China Tax Weekly Update

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Relevant industries: All
Relevant companies: All
Relevant taxes: VAT, CIT, IIT, UTLUT, UMCT and education surtax

Potential impacts on businesses:

- Operational costs reduced

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China VAT simplification and CIT reduction plans

As highlighted in KPMG *China Tax Weekly Update (Issue 10, March 2017)*, Premier Li Keqiang delivered the 2017 Report on the Work of the Government on 5 March 2017. In this he noted that in 2017: (i). China will simplify the VAT rate structure; (ii). Expand the number of small enterprises who can benefit from preferential Corporate Income Tax (CIT) treatment; (iii). Increase the research and development (R&D) expense super deduction for science and technology-related small and medium enterprises (SME).

The timing of these policy measures, and the rollout of further tax reduction measures specified in the Report on the Work of the Government, were outlined by Premier Li at an 19 April executive meeting of the State Council.

- The VAT brackets applicable to general VAT taxpayers will be reduced from four to three from 1 July 2017 onwards [a separate 3% rate continues to apply to small enterprises not registered as general VAT taxpayers]. The new VAT rates will be 17%, 11% and 6%. Agricultural products and natural gas, which used to be subject to the 13% rate, will be subject to the 11% rate going forward, and the 13% rate will be abolished.

  Under the existing VAT rules, an input VAT credit may be treated as arising from the purchase of agricultural products, and can be offset against the output VAT on onward sale of these goods, or supplies made out of them. This is despite the fact that no VAT will have been levied on the supply from the farmer to the initial purchaser of the goods (i.e. it is a deemed input credit). The input VAT credit calculated by multiplying 13% by the invoice purchase price. As the VAT rate for agricultural products will be reduced to 11% after 1 July 2017, this would have been expected to result in an increased tax burden for enterprises engaged in processing of agriculture products. In light of this, and in line with the government's focus on lowering tax burdens through the VAT reform, Premier Li indicated that input VAT entitlements in such cases would not change under the new rules. While the precise meaning of this statement is still to be clarified, it is anticipated that the input VAT credit in such cases would continue to be calculated with 13% rate.

- From 1 January 2017 to 31 December 2019, eligible small enterprises whose table income falls under RMB500,000, may pay CIT on 50% of their whole income at a rate of 20% (i.e., effective rate is 10%). The threshold was previously RMB300,000.

- From 1 January 2017 to 31 December 2019, "science and technology-related SMEs", whose R&D expenses are incurred for the development of new technologies, new products and new processes, can benefit from an improved CIT bonus deduction. The bonus deduction will now be 75%; previously the bonus deduction for such enterprises was 50%, at which level it remains for larger enterprises. The recognition criteria for "science and technology-related SMEs", which is a new tax concept, are yet to be clarified.
- Venture capital (VC) tax incentives have also been improved. Under the existing rules in Guo Shui Fa [2009] No. 87 and SAT Announcement [2015] No. 81), where VC enterprises, taking either corporate or partnership form, invest in non-listed small and medium high and new technology enterprises (HNTE) by way of equity investment then an incentive may be obtained. The small and medium HNTEs must not only go through the HNTE recognition process overseen by the Ministry of Science and Technology and other relevant authorities, but they also need to meet certain requirements on the number of their employees, annual sales turnover, and total assets. Where these criteria are met, and where the investment is for two years or more, 70% of the investment amount can be offset against the taxable income of the VC enterprise for CIT purposes.

  With the changes announced by Premier Li, investments made in science and technology enterprises at seed capital or start-up stage are now to be in scope of the incentive from 1 January 2017. It remains to be seen how the such investee enterprises are defined and whether they will need to perform some manner of special registration. The new incentive treatment will initially be piloted in eight designated locations, including Beijing-Tianjin-Hebei, Shanghai, Guangdong, Anhui, Sichuan, Wuhan, Xian, Shenyang, as well as Suzhou Industrial Park. Furthermore, individual investors who make such investments may now also enjoy the incentive, for IIT purposes, from 1 July 2017. It has not yet been clarified whether the individual investors will be able benefit from the incentive in the case of a direct investment in the investee, or whether this need to be made through a particular intermediary (e.g. a VC partnership).
- Premiums paid to eligible commercial health insurance providers are allowed to be deducted up to RMB2,400 per person per year for individual income tax (IIT) purposes. This has been piloted in certain regions, such as Beijing, Shanghai, Tianjin, Chongqing since 1 January 2016. Following this trial period the tax incentive is now to be applied nationwide starting from 1 July 2017, with the upper limit for tax deductions unchanged.

It was also decided during the meeting that a three-year extension would be applied to a package of current tax incentive policies that were due to expire by the end of 2016. These include, inter alia:

(i). 50% reduction of urban and township land use tax (UTLUT) levied on land used for construction of bulk commodity warehousing facilities owned by logistics enterprises;

(ii). a VAT exemption for interest income arising from small loans made to small farmer households by financial institutions. All finance companies (including smaller lenders) engaged in providing small loans to farmers are now in scope of this incentive, provided that their activities are in compliance with laws and regulations;

(iii). Reduction of VAT, urban maintenance & construction tax (UMCT), education surtax and IIT/CIT for new businesses or new employments (as relevant) set up or entered into by college graduates, the long term unemployed, or ex-servicemen. Specific procedures and qualifying criteria apply.

These policies outlined by Premier Li will be followed up in due course with detailed implementation guidance from the SAT and other bodies and we will report on this guidance as and when it is released.

Reference: N/A
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Relevant industries: All
Relevant companies: MNEs
Relevant taxes: N/A

Potential impacts on businesses:

- Risks of being challenged due to cross-border tax anti-avoidance arrangements increased

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Further OECD guidance on Country-by-Country reporting

The Organisation for Economic Cooperation and Development (OECD) on 6 April 2017 released additional guidance for the preparation and filing of country-by-country (CBC) reports, pursuant to the base erosion and profit shifting (BEPS) Action 13 report recommendations. This is the third set of CBC guidance provided by the OECD; in the previous two rounds the OECD explained: (i) how to conduct of voluntary filings in parent-surrogate situations; (ii) the impact of currency fluctuations on the EUR750m CBC reporting threshold; (iii) coverage of investment fund groups by CBC reporting; (iv) treatment of partnerships as stateless entities; (v) how to deal with local notifications of CBC reports filed elsewhere (see KPMG *China Tax Weekly Update (Issue 48, December 2016)* and *(Issue 41, November 2016)* for more details).

This third round of CBC guidance addresses five specific issues:

1. Definition of 'revenues' as stated on the face of the CBC report – It should include extraordinary income and gains (e.g. from asset disposals).
2. Determination of 'related party revenues' as stated on the face of the CBC report – The determination is based on the entities described as 'constituent entities' in Table 2 of the CBC report. Revenue from these entities will be recorded as 'related'. By contrast, revenue from, say, a joint venture entity, in which the parent has a minority interest, but which is not a 'constituent entity' in Table 2 of the CBC report, will be recorded as 'unrelated'. This is important to bear in mind as, for the purposes of applying the TP rules in many countries, such entities (and revenues from them) may be regarded as being 'related party'.
3. Definition of 'MNE group' for determining whether the CBC reporting (EUR750m) threshold is met – For determining the membership of a publicly listed group one may make reference to the group definition per the accounting standards used for consolidated accounts. For private groups one may use the accounting standards which would have been used if 'hypothetically' the group was traded on a public securities exchange. This means using the local GAAP of the parent company location.
4. Calculating 'group revenue' for determining whether the CBC reporting (EUR750m) threshold is met – The question arises of whether, in calculating group revenue, full inclusion or proportional inclusion should be made of the income of entities in which the group has less than a 100% holding. In determining this one has reference to the ultimate parent location's accounting standards and the approach these take to full or proportional consolidation.
5. Calculating 'group revenue' for determining whether the CBC reporting (EUR750m) threshold is met – Follow the parent location accounting to determine whether extraordinary items are included. While generally speaking gross revenues are to be used in making the revenue calculation, where financial institutions report a net figure as gross income in their accounts (e.g. offset of derivatives) then this net figure may be acceptable as the basis for the group revenue calculation.

* State Administration of Taxation (SAT) Announcement [2016] No. 42 provides China's CBC administrative guidance, together with a supplementary SAT announcement on 27 March 2017. You may refer to below our KPMG publications for more details:

- *China Tax Weekly Update (Issue 13, April 2017)*
- *China Tax Weekly Update (Issue 27, July 2016)*
- *China Tax Alert: State Administration of Taxation (SAT) Issued Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation (Issue 23, July 2016)*

Reference: N/A
Issuance date: N/A
Effective date: N/A

Relevant industries: All
Relevant companies: MNEs
Relevant taxes: N/A

Potential impacts on businesses:
- Risks of being challenged due to cross-border tax anti-avoidance arrangements increased

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New OECD guidance on Automatic Information Exchange

To further support the consistent implementation of the Common Reporting Standard (CRS), the OECD on 6 April 2017 released:

- A series of additional CRS-related Frequently Asked Questions on:
  - ❑ General CRS reporting requirements concerning, inter alia, "usufruct".
  - ❑ Due diligence requirements concerning, inter alia, the necessity of identifying the controlling persons of passive non-financial entities through chains of financial institutions, look-through requirements for widely-held collective investment vehicles (CIVs) and pension funds, where these take the form of trusts in non-participating jurisdictions, and other particulars.
  - ❑ Definitional issues including, inter alia, whether e-money providers qualify as "depository institutions" for CRS implementation purposes.
- The second edition of the Standard for Automatic Exchange of Financial Account Information in Tax Matters, which expands further the CRS XML Schema User Guide. It sets out additional technical guidance on the handling of corrections and cancellations within the CRS XML Schema, and provides a revised and expanded set of correction examples.

* With regard to the detailed analysis of the FAQs, please refer to KPMG's publication dated 11 April 2017 below:

- ❑ *OECD: Discussion of FAQ updates under common reporting standards (CRS)*

** In September 2014, China committed to implement the OECD CRS for Automatic Exchange of Financial Account Information in Tax Matters, which was developed at the OECD under a mandate from the G20. The SAT in Oct 2016 published a discussion draft on "Due Diligence Administrative Measures on Non-residents' Financial Account Information in Tax Matters", which provided the principles and procedures for Chinese financial institutions to use in identifying the accounts of non-residents and guidance on collecting the relevant information, and called for public comments. According to the timeline, financial institutions in China shall conduct due diligence procedures beginning from 1 January 2017, identify the financial accounts of non-resident individuals and enterprises, collect and report the relevant information to SAT. Such information will be exchanged with the competent tax authorities of other jurisdictions by the SAT on a regular basis and China is expected to engage in the first information exchange in September 2018.

With regard to the impact of the Discussion Draft on China tax management, you may click the following links to access the relevant analysis by KPMG:

- ❑ *China Tax Weekly Update (Issue 40, October 2016)*
- ❑ *China Tax Alert: Public Consultation for the Draft Measures on the Due Diligence of Non-resident Financial Account Information in Tax Matters (Issue 32, November 2016)*

Reference: MOFCOM Order [2017] No. 1
Issuance date: 5 April 2017
Effective date: 1 July 2017

Relevant industries: Automobile sector
Relevant companies: Enterprises which are relevant to car selling
Relevant taxes: N/A

Potential impacts on businesses:
- Compliance risks due to regulatory uncertainties reduced
- Operational costs reduced

You may click here to access full content of the circular.

New measures to deregulate auto sales

On 4 April 2017, the Ministry of Commerce (MOFCOM) issued new administrative measures for automobile sales ("new measures"). The new measures will take effect from 1 July 2017, replacing the existing implementation measures for automobile brand sales ("2005 measures") issued in 2005, which was annulled at the same time.

Under the 2005 measures, auto dealers must obtain sales authorisation from auto suppliers (i.e. brand owners) in advance of commencing sales activity and are subject to recordal filing with the administration for industry and commerce**.** Auto dealers are only permitted to sell one brand of cars – the 'single auto sales model'. The 2005 measures have helped the orderly development of China's auto sales and services market, but have also given rise to several problems. These include monopolistic behaviour by some vendors, imperfect competition, service quality issues, as well as overpriced cars and auto parts.

In a effort to move away from China's 'single auto sales model' the new measures set out the following reforms:

- The auto dealers no longer need the authorization of the auto suppliers to sell their cars and are not restricted to selling one brand in China. However, the old auto sales model (i.e., whereby the dealer obtains sales authorization from the auto suppliers) is still allowed. Automobile marketplaces, stores and e-commerce platforms will be facilitated as new ways to sell cars in China.
- The 2005 measures state that only auto dealers are legally required to supply after-sale services to customers. By contrast, the new measures require that both auto suppliers and auto dealers, who sell cars in China, shall provide facilities for after-sale services, and must establish and improve after-sale services systems to protect the interests of consumers**.**
- The new measures further regulate both auto suppliers and dealers, for example: (i). prohibit suppliers to take actions such as unilaterally setting the sales amount for dealers, requiring tie-in sales, restricting dealers from selling parts or providing services for other suppliers, and restricting the re-sale of the automobile products between dealers in the supplier's brand; (ii). dealers shall not purport to act in the name of the suppliers without the authorisation of the suppliers (particularly after the expiry of the authorisation).
- Under the 2005 measures, automobile general distributors and automobile brand dealers were required to meet certain conditions in order to establish operations and make recordal filings. These conditions have now have been eliminated by the new measures. In future, commerce departments (under MOFCOM) at the county level and above will supervise the auto sales and the relevant service activities on a random inspection basis. The new measures also requires that automobile suppliers and dealers shall record their basic information through MOFCOM's electronic "National automobile circulation information management" system, and report the relevant deals information.

In addition, a MOFCOM spokesperson indicated at the press conference launching the new measures that, with the development of internet technology, some enterprises are attempting to sell cars through the internet, which is still at a developmental stage. Supplementary measures would be introduced in due course to address the issues arising from this emerging auto sale model. In the interim, cars that are being sold through the internet, shall be subject to existing laws and regulations.

Reference: N/A
Issuance date: N/A
Effective date: N/A

Relevant industries: All
Relevant companies: All
Relevant taxes: VAT

Potential impacts on businesses:
- Risks of being challenged in international trade increased
- Tax uncertainty in respect of international trade reduced

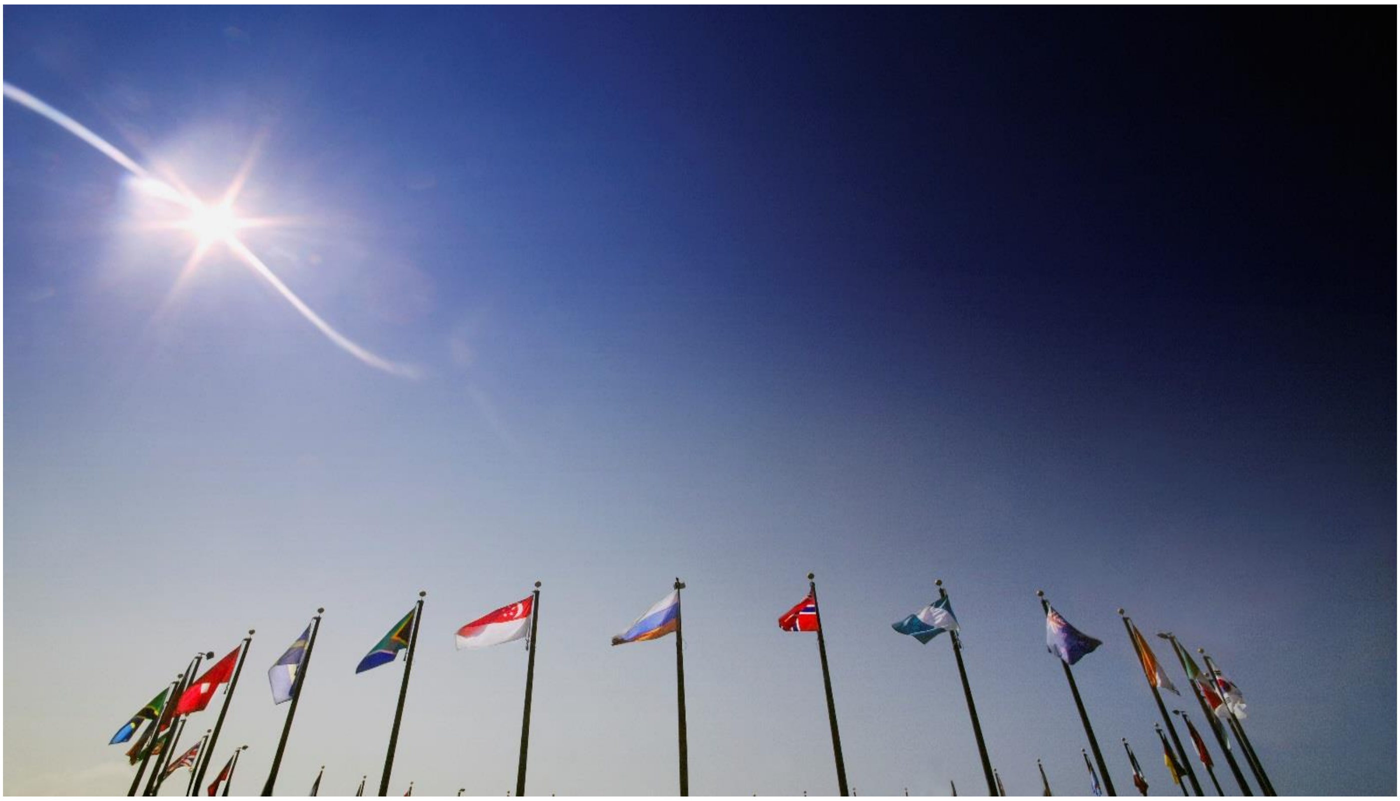
You may click here to access full content of the circular.

4th OECD Global VAT Forum focuses on China reforms

Per a news item posted on the OECD website on 13 April 2017, the fourth meeting of the OECD Global Forum on VAT was hosted in Paris on 12-14 April 2017. Approximately 300 participants, representing over 100 delegations from countries, jurisdictions and international organisations, were in attendance, as well as representatives from the business community and academia.

The keynote address at this meeting was delivered by Mr. Wang Jun, Minister of Taxation of the People's Republic of China, where he highlighted the comprehensive "Business Tax to VAT Reform" implemented in China since 2012 and which concluded in May 2016. The reform, one of the world's most wide-ranging and complex tax reforms in recent years, aims at supporting growth and boosting China's international competitiveness.

As mentioned in a previous news item posted by the OECD, this meeting of the OECD Global Forum on VAT had a particular focus on digital globalisation and on the rollout of the related International VAT/GST Guidelines. The participants focused on collection of VAT/GST on online sales by offshore vendors; the role of digital platforms in the collection of VAT/GST, and optimal use of technology. Other key focus areas were VAT/GST fraud detection and effective countermeasures, VAT/GST refunds policy and management, digitalisation of tax administration, and fostering of VAT/GST compliance through incentives, all areas in which China is at the forefront of global policy innovation.



Reference: (2015) Xing Ti Zi No. 13
Issuance date: 17 April 2017
Effective date: N/A

Relevant industries: Real Estate sector
Relevant companies: Real Estate Enterprises
Relevant taxes: Indirect taxes and bund protection fee

Potential impacts on businesses:
- Risk of being challenged due to low tax basis without a proper reason increased

You may click here to access full content of the circular.

First tax case decision by Chinese Supreme Court

On 17 April 2017 a tax appeal case decision by the Beijing-based Chinese Supreme People's Court (SPC) was published on the official China Judgments Online website. The case was brought as an appeal by Guangzhou Defa Housing Construction Co., Ltd. (a Chinese tax resident company, hereinafter referred to as "Defa Co., Ltd.", or "Defa") against an imposition of tax and penalties by the Guangzhou Local Tax Bureau (Guangzhou LTB), specifically the Guangzhou 1st Tax Audit Bureau within the LTB. The Defa case is the first tax appeal case heard by the SPC, to-date.

In the past two years, tax cases have begun to be heard much more frequently at provincial court level. For example, a case concerning the UK-based The Children's Investment fund (TCI) , heard by the Zhejiang Province People's High Court in December 2015, was the first case on the application of the general anti-avoidance rule to an indirect offshore transfer of a China investment. A further case, decided by the Shandong Province Zhifu District People's Court in December 2015, dealt with the Italian Illva Saronno Holding SPA's use of the CIT reorganisation relief provisions. A further decision, made by the Guangdong Province People's Intermediate Court in November 2015, was the first to deal with the individual income tax (IIT) treatment of dual employment arrangements, specifically under the China-US DTA. Building on these earlier cases, the Defa case takes China court engagement in tax cases to the next level, by involving the SPC. It might be noted that all three of the above cases were decided in favour of the tax authorities.

The Defa case, prior to its elevation to the SPC, initially underwent administrative review with Guangzhou LTB. It was subsequently brought before Guangzhou Tianhe People's Court and finally the Guangzhou Intermediate People's Court. This succession of appeals follows Article 19 (1)(2) of the Tax Administrative Review Rules (TARR) and Article 88 (2) of the Tax Collection and Administration (TCA) Law.

The SPC decided partly for Defa and partly for the tax authorities. The SPC affirmed the tax authorities' upward adjustment to Defa's business tax and flood defense fee obligations in respect of a real estate transfer. However, at the same time, the SPC decided in favour of Defa that late payment surcharges (LPS) were not justified and should be refunded by the tax authorities.

The approach adopted by the SPC in the Defa case is broadly in line with the approaches applied by lower tier courts in previous tax cases. The courts recognize the tax authorities as having competence to interpret the tax law – the courts will not seek to overturn adjustments to tax assessments, made by the authorities on the basis of their interpretation, so long as these are not obviously unreasonable or an abuse of power. This follows Article 70 (1) of the Administrative Procedure Law. However, with regards to administrative formalities and penalties, such as application of LPS, the SPC, as with earlier court decisions, has shown itself prepared to decide against the tax authorities.

The background facts to the case are as follows:

- On 30 November 2004, Defa signed a contract with Guangzhou Suihe Auction House Co., Ltd. ("Suihe"). The latter is a registered auction house in Guangzhou. The contract authorized Suihe to sell a piece of residential property located in Guangzhou, owned by Defa, by way of public auction. This constituted 70% of a large estate; the other 30% was sold separately by Defa. The value of the residential property sold by Suihe on Defa's behalf was estimated by Defa to be approximately HK$0.53 billion, and stated at this amount in the contract authorizing Suihe to auction it. This amount was certified by an accounting firm hired to value the property.

- A Hong Kong company on 19 December 2004 bid for a large part of the residential property being sold by Suihe (59,000 ㎡ out of the total 63,000 ㎡) and successfully acquired it through the auction. The price paid was HK$0.13 billion (RMB0.14 billion). Only the Hong Kong company participated in the bidding. It was noted by the tax authorities that the legal representatives of Defa and the Hong Kong company had previously been married.
- After the auction, Defa paid business tax at 5% (RMB6.9 million) and flood protection fees (RMB0.12 million) to the Guangzhou tax authority and obtained the relevant tax payment receipts. The business tax and flood protection fees were calculated based on the ultimate auction price of the house property, i.e., RMB0.14 billion.
- When the Guangzhou tax authority conducted a tax audit of Defa in 2006, in respect of the 2004 and 2005 tax years, they concluded that the ultimate auction price was much lower than what the tax authorities considered to constitute the market price. The Guangzhou tax authority referred to several indicators that the auction price was unduly low:
  - ❑ Comparison with the sale price of the other part (i.e. the other 30%) of the entire original Defa property.
  - ❑ Comparison with reported sales prices of similar grades of property sold in the same time period;
  - ❑ Comparison with the estimated value of the property per Defa’s authorization agreement with Suihe;
  - ❑ Comparison with the cost price incurred by Defa on its original construction/purchase (these costs had been audited by an accounting firm).
- The Guangzhou tax authority took the position that Article 35 (1)(6) of the TCA Law empowered them to make adjustments. It provides that where the taxable value declared by the taxpayer is unduly low and this is without a justifiable reason, the tax authorities are empowered to determine the tax payable on a deemed basis.
- The Guangzhou tax authority issued a notice of additional tax assessment to Defa on 14 September 2009.

The dispute between Defa and the tax authorities before the courts centred on several issues, the most important being the following:

i. Whether there was a basis in law for the Guangzhou tax authority to make tax adjustments on an assertion that the taxable value is unduly low and this is without a justifiable reason (i.e. whether Article 35 (1)(6) TCA Law was in point);

ii. Whether the Guangzhou tax authority’s imposition of LPS has a basis in law.

The SPC opined that:

- Guangzhou tax authority was legitimately entitled to make a determination that the auction price of the residential property in point was inappropriately low, and make a tax adjustment on Defa in accordance with Article 35 (1)(6) TCA Law.
- The SPC justified this decision with reference to the four price comparison factors raised by the tax authorities (i.e. the sales price of the other parts of the entire Defa property, the estimated price in the Defa-Suihe agreement, the cost price, and the reported sales prices for similar grades of property).

- The SPC noted that, in general, a price arrived at through an auction process conducted in compliance with the law should be acceptable as a market price for tax purposes. The tax authorities should, in principle, respect the auction price used by the taxpayer as the basis for his tax calculations, so long as the conduct of the auction is not found to be in violation of the auction law by the relevant regulatory authorities, or otherwise deemed invalid by the courts. However, the SPC concluded that this does not exclude the tax authorities from making tax adjustments as long as they have a legal basis to do so. The SPC noted that the courts will generally not disturb the conclusions of the tax authorities, unless they abuse their powers or their actions are obviously unreasonable (in line with Article 70 (1) of the Administrative Procedure Law).
- Turning to the LPS issue, the SPC decided in favour of Defa. The SPC noted that according to the TCA Law, the tax authorities may impose LPS where a taxpayer:

  i. Fails to pay taxes within the specified time limit (Article 32 TCA); or

  ii. Fails to pay or underpays taxes due to its own miscalculation or other fault (Article 52(2) TCA); or

  iii. Evades, refuses to pay or practices fraud in tax payment (Article 52(3) TCA).

  The SPC concluded that, as no such situations were identified in the course of the tax investigation, there was no basis in law to impose LPS.
- The SPC took the position that unless the tax authorities can prove that the tax in arrears was the fault of the taxpayers, then LPS need not be paid. They based this assertion on their interpretation of Article 52 (1) TCA Law, which formally says that LPS will not be imposed where the fault lies with the tax authorities.
- The SPC noted that the additional tax obligations first arose for Defa when the notice of additional tax assessment was issued and, as such, there was, in any case, no basis in law for LPS for any period prior to that date.

A number of matters were left somewhat ambiguous in the SPC's judgment:

- The SPC noted that prices set by auction processes, not otherwise considered in contravention of the auction law or determined invalid by a court, would be considered as fair market prices. When the SPC concluded that the tax authorities could nonetheless make an adjustment on the basis that the price was 'unduly low', it did not state whether it considered this to be because the auction was in contravention of the auction law, or otherwise invalid, such that the price emerging from the auction process was not a fair market price. As such the court did not make precisely clear whether or not they were rejecting the auction price as a fair market price, and allowing the tax authorities to adjust on this basis.
- The SPC decision raises questions on the operation of the 'clock' for calculation of LPS. Solely permitting LPS to be calculated from the time of issuance of the additional tax adjustment notice might be considered to create issues with the traditional understanding of Article 32 TCA Law. It was previously generally understood that LPS would, on the basis of Article 32 TCA Law, be calculated from the date of the transaction that gives rise to the underlying (underpaid) tax. The SPC's decision might therefore impact on existing LPS calculation practices.
- The SPC's position that no LPS applies where the tax authorities are unable to prove that the tax in arrears was the fault of the taxpayers is also a departure from the traditional understanding. The formal wording of Article 52(1) TCA Law indicates that the focus of this provision is on whether the tax authorities themselves were at fault.

The specifics of the decision aside, the fact that tax cases are now starting to go all the way to SPC level in China is an important development. It opens the way for an increasing body of court case guidance to emerge in the China tax space, looking ahead, and makes court appeal of tax cases an increasingly relevant option for taxpayer disputes.

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