail imports in 2016. This is making the related legislation landscape more concrete and uniform.

Before these laws and regulations became effective, the pilot cities had been operating e-commerce import arrangements on a trial basis in a manner that lacked enough transparency and which exhibited excessive diversity. The system of laws was not mature enough to secure revenue or foster fair competition between different types of business models (e.g. direct B2C e-commerce and traditional import models).

A new system is now provided in the Circular, of the Ministry of Finance, General Administration of Customs and State Administration of Taxation, on the tax policy for cross-border e-commerce retail imports, issued as Caiguanshui 18 (2016), and in the Announcement on the regulation of cross-border e-commerce retail imported and exported goods, issued as GAC Circular 26 (2016).

Firstly, the new system sets out the tax and customs clearance treatment for cross-border e-commerce supplies, as well as for import of normal postal and personal items. The new system clarifies the customs operational procedure for direct shipments and bonded shipments. Most importantly, the new system strengthens scrutiny on the import of foodstuffs, cosmetics, infant formula and dairy products, etc. However, according to customs information, the authorities have left some buffer time, until May 11 2017, before the cross-border e-commerce sector may start to be subject to the new commodity inspection and quarantine formalities under the new e-commerce regulatory framework, which are equivalent to the procedures applied to formal entry (general trade type) shipments.

Previously, cross-border e-commerce platforms cleared customs according to tax regulations on personal postal articles and purchases. This made the imported e-commerce items eligible for a duty-free allowance, where the duty that would otherwise arise fell below the threshold of RMB 50 ($7). Under the new rules, e-commerce imports are subject to an integrated tax rate. Whether the overall tax burden is higher or lower for e-shoppers under the new regulations, relative to the postal tax, depends on the types of goods.

For example, a parcel of foodstuff priced at RMB 200 imported through a cross-border e-commerce channel was, under the old rules, subject to a 10% personal postal articles tax (RMB 200 × 10% = RMB 20) before April 8 2016, but the duty payable was waived by customs because it amounted to less than RMB 50, the taxation threshold. A consumer paid only RMB 200 for this item. Under the new system, the same item needs to pay a customs tariff (temporarily set at 0%), VAT (RMB 200 × 17% × 70% = RMB 23.8) and consumption tax (no consumption tax for food = 0%). The consumer ultimately has to pay RMB 223.8. This example reveals that the consumer ultimately pays a higher price for the same item under the new tax policy.

E-commerce may have some advantages compared to traditional business models, but this does not necessarily mean that every business should switch from their traditional channels to cross-border e-commerce channels. Businesses should take into account product types, business strategies, end-to-end tax implications and operational efficiency to identify an appropriate model for their operations.

Tax to the aid of innovation and entrepreneurship in China

As China faces rising labour costs and competition from lower cost countries in the region, incentive supply side programmes such as the HNTE scheme and 150% super deduction will help achieve the government's aim of solid and stable growth for the Chinese economy as it enters its 13th five-year plan. Alan Garcia, Yang Bin, Josephine Jiang and William Zhang highlight the available benefits for R&D.

For companies with operations in China hoping to grow revenues by developing enhanced products, processes and services, the Chinese proverb "like the feeding of Peking ducks – all a matter of stuffing" is apt in the context of recent changes to the high and new-technology enterprise (HNTE) programme and 150% super deduction regulations. Of course a business's technical projects need to demonstrate the necessary hallmarks of R&D activity, but a company also needs to diligently prepare the regulatory documentation regarding its 'Peking duck' in order to secure and protect the appropriate benefit.

Supply-side incentives to boost industry and services-consumption

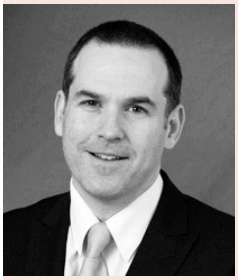
Monetary policy stimulus strategies implemented since the global financial crisis have largely fallen short of total factor productivity growth targets. In this context, innovation plays a critical part in China's 13th five-year plan (2016-20) to drive the economy and steer the country away from its traditional reliance on mass manufacturing.

So, what is the synergy – or otherwise – of the HNTE and 150% super deduction with respect to China's supply-side reform and five-year plan?

Importantly, the synergies are strong and the timing aligned. Both the HNTE and 150% super deduction support supply-side structural reform economics as they help increase production capability and lower barriers to production. For example, in the steel industry, factors such as pollution, energy consumption, output quality, occupational safety and technology will all benefit from new knowledge and improved processes supported by these incentives. By maintaining (and increasing) R&D benefits, businesses will find it easier to enter the market and invest in initiatives that increase supply, such as innovative goods and services. This will help lower prices and boost consumption across China.

Traditional sectors, such as manufacturing and agriculture, comprise a significant portion of China's GDP. However, China's manufacturing capability is behind other developed countries in terms of technology and efficiency gains. As a result, the five-year plan includes a "Made in China" 10-year initiative, which emphasises value-added production and intelligent manufacturing. The aim is to double R&D expenses in the manufacturing sector, with 40 manufacturing innovation centres to be created, and carbon dioxide emissions to be reduced by 40%. Both the HNTE and 150% super deduction incentives clearly support this broad objective.

'Green' services, products and technologies require the development of new and improved knowledge to fill the existing local and global gap in



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In China, Alan focuses on the R&D Super Deduction and HNTE/ATSE. 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. 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.

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.

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 also 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.

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non-fossil fuel energy conversion and supply. Green technology is another important component of the Chinese government's five-year plan, and such technologies are likely to be eligible under the 150% super deduction programme and enterprises in this sector should also carefully examine their potential eligibility for the HNTE status programme.

Critically, the services sector is a growing component of knowledge-based capital innovation and essential to long-term economic growth, as stressed by the OECD. However, until recently, China's prevailing focus on manufactured exports, combined with barriers to trade and investment in the services sector, has limited the development of the services sector in China. This is another area where the HNTE and 150% super deduction should support the objectives in the five-year plan. A shift away from manufacturing to consumer services requires supply-side support for innovative thinking and entrepreneurship regarding service delivery models and the technologies that enable them. However, as mentioned on later in this article, recent changes to the 150% super deduction restrict some services-oriented companies from claiming this benefit and this negative list restriction is inconsistent with the government's supply-side reform agenda.

Nevertheless, the good news for China is that its investment in education and research has increased markedly over the past decade. As such, China is considered among the top 10 destinations for multinational enterprises (MNEs) to expand foreign direct investment (FDI) in R&D. This is consistent with the National Bureau of Statistics of China's Economic and Social Development Report 2014, which stated that expenditures on R&D activities was worth RMB 1.3 trillion ($192.2 billion) in 2014, up 12.4% over 2013, accounting for 2.09% of GDP.

Should China have a higher rate of incentive benefits as part of its supply-side reform agenda?

A recent International Monetary Fund (IMF) fiscal monitor report, entitled *Acting Now, Acting Together*, highlighted the need for governments to swallow a short-term hit to tax revenue by boosting R&D incentives to stimulate long-term growth. Significantly for China, R&D incentives are particularly critical when access to credit and capital may be restricted. The IMF in its report contends that incentive programmes (like China's 150% super deduction) should be increased to stimulate GDP growth.

IMF economists concluded that a socially efficient correction should reduce the marginal cost of R&D by 50%. In other words, the cost for a company investing in extra R&D should be reduced by 50 cents per dollar. This need for fiscal correction on the supply side takes into account a private rate of return to business R&D, typically ranging between 20% and 30%, plus social rates of return (spill overs) generally estimated to be two to three times the private return.

Based on the IMF's empirical analysis, the Chinese government would do well to consider whether the net savings to companies from the HNTE and 150% super deduction programmes should be increased to enhance GDP growth.

HNTE: key regulatory changes

The HNTE rules in China originally came into effect on January 1 2008. Recognised HNTEs enjoy a reduced corporate income tax (CIT) rate of 15% (down from 25%) for three consecutive years.

Since 2008, HNTE policy has generated tax savings to eligible companies, allowing them to reinvest profits into recruitment, R&D and capital assets.

Importantly, new administrative measures for recognition of HNTEs under Guokefahuo (2016) No. 32 were announced in January 2016. The authorities also subsequently announced more specific HNTE guidelines in Guokefahuo (2016) No. 195 (the new guidance).

The new guidance sees change concerning HNTE compliance thresholds, and shows that the government will continue to strengthen its supervision of the HNTE status.

To be eligible as a HNTE, a company must satisfy criteria related to the following key areas:

- Technologies must fall into the encouraged domains;
- Ownership of core proprietary intellectual property (IP) rights;
- Income must be from high/new-tech products (services);
- Expenditure must qualify for R&D relief;
- The headcount of scientific technology staff;
- Innovation ability assessment criteria: scorecard
- The company's age; and
- Safety, quality and environment compliance.

Below we describe the main HNTE changes that impact enterprise compliance compared to the old HNTE provisions.

Main products and IP ownership

The new guidance specifies that an enterprise should own the core technological IP required of its main products. The enterprise needs to own the IP in China that technically plays a core role in relation to its main products (services), through independent R&D, assignment, acceptance of a gift, or a merger and acquisition.

The new guidance puts IP into the following categories listed in Table 1.

Importantly, IP in Type II can only be included in a HNTE application once, i.e. it cannot be used again for HNTE renewal.

Innovation ability assessment: quantitative and qualitative assessment of IP

The changes in respect of IP and the transformation of research achievements can be seen as part of the government's intention to promote proprietary and industry-leading R&D within HNTEs, with an overarching objective to push China to the technological forefront of the wider industry.

Overall, the assessment quadrants under the old guidance continue in the new guidance, i.e. IP, the ability to transform (capitalise on) the scientific and technological achievements, organisational excellence and enterprise growth. However, unlike the old guidance that only focused on the number of IP, the new guidance requires a more comprehensive assessment of IP when reviewing a company's innovation ability. In addition to the number of IP, the innovation scorecard now requires an assessment of the quality of the IP: technological advancement of the IP and impact on the IP on main products (services); and how the IP was acquired (or source of the IP right).

IP resulting from self-developed R&D activities will generate more points than those through acquisition, merger or donation, etc.

Table 1

Type I	Type II
• Invention patents (including defence technology) • New plant varieties; • National-level crop varieties • National-level new drugs; • National-level traditional Chinese medicine protection varieties; • Exclusive rights of integrated circuit layout design, etc.	• Utility model patents; • Design patents; • Software copyrights, etc. (excluding trademarks).

R&D management (organisational excellence)

This section includes a number of indicators such as the organisation and management of the company's R&D activities, in-house R&D cost centre, auxiliary accounting for R&D, cooperation with external bodies, and overall R&D competence. The new guidance has added a new requirement on technical staff training as part of the assessment criteria, although this is not detailed.

Clarification of HNTE criteria definitions

The new guidance provides more detailed definitions for some key application requirements, including:

- R&D expenses – The new guidance includes a slight adjustment concerning the R&D expense rules. The key change is that the ratio for the upper limit ratio of 'other expenses' has increased from 10% to 20%. This change allows enterprises to include some expenses that may previously have been disregarded because of the lower ratio under the old guidance;
- High-tech products (services) – The new guidance states that high-tech products (services) are those in which the core technology falls under the scope of "areas of advanced technologies strongly supported by the state". Critically, these 'categories' have also changed dramatically so companies must re-evaluate compliance in this regard;

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Bin joined KPMG Guangzhou in 2006. He has extensive experience in corporate compliance and corporate structure advisory. Bin's clients include numerous eminent multinational enterprises, as well as small and medium size companies in retailing, manufacturing, real estate and service industries. Having extensive experience working with the government, Bin has in-depth knowledge with respect to the regulations governing both domestic and overseas companies, as well as corporate structure. With sound understanding in the practical requirements of investment approval and management in major cities in mainland China, he has successfully assisted many overseas companies to establish subsidiaries/branches/representative offices in China. In addition, Bin has led many business and tax planning advisory projects for corporate restructuring, and the subsequent implementation tasks.

Bin is the leader of the research and development (R&D) team of KPMG China. He has abundant experience in R&D services, including high and new-technology enterprise (HNTE) assessments, R&D expense super deductions, assisting clients in the development of R&D management systems and defending their HNTE status. As a key contact between KPMG and the government R&D department, Bin has maintained strong relationships and sound communication with related departments and provides advice on policy planning.

Bin has an MBA.

- Main products (services) – This definition refers to high-tech products (services) for which the enterprise owns the IP of the core technology, and the revenue from which accounts for more than 50% of revenue of all high-tech products (services) during the same financial period;
- Total Revenue – This will be based on the total revenue less the non-taxable revenue. Total revenue includes operating revenue, non-operating revenue and investment returns. Both total revenue and non-taxable revenue should be determined according to the CIT Law and CIT Implementation Rules. The old guidelines previously defined revenue from a different perspective, i.e. sales revenue equals product sales revenue and technical services revenue. As such, it may now be more challenging for some enterprises to meet the 60% HNTE revenue as a percentage of total revenue;
- Technical personnel – The new guidance simplifies the concept of technical personnel and defines 'technical personnel' as those who are directly engaged in R&D activities and other relevant technology innovation activities, and/or those who provide management services and technical support for such activities. Such technical personnel would also need to have accumulated working days of more than 183 days per year. Technical personnel includes full time employees, part-time and temporary employees. The new guidance also clarifies the method for calculating technical staff. This will make it easier for some companies to meet the technical personnel requirement; and
- Enterprise growth – The assessment of the growth of total assets has been replaced by the assessment of 'net assets'. The assessment of the growth rate of sales revenue remains unchanged.

Strengthened supervision and administration

The new guidance sets out clear guidelines with respect to annual reporting, re-examination, enterprise name amendments, changes on major issues, cross-city relocation, application errors and violation of the law pertaining to the HNTE status. This is a tighter review policy compared to the old guidance. During the assessment process, auditors may undertake a site visit to review the HNTE eligibility at the company's premises.

The new guidance demonstrates that an expert panel will continue to be utilised for HNTE assessment purposes. The expert appointment system is retained, and financial specialists will be engaged to review income tax and other relevant financial data.

The changes regarding strengthened supervision highlight that the government will undertake a more regular and focused review of all HNTE applications. We note that, in prior years, some regions across China had issues with HNTE compliance. More recently, however, there has been an overall improvement in HNTE compliance across most regions. This is likely to have resulted from better education and understanding of the HNTE regulations by both claimant companies and local authorities. The new guidance seeks to build on this recent improvement and align applicants more closely to the overall policy objectives of the HNTE programme.

Next steps and action points regarding HNTE compliance

Companies should perform a comprehensive self-assessment in the context of the new guidance, and identify potential HNTE compliance risks. Key areas to examine are:

- How the enterprise's IP in China technically plays a core role in relation to its main products (services);
- Ownership of the IP rights, including scope of IP, frequency of use and IP classification into Type I or Type II;
- Nature and quality of the IP and the technological impact of the IP on main products (services) and its technological advancement;
- R&D expenses and determining if additional expenses can now be included in the R&D expense calculation;
- HNTE revenue calculations with respect to high-tech product revenues to check if the relevant revenue threshold target is still achievable;
- HNTE scorecard analysis to determine if the company still achieves the points target; and
- Group enterprises may wish to not only assess a single entity, but consider the R&D activities in the group as a whole, and make necessary arrangements to enhance HNTE compliance.

Given China's continued focus on supervision of the HNTE status, enterprises are encouraged to enhance reporting, substantiation, and record-keeping and thereby improve R&D management systems in case of an audit.

150% super deduction: key regulatory changes

R&D super deductions have long been used to spur and support innovation across the world. China's R&D super deduction fiscal policy offers companies a 150% tax deduction for eligible activities. This provides companies with a reduction in marginal cost of 12.5% for every eligible expense, assuming a CIT rate of 25%, excluding the base 100% tax deduction and assuming the company is paying tax.

To be eligible for the 150% super deduction in China, a company's technological activity must involve new knowledge applied in a creative way, and result in substantially improved product or process/service. This can include improvements to products and technologies in many industry sectors such as financial services (usually software development), IT, logistics, food and beverage, agribusiness, manufacturing, engineering and mining, as well as more typical R&D industries such as pharmaceuticals and automotive. Creative design activities undertaken for obtaining novel and innovative products are also eligible (refer below).

Notice Cai Shui (2015) No. 119 and Announcement (2015) No. 97

The Ministry of Finance, the State Administration of Taxation (SAT), and Ministry of Science and Technology jointly issued important notices on R&D policy:

- Improvement of the R&D super deduction, Cai Shui (2015) No. 119; and
- SAT Announcement (2015) No. 97 – detailed implementation.

Many companies will benefit from Cai Shui (2015) No. 119 and Announcement 97.

For example, R&D activities and associated expenses are eligible unless they fall within the "negative list" (see below), so this will have a positive impact on most companies. The retrospective three-year claim opportunity will represent a significant chance for companies to extract additional benefits from the 150% super deduction programme for expense incurred from January 1 2016.

Arguably, the scope of eligible activities has expanded to include industrial design and other creative design industries. Another key improvement is the specific reference allowing

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His experience covers a range of areas, from assisting multinational enterprises s in formulating expansion strategies into China, setting up and structuring their business operations in China, fulfilling relevant registration and filing requirements, up to the stage of working out practical solutions to various tax issues and exploring possible tax planning ideas.

In particular, William has assisted quite a number of multinational enterprises in industrial markets in, for example, high and new technology enterprise (HNTE) application review assessments, R&D bonus deduction applications and tax planning for restructuring transactions and cross-border fund repatriation arrangements.

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companies to use auxiliary or supplementary accounts to identify and capture relevant R&D expenses, which also includes references to the eligibility of other relevant support departments such as manufacturing. As always, a key issue will be how companies determine whether projects qualify for the 150% super deduction. This requires case-by-case analysis on an annual basis.

Below is a list that details the key enhancements and restrictions contained in the recent announcements:

Key enhancements:

- Retrospective three-year claims: companies will be able to deduct previously unclaimed R&D expenses for the preceding three-year period. However, this applies to expenditure incurred from January 1 2016 onwards;
- The encouraged R&D technical 'categories' specified in the original policy will no longer apply. This means that companies will need to satisfy the definition of R&D activities, but will no longer need to match the activity to one of the categories;
- Companies can now use a set of auxiliary or supplementary accounts to capture eligible R&D expenses, rather than capturing all eligible R&D expenses in one special account in the company's existing accounting system. This clarifies the interpretation of the regulations and simplifies the account keeping requirements, and accords with global best practice;
- The scope of eligible R&D activities and R&D expenditures includes additional eligible "other related costs" such as: expert consulting fees, high-and-new technology R&D insurance fees, R&D output related fees (including information retrieval, analysing, discussion, evaluation, assessment, checking and acceptance), IP right related fees (including application, registration and agent), travelling fees, and meeting fees. However, such costs are capped at 10% of total eligible R&D expenses.
- Creative design activities undertaken for obtaining creative, novel and innovative products, will be eligible. This is, arguably, an extension of the existing rules and highlights the government's intention to support design-related activities, and includes:
  - industrial design, and model designs;
  - designs of building construction (3 star Green Building standard);
  - development of multi-media software and animation game software, design and production of digital animation and game; and
  - landscape architecture.
- R&D registration requirements will be simplified and certain registration requirements have been relaxed so that registration with the Science and Technology Bureau is no longer required in most jurisdictions. However, 20% of R&D applications will be audited. As such, contemporaneous and post-filing record keeping will be important to manage tax compliance in case the authorities wish to investigate the activities or related expenses. Some local tax bureaus may still require some type of registration formality;
- The term "solely/exclusively" has been removed in respect of depreciation, rental and other relevant expenses regarding R&D devices and equipment, amortisation of intangible assets and development/manufacturing expenses for models and processing equipment. This indicates that a 'pro-rata' allocation of such R&D expenses may apply, e.g. if an asset is used for R&D purposes 50% of the year, then 50% of the depreciation expense may now be allowable in that year;
- Announcement 97 clarifies the definition of each type of R&D related personnel and includes 'supporting' staff but excludes logistics staff. For example, it appears that a

project manager or engineering support team member that contributes to the R&D project may be eligible for inclusion as 'technical staff' or 'support staff'. We suggest applicants consider such individuals on a reasonable basis and allocate and record the time at least on a quarterly basis to prove the nexus to the R&D activity. In respect of logistics staff, it is unclear if logistics staff directly involved in the key experimental activities involving substantial improvement to technology can be included, for example, where the logistics team member is directly resolving complex R&D issues of a technical nature, rather than as a 'supporting' team member; and
- Costs for externally engaged R&D personnel are now eligible.

Key restrictions

- Negative list as it applies to 'industries'. The circular specifically excludes certain industry sectors from 150% super deduction eligibility, including:
  - The tobacco manufacturing industry;
  - The accommodation and catering industry;
  - The wholesale and retail industry;
  - The real estate industry;
  - The leasing and commercial service industries;
  - The entertainment industry; and
  - Other industries as prescribed by the MOF and SAT.
- Companies that fall within the negative list 'industry' sectors will find it difficult, if not impossible, to claim the 150% super deduction. So, even if a company in these sectors is undertaking highly innovative activities, it is likely that such companies and projects will not qualify for the super deduction. For example:
  - Catering industry: does this negative list allocation mean that innovative functional food formulas which enhance health and reduce obesity are no longer eligible? Does this mean that innovative manufacturing technology to pack, seal and fill products for longer shelf-life stability will no longer be eligible?
  - Retail industry: (1) A large retailer may develop new distribution and logistics software functionality and systems to more efficiently manage the supply chain; and (2) according to the "Category and Code for National Economic Industry Classification", sales through the internet appear to belong to the retail industry – are these activities no longer eligible for companies in negative list industries?
  - Real estate industry: A real estate development company may also be involved in innovative construction techniques and related design – does that mean this company cannot claim the super deduction?

  This concept of 'industry exclusions' is understandable in the context of China's historical requirement for activities to fall within approved categories. However, given the general trend in China, and globally, towards a services-consumption driven economy, it would be beneficial for the in-charge authorities to reduce the scope of these exclusions. This is because the services sector is a key component of knowledge-based capital innovation, where companies increasingly invest in intangible assets such as software and technology to stay solvent and maintain a competitive edge in the market (as the above project examples demonstrate).
- Negative list as it applies to 'activities'. The circular specifically excludes certain activities from 150% super deduction eligibility. If the activities are not listed below, it is likely the activities will be eligible if there is a direct connection to the R&D project/activity:
  - Regular product upgrades;
  - Use of R&D results that are publicly available regarding new processes, materials, devices, products, services or knowledge;
  - Post-commercialisation support;
  - Repeat or simple update of existing products, services, technologies, materials or processes;
  - Market research and studies, efficiency research or management studies;
  - Industrial (services) processes or regular quality control, testing analysis, or maintenance; and
  - Humanities and social sciences related studies.
- Announcement 97 also implements a standard to calculate eligible R&D expenses by stating that if any income or revenue is received by the applicant in the form of R&D scrap, defects, faulty items, trial products, etc. then such income/revenue will be used to reduce or offset the total R&D expenses. This will decrease the total amount of eligible R&D expenses for R&D super deduction. In addition, material costs cannot be included as eligible R&D expenses if the output of R&D activities utilising such materials/parts etc. results in the 'final' product or 'parts of final' products.
- Finally, Circular 119 expanded the scope of R&D expenses by adding a new R&D expense category called "other related expenses" and lists a set of examples mainly concerning supporting R&D activities. This includes expenses relating to: search, analysis, evaluation, demonstration, identification, assessment and acceptance of R&D results, application fees, registration fees and agent fees for intellectual property, etc. However, to control the scope of claimable 'other expenses', Cai Shui (2015) No. 119 places a cap on the maximum allowable 'other' R&D expense amount, which is 10% of the total R&D expense.

Diligent R&D expense tracking recommended

Given that 20% of R&D super deduction companies will be audited, it is important that companies ensure that eligible R&D project identification and expense capturing protocols are well established so that your 'Peking duck' can be truly enjoyed. This will both maximise the value of the benefit, and protect the expenditure if questioned by the in-charge authorities.

Cai Shui (2015) No. 119 clarified the position that a separate R&D cost centre is not required to claim the 150% super deduction and this was a positive point of clarification that was very well received by Chinese industry. However, Announcement 97 suggests that companies need to create auxiliary accounts for R&D expenses when the R&D projects are first set up, but this can lead to compliance challenges since some engineers/scientists and finance staff do not always create project specific accounts. This may be the case notwithstanding that such projects are undertaken on a very systematic basis. In this regard, the announcement provides a standard template for auxiliary accounts that will help companies to record R&D related expenses in an 'authority-approved' way to reduce non-conformity risk.

Conclusions

A major factor concerning a country's ability to drive innovation is its capability to undertake the work. When governments encourage R&D investment by companies, this 'innovation capability' increases exponentially. This is a key attraction for local Chinese and foreign companies looking to establish or expand operations in China in the midst of technological change and disruption.

The HNTE and 150% super deduction programmes encourage innovation, help manage China's overcapacity, cut costs, and support urbanisation and mobility. As part of China's supply-side reform agenda, the government ought to consider increasing the net benefits accruing to companies from these programmes and implement 150% super deduction policy enhancements to support China's services-consumption economic development. Furthermore, when R&D incentives operate in conjunction with broader supply-side reforms, such a combination should lead to stronger and sustainable inclusive economic growth and help achieve China's 13th five-year plan policy objectives. In this context, companies with operations in China should examine their incentive compliance obligations to ensure their 'Peking duck' incorporates the appropriate contemporaneous records to protect the claim if audited by the authorities.

Challenges of the two invoices system for China's pharmaceutical industry

China has been rolling out various measures to reform its healthcare system. Among these changes, the "two invoices system" has attracted much attention and is likely to affect the way pharmaceutical companies are structured and how they sell their drugs. Grace Xie, Henry Ngai and Thomas Li provide an overview of what is happening in China and how it will impact the pharmaceutical sector.

Background to China's healthcare systems reforms

The new China healthcare system reform (CHCSR) was given its full-scale launch in 2009, with the issuance, by the Central Committee of the Communist Party of China (CPC) and the State Council, of the Opinions on deepening the Healthcare System Reform.

The overall goal of CHCSR is to establish and improve the basic healthcare system covering urban and rural residents, and provide the Chinese people with secure, efficient, convenient and affordable healthcare services. This reform gradually strengthens the leading role of government. It introduced a number of reform measures, such as:

- The separation of drug income from total medical income;
- Control of medical insurance expenses; and
- Reduction of drug prices.

In "Opinions on Deepening the Healthcare Reform in 2016", (Guobanfa (2016) 26, hereafter referred as Circular 26) it is specified that

> *"... the two invoices system will be rolled out to public hospitals in comprehensive Healthcare Reform pilot provinces. It is encouraged that hospitals directly settle the drug payment with drug manufacturers and drug manufacturers settle the drug logistics fees with distributors, which aims to compress intermediate processes and reduce unrealistically high drug prices."*

According to the spirit of Circular 26, the "two invoices system" will be rolled out to the provinces of Anhui, Jiangsu, Fujian, Qinghai, Shanghai, Zhejiang, Hunan, Chongqing, Sichuan, Shanxi and Ningxia. Depending on the result and feedback, then the two invoices system may be rolled out nationwide.

The most pioneering city in healthcare reform in China is Sanming, a city in Fujian province, which has experienced significant reform since 2011. The reform in Sanming has demonstrated significant achievements in terms of savings in social medical insurance funds, reduction of drug prices, optimisation of hospital income structures, income improvements for the medical workforce, and enlargement of social medical insurance coverage. It has had a profound impact on the government, pharmaceutical companies, as well as medical insurance and medical service providers. The details are summarised in the table below.

More details on the Sanming healthcare reform can be found in the KPMG report, entitled "Sanming: The real story of grass-roots healthcare transformation in China".

Figure 1

Reforming the government

- Establish a single, city-wide integrated management team to replace the weak, fragmented existing leadership.
- Establish a performance management system for hospitals, then make this data fully transparent to the public.
- Give control of surpluses and hospital savings to central teams to reinvest across the reform programme.

Reforming drug procurement

- Centralise procurement for all public hospitals and make purchasing open and price-competitive.
- Implement the "two invoices system" to reduce fraud and eliminate drug mark-ups by providers.
- Monitor and reduce drug usage, especially of antibiotics and drugs with low clinical outcomes and high commissions.

Reforming medical insurance

- Merge two of the three medical insurance funds and 'level up' the benefits of the least generous one.
- Centralise management of the funds from county to city level, thereby reducing the number of risk pools from 15 to two.
- Move commissioning arrangements to payment by disease-type and limit the reimbursement price on imported drugs.

Reforming service providers

- Shift incentives from prescribing medical services, and introduce a salary cap to dis-incentivise over-treatment.
- Increase salary payment to staff and eliminate drug commissions and illegal 'red envelope' income by staff with an increased 'sunshine salary" payment.
- Establish annual salary packages for hospital CEOs, with a comprehensive KPI (key performance indicator) performance management system (6 categories and 40 indicators).

On September 29 2016, Anhui province issued its detailed implementation rules for the roll out of the "two invoices system" (the Anhui two invoices system plan). Anhui was the first province out of the 11 provinces to put in place the two invoices system, after the Sanming reform, from November 1 2016.

Many other pilot provinces/cities have issued guidance for the roll out of the two invoices system. However, these guidance policies fall short of the details on how the system will be implemented or when it will be implemented. The comments made in this article are mainly based on the practice in Sanming and the Anhui two invoices system plan.

What is the "two invoices system"?

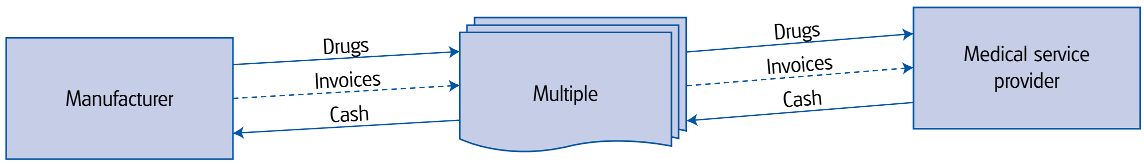
According to Article 4.2 of Circular 26, the two invoices include the following:

- The first invoice refers to the invoice from the manufacturer to the distributor; and
- The second invoice refers to the invoice from the distributor to the medical service providers.

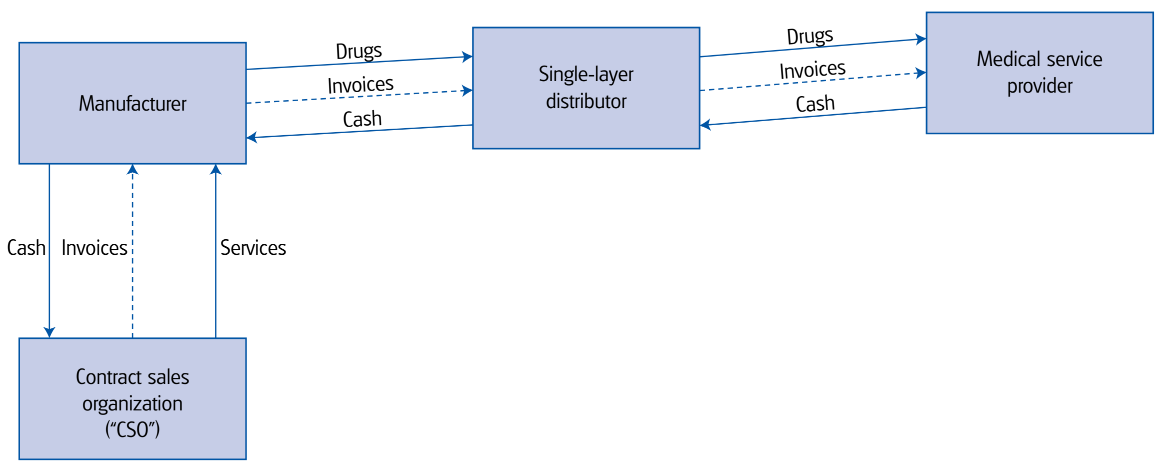
Furthermore, pursuant to Article 39 of Weiguicaifa (2010) 64 (Circular 64), the following companies can be deemed as manufacturers:

- A commercial enterprise set up by a manufacturing company that sells the products of the company only; and

Model 1: Buy-sell model



Model 2: Commission/service fee model



- Master agent of the imported drug for China (only one allowed);

Under the Anhui province two invoices system plan, the deemed manufacturer will also cover the following in addition to the above situations:

- Commercial enterprises set up by the manufacturing company that sells the product of the group only; and
- A drug listing permit holder who assigns another manufacturing company or commercial enterprise to sell the drug.

By adopting the two invoices system, the unnecessary invoice "pass through" within the value chain is expected to be eliminated, as well as increasing transparency over the pricing of drugs.

What is the impact for pharmaceutical company business models?

Before we look at the business impact of the two invoices system it is necessary to first understand the existing business models used by pharmaceutical companies. At present, the common business model of pharmaceutical companies could be depicted as shown in Model 1.

The manufacturer will sell the drugs at a relatively low price to the distributor. The margin retained in the distribution channel will be used to cover the promotion, marketing and sales support-related services provided by the distributors. Under this model, the drugs will be sold through multiple distributors before being sold to the medical service provider at a much higher price.

Under Model 2, the manufacturer will sell the drugs at a higher price to the distributor. The distributor will earn a limited margin for the distribution services provided. The promotion, marketing and sales support-related services provided by a third party will be compensated via commission/service fees paid by the manufacturer.

Due to the implementation of the two invoices system, model 1 will be phased out as there will only be one distributor allowed in the value chain. As such, any service providers that exist in the supply chain will need to be compensated separately through the commission/service fee arrangement. It is expected that more and more service providers will become specialised contract sales organisations (CSOs) as shown in model 2. It can also be foreseen that large distribution organisations will carve out their sales support divisions and put that into separate legal entities to comply with the two invoices system.

Where pharmaceutical manufacturers adopt model 2 to comply with the two invoices system, consideration should be given to the business and financial aspects, which are discussed in further detail below.

Business impact

The channel management for the pharmaceutical companies would change from a hierarchical structure to a flat structure under the reforms. Pharmaceutical companies may have to engage different distributors in each province based on the authorised distributor list of each province. More specifically, in some remote areas where the first tier distributor does not have direct presence, pharmaceutical companies would need to deal with the distributors in those locations directly. This will increase the number of distributors to be managed by the pharmaceutical company.

There will also be less invoice "pass through" arrangements due to the two invoices limitation. As such, many of the smaller/regional distributors would be acquired by large distributors or be forced out of business.

Financial impact

For those pharmaceutical companies that are operating under model 1, there are inventories maintained by distributors throughout the supply chain. Before the implementation of two invoices system, there is a need to clear those inventories from the supply chain. This will have an impact on the sales of the pharmaceutical companies in the short term.

Under the Anhui two invoices system plan, the distributor is required to submit the invoice issued by the manufacturer or importer to the hospitals. This requirement will ensure that drugs delivered to the hospitals are the same batch sold by the manufacturer or importer. In the meantime, it also makes the ex-factory price or selling price of the importer transparent to the hospitals. The hospitals procure the drugs based on the pre-determined price through the bidding/negotiation process. Currently, the price differences between the ex-factory price and the hospital purchase price are much greater than the normal margins earned by a pure distributor. The challenge to the manufacturer is how to determine its ex-factory price under the two invoices system.

If the manufacturer decides to increase its ex-factory price to match the purchase price of the hospital (excluding the distributor fee), it may represent a significant upwards adjustment of its selling price. The increase of its selling price will lead to higher VAT payable by the drug manufacturer. While the tax authority would most likely welcome such an increase, it may also raise an enquiry on the price fluctuation and in particular, the lower price adopted in the past.

If the manufacturer decides not to increase its ex-factory price, the two invoices system would disclose this ex-factory price to the hospital, which may demand a reduction of its purchase price. This will help to achieve the objective of lower drug prices set by the healthcare reform. However, this is also likely to lead to lower margins earned by the drug manufacturers if they have to pay the CSOs for the marketing and promotion services provided. Such a drop in the operating margin will likely attract an enquiry from the tax author-

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ity immediately. In order to maintain the target operating margin under its current transfer pricing model, the drug manufacturer may look to adjust the transfer pricing arrangement with its overseas supplier, either from the import price of the active pharmaceutical ingredients (API) or other key components required for its operation in China.

The CSO plays an important role in the promotion and marketing of the drugs to hospitals and doctors. Typically, the commission/service fee of the CSO will be calculated as a percentage of sale of a particular drug. There is a question of whether such fees would be treated as commission and subject to 5% deduction limit for commission expenses under the Corporate Income Tax Law. The genuine business substance of the commission/service fee should also be analysed from compliance perspectives.

For imported drugs, most of the multinational pharmaceutical companies will engage a third party logistics service provider to act as the importer and the distributor of the imported drugs due to the distribution license restriction in China. If there are currently more than two invoices in the distribution channel, i.e. from the importer to the hospital, some of the distributors in the supply chain will be eliminated. If those distributors also provide marketing and sales support services, they will need to be compensated by the overseas products owner directly. However, whether the overseas pharmaceutical companies are willing to engage directly with such service providers in China would depend on their assessment on the qualification and compliance status of the service provider. Therefore, it is likely that more multinational pharmaceutical companies will bring the marketing and sales support services into their own subsidiaries in China for better management of such activities.

As mentioned before, it is likely that the two invoices system will give rise to many specialist CSOs which will carry out the marketing and promotion activities historically performed by the multiple-layer distributors and bear such costs. MNE pharmaceutical companies have the option to either engage third-party CSOs directly or engage related party CSOs (or a related party consultancy company which subsequently procures the services from third party CSOs). When the CSOs are related to the MNE pharmaceutical companies, their arrangements with the MNE pharmaceutical companies are subject to transfer pricing regulations which mean that the transactions must be conducted at arm's length.

The exact level of compensation to the related-party CSOs or consultancies will depend, to a large extent, on the nature of activities that will be carried out by the CSOs or consultancies. If the CSOs' activities are akin to what would be carried by the multiple-layer distributors historically and will contribute directly to the sales of drugs, tax authorities are more likely to argue for a commission-based pricing. If, on the other hand, such CSOs or consultancies' activities are more ancillary or supportive in nature, a cost plus arrangement may suffice. This being said, the two invoice" system will have great impact on the commercial landscape of the pharmaceuticals industry in China, and companies' transfer pricing adjustments must adapt to the changing business environment.

In order to better manage the distribution of imported drugs in China, some multinational pharmaceutical companies are looking for ways to acquire the good supply practice (GSP) license. If they are successful, it will consolidate the importation and sale of the imported drugs with the marketing and sales support activities into one commercial legal entity. While this brings greater control to the management and the distribution activities in China, such change presents more challenges when the commercial company with the GSP license tries to minimise the fluctuation of the import price, meeting the targeted operating margin for tax purposes and achieving a reasonable selling price into the hospitals. These considerations send conflicting signals for the determination of the transfer price between the overseas product owner and the Chinese commercial company. Approaching this in a holistic manner and advance consultations with the relevant government authorities would be critical in order to minimise further audits/enquires on the transfer pricing arrangement of the commercial company.

Our suggestions

On a broader scope, pharmaceutical companies should follow closely the evolving healthcare reform, in particular the two invoices system, in China.

Pharmaceutical companies should review and understand the new features of the two invoices system from the latest rules issued in Anhui province and the reform in Sanming. Based on those policies, the pharmaceutical companies should assess their business models with regards to the setting of ex-factory prices and the bidding prices, arrangements with distributors and CSOs, and the transfer pricing arrangements with overseas related companies.

Hong Kong: A tax boost to the international investment hub

In 2016, Hong Kong has continued to work towards the future with enhanced tax benefits for offshore funds and corporate treasury centres by releasing a raft of guidance and clarifications. Meanwhile, the BEPS movement continues to gain momentum in Hong Kong, while the territory continues to expand its treaty network. Ayesha Lau, Darren Bowdern, Michael Olesnicky and Curtis Ng discuss Hong Kong's changes.

Background

Looking back, Hong Kong ended 2015 with the release of guidance from the Inland Revenue Department (IRD) on the tax treatment of court-free amalgamations in Hong Kong. This release was eagerly anticipated, but while it provided a clearer picture on how the IRD views court-free amalgamations in practice, it also highlighted conflicts in the interpretation of, and reconciliation with, universal succession concepts that are fundamental in amalgamation cases. These would need to be remedied through a formal legislative process.

Around the same time, the Hong Kong government introduced the Inland Revenue (Amendment) (No. 4) Bill 2015, formally introducing a concessionary profits tax rate for qualifying corporate treasury centres. Once enacted, the hope is that the measures will go towards promoting Hong Kong as a favourable location for multinational enterprises (MNEs) to establish their corporate treasury centres.

On a global level, Hong Kong has accepting the OECD's invitation to join in the Base Erosion and Profit Shifting (BEPS) movement, paving the way for the government to introduce legislation to strengthen transfer pricing regulations and curb treaty abuses. At the same time, Hong Kong continues to expand its treaty network with the conclusion of double tax treaties with Latvia and Russia.

Court-free amalgamation guidance

The concept of court-free amalgamations was introduced in March 2014 with the release of the new Companies Ordinance (Cap. 622). This development was welcomed by the business community, which saw these measures as a tool for efficient corporate acquisitions and restructuring exercises. However, two years since the release of the Companies Ordinance, there remains little guidance, legislative or otherwise, on how court-free amalgamations are treated for tax purposes.

The IRD's release in December 2015 of their views on amalgamation provisions was, therefore, eagerly anticipated by the business community and tax professionals alike. Although the guidance did not come in the form of an official departmental interpretation and practice note (DIPN), it is still a useful indication of how the IRD perceives that certain provisions of the Inland Revenue Ordinance (IRO) should apply to court-free amalgamations.

The main take-away from the IRD's guidance on court-free amalgamations is that the tax treatment of these transactions may not be the same as those that were applied in previous merger transactions undertaken in

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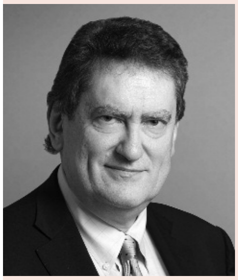
Hong Kong under private merger Ordinances. Further, the IRD also stated that the principles of universal succession will not be applicable for tax purposes. This conflicts with the widely-held belief that, since the court-free amalgamation rules in the Companies Ordinance were largely modelled on the Singapore and New Zealand corporate merger provisions (which are based on universal succession principles) the tax treatment of these transactions should thus follow in the same vein.

A notable example of the IRD's departure from the principles of universal succession is demonstrated in the treatment of carried forward tax losses post-amalgamation. Under the IRD's guidance, tax losses incurred by amalgamating companies before joining the same wholly-owned group as the amalgamated company (that is, the surviving company) cannot be utilised post-amalgamation. This clearly conflicts with the concept of universal succession, which envisages that the amalgamated company should merely "step into the shoes" of the amalgamating company, thus inheriting all of its tax attributes.

In addition to this, it is arguable that some of the rules in the IRD's guidance extend beyond the provisions of the IRO as it stands today. It is clear that the intention behind the tax loss rules in the IRD's guidance is to safeguard against situations where amalgamations are carried out wholly or substantially for the purposes of utilising tax losses. In other words, situations that would otherwise be caught by the anti-avoidance provisions in sections 61A and 61B of the IRO. However, in arbitrarily denying the utilisation of losses merely due to the timing of when the losses were incurred, the IRD's rules become arguably more restrictive than the anti-avoidance provisions, which would still allow the losses if it can be demonstrated that the amalgamation was not carried out for the purpose of utilising tax losses.

Although the guidance released by the IRD provides insight into the direction the authorities are heading towards when it comes to implementing the court-free amalgamation



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provisions, it also highlights gaps in legislation that would need to be remedied.

In the coming year, we look forward to the government filling in these gaps, either through legislation or formal guidance in a DIPN.

Developing Hong Kong as a treasury centre

Following the government's announcement in 2015 on measures to develop Hong Kong into a corporate treasury centre, draft legislation was introduced in December 2015 setting out the main features of the corporate treasury centre (CTC) rules that included:

- A concessionary rate of tax for qualifying CTCs on certain income;
- A deemed deduction for interest paid on intra-group lending; and
- A deeming provision for interest income and other gains on certain intra-group lending regardless of how the arrangement was entered into or where the loan funds were provided.

A qualifying CTC is a corporation that has either:

- Carried out only corporate treasury activities in Hong Kong during the year of assessment (i.e. a treasury CTC);
- Satisfied defined safe harbour rules (i.e. a safe harbour CTC); or
- Has obtained the Commissioner of Inland Revenue's discretionary consent (i.e. a discretionary CTC).

Corporate treasury activities are defined as, and generally involve, making loans, providing corporate treasury services and undertaking corporate treasury transactions to, and in respect of, associated entities.

The concessionary rate of tax is 8.25%. The effect of the second and third features of the CTC rules is to deem certain interest expenses and income, which would ordinarily be considered non-deductible/no-taxable under the offshore sourcing concepts, as deductible and assessable for Hong Kong tax purposes. Although the deeming provisions on interest deductions is a positive development for Hong Kong taxpayers, given current potential mismatches in the treatment of interest on cross-border lending and borrowing transactions, the deemed interest income rules gives rise to concerns as they may have an impact on financing arrangements already in place.

In addition to concerns regarding the interest deeming provisions, there are also uncertainties as to how the qualifying conditions will be applied. Under the draft legislation, it appears that a separate legal entity must perform qualifying treasury centre activities in order to qualify as a CTC. This would mean that the many existing entities in Hong Kong that operate corporate treasury activities in a separate division may need to restructure their operations in order to qualify as a CTC.

Notwithstanding these uncertainties and concerns, the CTC framework is still a positive step towards drawing corporate treasury centres to Hong Kong, especially in light of the greater scrutiny placed on intragroup financing activities resulting from the OECD's BEPS initiatives.

The rules should be further refined and drafted in consultation with industry and the business experts in order to produce a CTC regime that offers the right levels of incentives.

BEPS plan gains momentum in Hong Kong

On the global stage, the BEPS initiatives are gaining momentum and the movement has hit Hong Kong's shores.

In 2016, the Hong Kong government accepted an invitation from the OECD to join the BEPS project as an "associate", committing itself to the comprehensive package of reforms proposed by the organisation.

As a priority, Hong Kong will be implementing the following four action points with agreed minimum standards:

- Action 5: harmful tax practices and spontaneous exchange of information;
- Action 6: anti-treaty abuse;
- Action 13: country-by-country reporting (CbCR); and
- Action 14: improvements in cross-border tax dispute resolution.

The immediate priorities for the Hong Kong government will be to introduce a more comprehensive transfer pricing regime with specific documentation rules and to increase scrutiny on related-party transactions in IRD audits and investigations. On the treaty shopping front, the simplified limitation of benefits rule and the principle purpose test are likely to be incorporated into all of Hong Kong's future tax treaties.

In line with this, a public consultation paper was released on October 26 2016. Among others, the most significant proposals were to:

- Codify the transfer pricing rules into tax legislation and to extend the transfer pricing regime to cover financial and business arrangements;
- Mandate the preparation of transfer pricing documentation based on Action 13. This means that companies must prepare a master file and a local file where they meet two of the following criteria – annual revenues exceeding HK$100 million ($13 million), assets exceeding HK$100 million and a workforce exceeding 100 employees. Companies with consolidated group revenues of more than €750 million ($795 million) will be required to prepare a country-by-country report;
- Provide for the exchange of country-by-country reports with jurisdictions with which Hong Kong has a double tax treaty in force;
- Implement an OECD-coordinated multilateral instrument and amend double tax treaties to counter the use of hybrid entities and hybrid instruments and to strengthen treaties against the avoidance of tax. Hong Kong will adopt a principal purpose test under which benefits of a tax treaty cannot be obtained if one of the principal purposes of the transaction or arrangement is to obtain the benefit;
- Introduce legislation to formalise mutual agreement procedures and mandatory arbitration to resolve treaty disputes and to provide for the spontaneous exchange of certain information with tax treaty partners; and
- Extend the time period for claiming tax credits from two years to six years.

How all the pieces will fall into place after the implementation of the BEPS recommendations will depend on the details in the resulting legislation, but the Hong Kong government has stated that it will strive to maintain a simple, neutral and highly transparent tax regime. At the very least, for the international taxpayer, this means that robust transfer pricing support and documentation are becoming more important in a climate of increasing scrutiny of related-party transactions.

Structures will need to be reviewed for sustainability and future tax planning structures should be future-proofed as best as possible, taking into consideration the anti-treaty abuse measures.

Expanding the treaty network

Along with adopting the BEPS measures, Hong Kong is continuing to build on its international profile by expanding its tax treaty network. In 2016, it concluded double tax treaties with Latvia and Russia.

The conclusion of the treaty with Latvia is representative of Hong Kong's efforts to build relations with economies along the Belt and Road. Hong Kong was previously listed on Latvia's list of low-taxing jurisdictions. Under the agreement, dividend and interest withholding tax rates are capped at 10% (compared with the maximum Latvian domestic withholding tax rate for dividends at 30% and interest at 15%). In addition, withholding tax on royalties are capped at 3% (compared with the maximum Latvian domestic withholding tax rate of 23%).

Withholding rates under Hong Kong's agreement with Russia are capped at 10% for dividends (compared to the Russian domestic withholding tax rate of 15%), 0% for interest (compared to the Russian domestic withholding tax rate of 20%), and 3% for royalties (compared to the Russian domestic withholding tax rate of 20%).

Negotiations are continuing with India, Pakistan, Turkey, Germany and Cyprus, among other jurisdictions.

Concluding thoughts

In 2015, various announcements were made by the government on Hong Kong's future. In 2016, the future started to become clearer as Hong Kong works towards clarifying and implementing previously announced measures.

Clarifications from the IRD on its view of the court-free amalgamation provisions shed some light on an issue where guidance was previously absent. However, it remains to be seen whether these views will eventually translate into legislation or a DIPN.

Draft legislation introducing the CTC rules is another welcome step towards making Hong Kong an attractive location for corporate treasury centres. For the remainder of 2016 and possibly well into 2017, consultations will continue in order to refine the rules. These rules come at an opportune time as the BEPS movement increases scrutiny on intra-group financing measures.

On the BEPS front, Hong Kong's entry into the BEPS movement is likely to gather momentum in the immediate future. Any future policies and measures enacted by the government are likely to be heavily influenced by BEPS.

Taiwan: tax changes towards growth and progress

Taiwan's geographic location in the heart of the Asia-Pacific region, together with its low corporate income tax rate of 17%, makes it an ideal place for multinational enterprises to establish their headquarters in the region. Stephen Hsu, Hazel Chen and Betty Lee highlight Taiwan's key developments over the past year.

Not only is Taiwan a hub that connects Europe, the US, Japan, and emerging Asian markets, but it also has a highly skilled labour force, and is very active in the global research and development (R&D) and high-tech fields. Taiwan's access to mainland China's productive capacity, and its capability to commercialise innovative products, makes it highly competitive in the global economic landscape.

Completing the anti-tax avoidance framework

In line with recent global tax developments, Taiwan has also made a number of significant changes to its income tax regime, completing its anti-avoidance framework by introducing the controlled foreign company law (CFC) and the place of effective management (POEM) law.

Articles 43-3 (CFC rules) and 43-4 (POEM rules) were inserted into the Taiwan Income Tax Act (ITA) in 2016 when the Legislative Yuan passed its third reading. However, the actual effective dates of these rules are still to be announced. One key factor that will affect the effective dates of these new rules is the timing of the ratification of the China-Taiwan cross-straits double tax agreement (cross-straits DTA).

Historically, Taiwan companies have invested into China via intermediate holding companies in low or tax haven jurisdictions (e.g. the British Virgin Islands, Samoa, etc.). These arrangements will be significantly impacted upon by the new CFC and POEM rules entering into force. However, with the use of the cross-straits DTA, these impacts could be minimised. This could be achieved by treating the intermediate holding company as a Taiwan tax resident company, under the POEM rules, which are the same as the residency definitions under the cross-straits DTA, and thereby accessing the benefits under the cross-straits DTA.

Introduction of the CFC rules

According to Taiwan's ITA, as long as offshore subsidiaries do not repatriate earnings to Taiwan, their Taiwan parent company would not be subject to Taiwan income tax on such foreign earnings. As a result, Taiwan companies can defer Taiwan income tax on their foreign investment revenue by parking investment income in an offshore entity.

There had been concern about Taiwan companies indefinitely retaining profits in their offshore subsidiaries located in tax havens or low tax jurisdictions and circumventing income tax by not distributing dividends. It was considered that this could end up eroding the domestic tax base. To prevent this, the Taiwan Ministry of Finance (MOF) introduced the CFC rules in the ITA under Article 43-3.

By introducing the CFC rules, which have already been in place in many other countries for a long time, the MOF would be able to focus on those CFCs that retain profits offshore for the purpose of deferring Taiwan taxation. The Taiwan parent company would be required to recognise the amount as (foreign) investment income based on its holding percentage. This would deem the revenue to have been distributed to Taiwan and result in it being treated as taxable profits for the Taiwanese parent company in the relevant tax year.

An offshore entity will be considered as a CFC under the Taiwan ITA if a Taiwan company directly or indirectly controls such an entity and where the offshore entity is located in either a low-tax jurisdiction (currently where the benchmark tax rate is below 11.9%) or a jurisdiction which taxes on a territorial basis. Once an entity is determined to be a CFC, then the Taiwan parent company must recognise and include its pro-rated share of the offshore entity's profits as its investment income within its taxable income for the relevant year. A CFC will be exempted from such treatment if a substantial amount of income derived by the CFC arises from actual business operations or if the profit of the CFC for the particular year is below the de-minimis threshold (which is yet to be prescribed by the authorities).

Introduction of the POEM rules

Under the ITA, Taiwan uses a tax residence test that is based on incorporation, rather than a test based on a company's place of central management and control. As such, to minimise tax, Taiwan companies can set up foreign incorporated entities and divert profits to such overseas paper companies, and thereby fall outside the scope of Taiwan income taxation. Usually these offshore companies exist only for tax minimisation purposes with no economic substance or commercial necessity, with management and control of the entity effectively being performed in Taiwan.

Increasingly, it has been international tax practice to determine the tax residency status of an entity according to the location of its POEM. Consequently, the MOF has introduced this concept into the ITA to ensure that an offshore company with its POEM in Taiwan will be determined or deemed as having its head office within Taiwan. This treats the offshore company as a Taiwan company for corporate income tax purposes and subject to taxation similar to that of a Taiwan incorporated company.

Expanding the tax treaty network

Although Taiwan is enhancing its anti-avoidance framework, it is also seeking to remain competitive in the international tax realm.

Taiwan continues to expand its tax treaty network and it has now signed DTAs with 32 tax jurisdictions.

DTA between Taiwan and Japan

The agreement with Japan was signed on November 26 2015 and marked the 30th DTA that Taiwan had signed. It is also the first DTA signed with another northeast Asian country, which signifies the solidification of Taiwan's treaty network in Northeast Asia.

The agreement will come into effect from 2017.

The purpose of the DTA is to clearly distribute taxing rights, eliminate double taxation, decrease uncertainties with taxation, and improve both Taiwan and Japan's investment environments.

Both the OECD Model Tax Convention and the UN Model Double Tax Convention served as blueprints for the Taiwan-Japan DTA. The domestic tax regulations, economic and trade conditions, various income-generating cross-border activities and existing double taxation eliminating relief measures for each jurisdiction were taken into consideration in finalising the DTA. The agreement addresses methods to resolve tax disputes and enhance bilateral economic and investment relations. A few key features of the Taiwan-Japan DTA are discussed below.

Reduced withholding tax (WHT) rates

The WHT rates on dividends, interest and royalties in the source territory will be reduced as follows:

- Dividends: If the company paying a dividend is a resident and if the beneficial owner of the dividend is a resident of the other territory, the tax charged will not exceed 10% of the gross amount of the dividend;
- Interest: If the beneficial owner of the interest is a resident of one territory, the tax charged in the other territory will not exceed 10% of the gross amount of the interest; and
- Royalties: If the beneficial owner of the royalty is a resident of the other territory, the tax charged in the other territory will not exceed 10% of the gross amount of the royalty.

Applicable WHT rates

	Japan domestic WHT	Taiwan domestic WHT	DTA Rates
Dividends	15%/20%	20%	10%
Interest	15%/20%	15%/20%	10%
Royalties	20%	20%	10%

We note that dividends received by Japanese companies from their wholly owned foreign subsidiaries can effectively be tax exempt in Japan. As such, the preferential dividend WHT rate of 10% should reduce the overall tax burden of the Japanese parent company.

For Taiwanese parent companies, the dividend received from its Japanese subsidiaries will still be subject to tax in Taiwan at 17%. However, the DTA reduces the issue of excess foreign tax credits being wasted under Taiwan's foreign tax credit regime and thus reduces the overall tax burden for the Taiwanese parent company.

Based on the above, the Japan-Taiwan DTA should encourage more direct investments between Taiwan and Japan.

Capital gains

Where a company is a resident of a territory that sells its shares in the company, which is a resident of the other territory, then the capital gains taxing rights will lie with the alienator resident territory. This is the case unless the subsidiary is a company deriving at least 50% of the value of its property directly or indirectly from immovable property situated in the other territory.

Permanent establishment (PE) and business profits

Typical to treaties, there is a provision within the Japan-Taiwan DTA governing PE profit attribution that draws on the OECD Model. It provides that profits from an enterprise of one jurisdiction will not be taxed by the other jurisdiction if the enterprise does not carry on business through a PE in that other jurisdiction.

In addition to the general definitions of a PE, the DTA also stipulates that companies furnishing services, including consultancy services, will create a PE in the other jurisdiction only if the enterprise, through employees or other personnel engaged for the same or a connected project, provide services for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the taxable year concerned. This services PE article provides an opportunity for Japanese companies to benefit from the exemption under the business profits article.

Pursuant to the Taiwan ITA, foreign companies may be subject to a Taiwan income tax liability where they derive Taiwan sourced income. The existence of a PE (a fixed place of business or a business agent) in Taiwan does not affect the determination that income is taxable, instead it only affects the tax rate and manner of making the tax payment.

If a foreign company does not have any PE in Taiwan (under the Taiwan ITA definition), yet derives Taiwan sourced income, such income will be subject to WHT at 20%, provided that the type of income is within the scope of WHT. If a foreign company derives Taiwan sourced income, which is not within the scope of the WHT, the foreign entity would need to report such income by appointing an agent to file Taiwan income tax on its behalf.

Before the Taiwan-Japan DTA is effective, where a Japanese company derives (Taiwan sourced) service income from Taiwan customers, the service fees will be subject to 20% WHT. Once the Taiwan-Japan DTA comes into force, where the Japanese company can evidence that it does not have a PE pursuant to the PE article (e.g. its employees stayed in Taiwan for less than 183 days in any 12-month period), the Japanese company can apply for such income to be exempt from Taiwan taxation under the business profits article and the 20% Taiwan WHT should not apply. For using the business profits exemption under the Taiwan-Japan DTA, the Japanese company will need to obtain pre-approval from the Taiwan tax authorities.

International transportation

Profits from shipping and air transport operations in international traffic carried on by an enterprise of a territory will be taxable only in that territory.

Dependent personal services

Remuneration derived by a resident of a territory in respect of an employment exercised in the other territory will be exempt from income tax in the other territory if all of the following conditions are fulfilled:

- A continuous or cumulative stay in the other territory for no more than 183 days in any 12-month periods;
- The remuneration is paid by (or on behalf of) an employer who is not a resident of the other territory; and

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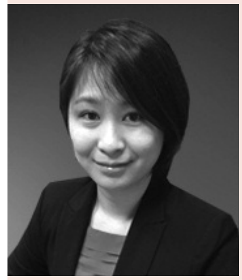

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She is a member of the Institute of Chartered Accountants in Australia, a chartered tax adviser of The Taxation Institute in Australia as well as an international affiliate member of the Hong Kong Institute of Certified Public Accountants.

- The remuneration is not borne by a PE in which the employer has that other territory.

Under Taiwan domestic law, where a foreign company sends its employees to provide services in Taiwan, and the individual employees stay in Taiwan for 90 days or less in a calendar year, such individuals will generally be exempt from Taiwan income taxation. However, where the individuals stay in Taiwan for more than 90 days, but less than 183 days, in a calendar year, he/she will be required to report and pay tax in Taiwan.

Pursuant to the new Taiwan/Japan DTA, having satisfied the conditions under the aforementioned article, the particular individual could be exempt from Taiwan income taxation where he/she stays in Taiwan for less than 183 days (but more than 90 days) in a calendar year.

Minimising double taxation

Under the DTA, should the conduct of businesses between a Taiwanese company and a related Japanese company lead to issues with respect to transfer pricing adjustments in Japan, which increase the Japanese company's taxable income, the companies are entitled to access a tax dispute resolution mechanism. They may request the initiation of a mutual agreement procedure (MAP) with the Taiwanese tax authorities concerning the right of taxation, effectively eliminating double taxation.

Apart from the MAP, a Taiwanese company and Japanese company may approach the respective tax authorities to apply for a bilateral advanced pricing agreement. Once a consensus is reached and approved, this will not only comprehensively address and resolve any potential transfer pricing disputes for the relevant years, but also minimise scrutiny from the tax authorities from either contracting jurisdictions in reviewing or making post-transactional adjustments.

Revisiting Taiwan-Japan investment holding structures

In the past, given the high domestic WHT rates in Taiwan and Japan without a DTA in place, we had observed the common use of intermediate holding companies in a third jurisdiction (e.g. the Netherlands) for inbound and outbound investment holdings structures by Japanese and Taiwanese investors, respectively. The Taiwan-Japan DTA may trigger a need for Japanese investors to revisit their investment holding structures for investing into Taiwan and vice versa.

Overall, the DTA is a very positive development, providing more attractive investment options in terms of taxation and opening doors for potential tax efficiencies.

Draft VAT proposal to catch foreign e-commerce businesses in the Taiwan VAT net

In additional to the above changes, on September 22 2016, draft VAT law changes were passed by the Executive Yuan.

The proposed changes seek to include foreign e-commerce enterprises, without a Taiwan fixed place of businesses (e.g. a Taiwan branch), that sell electronic services to individuals in Taiwan, within the Taiwan VAT net. This will be achieved by requiring those foreign entities to register for and remit VAT in Taiwan.

Under existing provisions, where a foreign enterprise without a fixed place of business in Taiwan sells services to Taiwan businesses/consumers (individuals or enterprises), it will be the Taiwanese business/consumers which will be the VAT taxpayer in Taiwan. Based on the proposed changes to the VAT Act, this will no longer apply for foreign enterprise selling electronic services to domestic individuals. The VAT taxpayer status will be shifted to the foreign enterprise itself.

The foreign enterprise (or appointing a local agent) will need to register and file for VAT with the competent tax authorities if it has annual sales exceeding a certain threshold. Should the taxpayer or the tax-filing agent for the business entity fail to remit VAT within the prescribed period of time, penalties will be imposed.

Aligning with the OECD BEPS recommendations and recent observed changes in this regard in the EU, Japan, and South Korea, the draft proposal highlights an increase in the compliance requirements for foreign e-commerce businesses selling services to individuals in Taiwan. Although not officially announced, it is anticipated that there would be future developments in the income tax rules in relation to this area.

Conclusion

We note that the Taiwan tax authorities are actively observing and studying the outputs under the 15 action items of the OECD BEPS Project. In view of the various changes (e.g. the CFC and POEM rules) that have taken place in Taiwan over the past year, as well as the proposed VAT changes, we are expecting more changes to come.

Companies should closely monitor the development and implementation details of the upcoming and proposed changes to ensure that tax risks are appropriately managed. They should also keep an eye out for tax efficiencies (e.g. the use of the Taiwan-Japan DTA) so they do not miss out on any potential tax opportunities.


Securing R&D tax incentives in China
China has been encouraging and promoting research and development (R&D) for over 10 years by offering tax incentives to enterprises which conduct R&D activities. A good understanding of R&D tax incentives can lead to significant tax savings for your business. KPMG has an established practice and the capabilities to assist your company to identify eligible R&D entitlements, such as the R&D super deduction and HNTE status.
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