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China – Looking Ahead

4 Foreword

Lewis Lu, head of tax at KPMG China, and **Khoonming Ho**, head of tax for KPMG Asia Pacific.

7 What to look out for in 2018

Checklist of hot China tax issues for multinational enterprises (MNEs) in 2018

In 2018, MNEs should in particular be on alert for the following anticipated China tax developments.

10 VAT

VAT: A pathway to 2025

Lachlan Wolfers, **Shirley Shen**, **John Wang**, and **Aileen Jiang** consider the long-term trends in the global development of indirect taxation, with a particular focus on the role of technology, and the implications for China's VAT system.

20 International tax

China after BEPS, for now...

In 2017, we saw China continue with its roll-out of the BEPS changes, make proposals for new incentives for foreign investment in China, and leverage new technologies for enhanced enforcement efforts. What is more, a new vision for China's international tax policy is gradually emerging. These developments are the focus of this chapter by **Chris Xing**, **Conrad Turley**, **Jennifer Weng**, and **Karmen Yeung**.

29 Belt and Road

A thousand miles begin with a single step: tax challenges under the BRI

As companies embark on overseas investment and projects under China's Belt and Road Initiative (BRI), they are increasingly encountering tax issues in emerging and developing countries. **Michael Wong**, **Joseph Tam**, **Alan O'Connor**, **Karen Lin**, and **Cloris Li** look at key corporate tax issues they may face, and how the SAT is supporting Chinese companies navigate through these overseas tax challenges.

35 Transfer pricing

TP in China: all the data in the world

In 2017, China's State Administration of Taxation (SAT) completed its multi-year TP legislation overhaul by issuing Announcement 6 on special tax adjustments, investigations and MAP. With a distinct anti-avoidance flavour, Announcement 6 precludes the escalation and growing complexity of TP enforcement in China. **Cheng Chi**, **Xiaoyue Wang**, **Kelly Liao**, **Mimi Wang** and **Rafael Miraglia** discuss.

43 Inbound M&A

Chasing deals: tax trying to keep pace with business in China

John Gu, **Yvette Chan**, **Chris Mak**, and **Sam Fan** explore the M&A tax challenges arising in hot sectors like TMT and healthcare, and for take-private transactions, establishing how investors can best get prepared. They note how, given the pace of developments and tax uncertainties, there is a need for the China tax authorities to provide greater clarity. More than ever, appropriate tax planning is crucial for M&A transactions.

51 Tax management

Adding wings to a tiger: data in tax enforcement in China

New data and technology-driven, risk-oriented, tax administration and enforcement approaches by the Chinese tax authorities are compelling taxpayers to up their game. Taxpayers are developing enhanced internal tax risk controls and IT, and engaging with the tax authorities in a collaborative manner. **Tracy Zhang**, **Wei Fang**, **Anthony Chau**, **Lilly Li**, discuss the latest trends and changes.

60 CRS

A brave new world in tax transparency: CRS in China, Hong Kong and Taiwan

Increasing cross-border business and investment has made the holding of assets overseas through offshore accounts increasingly common. This has become a new tax battleground for businesses and governments. **Charles Kinsley**, **Henry Wong**, and **Eva Chow** look at the latest developments on these efforts in China, Hong Kong and Taiwan.

66 IIT

This time it's personal: China IIT on the eve of a major revamp

In 2017, we saw significant new China individual income tax (IIT) enforcement trends in relation to outbound and inbound expat tax monitoring and audit, as well as equity incentive schemes. [Michelle Zhou](#), [Jason Jiang](#), [Sheila Zhang](#), [Angie Ho](#), and [Murray Sarelius](#) highlight areas to watch for in the future.

72 Customs

All roads lead to...: new integration regime in China customs

In 2017, the China customs authorities took major steps to revamp their existing national structures, with consequences for audit processes and enforcement approaches. In this chapter, [Eric Zhou](#), [Rachel Tao](#), [Cheng Dong](#), and [Helen Han](#) explore the impact of these reforms.

77 Digital economy

One billion Chinese mobile phone users can't be wrong: tax and the digital economy

The disparity between China's rapidly developing and evolving digital economy and its largely traditional economy-based tax administration system is growing, and is creating challenges for both the tax authorities and taxpayers. [Sunny Leung](#), [Benjamin Lu](#), [Jessie Zhang](#), and [Grace Luo](#) explore the issues.

86 Environmental tax

The future is green: EPT in China

In accordance with China's 13th five-year economic development plan, which commenced in 2016, new policy tools such as the environment protection tax (EPT) and a reformed resources tax (RT) are being used to promote a 'green development philosophy'. [Jessica Xie](#), [Flora Fan](#), [William Zhang](#), and [Maria Mei](#) explore these new developments and what they mean for China's greener future.

91 R&D

Better smart than lucky: China R&D incentives 2.0

[Yang Bin](#), [Rachel Guan](#), [Josephine Jiang](#), and [Henry Ngai](#) examine the refinements being made to China's innovation incentives, and their importance as a driver of continued Chinese economic growth.

98 Taiwan

Taiwan: tax goes digital

In 2017, the Taiwan government proposed imposing VAT on foreign enterprises providing e-commerce services to Taiwan individuals, expanding the Taiwan corporate income tax (CIT) nexus rule, and making personal income tax changes. It is also looking at abolishing and replacing the corporate-shareholder imputation tax system. [Stephen Hsu](#), [Hazel Chen](#), [Ellen Ting](#) and [Betty Lee](#) elaborate.

103 Hong Kong

Hong Kong tax: Let the economy take the lead

[Ayesha Lau](#), [Darren Bowdern](#), [Michael Olesnick](#), [John Timpany](#) and [Curtis Ng](#) discuss Hong Kong's BEPS-related changes after the territory issued a consultation paper to codify and strengthen TP regulations, as well as joining the Multilateral Convention (MLI). The Hong Kong government is also increasingly using tax policy to encourage economic development.

109 HK Asset Management

Tax boosts for Hong Kong funds industry

[Darren Bowdern](#), [Matthew Fenwick](#), and [Malcolm Prebble](#) explore the various initiatives that the Hong Kong government has introduced to boost Hong Kong's position as a regional management hub in Asia. While Hong Kong is making positive changes to attract more funds to domicile in Hong Kong, more tax certainty is needed to convince fund managers to move.

Editorial



Anjana Haines
Editor
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It's been a busy year for China's tax system, and more is still to come.

The seventh edition of KPMG's *China – Looking Ahead* guide shows that all parts of the tax systems in mainland China, Hong Kong and Taiwan are being transformed to align with the OECD's BEPS project. For example, Announcement 6, released in March 2017, completed the package of rules to overhaul the transfer pricing regime and align it with the BEPS Action Plan, albeit with a local flavour.

But China has not limited itself to changes exclusively relating to BEPS. Beyond BEPS, changes are taking place in the individual income tax regime, the availability of research and development incentives, and the opening up of the Chinese economy to foreign investment and talent through a range of measures. Moreover, recent enhancements and further planned changes to the Golden Tax III System are making this system truly golden.

The Belt and Road Initiative is another key driver for many of the changes taking place. Not only are opportunities opening up for Chinese enterprises, but they are being given government support to take the leap of trading abroad. Further, China's commitment to the multilateral instrument (MLI) and the subsequent tax treaty changes mean the opportunities for businesses to expand, both outbound and inbound, are growing.

At the same time, China is beginning to take advantage of digital tools and collaborative global efforts against tax fraud, as well as introducing incentives to stimulate investment and trade. More advancements are planned for 2018 that could help set the global standard for the efficient use of technology, as well as minimise tax leakage in line with President Xi Jinping's vision for a "fully modernised socialist state by 2035".

The 2017 Year of the Red Fire Rooster has seen China make meaningful advancements to its tax system. Given the rapid pace of developments, the coming Year of the Dog is likely to see the government build on the groundwork laid so far and take action on some key tax measures. We hope that the seventh edition of KPMG's *China – Looking Ahead* will be a valuable tool in guiding you through the changes.

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Foreword

The Year of the Rooster will soon give way to the Year of the Dog. China begins 2018 with the administration of President Xi Jinping entering its second term (2017 to 2022), following the 19th National Congress of the Communist Party of China (CPC) in October 2017. At the same time, China's 13th five-year plan (2016 to 2020) enters its core phase.

President Xi's October 18 2017 speech to the CPC Congress set out a clear vision of China's development priorities. The government is committed to continuing the reform and rebalancing objectives in the five-year plan and, at the same time, Xi indicated a shift in focus from the pace to the quality of growth. China is still targeting annual GDP growth above 6% in the three years to 2020, but has dropped the use of a long-term GDP goal. This provides more flexibility for the government to focus on the goals of continuous 'green development', tackling inequality, and cultivating home-grown innovation, emphasised in Xi's speech.

China will continue to prioritise supply-side reform, with a focus on reducing over-capacity and excessive leverage in the economy. To this end, a tight rein is being kept on wealth management products and other shadow finance vehicles, and controls on the property market are in place. Partial privatisation of many state-owned enterprises (SOEs) is envisaged in a move to a 'mixed-ownership' model, with foreign investment participation also sought. Various initiatives are being pursued to support national e-commerce and e-finance development, notably the Internet Plus action plan and the national big data strategy. At the same time, the 'Made in China 2025' strategy is directed at building key China industrial strengths in strategic sectors, including advanced IT, robotics, aerospace, new energy vehicles, new materials and medical devices. The overall objective of these initiatives, as set out in Xi's speech, is for China to become a 'fully modernised socialist state' by 2035 and a 'leading global power' by 2050.

At the centre of China's external economic strategy is the Belt and Road Initiative (BRI). This is an ambitious plan to more deeply integrate the economies of more than 60 countries across Eurasia, encompassing 63% of the world's population and 35% of global GDP, through more than \$1 trillion in infrastructure investment. China is, since 2015, a net exporter of capital; in 2016 outbound direct investment of \$183 billion greatly exceeded inbound direct investment of \$131 billion. Chinese enterprises have moved quickly to seize BRI opportunities and, while outbound investment dipped somewhat in 2017 as the government

sought to rein in some of the more speculative overseas investments, the regulators have facilitated BRI investments as officially ‘encouraged’.

At the same time, to encourage greater inbound investment, the State Council’s January 2017 Notice No. 5, and the subsequent August 2017 Notice No. 39, have set out a new range of ‘opening up’ measures. These include plans for a streamlined negative list of sectors for foreign investment, with various service and advanced manufacturing sectors to be liberalised and foreign involvement in Made in China 2025 to be encouraged. These are accompanied by measures to protect foreign intellectual property (IP) rights, ease visa processes, and make the regulatory environment for foreign enterprises simpler and more neutral *vis-à-vis* local firms. Further details of these policies are awaited, with progress likely to be seen in the run up to the March 2018 session of the National People’s Congress.

With these structural economic policies as a general context, in this seventh edition of *China Looking Ahead*, KPMG China’s tax experts examine recent developments and explore what the Year of the Dog may bring for foreign investors in China, as well as for Chinese multinational enterprises (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.

In the seventh edition of *China Looking Ahead*, two key themes come repeatedly to the fore throughout the chapters – the impact of digitalisation and technology, and China’s repositioning of itself for a new stage in its economic development, both of which themes are intertwined.

The first chapter, *VAT: a pathway to 2025*, confronts both of these themes head-on. The chapter asserts that the digitalisation of economies, and the leveraging of new technologies in tax administration, will, in three major trends: (i) drive VAT and GST systems to morph into ‘in substance’ retail sales taxes; (ii) lead indirect taxes to be managed and administered nearly entirely through technology; and (iii) enable expansion of the tax base for indirect taxes. In the China context, these trends are turbo-charged by the extent to which mobile payments and e-platform commerce have come to dominate the Chinese economy, as well as by the rapid progress already made by the authorities with tax digitisation (e.g. online filing, electronic invoicing, automated invoice verification, etc.). China is well placed to move to the next steps of automated point of sale VAT collection and blockchain transaction chain authentication, and indeed the State Administration of Taxation (SAT) is already looking at the possibilities of the latter in detail. The chapter notes how aspects of China’s VAT rules, in relation to financial services and digital economy consumer-to-consumer (C2C) activity, are much better primed for the future than other countries’ more established VAT systems.

China’s orientation to the future, and its reimagining of its tax policy for a new global role, are further considered in the chapters, *China after BEPS, for now...* and *A thousand miles begins with a single step: tax challenges under the BRI*. Since 2015, China has been a net capital exporter, and is experiencing both the challenges and opportunities that this brings. Chinese companies are increasingly running into tax disputes overseas, and SAT assistance in mutual agreement procedures (MAP) is increasingly invoked. This experience is filtering into policy thinking, with consideration being given to how best to collaborate with BRI countries to smooth tax frictions. In addition, policy options that could have created greater frictions for outbound and inbound investment, such as the expansion of permanent establishment (PE) rules through the multilateral instrument (MLI), have been quietly left aside. Work is underway on the enhancement of foreign tax relief for ‘Go Out’ Chinese enterprises, including consideration of a potential China participation exemption – this might better support ‘Go Out’ enterprises in the face of similar tax reform changes being pushed through in the US. At the same time, tax enforcement efforts for foreign business activity cross-border into China have not let up – indeed big data and information exchange are being leveraged to an ever greater degree in PE and treaty relief cases.

The pressure on foreign businesses remains particularly high in the transfer pricing (TP) space. The chapter, *TP in China: all the data in the world*, outlines how, after several years of extensive overhaul, culminating in the 2017 release of a new China TP framework, the Chinese tax authorities now have a very robust set of TP information and investigation/adjustment tools. They are using these to significant effect, as made clear in the many enforcement cases detailed in the chapter. Enforcement challenges also continue unabated in the mergers and acquisitions (M&A) space, and the chapter, *Chasing deals: tax trying to keep pace with business in China*, looks in particular at best practices for tackling the indirect offshore disposal rules.

The use of technology by the tax authorities to bring vast amounts of tax information on tap is the central focus of the chapters, *Adding wings to a tiger: data in tax enforcement in China*, and *A brave new world in tax transparency: CRS in China, Hong Kong and Taiwan*. The Chinese tax authorities have invested heavily in their data storage and processing capacity – big data analytics, married with a sophisticated risk-driven approach to audit targeting, promise an exponential increase in China enforcement tax effectiveness in the coming years. China’s commencement of international automatic tax information exchanges, from 2018 onwards, will turbo-charge this process. It is, in particular, likely to lead to a sea-change in the individual income tax space. The chapter, *This time it’s personal: China IIT on the eve of a major revamp*, outlines how enforcement is becoming increasingly robust, even in advance of this new swell of tax data coming



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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 continuing VAT reforms.

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on tap. The China customs authorities are becoming equally adept at leveraging data, taxpayer ratings and automated processes to great effect, as made clear in the chapter, *All roads lead to...: new integration regime in China customs*.

The rapid re-orientation of China's economy for the future is borne out in the chapter, *One billion Chinese mobile phone users can't be wrong: tax and the digital economy*. Continuing on the themes raised earlier in the chapter on VAT, the digital economy chapter explains how the breathtaking advance of China's digital economy has left the regulatory and tax authorities struggling to keep up, resulting in ambiguity in the taxation of the sharing economy, cloud services and other new business models. The digital economy advance also exposes how archaic certain aspects of the traditional tax administration have become in the face of new modes of economic organisation – the chapter notes some of the administrative innovations being made in other countries in this regard. The theme of reorienting China's future path is also at the core of the chapters, *The future is green: EPT in China*, and *Better smart than lucky: China*

R&D incentives 2.0. Both chapters outline the steady progress being made in refining tax incentives for more innovative, and more ecological, economic growth.

These chapters are rounded off with a look at developments in Hong Kong and Taiwan. The digital economy is again to the fore in the chapter, *Taiwan: tax goes digital*. This details the recent adaptations of the VAT system to cover cross-border digital service supplies in Taiwan, and the planned new corporate tax digital nexus, alongside broader planned reforms to the imputation tax regime. The chapters, *Hong Kong tax: let economy take the lead* and *Tax boosts for Hong Kong funds industry*, outline Hong Kong's adherence to the MLI and roll out of TP rules, and explore the new and improved special regimes for aircraft leasing, corporate treasury centres, and PE funds.

2018 is the Year of the Dog in the Chinese zodiac, and a time for action. This certainly looks to be the case, across the spectrum, in the field of China taxation.

A special thanks to Conrad Turley at KPMG China for his contributions to the editing and compilation of this guide.

Checklist of hot China tax issues for MNEs in 2018

In 2018, multinational enterprises (MNEs) should in particular be on alert for the following anticipated China tax developments.

- **New withholding tax guidance** – Following the October 2017 issuance of State Administration of Taxation (SAT) Announcement 37, foreign investors should monitor how the rules will be implemented in practice. This is particularly important for M&A transactions involving indirect transfers of Chinese assets. Indirect transfers, which may be taxable under Announcement 7, also continue to be an M&A planning challenge due to uncertainties with capital gains calculations and qualification for internal group restructure relief. M&A investors need to monitor the interaction of Announcement 37 with Announcement 7 and carefully structure their investments going forward.
- **Reinvestment rules in China** – In July 2017, the State Council proposed a new incentive rule that would defer the imposition of withholding tax on dividends paid out of China, where the amounts were reinvested in ‘encouraged projects’ in China. Investors who are considering reinvesting their investment returns in China should monitor further developments from the SAT on which industries are covered and how these rules will be implemented.
- **Claiming tax treaty benefits under BEPS** – China has introduced various rules in respect of claiming tax treaty relief under China’s double tax agreements (DTAs) including the limitation on benefits (LOB) rule and the principal purposes test (PPT). Foreign investors investing into China therefore have to ensure that their investment structures meet the minimum substance requirements, and that appropriate supporting documentation is maintained to withstand any potential challenges from the tax authorities. The impact of these new rules will become more apparent when making tax treaty relief claims in future.

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- **Increased VAT audits and queries** – With the VAT reforms having been implemented for more than 18 months now, the tax authorities are expected to significantly increase their enforcement efforts. Businesses are strongly encouraged to carry out health checks to identify any shortfalls in their VAT compliance and processes. This is especially important for businesses that implemented changes following the

recent VAT reforms, given that the time period was short and errors occurred.

- **Use of data and analytics in managing VAT risks** – With recent enhancements to the Golden Tax System, the tax authorities are increasingly able to use data and analytics to identify potential VAT errors and anomalies. Data and analytics solutions, such as KPMG's Tax Intelligence Solution, can assist in identifying and rectifying those errors and anomalies, including reconciling data between business enterprise resource planning (ERP) systems and the Golden Tax System.

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- **National reform changes customs audit and review process** – In 2017, the China customs authorities undertook a national reform that significantly changed the national customs organisational structure. It is expected that more frequent and targeted customs audits will be performed, as adoption of data analytical tools allow better monitoring of the accuracy of enterprise declarations. Enterprises importing/exporting goods into/from China need to enhance their internal control procedures and ensure customs declarations are accurate.

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- **New treaty and permanent establishment (PE) guidance** – In June 2017, China signed the BEPS Action 15 multilateral instrument (MLI), committing to update nearly half its existing tax treaties with effect from 2019/2020. In anticipation of the addition of new PPT articles to many of China's treaties, the SAT is set to release new treaty guidance in 2018. This may bring some long-awaited clarity to the application of treaty relief for foreign investor income from China. At the same time, while China did not elect to update its PE articles through the MLI, the much anticipated PE guidance is also set for release in 2018. As both securing access to treaty relief and managing PE exposures are key issues for structuring operations and investment cross-border into China, investors are advised to monitor closely for this new guidance. They should prepare to adapt documentation, management protocols, and investment and operational structures, where necessary.
- **Common reporting standard (CRS)** – The automatic exchange of information (AEOI) by China under the

OECD CRS framework will commence in 2018. The Chinese tax authorities have already invested heavily in big data analysis capabilities, are effectively pooling data from across government agencies, and are set to bring more taxpayer information, e-commerce and domestic financial institutions on tap with the upcoming new Tax Collection and Administration Law. The CRS information received from next year is thus likely to be quickly deployed in targeting taxpayers for audit and in building taxpayer credit ratings, and so businesses need to be aware of sharply heightened enforcement going forward.

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- **Increasing individual income tax (IIT) enforcement on overseas sourced income** – The Chinese tax authorities are making much greater use of tax information exchange mechanisms, and this will increase further with the anticipated implementation of CRS by China from 2018. In this context, the compliance of Chinese nationals with their China tax filing obligations for their overseas income is set to become an ever more important focus area for the Chinese tax authorities. This is particularly true of overseas employment income derived by outbound expatriates working overseas on Belt and Road Initiative (BRI) projects. Chinese enterprises consequently need to plan ahead and carefully manage their employees' IIT matters.
- **IIT reform** – In 2018, tackling inequality will be a key Chinese government policy goal and the IIT reform could play a key role in these efforts. As the final IIT reform is highly anticipated to be introduced in 2018, enterprises should continue to monitor for further developments and be prepared to implement necessary changes.

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- **Preferential research and development (R&D) tax policies** – Technological innovation has become a driving force for China's continued economic growth. China's preferential R&D tax policies are key to fostering and facilitating the implementation of innovation-driven enterprise development strategies. Enterprises engaged in R&D should proactively monitor the changes to R&D tax policies, ensuring that these can be leveraged to enhance enterprise core competitiveness, while managing tax compliance risks.

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- **Environment Protection Tax (EPT) Law** – The 13th five-year plan (from 2016 to 2020) sets out a Chinese government ‘green development philosophy’. As a crucial element of the government’s environmental strategy, the EPT was instituted in late 2016, to replace the previous pollution discharge fees, and will apply from January 1 2018. The EPT is expected to increase the cost burden of polluting behaviour, and is intended as a significant deterrent for polluting emissions. Further guidance is anticipated and affected enterprises should keep a close eye on policy developments, and quickly assess the EPT business impact.

- **Milestone resource tax (RT) reform** – Effective from July 2016, the Chinese government reformed and expanded the scope of RT impositions. The reforms transitioned RT from a volume basis tax to an ad valorem basis tax, abolished local resource consumption-related charges and fund contributions, and set uniform tax rate ranges and tax incentives. Following the abolition of the previous local charges on resource extraction and use, RT has become the sole national tax levied on the use of mineral resources, and affected enterprises need to ensure they factor the changes into business planning and processes.

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- **New guidance on royalty and service charges** – In March 2017, the SAT issued the long awaited Announcement 6, which covers substantive transfer pricing issues, royalty fees and intragroup services. Intragroup service charges are set to become even more of a key focus area for the tax authorities in China. This is particularly the case for ‘non-beneficial’ or shareholders’ services, service charges from low-substance entities, or charges paid to low-tax jurisdictions. Taxpayers can expect greater scrutiny on royalty fees, and on charges deemed not commensurate with benefits generated for the local entity. In respect of secondary marketing intangibles, with the final ‘P’ added to the OECD’s development, enhancement, maintenance, protection, exploitation and promotion (DEMPEP) concept for the attribution of economic ownership of intangibles, China is expected to focus on (secondary) local marketing intangibles generated by significant promotional activities in China, and the incremental profits expected from such activities.
- **Mutual agreement procedure (MAP)** – With more transfer pricing controversies on the horizon, post-BEPS, the effectiveness of dispute resolution mechanisms becomes

highly relevant for MNEs. The expected outcome from BEPS Action 14, and the peer review to which China is subject, is expected to be an increase in the effectiveness of MAP and a reduction in the number of unresolved cases after a two-year period.

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- **Digital e-commerce** – As China continues to digitalise, the Chinese tax authorities will increasingly embrace technology tools and digitised processes that will improve the tax administration system and the efficiency of tax collection. Taxpayers can expect certain deficiencies in the rules governing the taxation of digital economy activity to be amended in the near future. This should provide a fairer tax environment for digital players *vis-à-vis* those in the traditional economy.

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- **Thousand enterprises initiative (TEI)** – Since the launch of the TEI initiative in October 2015, the Chinese tax authorities have been collecting data from the TEI-covered enterprises and performing analyses to understand the business and tax risks. Drawing on this accumulated data and the analysis conducted, it is expected that the Chinese tax authorities will make even more effective use of tax risk indicators (by industry) to identify tax risks. Taxpayers can therefore expect an increase in tax risk enquiries or tax investigations by the Chinese tax authorities in 2018.
- **Tax risk assessment model used by tax authorities** – The Chinese tax authorities have been rapidly building a tax risk assessment model with a set of tax risk indicators and benchmarking ranges. In April 2017, the SAT issued Announcement 10, which provides taxpayers with an optional tax service to automatically identify and correct their tax calculation errors in advance of formally submitting their corporate income tax (CIT) annual filing returns. With the Chinese tax authorities introducing various measures, such as automated cross-checking of VAT filing returns, taxpayers can expect tax authorities to bring more transparency to taxpayers on how tax risk assessments are performed in the near future.

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VAT: A pathway to 2025

Lachlan Wolfers, Shirley Shen, John Wang, and Aileen Jiang consider the long-term trends in the global development of indirect taxation, with a particular focus on the role of technology, and the implications for China's VAT system.

The global indirect tax leader of another Big 4 accounting firm recently published a blog post entitled 'Indirect tax: Five global trends'. The article outlined five key trends sweeping the indirect tax landscape. They were:

1. Value added tax (VAT) and goods and services tax (GST) rates are stable, but they remain high;
2. Reduced VAT and GST rates and exemptions are making a comeback;
3. The global reach of VAT and GST is expanding;
4. Digital tax measures proliferate; and
5. Tax administrations are embracing technology.

Most tax professionals would doubtless conclude that these are indeed trends in VAT and GST systems around the world. However, they are very 'safe' in their assessment in the sense that they reflect trends that are already clearly evident, or obviously emerging. In other words, are they really insightful or remarkable? Do they really inform an audience of anything they are unlikely to have witnessed already?

The purpose of this chapter, however, is not to critically analyse the blog post, but rather, to beg the question – what are the trends or changes that are likely to sweep indirect taxes beyond what we can already clearly see, and which will emerge as we plot a pathway to 2025? What do these global trends mean for China's VAT system?

The 'here and now' trends

Let's start this exploration with a quick snapshot of the 'here and now'. In succinct terms, throughout the authors' 18-year career practising in indirect taxes, there has never been a time when there has been greater certainty about the future global direction of indirect taxes, at least over the next few years. Consider the following:

First, VAT and GST rates throughout the world are at an all-time high, and there is very little pressure being brought to bear to either increase or decrease them. The general consensus seems to be that rates in the EU have hit a natural ceiling, while those in the Asia Pacific region maybe have greater scope for increase rather than decrease. Therefore any global shift from a rates perspective is unlikely to be seismic, certainly as compared to what took place globally in the period from 2008 to 2015.

In China, the general VAT rate of 17% sits just below the OECD average of 19.18%, but it is considerably higher than the average in the Asian region of around 12.73%. Some rate changes may be expected though, given the State Council's recent flagging that the number of VAT rates in China would

be further reduced, following on from the recent removal of the 13% rate. This is not surprising given that multiple rate VAT systems tend to create greater levels of complexity.

Second, from 2016 through to 2018, we will have seen several major economies throughout the world implement a VAT or GST, either for the first time or through the expansion or rationalisation of their existing indirect tax systems – China in 2016, India in 2017, and then on to the Gulf region in 2018, and Brazil (date yet to be fixed). At that point in time, there will be no major economies throughout the world without a VAT or GST system, with the exception of the US, which is a subject touched on further below.

In China, we do have the special administrative regions of Hong Kong and Macau without broad-based indirect tax systems. Macau can perhaps be put to one side because it has alternative forms of indirect taxation, such as a tourism tax, and its major industry of gambling is subject to a special gaming tax (as well as licence fees). However, in Hong Kong, the government's coffers are seemingly pretty full, and with a retail sector struggling due to high rents, there is little political pressure for change. Implementing a VAT or GST would also be seen to change its traditional status as a free port. As such, even if a VAT or GST were to be introduced, it would likely be at a relatively low rate.

Third, in a global context, the period from 2015 through to 2019 (or thereabouts) will be remembered for the proliferation of digital tax measures – whether they are measures to tax the cross-border provision of services that can occur digitally and without the creation of a permanent establishment, or through new measures to tax the business-to-consumer (B2C) importation of goods through e-commerce platforms. The OECD has taken a leadership role here in defining the challenge that needs to be addressed, but perhaps to the frustration of many digital providers, the implementation of its recommendations has occurred in an extraordinarily wide-ranging and seemingly uncoordinated way, except perhaps in the EU, where a 'mini one-stop shop' (MOSS) approach has been adopted.

When the OECD's recommendations were first published, the authors took the view that they were clearly designed with a view to implementation in the EU. However, when applied to countries in the Asia Pacific region they would be problematic, given the absence of any 'one-stop shop', currency controls in place in many countries, VAT/GST systems that fundamentally do not already recognise non-residents, the absence of refunds of excess VAT/GST credits in many jurisdictions, and even the non-implementation of the destination principle of VAT/GST in certain countries. Not surprisingly, China is yet to implement these measures given that it possesses most of the features that make their adoption more difficult than in other countries.

If we wind forward to 2017, many of these concerns are starting to be borne out in reality. Within the Asia Pacific



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region, we have countries such as Australia and India that are seeking to impose primary liabilities for VAT/GST on platform providers – that is, the parties who provide the infrastructure that facilitates e-commerce sales, either on their own account or as an agent for third party vendors. We have tax jurisdictions such as Japan, Korea, Taiwan and New Zealand, each of which seemingly have adopted the OECD's recommendations more faithfully (with Singapore



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Shirley has rich experience in advising multinational companies. She has been providing tax health checks, tax provision reviews, tax due diligence, and structuring and planning advice.

She is also now actively involved in the VAT reforms in China, having been assisting the Legislative Affairs Office of the Budgetary Affairs Commission of the National People's Congress and the Ministry of Finance (MOF) since 2009.

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She has been instrumental in influencing policymakers on behalf of industries such as the transportation industry, finance leasing industry and financial services sector to achieve improved policy outcomes under the VAT reforms.

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approach results in poor levels of compliance, and is therefore unsustainable.

Outside the Asia Pacific region, we have a number of EU countries such as the UK, Italy, Poland and Romania either implementing, or seriously considering, the adoption of 'split payment' methods for VAT collection, whereby the recipient diverts the VAT included in the purchase price directly to a bank account held for the benefit of the tax authorities. In the Americas, countries like Colombia, Costa Rica and Argentina appear willing to depart from OECD guidelines to impose a VAT withholding on financial institutions for B2C e-commerce supplies.

In parallel with B2C supplies of services, in recent months discussions seem to be escalating globally about ways in which to more effectively tax the importation of low-value goods, including Australia, the EU, Switzerland and Russia. This is not so much of an issue in China given the threshold for taxing low value goods being imported is CNY 50 (\$7.50), coupled with the recent adoption of new measures for taxing e-commerce imports of goods.

At the extreme end of the spectrum, we have countries such as Thailand and Indonesia, which have either enacted or have issued proposals to enact, measures that are crude at best – if enacted they will require or deem non-resident providers of goods and services to have a permanent establishment in those countries if they take normal steps in the digital world to establish a local country virtual shop front. This latter group of proposals appears to be based more on an appeal to political considerations – that is, a desire to get even or play catch-up in taxing global platforms such as Google, Facebook, and the like.

To be clear, individual country measures will continue to change and evolve over the next few years, and while they will present challenges to the affected companies (and their advisers), the broader trend is clearly established and is not particularly newsworthy.

The question therefore posed by this chapter is this – what if these trends were merely events or incidents that arose from something bigger? In other words, are there bigger changes afoot with indirect taxes as we move into the second quarter of the 21st century? How will they affect China's VAT system?

Lighting a pathway to 2025

In the spirit of prompting discussion and debate, and with a deliberate intent to add some colour and controversy, we want to posit three key indirect tax trends as we light a pathway to 2025:

1. VAT and GST systems will be replaced, perhaps not in form, but in substance and reality, with retail sales taxes.
2. In conjunction with point 1, indirect taxes will be almost entirely managed and administered through the use of technology.

likely to do so soon) in enacting measures that tax digital supplies of services from non-residents to consumers in those countries, either with a broad tax base or with more targeted measures (at least initially).

As noted, countries such as China and curiously also Malaysia (given its GST system is so new), are yet to implement these measures at all. In our view, this is only a matter of time, for the simple reason that the non-implementation of these measures results in a cost to the revenue and represents a potential threat to the tax base. While in China the B2C cross-border supply of services is technically subject to VAT withholding, the OECD acknowledges that this type of

3. The tax base for indirect taxes will be expanded in ways not previously contemplated.
Let's take each of these trends in turn.

VAT and GST systems will more closely resemble retail sales taxes

A global leader in the field of indirect taxes and former KPMG partner, Michael Evans, used to have the uncanny ability to connect seemingly disparate issues by seeing them as symptoms of a bigger trend or change. By doing so, he had the ability to foresee the need for change years ahead of virtually anyone else, including the governments he often advised.

The first such trend, that VAT and GST systems would be replaced by retail sales taxes, was something which Michael first raised around 2009 – at the time it was dismissed as nonsense given that many countries were in the midst of introducing VAT and GST systems, and VAT/GST rates were in the process of increasing as reliance on corporate taxation was diminishing. In short, in the midst of its most expansive growth phase in its history, Michael was already predicting its demise. To change course and foresee the end of VAT/GST systems seemed ludicrous. But in the authors' view, he was right. Let's take a closer look.

The starting point for this argument is to understand two fundamental principles about how VAT and GST systems are intended to operate. They are:

1. The tax base for a VAT or GST is final consumption expenditure by households. In other words, the object of a VAT or GST is to collect tax on the price or value of what is consumed by the end-consumer – this is described in the OECD's VAT/GST Guidelines as the 'overarching purpose' of a VAT.
2. Apropos to point 1, VAT/GST is not intended as a tax on business. That is, in business-to-business (B2B) transactions, the VAT or GST is not intended as a real cost, except where explicitly provided for in legislation (such as with exemptions) – this is known as the principle of fiscal neutrality.

What follows from this is the implicit understanding that in a typical supply chain when there is a flow of goods from say:

- a) The manufacturer to the wholesaler;
- b) The wholesaler to the retailer; and
- c) Then from the retailer to the end-consumer.

The only transaction that truly 'matters' from a VAT or GST perspective in the sense that it raises the revenue to which the tax is directed is transaction (c). The process of collecting the tax and allowing input credits in transactions (a) and (b) is merely an administrative mechanism to reinforce the integrity of tax administration throughout the whole supply chain.

Interestingly, from a tax adviser's perspective, many of the challenges we confront each day are focused on the problem when the system breaks down in relation to



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transactions (a) and (b) – that is, in ensuring the fiscal neutrality of those transactions. If fiscal neutrality breaks down, typically we end up with inefficiency, uncompetitiveness and tax cascading through the supply chain.

So why will governments move from a multi-stage credit offset system such as a VAT or GST into a tax that more closely resembles a single stage retail sales tax? There are three main reasons.

First, as technology evolves, the need for the supplier to account for the output VAT/GST at a certain point in time and for the recipient to claim input VAT/GST at another point in time in a B2B supply chain context, will disappear. Put simply, these obligations will be settled instantaneously, without the need for any real payment, crediting or refund. A recent paper by two European academics posits this same theory, which is broadly as follows:

- All sales will be recorded via a real-time data processing system, with the tax being waived on B2B sales by means of an electronic certificate;
- For B2C sales, the status and location of the customer must be ascertained for the correct calculation of the tax (and the country in which the tax is imposed);
- Automated tax audit software to establish an electronic trail for each transaction, rather than a paper trail; and



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- VAT collected on B2C sales is automatically directed to the Treasury, without ever touching the bank account of the supplier, so as to enhance enforcement.

While their theory does not purport to resolve the issues for all transactions, the direction of travel is obvious.

Second, already we are seeing examples around the world of governments modifying their VAT or GST systems to overcome problems caused by fraud – carousel or missing trader fraud being among the most prominent. In most cases, the fraud occurs through the payment of a refund to a business recipient in circumstances where the supplier fails to account for the output VAT/GST. In recent years we have seen instances of massive frauds occurring in relation to carbon emissions permits in the EU (estimated at up to €5 billion (\$5.8 billion)), and in Australia with respect to precious metals. The responses from the legislature have included the invocation of a reverse charge mechanism in place of a proper VAT or GST, so as to place the obligation to pay and credit on a single party. More recently, we have seen a number of European countries implement, or propose to implement, ‘split payment’ mechanisms whereby the VAT on the transaction is remitted directly by the recipient to a separate bank account held for the benefit of the tax authorities. The split payment mechanism has been implemented already in Italy (in the context of B2B transactions with public agencies). It is also at various stages of consultation or implementation in places like the UK (B2C online sales only), Poland (in a B2B

context from January 1 2018), and Romania (B2B and B2C, likely to be compulsory from January 1 2018).

Conversely, carousel or missing trader fraud does not seem to be a major problem in China given that the entitlement to an input VAT credit is dependent on the supplier issuing a special VAT invoice which requires the payment of output VAT. Instead, fraud in China seems to be directed more at either the production of fraudulent invoices, or through failing to record transactions through the system (i.e. evasion).

What is pertinent about each of the above examples though is that the fraud or evasion is often perpetrated in B2B transactions, not B2C transactions. So if there is a recognition already that by taxing and crediting B2B transactions the system is prone to fraud or evasion, then why do it?

Third, we are starting to see some early steps in this direction with governments in China and more recently India, either introducing or significantly upgrading their regulated invoicing systems. These developments follow a similar global trend, with Brazil leading the way with perhaps the most advanced e-invoicing system in the world, requiring a digital stamp from the tax authority and real-time reporting of transactions. While the operation of these regulated invoicing systems differ around the world, the common thread is not to allow a recipient an input tax credit without first ensuring the supplier has accounted for the output tax.

It does not take a leap of imagination to foresee the day when the system of data matching that underpins these measures will not require the payment of output tax or crediting of the corresponding input tax. In fact, New Zealand implemented compulsory zero rating of B2B sales of land back in 2011, specifically to combat fraud. This is economically akin to limiting the GST on land sales to a retail sales tax only. In China especially, it's not difficult to foresee the day when these technological advancements are embedded in the Golden Tax System, possibly in version five or six.

The point, which arises here, is that the concept of the supplier accounting for output tax and the recipient claiming input tax in B2B transactions will be rendered superfluous. Once that happens, we are left with a retail sales tax. That is, a single stage tax that applies to transactions with end consumers only.

To be clear, the authors are not necessarily suggesting that VAT or GST systems will be replaced as a matter of form with retail sales taxes – rather, it is suggested that VAT or GST systems will, as a matter of substance, operate similarly to retail sales taxes. This is an important distinction, because the history of retail sales taxes highlights that where the tax applies as a single stage tax only, it is more prone to fraud and evasion, certainly as compared with the self-reinforcing aspects of a multi-stage VAT.

The retail sales taxes that they replicate will be different from those used historically in countries such as Australia,

where its wholesale sales tax ceased in 2000, or even China's VAT or India's GST before their recent reforms. The crucial differences being that the retail sales taxes that they replicate will be broadly based – that is, they will apply to both goods and services, and the process of excluding B2B sales from the tax will be automated. Recent international developments in areas such as 'split payment' mechanisms and imposing obligations on platform providers are merely a transitory step in the direction of having automated point of sale tax collection software divert the VAT or GST on B2C transactions directly to the tax authorities.

One final question on this topic which is worth considering – if we are predicting the demise of VAT or GST systems, at least in terms of their substantive operation, where does that leave the US with its system of state and local sales taxes? For many years pundits have predicted the demise of those taxes in place of a VAT or GST, yet here we are proposing the opposite. Unfortunately, that is an entirely separate topic which time and space does not permit us to examine here.

Indirect taxes to be managed almost exclusively through technology

To consider the future impact in 2025 of technology on indirect taxes, it is worthwhile looking to the recent past as a guide.

Over the past five years or so, we have seen the introduction or rapid expansion of electronic invoicing in many countries around the world, and the online filing of VAT and GST returns. More recently, we are seeing early stage developments in the pre-populating of information in VAT and GST returns (for example, of customs transactions in China and automated invoicing verification for purchases, and in India, with sales declared by suppliers being automatically populated in their customer's purchase returns); the development of real-time tax reporting (in places like Brazil, in Spain with its SII system, in Hungary, and in Poland, Norway and Lithuania with standard audit files for tax (SAF-T) reporting); the use of data and analytics tools, including predictive analytics; and finally, a shift in thinking by governments such as Singapore's in rewarding taxpayers who engage in preventative risk controls, known as the assisted compliance assurance programme (ACAP). More sophisticated taxpayers are also implementing tax engines to largely automate their indirect tax determination process. Deploying artificial intelligence to fully automate the determination and compliance process is the logical next frontier.

While these developments may be interesting to tax professionals, in reality they are not the main reason why indirect taxes will be managed through technology. The main reason is because of technology developments in the broader economy itself.

Consider this – indirect taxes are, by their very nature, transaction-based taxes. As more and more transactions occur in the digital world, the logical outcome is that the indirect taxes whose liabilities flow from these transactions will also be managed and administered digitally. Let's take a few examples to illustrate this point.

If we consider one of the major developments in retail trade over the past five years, it has been the growth and proliferation of platform providers. That is, the creation of digital marketplaces that link buyers with sellers anywhere around the world.

In 2017, governments in places such as Australia, India, Singapore and even the EU, have started to debate (or have even introduced legislation) to collect taxes on the importation of goods by leveraging the market power of platform providers. In our view, this is merely a passing fad – that is, a bridge in time before the technology possessed by tax authorities truly provides the solution. If we consider why governments would seek to impose tax compliance obligations for transactions effected through platforms onto the providers of those platforms, the reason is obvious. It is the belief that they can collect the tax more efficiently and effectively from the platform providers than by imposing VAT/GST registration and payment obligations on the smaller vendors using those platforms. In other words, governments are outsourcing the collection and compliance obligations on to these large platform providers. But what happens when technology solutions become more readily available, so that the VAT or GST due on a sale to an end consumer can automatically be diverted from a small vendor in country A to a tax authority in country B? When that happens, the need to collect from the platform providers will disappear. Already, there are patents in place to protect point of sale tax collection technology.

To add to this, we anticipate the growth of blockchain or distributed ledger technology will, at least in part, support that solution. If we consider that the fundamental nature of blockchain technology is to provide security, transparency and certainty of transactions based on cryptography, then it's not difficult to foresee blockchain being used to support both the payment and invoicing process in a VAT. In an invoicing context, to use the words of a noted academic in this field: "The invoice is the most critical VAT document. A blockchain-based regime will require that every valid VAT invoice must display a digital fingerprint derived through the VAT blockchain consensus process." Interestingly this idea is not actually quite so forward thinking, given a proposal has already been forcefully made for its adoption in the Gulf region from the inception of its VAT system in 2018, as such an adoption would not displace existing technology.

Putting it all together, if technology solutions exist to alleviate the need for the supplier in a B2B transaction to account for the output tax and the recipient to claim the related input tax, then the role of indirect tax advisers will

largely be limited to B2C compliance. Invoicing will be largely automated and we anticipate, even more highly regulated (to enable the technology to automatically detect fraudulent transactions), and VAT/GST returns will be pre-populated. The role of the indirect tax adviser will therefore be akin to the conductor of an orchestra – not playing the instruments, but directing the musicians and ensuring they keep time. The role of the indirect tax adviser will be to maintain a watch over the technology, testing the controls, and addressing problems when they are detected.

Just to be clear, we are not proponents of the lazy view that ‘robots will take your job by 2025 and you will therefore be redundant’, but in the realm of indirect taxes, there is perhaps no better example of a tax that will become more highly automated. Moreover, the shift to automation will not simply be because the technology will improve to help manage tax compliance, but the tax itself will be adapted to fit the technology. Take the example of recent measures introduced in Australia to tax B2C cross-border supplies of services and B2C cross-border sales of low-value goods – in each case, the definition of an ‘Australian consumer’ was modified to provide a safeguard to enable automated decisions based on the number of non-contradictory data points maintained by platform providers. In other words, automation will be a function of two forces coming together – technological advances to help manage tax compliance, and developments in tax legislation to help the technology apply in a more automated way.

In China, we are already seeing change in this direction. Electronic invoicing is now permissible for e-commerce transactions, and we anticipate it will become the norm across all industries in the near future. Invoice verification is becoming more highly automated; and VAT returns can be filed online. Overlaying a technology solution onto the Golden Tax System to avoid the need for the supplier to account for output VAT where it is matched by the recipient’s input VAT does not require significant advancement, and placing the already highly regulated invoicing system onto blockchain would seem imminently achievable.

The tax base for indirect taxes will be expanded in ways not previously contemplated

When VAT was significantly expanded throughout Europe in the 1970s, governments were faced with the challenge of overlaying a new tax onto their existing taxation systems. A compromise ensued and, as a result, VAT on things such as residential housing were carved out, partly to achieve neutrality between homeowners and renters (given that the former do not pay VAT on imputed rent), and partly because of the existence of property transfer taxes and stamp duties already. Other exemptions were introduced so as to ensure that basic needs were not taxed under a VAT, given its regressive nature. A similar rationale was applied to other basic needs such as education and healthcare. Financial services were also

exempted, due to the difficulties of capturing the value added on a transaction-by-transaction basis. The tax base was also directed at transactions engaged in by businesses and other entrepreneurs, again in part due to the fact that those participants who were not profit-making would invariably cost the tax system in the form of refunds of VAT credits. Furthermore, at the time the concept of a business could ordinarily be equated with a shop front or other ‘bricks and mortar’ existence.

The question is whether these principles will still hold true in 2025. In our view, they will not. Instead, we anticipate many of the developments that have recently been enacted in China will light a pathway for the rest of the world to follow. In succinct terms, consider the following:

1. The precondition of being a ‘business’ or ‘entrepreneur’ for VAT/GST registration will no longer apply.

Virtually all VAT or GST systems around the world have a precondition for registration and VAT/GST payment obligations that the supplier is either carrying on a business, is an entrepreneur, or carries out some other commercial activity. China’s VAT system, by contrast, has no such precondition. Instead, China’s VAT system imposes registration and payment obligations on ‘units’ (which is a broad concept not limited to business activities) and then imposes different obligations depending upon turnover thresholds.

Other countries around the world are discovering that advances in digital marketplaces mean that businesses or entrepreneurs need not have a physical shop front, need not hire employees, and in fact, need not really have inventory either. As a result the traditional tax base of applying VAT or GST in situations akin to when a business has a permanent establishment must surely be under threat. The question this raises is whether a profit making pursuit, coupled with a de minimis exclusion (where the compliance costs would exceed the tax collected) is all that is really needed as a precondition for imposing VAT or GST liabilities. The private consumer/business divide would then become redundant, in favour of a system that more closely resembles what we already see in China!

2. VAT/GST systems will even tax consumer-to-consumer (C2C) transactions.

Similar to point 1, digital marketplaces now facilitate trade between private individuals. Consider the growth of peer-to-peer (P2P) lending, the rise of online accommodation platforms, and even companies like Didi in its role as an intermediary between a passenger and a transportation service. These developments in commerce are commonly given labels such as ‘sharing economy’, ‘crowd funding’, ‘crowd sourcing’, and ‘ride sharing’.

The central question is why should the profit or gains derived from these activities fall outside the VAT or GST net? Already there is some tax authority activity in this

area, especially in relation to crowd funding and ride sharing. But to what extent are these merely symptoms of a bigger issue – which is that VAT or GST systems need to be adapted to tax the value added, irrespective of whether it is by a traditional business or a consumer sitting online. The value added by employees is already taxed in the hands of the business or company they are servicing, but what about the value added by these other forms of independent contracting?

Here is where the Chinese VAT system again lights the way. In China there is no real distinction drawn between business and non-business activities. VAT or GST can apply to either, and turnover thresholds lead to either the imposition of a lower rate turnover tax (i.e. no credits) or a traditional credit offset VAT. Expect other countries to follow suit.

3. Customs duty will need to find a new tax base.

Customs duty is imposed on the importation of goods, often in parallel with VAT/GST.

Customs duties are inherently narrow in their tax base in that they typically apply only to goods, not services. Consider that as technology has advanced over the past 10 years, fewer products are now imported as goods and are provided digitally in the form of services – whether they are books, magazines, newspapers, videos, television content, or music. And this is merely the list before 3D digital printing takes hold.

The question must surely be raised as to whether customs duty is at risk of a terminal decline in its tax base unless changes are made. If they are addressed, is it possible that customs duties will be expanded to services, and if so, how would they be collected and administered? Is the new Trump-era likely to result in a reversal of free trade agreements, and an increase in tariffs around the world?

Interestingly, the Chinese government recently took preemptory steps by merging the collection and payment of VAT and customs duty with consumption tax on cross-border e-commerce sales of low-value goods to consumers. Under these measures, transactions below a certain threshold (CNY 2,000 (\$302) for a single transaction or CNY 20,000 per person per year), attract customs duty at 0%, and the VAT and consumption tax is reduced to 70% of the amount separately applicable. In other words, a discount is provided and the collection and payment of these taxes is effectively merged. Is this a harbinger of things to come around the world, with VAT and customs duties being merged more generally, at least from an administrative perspective?

4. VAT/GST will apply to financial services.

The traditional reason cited for not taxing financial services under a VAT or GST was the inability to apply the tax on a transaction-by-transaction basis. However, that rationale was conceived in an era when margins were the dominant model rather than fee-based services.

Early steps to dismantle this were taken in places like New Zealand (with GST imposed on insurance, through a cash-based tax), in South Africa (with VAT on fee-based services), in Australia (with the introduction of the reduced input tax credit regime to remove the bias against outsourcing and to achieve a broadly similar tax outcome to exemption), and in New Zealand again (with B2B zero rating).

More recently, China's attempt to have a broad-based VAT on financial services (with few exemptions) was ably assisted by its having imposed business tax on these services previously. Whatever the reason though, the experiment in applying VAT to financial services is shown to be largely working, perhaps prompting other countries to follow suit.

5. The tax base for VAT/GST will be expanded in other areas too.

Even those areas of VAT/GST traditionally exempted, such as healthcare and education, could potentially be taxed. Again, traditional arguments used against the imposition of such a tax have included the fact that governments are often major providers in these areas (and therefore any VAT or GST just produces a 'churn' of funds). However, more recent studies suggest that if the objective of exempting these services from a VAT or GST is to address the regressive nature of a VAT/GST, then it is poorly targeted. Put simply, the case may be made for applying VAT or GST broadly, but then redirecting part or all of the proceeds back to those in need in the form of specific subsidy arrangements.

The challenge in this area is in balancing the desire for good policy (which may support the removal of exemptions) with the political realities of doing so (where taxing the necessities of life may be seen as politically unpalatable in some countries).

A case study in the need for change may be found in Australia, where the proportion of consumption that is subject to GST has fallen from 61% in 2000/01 (when the GST commenced) to around 56% in 2012/13. Essentially, households are spending a greater proportion of their income on exempt healthcare and education, rent, insurance and finance. Unless this trend reverses, it may have important long-term implications for the tax base.

6. Taxes like a VAT/GST that are founded in transactions or flows will continue to grow in importance.

Over the past 10 years or so, there has been a noticeable increase in the rates of VAT and GST around the world, and a consequential decrease in corporate tax rates. KPMG's global corporate tax rate survey shows a decline in the global corporate tax rate average every single year from 2003 through to 2016, starting at 29.42% and finishing at 23.47%. The OECD's average corporate tax rate follows a similar trend, starting at 30.08% in 2003 and dropping to 24.27% in 2017. By contrast, the OECD average rate of VAT/GST has steadily

increased from 17.81% in 2005 through to 19.16% in 2017. Were it not for new countries implementing a VAT/GST (which they typically do at lower rates, and then increase them over time), the trend would be even more pronounced.

The question may reasonably be asked, will this trend continue?

The short answer is ‘yes’, at least in part. In our view, in an era of unprecedented dislocation and disruption to historical business models, what we consider will emerge is taxes that are imposed on ‘transactions’, or on ‘cash flows’, and directed to the place where ‘consumption’ occurs.

In an era of digitisation of business, of the proliferation of e-commerce transactions, increased deployment of robotics and more highly mobile personnel, the era of corporate taxation based on vague concepts of residency and source, is largely over. In time we will come to see whether the BEPS project represents the last throw of the dice in modernising outdated concepts such as ‘permanent establishment’, or whether it heralds the long-lasting resurgence of corporate taxes, but we doubt it.

Why? Because taxes based on ‘transactions’ or on ‘cash flows’ are inherently more determinable, measurable, and perhaps most fundamentally, more closely aligned with business objectives in entering new markets, selling their goods and services from which they derive profits. To take a simple example, the destination based cash flow tax, which had

been considered (but was subsequently set aside) in the course of deliberations on tax reform in the US, has many of these features. It incorporated features of a VAT in the sense that it would tax consumption, incentivise production activities in the US, and tax cash flows.

So in short, we are not predicting the demise of corporate taxes. Rather, we are predicting they will transmogrify until they more closely resemble the features of a VAT/GST. Again though, China is perhaps already ahead of the curve, given that its reliance on indirect taxes as a percentage of overall tax revenue is very high by international standards.

Final thoughts

This chapter seeks to guide a path to 2025. The challenge is in predicting the intersection of two key developments – the first being the profound changes we are witnessing to the economy itself through technological developments that have been labelled as the fourth industrial revolution; and the second being an increasing reliance on indirect taxes as they mature into a dominant form of taxation in the 21st century. In many respects, China’s recent reforms to its VAT system, coupled with expected advances to the Golden Tax System, mean it will potentially light a pathway to 2025 that other countries may seek to follow.



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China after BEPS, for now...

In 2017, we saw China continue with its rollout of the BEPS changes, make proposals for new incentives for foreign investment in China, and leverage new technologies for enhanced enforcement efforts. What is more, a new vision for China's international tax policy is gradually emerging. These developments are the focus of this chapter by **Chris Xing, Conrad Turley, Jennifer Weng, and Karmen Yeung.**

Introduction

In last year's sixth edition of *China Looking Ahead*, the chapter *BEPS in China – multi-track developments* looked at China's rollout of the BEPS 2015 deliverables. We highlighted China's enhanced big data-driven cross-border tax enforcement efforts. We also outlined the rapid development of China's external tax policy. In this year's edition, a new chapter, *A thousand miles begins with a single step: tax challenges under the BRI*, separately addresses the Belt and Road Initiative (BRI) tax issues. Consequently, this chapter hones in on the continued China BEPS rollout, tax enforcement intensification, and the gradual reorientation of China's international tax policy to reflect China's evolved role in the global economy.

The evolving Chinese international tax policymaking context

Before diving into the details of China tax legal and enforcement developments during 2017, it is worth standing back to take in the broader picture. It is clear that the context in which China formulates its international tax policy has rapidly shifted since the commencement of the BEPS project in early 2013. By the end of 2012, on the cusp of the BEPS project launch, China had become the world's third largest outbound investor, after the US and Japan. China's outbound direct investment (ODI) had, starting from minimal levels in 2005, consistently grown at rates exceeding 30%, and was \$88 billion for 2012. This still fell short of Chinese inward foreign direct investment (FDI), which stood at \$112 billion in that year.

Zoom forward to 2017 and the scene is transformed. China ODI overtook FDI back in 2015. Consequently, China became a net capital exporter for the first time, simultaneously becoming the world's second biggest capital exporter after the US. By 2016, China ODI had surged well beyond inward FDI, with ODI at \$183 billion and FDI at \$131 billion. While government measures taken in 2017 to temper some of the perceived imprudent ODI activity had an impact on outflows, China appears likely to structurally remain a significant capital exporter for the foreseeable future. Equally notable is that the nature of China ODI has changed significantly over the years, with highly innovative Chinese digital economy companies now making a key contribution to outflows (see further detail in the chapter, *One billion Chinese mobile phone users can't be wrong: tax and the digital economy*).

While, as yet, there have been no major new tax rule changes reflecting this shift in the underlying tectonic plates of Chinese international tax

policymaking, the signs of a shift are already becoming apparent. The steadily increasing numbers of tax disputes facing Chinese MNEs in overseas investee jurisdictions, especially in relation to permanent establishment (PE) challenges, have led to increased demands on the State Administration of Taxation (SAT) to offer assistance through mutual agreement procedures (MAP), as detailed further in the BRI chapter. This may have given Chinese tax policymakers pause for thought when considering where the global tax consensus, as mediated through the G20, OECD, UN and other bodies, should move next on novel digital economy source nexus concepts.

The desire to help Chinese MNEs with the continuous recycling and redeployment of their overseas capital and profits has spurred efforts to revise China's outbound investment tax rules. Enhancements to the foreign tax credit regime, or even a Chinese participation exemption, are now on the cards. This was a highlight of the State Council Circular No. 39, issued in August 2017, which sought to implement the directives of the State Council's January 2017 Circular 5 and President Xi Jinping's January 2017 World Economic Forum speech, which set out China's central role in sustaining globalisation.

On the whole, a shift in China's thinking from that of a 'source' country to that of a 'residence' country is in evidence, including the updated terms of tax treaties with BRI countries, which pushed for much lower withholding tax (WHT) rates (e.g. Russia, Romania, Malaysia double taxation agreement (DTA) updates). This being noted, it can hardly be said that China has let up in the enforcement of its source taxing rights, with better data collection and analysis driving ever more intensive efforts in this space. Furthermore, the relative stagnation of inward FDI in recent years is spurring China to develop new tax measures to encourage inward investment. This includes deferring WHT on outbound dividends where the dividends are used to finance reinvestment in China.

Viewing the entire Chinese international tax policy and administration 'waterfront' together, one may speak of a progressive structural shift in the China tax policy lens towards a 'residence' country perspective, while at the same time technological and organisational developments in the Chinese tax authorities drive ever more effective 'source' enforcement.

China and BEPS – the latest state of play

In the international tax chapter of China Looking Ahead in previous years we have given an annual round-up of China's stance and progress on each of the 15 items of the BEPS Action Plan. China's policy decisions on which BEPS changes to adopt are determined by the SAT and the Ministry of Finance (MOF) working together. Most rapid progress has been made in the transfer pricing (TP) space,



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with the BEPS work on revamping TP rules (Actions 8 to 10) 'localised' for China's economic context in SAT Announcement [2017] No. 6 and the BEPS TP documentation revamp (Action 13) given effect in China through SAT Announcement [2016] No. 42 (for details see the chapter, *TP in China: all the data in the world*). Outside of the TP space, China has made clear how it will update its treaties for the BEPS anti-treaty abuse work (Action 6). This is evident in the selections China has made for multilateral instrument (MLI) (Action 15) updates to China's tax treaty network (discussed below). Further SAT guidance on treaty abuse rules is understood to be forthcoming in the first half of 2018.

However, for other BEPS areas of concern, China's position is yet to be revealed:

- Senior SAT officials have noted in public pronouncements that work is continuing on revised PE recognition and profit attribution guidance – this is anticipated for release in the first half of 2018. China elected not to adopt the revised BEPS PE definition (Action 7) into its tax treaties through the MLI. Therefore, it remains to be



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seen how much the new guidance looks to 'push out' the boundaries of PE interpretation, operating within the existing PE language of China's DTAs.

- Work is understood to be continuing on anti-hybrid rules, which would be expected to draw on the BEPS Action 2 work. It is noted though that Chinese regulatory and forex rules, as well as aspects of the overall China tax system, make hybrid planning far less of an issue in China than in many developed countries.
- Work is understood also to be continuing on new controlled foreign company (CFC) rules guidance. It is not yet known how far this will depart from the earlier 2015 draft CFC guidance, which had drawn some concepts from the BEPS Action 3 work.
- As far as the BEPS Action 5 review of harmful preferential tax regimes is concerned, China's high and new technology enterprise (HNTE) incentive and the advanced technology service enterprise (ATSE) incentive were both, in 2017, determined by the OECD Forum on

Harmful Tax Practices (FHTP) not to be harmful and do not require adjustment.

- It is understood that China's tax policymakers do not intend to roll out the BEPS Action 4 interest limitation rules.

It is anticipated that some of the draft guidance detailed above may be issued, at least in public consultation form, in the first half of 2018. Final details remain to be seen.

MLI – wholesale update of China's tax treaties

China signed the MLI on June 7 2017, committing to the update of virtually all of its tax treaties. Which Chinese treaties get updated through the MLI is a function of two factors. It depends on (i) whether China's nominated treaty counterparties also sign the MLI and (ii) whether they make selections for treaty update that are compatible with the selections made by China. Where both factors are fulfilled, treaty MLI updates may take effect. At the time of writing, 71 jurisdictions had committed to the MLI and these matched to China in 48 cases. This means that nearly half of China's 106 double tax agreements (including treaties with sovereign states and arrangements with non-sovereign jurisdictions) would see MLI updates. The MLI updates cover the treaties with China's major OECD trading partners (with the exception of the US) and partly cover treaties with China's BRICS trading partners (excluding Brazil and India).

The principal update, made to all of China's MLI-updated treaties, is the inclusion of a principal purposes test (PPT). The PPT asks whether 'one of the principal purposes' of a business or investment arrangement, designed and used by a taxpayer, is to gain access to benefits under a DTA (so-called 'treaty shopping'). DTA benefits may be denied where the tax authorities determine this to be the case. In the case of 12 of the MLI-updated treaties, the existing China treaty 'main purpose' anti-abuse rules (mainly included in dividends, interest, and royalty articles) will be replaced. In other cases the PPT article will be inserted in Chinese treaties that did not have existing anti-abuse rules. This will be accompanied by a new treaty preamble, inserted in all the MLI-updated treaties, clarifying that the object and purpose of tax treaties is not meant to facilitate treaty shopping.

Beyond this, other China-selected MLI updates affect a far smaller number of Chinese treaties. A clarified 12-month shareholding period to access dividend WHT reductions will be inserted in seven treaties, a new corporate residence tiebreaker rule (which does away with the place of effective management test) will be inserted in 18 treaties, and the older MAP and TP corresponding adjustment rules in China's nominated treaties will be replaced.

For the MLI updates to China's treaties to take effect it is required that both China and the treaty counterparty first complete their domestic procedures for ratifying the MLI. It

is estimated that China's MLI updates will start to be effective from 2019/2020 onwards, with some treaties taking longer for the updates to take effect.

As more of China's treaty partners sign up to the MLI more Chinese treaties will be updated. China could also potentially modify some of its preferences in the MLI, resulting in further treaty updates where these selections match with those of other countries – though for the moment China appears to have no interest in the BEPS PE updates. More intriguingly, as the OECD develops further global tax treaty standards, through the BEPS Inclusive Framework, the MLI provides an existing platform to put these into global effect, including through China's treaties. As such, MLI developments need to be continually monitored by taxpayers and China's tax professionals.

As to the effect of the MLI, a key question is what impact the PPT updates will have on access to benefits under China's tax treaties. Use of DTA benefits in practice had already become highly challenging since the issuance of SAT Circular [2009] No. 601, with its substance-focused beneficial ownership definition. Treaty administrative procedure reform with SAT Announcement [2015] No. 60 has not made access to treaty relief, in practice, measurably easier. In fact, the inconsistent application of Announcement 60 by local tax authorities across China may have made matters more difficult in many cases. It is to be hoped that the forthcoming SAT guidance on treaty abuse (anticipated in the first half of 2018) will take the opportunity to clarify the respective roles of the PPT, beneficial ownership rule, and other anti-abuse provisions in regulating access to treaty relief, provide detailed rules on how they are to be applied, and streamline administration. The extent to which the SAT's PPT guidance draws on the OECD's PPT guidance, set out in the BEPS Action 6 report and supplementary OECD documents, remains to be seen.

Enhancing China's foreign investment attractiveness

As noted above, the renewed political commitments to globalisation, made by China's leadership in early 2017, have been followed by a string of tax proposals to enhance China's investment attractiveness.

State Council Circular 39 sets out a new policy under which foreign enterprises will be able to reinvest the distributed profits of FIEs in China without immediate imposition of the standard 10% dividend WHT. This could be of value as the existing measures to limit tax leakages in reinvestment cases, such as by setting up onshore holding companies in China, are hampered by regulatory limitations. The new incentive could be a great boon to the use of Singapore and Hong Kong offshore holding companies for Chinese operations. Details of the incentive are to be clarified by the end of 2017.



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Circular 39 also highlights that enhancements are to be made to the existing regime for granting foreign tax relief for overseas dividends received by Chinese enterprises. This might be by way of improved tax credits or by introducing a participation exemption. The planned improvements are asserted to make it more attractive for MNEs to establish regional headquarter companies in China. Given other regulatory and commercial issues with using a China hub as an ASPAC headquarter (e.g. forex controls, air travel and visa considerations) the success of this incentive in spurring ASPAC headquarters to relocate to China remains to be seen. As noted above though, this will be very welcome for Chinese MNEs expanding overseas.

Very recently, efforts have also been made to clarify China's WHT administration rules, to reduce filing requirements and make the timing of payments more reasonable. To this end the SAT issued Announcement [2017] No. 37 in October 2017 to replace the WHT agent obligations set out in SAT Circular [2009] No. 3, as well as the capital gains calculation provisions of Circular [2009] No. 698.

Announcement 37 reduces the compliance burden on WHT agents somewhat by abolishing the Circular 3 cross-border contract registration requirements, and by extending the WHT payment deadline for arrangements with staggered payment terms. It also modifies the secondary liability obligations for non-resident payees, where a WHT agent fails to withhold, to shift obligations more towards the WHT agent, and in particular to the buyer in equity transfer transactions.



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At the same time, there are certain uncertainties on how the Announcement 37 rules interact with the Announcement 7 indirect disposal rules, as explored further in the chapter, *Chasing deals: tax trying to keep pace with business in China*. China's WHT administration is still in need of further improvements, in particular with regard to its interaction with DTA relief, as noted above.

Enforcement efforts further leverage big data

As outlined above, China tax policy work continues on reshaping China's treaty network through the MLI, integrating the BEPS deliverables into Chinese law, and enhancing the tax policies for both ODI and FDI. At the same time, at the 'coal face' of tax administration, China's tax enforcement efforts on cross-border transactions have been getting ever more targeted and effective. A round up of notable enforcement cases reported in the last year is set out below. It should be noted though that, with relatively few cases going to court in China (though the number is increasing), the main sources of information on tax enforcement cases are business and tax-specialist media, as well as the SAT and local tax authorities themselves. The latter make particular use of their

official WeChat social media feeds to highlight cases. The details available are generally limited, with relatively little technical discussion, though they do serve to highlight enforcement focus areas and key pitfalls for taxpayers.

Treaty abuse cases

As noted above, further SAT guidance is anticipated in the first half of 2018 to clarify the application of treaty anti-abuse rules and treaty relief administration. In the interim, local tax authorities have continued to put the guidance in SAT Circular [2009] No. 601, with its substance-focused beneficial ownership definition at the centre of their enforcement efforts:

- Dividend WHT reductions under China's DTAs continue to be frequently challenged on the basis of insufficient economic substance in the DTA relief claimant entity. Many of the reported cases relate to Hong Kong DTA relief claimants.
- In a case reported by China Taxation News (CTN) in February 2017, the Baotou (Inner Mongolia province) State Tax Bureau (STB) denied dividend WHT DTA relief to a Hong Kong company. This was on the grounds that, while the Hong Kong company's main source of income was from the financing of its subsidiaries, its functional oversight and risk management of the day-to-day operations of the Chinese distributing subsidiary was minimal. The zero Hong Kong taxation of its dividends was taken to strongly imply a tax motivation for the use of a Hong Kong company. While these conclusions do draw on the seven factors set out in Circular 601, the negative inference drawn from non-taxation of dividends in Hong Kong contradicts the guidance in SAT Circular [2013] No. 165, which sought to nuance China-Hong Kong DTA interpretation.
- Similarly, a September 2016 case reported by CTN involved a denial of dividend WHT DTA relief to a Hong Kong company. This was on the basis that, with minimal operations, the extent of the Hong Kong company's assets and staff did not adequately 'match' the dividend income drawn from the Chinese subsidiary. Again, while this draws on the Circular 601 factors, this does not appear to have regard for the Circular 165 guidance. This accepted that, for a holding company, a minimal, but competent, staff could be reconciled to the grant of DTA relief, so long as the holding company had rights of control and disposal over the equity investment and related income. A further factor in this case though was the inability of the Hong Kong company to provide a tax residence certificate – this is an increasing challenge in recent years as the Hong Kong tax authorities have become highly cautious in issuing Hong Kong tax residence certificates to holding companies in Hong Kong.

- Numerous cases of denied dividend WHT DTA relief for holding companies in other jurisdictions have also been reported. A case reported in July 2017 concerned a Barbados tax resident holding company (a subsidiary of a Canadian mining group). This sought dividend WHT DTA relief on dividends received from a Qinghai province-registered company under the China-Barbados DTA. As the Qinghai STB lacked sufficient experience they forwarded the case directly to the SAT for handling. The SAT concluded that the Barbados company lacked sufficient staff and capital to assume and manage the risks associated with its investment in the Chinese company. It also noted the lack of any tax paid in Barbados. The SAT concluded that DTA relief should not be allowed.
- Beyond dividend WHT DTA relief cases, there continues to be reports of capital gains WHT DTA relief being denied on the basis that the DTA relief claimant lacks ‘beneficial ownership’ of the disposed China equity. This is a long-contested matter in the China tax treaty interpretation space, going back to the 2010 *Xuzhou* (Jiangsu province) case. The beneficial ownership requirement, included in the dividends, interest and royalty articles of tax treaties, is not included in the capital gains article of treaties. Nonetheless, starting with the *Xuzhou* case, the Chinese local tax authorities have ‘read this into’ treaty capital gains articles. Senior SAT officials have at various points clarified that they considered this not appropriate and that abuse of capital gains WHT DTA relief would need to be challenged using a specific DTA anti-abuse rule or the domestic law general anti-avoidance rule (GAAR) – this has not stopped local tax authorities taking this line in practice. The latest example is a denial of relief to a Hong Kong company’s disposal of China equity on this basis by the Huzhou (Zhejiang province) STB, reported by CTN in September 2016.

What is clear from the above cases is that there is a pressing need for the forthcoming SAT treaty abuse guidance to clarify the manner in which the various treaty anti-abuse rules apply and interact with each other. The rollout of the PPT throughout China’s treaty network provides a good opportunity to draw a line between the beneficial ownership concept, as a measure of the degree of control that a treaty relief claimant has over an investment and the related income flows, and tax purpose-focused anti-treaty shopping rules. The latter analysis would ideally occur solely within the scope of the PPT/domestic GAAR. There is also a continuing need for clarification that capital gains WHT DTA relief will be challenged under the PPT/GAAR, rather than by reading the beneficial ownership requirement into capital gains articles.

PE cases

As in many other countries around the world, PE exposures have been an area of increased concern for foreign investors

in China in recent years. With senior SAT officials repeatedly marking out PE as a focus area for increased local tax enforcement efforts, many foreign investors have been re-examining their potential PE risks and adjusting their contractual arrangements and operating protocols accordingly. As noted above, China made a policy decision not to expand agency PE, with reference to the BEPS changes, through the MLI. In contrast to many other ASPAC countries (e.g. Indonesia, Thailand, and Australia), China has not yet sought to introduce any novel digital economy tax nexus concepts. Consequently, enhanced PE enforcement has continued, in the interim, to focus on traditional PE issues in China, notably service PE:

- Equipment installation and calibration services, provided by a foreign company in connection with supply of equipment, are a notable service PE focus area. Pingtan (Fujian province) STB was reported by CTN in January 2017 to have imposed service PE taxation on a Japanese company, which had supplied equipment and installation under a single contract, with no separate billing of services. Administratively-speaking, local tax authorities readily pick up on and scrutinise service payments, as where these exceed \$50,000 they must be recorded with the tax authority. Bundling installation into the equipment supply contract avoids the recordal requirement as payments under goods supply contracts require no recordal. The Pingtan STB identified the supply from a general screening of online business news reports – a tax audit investigation showed the visiting Japanese installation staff to have been in China for a period exceeding the service PE treaty time threshold, and tax was imposed. Similarly, a July 2017 CTN report noted that the Jiyuan (Hainan province) STB had imposed service PE taxation on an Italian company that had dispatched staff to China to install and calibrate equipment sold by the Italian company to a Chinese buyer.
- It is notable that, going in the other direction, there have been numerous reported cases of Chinese equipment companies running into similar PE issues overseas. In India many of these have become high-profile court cases (e.g. *Shanghai Electric Group Co. Ltd. v. DCIT* [2017], *ZTE Corporation v. ADIT* [2016]). The SAT has frequently got involved in resolving such cases through the MAP, and has repeatedly flagged to Chinese MNEs its willingness to assist, including through highlighting individual resolved cases over WeChat and on their website. For example, the SAT website in October 2016 reported the case of *Chongqing Wukuang Machinery Export Ltd.*, which had been subject to a PE challenge in Vietnam on a supply of equipment and installation services. The company was willing to concede PE tax on the service element but not on the equipment supply – through SAT MAP support the company succeeded in having the Vietnamese authorities stand down on this point.

It is striking that the increase in the number of PE disputes for Chinese companies overseas may be having an impact on overall China policy thinking on PE. Certainly, China is getting more effective at using data to track and challenge inbound PE cases, whether this is data pooled between Chinese regulatory bodies or the details are obtained from public sources, for which extensive use of ‘web crawler’ technology is notable. However, whereas at an earlier point in time China would have been considered a prime candidate for adoption of expanded PE and source nexus concepts, this can no longer be said with the same confidence. The upcoming new SAT PE guidance will be heavily anticipated to see whether China tax policymakers use a revised interpretation of existing treaty PE language to expand its scope, or whether limits will be set on how far China plans to push PE, with an eye to the position of China ‘going out’ enterprises.

CFC cases

China began to use its CFC rules in 2014, with the *Shandong* and *Hainan* cases, and followed this in 2015 with the *Urumqi* case. The trend for increased use of CFC rules has continued, and CTN reported in June 2017 of a CFC tax imposition by Suzhou Industrial Park (Jiangsu province) Local Tax Bureau (LTB) against a Hong Kong subsidiary of a Suzhou-registered company. Relative to the earlier CFC cases, the report on this case provides a much higher level of detail on the rationale used by the tax authorities in deciding to use the CFC rules.

The Hong Kong company had, in its registration with the Jiangsu foreign investment promotion agency, stated its main business to be management service provision. However, the Suzhou Industrial Park tax authorities observed, from the regular CFC reporting provided by the Chinese company, that the income of the Hong Kong company consisted mainly of investment returns, including equity disposal gains (accumulated in 2014 and 2015). As these were offshore sourced these fell outside the Hong Kong tax net and suffered no Hong Kong tax.

The Chinese CFC rules impute the income of a foreign controlled company to the controlling Chinese company where the effective tax rate in the overseas jurisdiction is significantly lower than the Chinese corporate income tax (CIT) rate (12.5% rate indicated by the guidance), and where non-distribution of income back to China is not justified by reasonable business needs of the CFC. There is a let out where the CFC’s income is mainly from active business operations, which is left undefined by the law and guidance.

The tax authorities rejected the taxpayer’s assertion that the low tax criterion was not met. While Hong Kong’s statutory CIT rate is 16.5%, the effective rate in this case was 0%. The authorities also noted that Hong Kong does not appear on the China CFC white list.

Against the taxpayer’s argument that the retention of income and gains offshore, and its non-distribution back to China, was for the reasonable purposes of long-term operational expansion, the authorities observed that the proceeds of the equity disposals had been simply left as accounts receivable, and had not been used for the expansion of the business or reinvested. As to the argument that the CFC income was mainly from active operations, the tax authorities observed that the international tax consensus was to regard dividends, interest and capital gains as passive in nature.

It is notable that, in defining reasonable business purposes, and in setting out the active income-passive income divide, the authorities appear to have drawn on the yet-to-be-finalised draft China CFC guidance issued in September 2015. The finalisation of this guidance (anticipated in the first half of 2018) and the continued reporting of CFC enforcement cases should progressively bring greater clarity to the bounds of China’s CFC rules.

Exchange of information (EOI) and big data

The SAT and provincial tax authorities have for many years now been flagging for taxpayers their enhanced tax audit capabilities deriving from greater sources of pooled data, both from domestic and overseas sources, and their big data analytical capabilities. Numerous cases where the Chinese authorities reached out to their overseas counterparts through EOI on request (under revamped treaty EOI provisions) are highlighted on tax authority official websites and WeChat feeds, as well as in the Chinese business and tax media:

- A December 2016 CTN report highlighted how in 2016 Shenzhen Guangming (Guangdong province) STB initiated an EOI request with a foreign jurisdiction. This followed the recordal of a CNY 200 million (\$30 million) outbound related party service payment by a local textile industry FIE. The fluctuating cost base of the FIE and lack of contractual clarity on the FIEs risks and responsibilities spurred the EOI request. On clarification being obtained from overseas, the service fee tax deduction was adjusted downwards, raising an additional CNY 7 million in tax and penalties.
- A November 2017 CTN report highlighted how Guangzhou (Guangdong province) LTB used big data analysis and matching to detect tax evasion by the operator of a large-scale wholesale market. Guangzhou LTB, working together with the public security authority, obtained electronic data from the shareholder of the operating enterprise. The data revealed that personal bank accounts of the shareholder were used to handle off-account enterprise business income and expenditures over a 10-year period. CNY 690 million in tax and penalties was imposed.

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- A September 2016 case reported in CTN noted how Yanqing (Beijing municipality) STB, following an information exchange with the local Commission of Commerce, detected an equity transfer meriting further tax audit. The transfer, of equity in a domestic enterprise from another local enterprise to a foreign transferee, was determined taxable and CNY 12 million in tax and penalties was imposed.
- A February 2016 CTN report noted efforts by Haian (Jiangsu province) STB to build up a mechanism for cross-border tax information with other government agencies, including local MOF, the Ministry of Commerce (MOFCOM), and the Industrial Development Bureau. Under this mechanism, a WeChat group for these authorities is used to share cross-border transactions and identify those with high-risk. In 2015 this collaborative initiative led to the collection of further tax of CNY 52 million.

Starting from September 2018, China will commence automatic EOI (AEOI) via the OECD common reporting standard (CRS) mechanisms, opening a new chapter in the targeted effectiveness of Chinese cross-border tax enforcement (see the chapter, *A brave new world in tax transparency: CRS in China, Hong Kong and Taiwan*).

Tax certainty – court cases and rulings

As noted in the international tax chapter of last year's China Looking Ahead, taxpayers in China have been growing in confidence in bringing disagreements over tax assessments into the mechanisms for formal tax dispute resolution, and increasingly going to court. Last year, we noted cases rising to the provincial people's court level in relation to an indirect offshore disposal (The Children's Investment (TCI) fund), the application of the CIT reorganisation relief (Ilva Saronno), and a China-US treaty case concerning dual employment arrangements into China.

In 2017 these developments carried even further, with the first ever case decision by the Beijing-based Chinese Supreme People's Court (SPC) released online in April 2017. This was an appeal by Guangzhou Defa Housing Construction Co., Ltd. (Defa) against an imposition of tax and penalties by the Guangzhou (Guangdong province) LTb, following an earlier administrative review and hearings at local and provincial court levels. Defa disputed an additional assessment of business tax and local charges, as well as late payment surcharges (LPS), on a sale of land through auction. The authorities asserted that the auction price was unduly low, providing a range of comparative price information from the sale of other parts of the same estate, comparable Guangzhou property, as well as valuer assessments. Ultimately the SPC decided for the tax authorities on the

substantive matter, but decided for the taxpayer on the LPS, taking a favourable interpretation of the penalty provisions that the tax authorities would need to prove the taxpayer to be at fault to sustain the imposition.

More notable than the specifics of the decision, 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 and makes court appeal of tax cases an increasingly relevant option for taxpayer disputes, including in the cross-border tax space. In fact, the *TCI fund* indirect offshore disposal case was also appealed to SPC level, though the court decided (September 2016) to reject the application of TCI for retrial, meaning the imposition of CIT by the Hangzhou (Zhejiang province) tax authority was affirmed.

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 early 2016, a municipal STB in Hubei province was reported to have issued a private tax ruling covering the application of DTA dividend WHT relief rules to distributions made by a domestic enterprise. This followed on from reports of private rulings granted in 2015 by a municipal tax bureau in Jiangsu province in relation to cross-border reorganisation relief.

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 2018 when the new Tax Collection and Administration (TCA) Law, which includes specific provisions on rulings, is expected to be finalised.

Looking ahead to 2018

In 2018, with the upgrade of China's tax relief for the foreign income of Chinese enterprises, the finalisation of the CFC rule guidance, and the clarification of China's position on PE recognition, China's evolving thinking on the appropriate balance between residence and source taxation should become more evident. In parallel, further tax court cases and the finalisation of the TCA Law, with the institution of advance rulings, should further solidify tax certainty. This is at the same time as technology-driven enforcement and the tax data revolution heralded by CRS to drive a much more transparent and compliant China tax environment.

In the Chinese zodiac, 2018 is the Year of the Dog, and a time for action. This certainly looks to be the case in the international tax space.

A thousand miles begin with a single step: tax challenges under the BRI

As companies embark on overseas investment and projects under China's Belt and Road Initiative (BRI), they are increasingly encountering tax issues in emerging and developing countries. Michael Wong, Joseph Tam, Alan O'Connor, Karen Lin, and Cloris Li look at key corporate tax issues they may face, and how the SAT is supporting Chinese companies to navigate through these overseas tax challenges.

In 2013, Chinese President Xi Jinping announced plans to rebuild China's old trade links with Europe and Asia via the Silk Road Economic Belt and the 21st Century Maritime Silk Road – the BRI. The BRI is aimed at building essential infrastructure and boosting financial and trade links to enhance commerce, and spread prosperity, across the more than 60 countries that lie along the BRI routes.

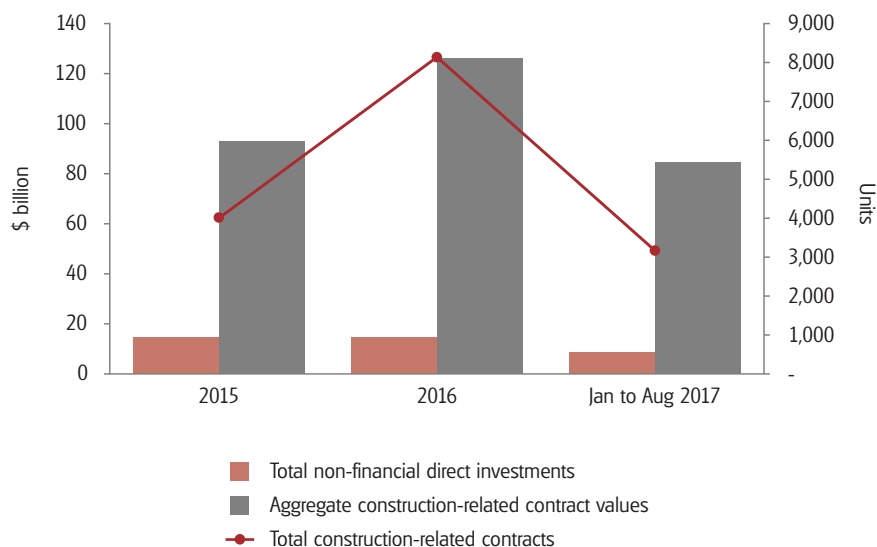
The BRI has already drawn strong participation from Chinese companies. Statistics from China's Ministry of Commerce indicate that non-financial related direct investment by Chinese companies into BRI countries was almost \$38 billion during the period from January 2015 to August 2017 (see Figure 1). The statistics also indicated that Chinese companies had signed more than 15,300 new construction related contracts, with an aggregate project value of more than \$303 billion, in BRI countries over this same period.

This BRI investment growth is expected to continue following the recent Chinese government pronouncement, Guo Ban Fa [2017] No. 74, issued on August 18 2017. This set out a regulatory classification of outbound investments as encouraged, restricted and prohibited. From the list of encouraged outbound investments, it is evident that the BRI is being strongly supported by the government. The encouraged list includes:

- Infrastructure and construction projects under the BRI;
- Outbound investment facilitating China exports of machinery, industrial equipment, and technical standards;
- Outbound investment that serves to strengthen investment cooperation with overseas high-tech and advanced manufacturing enterprises;
- Outbound investment in overseas research and development (R&D) centres;
- Participation in projects for the exploration and development of off-shore oil and gas, mineral and other energy resources;
- Outbound investment in the agricultural sector;
- Outbound investment in services sectors, such as commerce, trade, culture, logistics; and
- Set up of branches and overseas service networks by qualified financial institutions.

At the same time, the Chinese authorities continue to tighten the approval requirements for outbound investments in 'sensitive' sectors. The most recent example is draft rules, released in November 2017,

Figure 1: Chinese non-financial direct investment and construction-related contracting in Belt and Road countries



which clarify that investment transactions conducted through an offshore subsidiary of a Chinese company, using funds raised outside of China, will still be within the scope of the pre-approval procedures. The authorities refer to this as a ‘substance over form’ approach to the oversight of Chinese investment overseas.

Driven by the BRI initiative, Chinese companies are extensively participating in overseas BRI projects. For many, these investments and projects are their first undertaking outside China. BRI projects are predominately large-scale infrastructure construction and natural resource extraction and production works, and they offer a wide range of roles that Chinese companies can play. This includes roles as engineering, procurement and construction (EPC) contractors, operators, equipment manufacturers/suppliers, project financiers, and equity investors.

However, Chinese enterprises may not be fully prepared for the challenges that may arise from these overseas projects, particularly in the area of taxation. This is particularly the case if they are unfamiliar with the overseas tax systems of the countries in which they operate/invest. Tax matters can also be problematic if the Chinese companies have inadequate tax risk management systems in place to tackle the issues, before or as they arise. Most of the countries involved in the BRI are emerging or developing economies, whose tax laws and regulations are not yet

fully developed and frequently subject to different local interpretations and unanticipated changes. Accordingly, Chinese enterprises may encounter difficulties in managing their overseas tax affairs, creating tax risks and costs that ultimately reduces their returns from the investment/projects, and consuming management time and attention.

This chapter looks at a few of the key corporate income tax (CIT) related risks that Chinese companies may face as they embark on overseas projects under the BRI. There are other tax issues that could also impact the tax risks and costs associated with overseas BRI related projects, such as VAT and customs duty on imported equipment and other construction inputs, tax reporting and withholding for seconded staff, etc. We will also look at measures announced by the Chinese tax authorities to support Chinese companies with these tax challenges.

Permanent establishment (PE) risk

Chinese tax resident EPC contractors and project operators are subject to China taxation on their worldwide profits at the standard China CIT rate of 25%. However, these companies will also find themselves liable to overseas taxes on their overseas projects to the extent they are derived through a PE in the project country. What constitutes a PE will be based on the domestic tax legislation in the project



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host country and any applicable double tax agreement (DTA) with China. Broadly speaking, a PE requires there to be a physical presence in the country (i.e. people, tangible assets, etc.) and a measure of permanence for such presence (e.g. through recurrent activities).

There are a number of steps that non-resident companies may take to limit the incidence and/or scope of project host country PEs. The non-resident company may use a separate local subsidiary to perform in-country project related activities. Alternatively, the non-resident contractor may look to split a project into separate contracts. The contracts can thus separately cover the PE activities undertaken within the project host country (e.g. construction services), and the activities undertaken outside the project host country (e.g. sale of equipment).

However, these approaches are being increasingly challenged. Changes are being made in countries at a tax policy level in response to proposals made by the OECD's BEPS Action Plan 7 (Preventing the artificial avoidance of permanent establishment status), and individual countries looking to enforce more rigorously their domestic law and DTA standards on PE. This has seen increasing levels of PE disputes for Chinese contractors in project host countries. 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 and others),

and 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)).

In 2017, Shanghai Electric faced a PE challenge in relation to its project for the supply, installation and commissioning of power plant related equipment in India (*Shanghai Electric Group Co. Ltd. v. DCIT* [2017] 84 taxmann.com 44 (Del)). In that case, the authorities disregarded the separation of the (offshore) supply and (onshore) service contracts and taxed the combined profits from the two 'linked' contracts as being from a supervisory PE in India. This was done without regard to the facts of whether the activities were undertaken within or outside India.

Haier, Huawei and Dongfang Electric have similarly all been engaged in high profile Indian tax disputes involving PEs in India. These cases are just a sample of those arising for Chinese enterprises in India. With Chinese investments covering a range of more than 60 countries along the BRI, tax from a multitude of national tax authorities is becoming a key challenge for Chinese outbound companies to manage.

Overseas PE tax impositions may not always result in a net tax leakage for Chinese enterprises where the PE countries apply the same (or a lower) CIT rate as China. This is because a foreign tax credit should generally be available for the foreign corporate income taxes, paid by the Chinese contractor, when they compute their China CIT on the



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project profits. However, there can be issues in obtaining the credit due to differences, between the host country and China, in the timing of tax impositions e.g. due to timing differences for project profit accounting recognition. Furthermore, penalties and interest charged by the overseas tax authorities may not be creditable in China. We consider that PE related disputes will certainly remain a concern for Chinese contractors undertaking projects in higher taxed jurisdictions (e.g. India), and companies will need to pay close attention.

Double taxation on financing and equity returns

Chinese companies are providing significant funding to BRI projects, most commonly in the form of debt financing or equity investment. The overseas tax treatment of the returns earned by Chinese persons from these loans/investments can differ from country to country. A full or partial tax exemption may be applied to interest, dividends and gains from the disposal of the loans/investments, or the source country may impose tax on a withholding basis that must be deducted by the payer. These differing tax positions can significantly alter the after-tax returns and Chinese companies should consider this when evaluating the economics of such transactions.

Source country withholding tax (WHT) on interest, dividends and gains can potentially be reduced under an applicable DTA – China has DTAs with the vast majority of the

BRI countries. However, there is considerable divergence in the scope, conditions and benefits under China's various DTAs, which merit close review. It is also noteworthy that variable and burdensome local administrative practices for granting DTA relief can potentially create cash flow issues. In this regard a key consideration is whether the local tax authorities grant DTA relief up-front, or by way of a subsequent WHT refund application. The latter can be highly problematic in practice.

How the Chinese tax authorities are supporting Chinese BRI investors

The State Administration of Taxation (SAT) recently announced various measures to support Chinese enterprises participating in BRI investments and projects. In particular, per SAT Circular 42 [2017], the SAT is committed to:

- Assisting Chinese enterprises to negotiate with overseas tax authorities. This is with the aim of safeguarding and protecting the legal rights and interests of Chinese enterprises investing overseas (e.g. mutual agreement procedure (MAP) negotiations to resolve disputes);
- Improving the China domestic tax law and regulations relevant to Chinese enterprise overseas investments and operations. This is with a view to eliminating double taxation under CIT (with consideration being given to a participation exemption), improving and simplifying the VAT export refund/exemption rules and procedures, and



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Cloris has built up a broad range of industry experience across a number of sectors, including automotive, manufacturing, real estate, technology media and telecommunications (TMT), logistics & transportation, mining, and infrastructure.

streamlining the process for issuing China tax residency certificates;

- Publishing studies on the tax regimes of the BRI countries for Chinese enterprise reference; and
- Strengthening cooperation with the overseas tax authorities in the BRI countries.

The SAT encourages Chinese companies to study the tax practices of intended project host countries, in order to understand the tax compliance obligations in such countries and the impact of tax on operations and costs. To this end, the SAT has already published investment guides for 59 of the BRI countries and the SAT expects to release similar guides for the remaining countries by the end of 2017. The SAT also released a 245-page ‘Go Global’ Taxation Guide in October 2017 to help companies mitigate potential overseas tax risks. The guide covers the following four areas:

- Overview of Chinese tax policies applicable to Chinese outbound companies;
- Overview of China’s network of DTAs and an explanation of common provisions within China’s DTAs applicable to Chinese outbound companies;
- Overview of the China tax-related registration and reporting obligations for Chinese outbound companies in relation to their overseas investments/projects; and
- Overview of the key supporting services offered by the SAT regarding Chinese outbound companies in relation to their overseas investments/projects.

At the same time, the SAT has recommended that Chinese outbound companies should seek assistance from tax advisers to ensure that they are properly advised in respect of their overseas investment structures and business operating models.

The SAT has provided, and continues to provide, assistance to Chinese companies encountering tax issues abroad. In line with the SAT’s efforts to raise awareness of the availability of such support, SAT-resolved MAP cases have been reported on government online platforms with increasing frequency throughout 2016 and 2017. However, the details tend to be somewhat limited, being whatever the tax authorities are willing to disclose. For example:

- In a case publicised in August 2016 on the Beijing State Taxation Bureau (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). It was reported that the foreign tax authority focused on the DTA provision that indicated that loans guaranteed by a foreign government could benefit from a 0% WHT rate on interest and disputed that the terms of the subject loan did not meet such requirements. The Chinese enterprise’s position, supported by the SAT in the MAP discussions, was that 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.
- In a case publicised in May 2017 on the Beijing STB website, a leading Chinese glass manufacturer invested CNY 1.17 billion (\$176 million) in the construction of two glass production lines in Malaysia. These were expected to generate an average annual profit of approximately CNY 150 million. However, it was reported the company encountered difficulties when the local tax authorities imposed WHT on its outbound interest payments from Malaysia to China, contrary to the intended position under the China-Malaysia DTA. The company sought assistance from the SAT to negotiate with the Malaysian tax authorities. As a result of agreement being reached, a WHT saving of CNY 34 million was achieved. As a follow up to the case, an inter-governmental exchange of notes in relation to the China-Malaysia DTA clarified the position that wholly state-owned institutions are eligible for an interest WHT exemption under the China-Malaysia DTA.
- In a case publicised in May 2017 on the Beijing STB website, a Chinese shoe manufacturing group had set up a number of factories in Ethiopia. It was reported the Ethiopian tax authorities had looked to impose a 10% WHT on a dividend received by the Chinese company

from its Ethiopian operations. This was different from the 5% reduced rate prescribed under the China-Ethiopian DTA. Upon the group's application, the Dongguan tax authorities took action to assist the group to lodge an appeal letter with the Ministry of Finance of Ethiopia. Following several rounds of communication, the Ethiopian Ministry of Finance accepted the Chinese manufacturer's position and a tax saving of \$300,000 was secured.

With the continuing growth in outbound activity associated with the BRI, reliance by Chinese enterprises on advance pricing arrangements (APAs) and the MAP is expected to become ever greater. We also expect to see the

SAT more involved in helping Chinese outbound companies to manage their overseas tax issues.

More to come

Chinese enterprises are ever more exposed to changes in tax laws and regulations, and uncertainties inherent in tax systems, of the BRI countries in which they invest. Chinese companies must therefore critically evaluate the capability of their existing in-house tax resources and systems to ensure they can meet their overseas tax obligations. Where necessary, they should seek assistance from external advisers to supplement or address any gaps.

TP in China: all the data in the world

In 2017, China's State Administration of Taxation (SAT) completed its multi-year TP legislation overhaul by issuing Announcement 6 on special tax adjustments, investigations and MAP. With a distinct anti-avoidance flavour, Announcement 6 preludes the escalation and growing complexity of TP enforcement in China. **Cheng Chi, Xiaoyue Wang, Kelly Liao, Mimi Wang and Rafael Miraglia** discuss.

Background: China's new transfer pricing (TP) framework

Legislative framework

China's TP framework had, until 2016, remained largely unchanged since 2009. In 2009, the Implementation Measures of Special Tax Adjustments – Guoshuifa No. 2 (Circular 2) had consolidated special tax adjustment rules covering the gamut of TP and anti-avoidance rules: related-party filing, contemporaneous documentation, primary adjustments, audit activity, TP methods, advance pricing and cost sharing agreements, the controlled foreign corporation (CFC) regime, thin capitalisation, general anti-avoidance rules, corresponding adjustments and competent authority matters.

In the wake of the G20/OECD BEPS project, the SAT moved rapidly to overhaul the transfer pricing legislation. The first initiative was the public consultation draft of a circular on implementation measures for special tax adjustments (discussion draft) intended to replace Circular 2, issued in September, 2015. The discussion draft, however, was short-lived. Perceived as excessively aggressive and potentially detrimental to foreign investment, it was not finalised in its original form. Instead, the SAT adopted a piecemeal approach, issuing topical legislation on selected TP areas.

The first pillar of the TP revamp was the Announcement on the Enhancement of the Reporting of Related Party Transactions and Administration of Contemporaneous Documentation (Announcement 42), issued in July 2016. Announcement 42 laid down stringent requirements for TP documentation compliance, including the three-tiered documentation approach advocated by the new post-BEPS version of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TP Guidelines), and set out a multitude of new TP disclosure forms.

Subsequently, the SAT released the Announcement on the Enhancement of Administration of Advance Pricing Arrangements (Announcement 64) in October 2016. With a view to reducing the advance pricing agreement (APA) logjam, Announcement 64 introduced a revised, front-loaded procedure (with examination and evaluation processes being conducted before the formal application) and included a priority list for acceptance of applications and an information exchange clause, in line with BEPS Action 5.

Announcements 42 and 64 were covered in detail by the TP chapter of the 2016 China Looking Ahead, *China transfer pricing – first mover on BEPS*.



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The last chapter of the TP overhaul was the Announcement on Special Tax Investigations, Adjustments and Mutual Agreement Procedures (Announcement 6), released in March, 2017. Announcement 6 completed the BEPS-inspired TP framework that is expected to steer administration, policy and controversy for the years to come.

Announcement 6 on Special Tax Adjustments, Investigations and Mutual Agreement Procedures (MAPs)

Announcement 6 has a distinct anti-avoidance flavour. It is the third and most comprehensive in the series of announcements that make up China's post-BEPS TP framework. It regulates the tax audit process, special tax adjustments, self-adjustments and outbound payments from China, and writes into formal legislation some of the existing administrative practices adopted in Chinese TP audits. In addition, it replaces the guidance on many of the substantive issues related to TP: TP methods and comparability, TP adjustments, MAP and penalties applicable to TP adjustments.

Yet, perhaps the most far-reaching provisions within Announcement 6 refer to intragroup services, intangibles and substance at the level of overseas affiliates. Regarding intangibles, Announcement 6 endorses the OECD's distinction between the legal and economic ownership of intangible assets and emphasises that benefits derived from intangible assets are to be allocated based on economic substance. Building on the OECD's development, enhancement, maintenance, protection and exploitation (DEMPE) concept, which signals the functions that are relevant for the attribution of economic ownership and entitlement to intangible related returns, Announcement 6 puts forward the concept of DEMPEP – the additional 'P' standing for 'promotion'. This highlights the SAT focus on the role of intangibles throughout the value-chain and the importance of local marketing activities in the value creation process. Also, importantly, Announcement 6 indicates that royalty rates should be adjusted when the value of the intellectual property (IP), or functions, assets and risks, have changed over time, or when DEMPEP functions are not properly reflected in the remuneration.

With respect to intragroup services, Announcement 6's bedrock principle is that outbound payments for non-beneficial or 'low-substance' activities will be subject to more rigorous scrutiny and may be disallowed under certain circumstances. Non-beneficial services include shareholder activities, duplicative services, those delivering incidental benefits and, broadly, irrelevant services. As expected, and consistent with the Chinese tax authorities' position that intra-group service transactions are high-risk transactions, Announcement 6 left out the safe-harbour provision for 'low value-adding' services advocated by the OECD. It is also worth noting that Announcement 6's definition and interpretation of 'shareholder activities' is arguably wider than the definition under the OECD guidance, which may give rise to further difficulties for MNEs looking to implement consistent service charge models across the world.

As it can be seen, China has adopted the BEPS project's recommendations with a local flavour, and the country is not alone in this respect. Although the intention of the BEPS project was to bring consensus to international taxation, the application of BEPS recommendations does differ from country to country. Additionally, a number of countries have introduced domestic anti-avoidance legislation that operates outside treaties. We are expecting more disputes going forward and having effective dispute resolution mechanisms is therefore paramount. The OECD has recommended a two-year limit for resolving MAP cases. Announcement 6, however, does not provide any indication on the time that the SAT would take to resolve MAP cases. Nonetheless, it is expected that the outcomes from BEPS Action 14 and peer review pressure will increase the MAP

effectiveness and reduce the inventory of unresolved cases after the two-year period.

New weaponry in the age of transparency: big data, desktop analytics and trends in TP administration

Country-by-country reporting (CbCR) is a ground-breaking outcome from the BEPS project. In the interests of greater transparency, the TP documentation standard set forth in the new version of the OECD TP Guidelines requires large MNEs to profile their deployment of resources, and allocation of revenues, profits, and tax payments, across the world. This report must typically be filed in the jurisdiction where the ultimate parent company of the group has tax residency.

With Announcement 42, China has introduced the obligation to prepare CbCR. Accordingly, an MNE with its ultimate parent company in China and consolidated revenues in excess of CNY 5.5 billion (\$828 million) in 2016 had to file the CbCR for the first time by May 31 2017. The short timeframe proved to be a concern for many Chinese MNEs and, in the absence of comprehensive guidance from the OECD or the SAT, a number of implementation issues emerged, of both practical and interpretative nature. Those ranged from, for example, disparities between centrally consolidated revenues and audited subsidiary financial data, to revenue recognition practices for joint ventures, to more practical issues such as mismatches between filing deadlines for taxes and accounting periods, and even the availability and stability of the IT platform developed for the electronic filing of CbCR.

China has taken preemptive steps in relation to tax-related data collection and analysis. Even in advance of CbCR exchanges, China has already attained a head-start in taxpayer monitoring through the use of desktop analytics to select audit targets and candidates for scrutiny. This administrative approach basically relies on three sources of information: (i) TP disclosure forms (Chinese taxpayers may need to submit as many as 22 disclosure forms on an annual basis); (ii) TP documentation; and (iii) industry-wide or sector-specific financial data.

Based on the relevant sources, the SAT is equipped to extrapolate and combine industry statistical data with taxpayer-specific screening for red-flag indicators of risk or pattern deviations. This risk-monitoring resource has been referred to as the China Tax Administration Information System (CTAIS).

In accordance with Announcement 6, the SAT will focus on nine target situations that will warrant greater scrutiny (audit targets):

- 1) Enterprises with a significant number of related-party transactions or relatively more types of related-party transactions;
- 2) Enterprises with continuous losses, low profitability or fluctuating profitability;



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Prior to joining KPMG, she had a distinguished career in international tax administration with the State Administration of Taxation (SAT), rising through the ranks to deputy director general of the international tax division. In various capacities, she represented China in international negotiations and inter-governmental cooperation on tax administration matters, led the drafting and promulgation of all major transfer pricing and anti-avoidance legislations to date, and developed a highly effective national structure for transfer pricing and anti-avoidance administration within the SAT.

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- 3) Enterprises with profit levels lower than those of other enterprises in the same industry;
 - 4) Enterprises whose profit levels do not match their functional and risk profiles or whose shared benefits do not match their allocated costs;
 - 5) Enterprises that engage in transactions with related parties in low tax countries (jurisdictions);
 - 6) Enterprises that fail to file their related-party transaction reporting forms or to prepare contemporaneous documentation;
 - 7) Enterprises whose related-party debt-to-equity ratio exceeds the standard ratio;
 - 8) Enterprises controlled by Chinese tax resident companies, or by Chinese tax resident companies together with Chinese nationals, which are established in a country (jurisdiction) where the effective tax rate is lower than 12.5%, and have failed to distribute profits or reduced distributable profits other than for reasonable operating needs; and
 - 9) Enterprises that engage in tax planning schemes or tax arrangements that lack reasonable business purposes.
- A few conclusions can be drawn from the target list.
- First, profitability will be a yardstick to assess compliance with the arm's-length principle. As in the pre-



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Kelly became specialised in transfer pricing in 2004. She has been actively assisting multinational enterprises in transfer pricing dispute resolution, value chain planning, rationalising transfer pricing policies, formulating cost recharging policies, applying for advance pricing arrangements and preparing transfer pricing documentation in China.

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Announcement 6 guidance, Chinese entities are expected to report consistent profits (especially limited-risk or single-function entities), in line with industry standards and their own functional profile. Announcement 6 clearly states that single-function enterprises, such as contract-manufacturers, should not report losses. Yet, companies reporting a sales revenue increase without a corresponding effect on profits are likely to be on the radar screen. This should sound especially alarming for companies that report a cost-based remuneration while undertaking material sales functions.

Second and foremost, there is abundant interest from the SAT regarding what happens on the other side of the transaction, i.e. outside China. The SAT has grown wary of TP models that readily assume that the Chinese operations are simpler *vis-à-vis* those of the foreign counterparties and should thus only generate a routine, 'benchmarkable' return.

Beyond TP audit requests and the use of information exchange mechanisms, the SAT has access to a wealth of information on Chinese entities' foreign counterparties. For example, both the annually-filed related party form

G112000 (due for the first time by May 31 2017) and the local file (due to be finalised one month thereafter) require Chinese taxpayers to disclose their foreign affiliates' effective tax rates (and not merely the headline rate), and senior management structure and activities. Adding to that, the new local file standard requires a value-chain analysis (VCA) with a significant level of detail on the value created by the various participants along the supply chain, including the foreign entities' financial statements.

While Circular 2 specifically targeted transactions with 'tax havens', Announcement 6 alludes broadly to 'low tax jurisdictions'. The reference was clearly expanded to target transactions with countries that, despite their relatively high headline rates, are known to grant taxpayers low concessionary rates through advance rulings or otherwise, in exchange for investment commitments.

China's new TP framework has already had a measurable impact on the business environment. The next section sheds some light on the hot issues and trends in TP enforcement throughout the past year.

Moving the needle: growing complexity of TP enforcement

Leveraging its new technology resources and the critical mass of information now available, the SAT has been boldly stepping up TP enforcement by selectively focusing on specific issues and industries (i.e. 'campaign approach') or more material cases. This new audit strategy can be illustrated by the following fact: according to SAT statistics, while the number of TP assessments grew modestly in recent years, from 208 in 2011 to 254 in 2016, the average amount of adjustments grew by more than 300% in the same period, i.e. from CNY 11.8 million per each settled case in 2011 to just over CNY 37 million in 2016.

Through the last year, the audit focus on service fees and royalty payments to low-tax jurisdictions and/or low-substance entities, which began in 2014, has ramped up and represented the most noticeable TP enforcement trend in the past year. Royalty fee structures not commensurate with benefits were also under fire. As widely publicised, two of the largest assessments ever issued by the SAT were made in the past year and involved Chinese entities held through low-tax Singaporean principals.

Profitability

The large mass of information routinely collected through compliance obligations is helping the SAT to continue building a data warehouse of comparable companies. This will help the tax authorities to spot sharp deviations from profit standards and obvious outliers as preferred candidates for scrutiny.

In an investigation concluded by the Ningbo Tax Bureau in October 2015, tax officials reportedly argued that in spite

of a significant growth in sales, a Chinese joint-venture in the consumer electronics industry had consistently reported low profits, while 99.72% of sales were made to a related party. Tax officials asserted that the company's 1.72% operating profit margin was significantly lower than the average 5.89% reported among the electronic components manufacturers in Ningbo, and issued an assessment of approximately CNY 50 million, including interest.

It is worth mentioning that Announcement 6 reserves the tax authorities' right to rely on secret comparables data, such as the taxpayer's peer group financial performance, although public data should be prioritised when possible. In two subsequent audit investigations involving a single taxpayer, a manufacturing enterprise, the Beijing Second Tax Bureau reportedly relied on publicly available data and conducted interviews with manufacturing entities in the same industry to assess the adequate level of profits enjoyed by peers operating in similar circumstances. The two investigations lasted for more than six years and resulted in a tax claim of over CNY 800 million.

Service fees

Payments for intra-group services to low-tax jurisdictions and/or low-substance entities are definitely in the crosshairs of the Chinese tax authorities.

In a recent assessment issued by the Shenzhen Tax Bureau in 2017 and reported by China Tax News in June 2017, a large amount in consulting fees paid by a Chinese entity for financial advisory services related to an investment in China was disallowed. The payment was treated as non-deductible in light of the fact that the low-substance, low-tax overseas service provider was considered not to have adequate means and assets to render services of that particular nature, and the Chinese taxpayer already had an experienced in-house project investment team capable of carrying out the same work.

In an earlier audit case from 2015, the Xiamen Tax Bureau reportedly concluded that a disproportionate amount of global service fees had been charged by a parent company in a low-tax jurisdiction to two Chinese entities. The fees were based on a particular allocation key (i.e. sales), while different allocation keys had been used for affiliates in other jurisdictions. Furthermore, given that the Chinese entities were not entitled to ownership of any resulting intangible assets, certain payments for IT services were re-characterised as royalty payments, subject to applicable withholding taxes. An additional assessment in excess of CNY 30 million was ultimately issued.

A different type of challenge arose in an audit by the Zhejiang Tax Bureau: it was reported that from 2004 to 2014, the taxpayer had paid technical services fees totalling CNY 57.99 million to its parent company, calculated as 4% of sales revenue, in addition to trademark royalties paid



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

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between 2011 and 2014. In addition to challenging the beneficial nature of the services, the tax bureau also challenged the reasonableness of a service fee expressed as a percentage of sales. Ultimately, the taxpayer made a supplementary payment for the corporate income tax and relevant interest.

Royalty payments

The issue of royalty payments for use of intangible property also remains a conspicuous focus point in China.

The SAT has long taken the stance that if a Chinese manufacturer was charged a royalty fee based on a fixed percentage of sales in its early stage of operations, it would not be reasonable for the same royalty fee to be levied after a long period of time. The logic behind this claim is two-fold: first, the value generated by the IP in the manufacturing process tends to decrease over time. Second, through a process of trial and error, the Chinese manufacturer has enhanced the value of the IP over the years.



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Before joining KPMG China, Rafael worked between 2011 and 2015 as a tax associate with a global law firm in the Netherlands and, before that, as head of tax with a Brazilian law firm.

In an assessment issued by the Qingdao Tax Bureau in June 2016, it was reported that while the technology used by a Chinese company in the chemicals industry had become obsolete over time, the same level of royalty fee, based on a fixed percentage of sales, was being charged annually to the Chinese company by its overseas affiliate. The royalty fee was ultimately adjusted, leading to additional taxes of approximately CNY 15 million.

This case is not isolated. Moreover, it illustrates the SAT's focus on intangibles at both ends of the supply-chain. Not only will technology and process-related IP be more scrutinised in light of the value generated, but there is also a greater focus on marketing intangibles created by 'promotion' activities in China (the final 'P' in DEMPEP).

The importance of the promotion factor in China is not to be overlooked. As the country transitions from a production powerhouse to a consumption-driven and diversified economy, the SAT is expected to increasingly impose adjustments that reflect the contribution of the burgeoning Chinese consumer market to multinationals' profits.

Reassurance in times of uncertainty: growing interest in proactive controversy resolution and China's APA programme

Over the past few years, many multinationals around the globe have substantially increased their tax reserves, largely due to TP positions. A disproportionate amount in tax reserves ultimately impacts the quality of earnings, as they become harder to forecast. Companies have thus been increasingly relying on APAs as an instrument to reduce uncertainties with material transactions and positions.

Particularly in China, given the continuing changes in the TP landscape, the overwhelming mass of sensitive information available to tax authorities, and the envisioned escalation in challenges and disputes, taxpayer interest in proactive negotiations through APA procedures is expected to soar.

While the SAT is well aware of this trend and has been trying to mend the structural hurdles that have historically limited access to the APA programme, the volume of cases is still very modest, especially when compared to other large economies.

According to the China Advance Pricing Arrangement Annual Report (2015), between 2005 and 2015 the SAT concluded a total of 125 APAs, of which 76 were unilateral and 49 bilateral. Of the 49 bilateral APAs, 34 were with Asian countries (predominantly Japan and Korea), nine with European countries and six with North-American countries. In 2013, 2014 and 2015, the Chinese tax authorities concluded, respectively, 19 APAs (11 unilateral and eight bilateral), nine APAs (three unilateral and six bilateral) and 12 APAs (six unilateral and six bilateral). Although the vast majority of APAs still involve manufacturing operations, there is an identifiable trend of further diversification as the Chinese economy undergoes structural changes.

The main reason for the modest inventory of completed cases and the significant logjam is the SAT's scarcity of resources, aggravated by China's commitment of senior personnel to BEPS meetings in the period of 2013 to 2015. During the last year, the SAT continued to invest in capacity building. Consistent with the BEPS Action 14 proposition on improving dispute resolution effectiveness and with the increase in TP audits and competent authority procedures post-BEPS, the SAT hired 16 new resources in 2016 and 26 more are expected in the coming years. This will result in a dedicated team of approximately 50 resources at the SAT headquarters and approximately 500 inspectors involved in anti-avoidance across the country. In July 2016, the SAT set up a new division (Unit 3), which will also support Units 1 and 2, primarily on APA, MAP and national joint-audits (there is a notable overlap with the 1,000 enterprises initiative launched by the SAT).

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What lies ahead: paving the way to operating effectiveness and value chain equilibrium

Transfer pricing planning and optimisation opportunities are still abundant, although multinationals will have to grapple with substance issues at the level of the principal, shared-service centres (SSC), IP holding or central finance jurisdictions.

BEPS and the ensuing changes in global taxation are triggering important changes within multinationals' tax departments: tax is being elevated from a support function to a strategic business partner. In order to deliver financial performance and shareholder value in a post-BEPS environment, enterprises will need to align operating models, tax structures and business goals. As a result, tax departments will need to think proactively and strategically, and operate hand in hand with the business, extending their influence beyond compliance. The days of simply 'finding the pains' seem to be numbered.

The reality in China is no different. Increased transparency will push multinationals to seek greater equilibrium between TP models and value generation – the new TP framework (especially Announcement 6) has affirmed this position. In addition to the five commonly accepted TP methods specifically discussed in the OECD guidelines, Announcement 6 has

formally written into regulation that other methods, which adhere to the principle that profits are taxed where economic activity takes place and value is created, are acceptable transfer pricing methods, alongside valuation methods. The Chinese tax authorities have publicly cited difficulties in applying the arm's-length principle in practice and their willingness to consider other methods that adhere to the principle that profits are taxed where value is created. Whilst the controversial value chain apportionment method set out in the 2015 special tax adjustments discussion draft did not make its way into Announcement 6, Announcement 6 does leave room for the Chinese tax authorities to consider what some may consider to be non-conventional TP methods.

Going forward, enterprises operating in and out of China should revisit their operating and TP models and develop a risk management approach that addresses (i) mismatches between management accounts, tax accounts and group consolidated financial statements, (ii) TP models that allocate high profits to overseas affiliates with limited economic substance, particularly when the actual value-creation activities are wholly or partly performed in China, and (iii) significant outbound payments such as service charges, royalty or interest payments.

Chasing deals: tax trying to keep pace with business in China

John Gu, Yvette Chan, Chris Mak, and Sam Fan explore the M&A tax challenges arising in hot sectors like TMT and healthcare, and for take-private transactions, establishing how investors can best get prepared. They note how, given the pace of developments and tax uncertainties, there is a need for the China tax authorities to provide greater clarity. More than ever, appropriate tax planning is crucial for M&A transactions.

The Chinese mergers and acquisition (M&A) market saw a very active year in 2016. This was especially true of China outbound M&A, which accounted for \$220 billion of deals. Chinese buyers were the number one buyer of global assets by value in 2016. However, since the introduction of stricter policies on outbound investment and tightened capital remittance controls in late 2016, outbound M&A activity has slowed down significantly. Statistics show that the value of outbound M&A deals in Q1 2017 was \$12.5 billion, which is 85% lower than that in Q1 2016 (\$82 billion). As a result, in 2017, the gap between the values of inbound and outbound transactions has been closing. According to Thomson Reuters, as of February 2017, inbound M&A deals in China reached \$7.1 billion, which is double the amount in the same period in 2016. On the other hand, the outbound M&A deals in the same period in 2017 have decreased by 40% to \$8.4 billion.

In recent years, there has been considerable M&A activity, both by domestic and international investors, in hot sectors such as telecommunications, media and technology (TMT) and healthcare (including hospitals). Given China's fast developing and uncertain tax landscape, tax due diligence (TDD) and tax planning strategy are crucial to managing tax risks in China M&A transactions. In this chapter, we will explore some of the common TDD issues faced by investors in these hot sectors, as well as those faced in take-private transactions. We will also discuss the practical approaches investors may take to deal with potential challenges in an M&A transaction.

In Chinese M&A transactions, it is not uncommon to see internal restructuring being undertaken by a seller or buyer pre- or post-M&A. In this regard there is a particular need to deal with Announcement 7, and we focus below on the practical difficulties in qualifying for the Announcement 7 group restructuring 'safe harbour'. Furthermore, we look at the different investment structures adopted by investors to mitigate the risk of tax exposures impacting on investment returns.

The China State Administration of Taxation (SAT) also recently issued the long awaited Announcement 37 on 'Issues Relating to Withholding at Source of Income Tax of Non-resident Enterprises', which replaces both SAT Circular 3 [2009] and SAT Circular 698 [2009] effective from December 1 2017. While Announcement 37 is welcomed by industry and provides clarity on certain issues, it also leaves certain areas of uncertainty. In this chapter, we look to highlight some of these key issues for M&A transactions.

Common China tax due diligence issues in hot sectors Telecommunication, media and technology (TMT)

Since 2013, we have observed a remarkable growth in M&A activity in the TMT sector. Both domestic and overseas investors are keen to participate in the explosive growth in this market. The deal size varies significantly, depending on the business and lifecycle stage of the target company. Among the target companies in the TMT sector, the hottest type for the past few years has been online to offline (O2O) companies. Most of the investors in this sector are private equity (PE) and venture capital (VC) funds, which usually have a higher tolerance for historical risks attached to target companies, especially when the target companies are in their start-up stage.

The typical tax issues in the TMT sector include:

- Under-withholding of individual income tax (IIT) liabilities for agents (e.g. service providers) who are individuals, and who receive cash payment from the TMT companies;
- Under-reporting and under-payment of taxes, facilitated through maintaining multiple sets of accounts for tax avoidance purposes in the initial stage of business operations (this issue is, as a general matter, not unusual for small, privately owned companies in China); and
- Improper use of invoices and improper employee expense reimbursements.

In addition, there are foreign exchange issues. In particular, due to regulatory restrictions on foreign investment in the TMT industry, variable interest entity (VIE) structures are very popular. Under a typical VIE structure, it is difficult to transfer funds from an overseas company to the VIE. It is therefore not uncommon for the funds to be remitted to China via the founder's personal bank accounts, which may give rise to potential foreign exchange risk. In addition, there could be fictitious transactions between a VIE and wholly-foreign owned enterprises (WFOEs) to manage the cash flow between the entities.

Healthcare and hospital sector

From 2013 to 2014, medical and health system reform measures were issued to encourage the establishment of medical institutions funded by social (i.e. private) capital. Furthermore, in August 2014, the government issued a notice to allow foreign investors to take full ownership of hospitals in seven cities and provinces. Investors including MNEs, local listed companies and PE funds have consequently been seeking to enter into China's fast-growing private hospital sector through M&A.

Investors looking at targets in the private hospital sector should be aware of the following potential tax exposures:

- Sales of medicine and medical services by hospitals can avail of specific exemptions from VAT. However, some of the private hospitals, being considered as investment targets, may have been claiming VAT exemption for non-medical income (such as sales rebate income,

accommodation income, training income, etc.). Consequently there may have been VAT underpayment by the target hospitals;

- Not-for-profit hospitals can potentially enjoy a corporate income tax (CIT) exemption upon application and approval by the tax authority. However, defects in the conduct of application procedures may give rise to potential CIT exposures;
- Some private hospitals may have granted compensation to their part-time doctors, without properly withholding IIT for the doctors;
- Many entities in the private hospital sector are not-for-profit organisations. To the extent these entities were to be transformed into for-profit organisations before transaction closing, one-off payment of the exempted CIT of previous periods might be requested to be made (subject to negotiation with the tax authority). The additional tax cost should be taken into account in the valuation; and
- Potential tax exposures may arise from conversion of not-for-profit hospitals to for-profit hospitals, post transaction.

While investors may still proceed with the transactions in spite of the historical tax issues, the following actions may need to be taken in order to reduce the tax risks:

- Obtain a specific tax indemnity in the sale and purchase agreement (SPA);
- Request the target to rectify the incorrect tax practice before closing, negotiate with local tax authorities regarding the method to make up the underpaid taxes, and/or obtain an official tax clearance certificate from the local tax authority; or
- Work together with the target and advisers to improve the tax compliance level post transaction. For cases where the investor has an expected timeline to exit (e.g. initial public offering (IPO)), a clear step plan would be essential to the transaction.

Common tax issues in take-private transactions

Planning for a takeover transaction

In take-private transactions involving listed Chinese group companies, apart from regulatory and legal restrictions, there are several factors that investors need to take into consideration. Tax planning is crucial as any tax leakage directly affects the return on investment of shareholders and the availability of external acquisition finance for the M&A transaction. Investors should consider their investment objectives and holding intentions, such as the length of holding period, investment structure and the potential future exit strategies.

Dealing with target management/employee shares

A common feature of a take-private transaction is the involvement of target management post transaction. This

typically involves continuing participation of key management personnel. In order to align the interests between the shareholders and target management, it is common for the target to issue a portion of its shares/equities to key management personnel as an incentive. In this regard, investors should take into account the potential tax implications arising from the share-based incentive schemes (e.g. IIT that may be imposed on share remuneration received by the key management personnel).

Profit repatriation/acquisition debt funding

When planning an appropriate investment structure for a take-over transaction, a common tax consideration is the potential tax leakage on future repatriation of profits from the operating subsidiaries. It needs to be considered whether such income (dividend, interest, royalties, etc.) would be taxable locally, as this would impact on the return on investment for shareholders and/or affect the fund repayments on any acquisition loan financing.

For example, dividends paid by Chinese target companies are subject to a 10% withholding tax (WHT), unless a relevant double tax agreement (DTA) with a lower WHT rate applies. Dividends can only be paid after certain specified conditions are met, including that a minimum of 10% of the Chinese target company's after-tax profits are allocated to a statutory reserve annually, until a ceiling of 50% of its registered capital is reached. These restrictions on the timing and amount of cash dividends that a Chinese target company can repatriate back to the investors should be taken into account as this would affect the investment returns for the investors.

Historically, where a Chinese company distributes dividends to a non-resident enterprise, the Chinese enterprise would withhold and remit the CIT payable to the Chinese tax authorities when a resolution on the profit distribution has been passed. However, under the new Announcement 37, the withholding obligations on dividend distributions paid offshore arise on the actual dividend payment date. In practice, most companies pay tax when dividends are distributed. Therefore, Announcement 37 provides clarity and certainty to companies on when the tax would be imposed and provides better cash flow management as the tax payment is effectively deferred until actual dividend payment date.

In addition, to some extent, availability of external acquisition finance for a takeover transaction is affected by the estimated cash flow available to debt providers. If tax leakage from target companies is reduced through tax planning, the cash flow available to potential debt providers should be greater, which will enable investors to obtain a larger loan and take full advantage of debt financing. Therefore, in a leveraged buyout, an understanding of cash traps and historical tax compliance status is paramount to understand the quantum of available cash to fulfil the target's debts and hence should be one of the focus points of the TDD procedures.



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Exit strategy

For PE funds or other short term investors, an exit strategy is central in tax planning. The planning should ensure that the acquisition structure provides adequate flexibility and efficiency for future exit. Exit may be achieved via IPO or a trade sale, and it is common to model the expected tax consequences and costs arising from the future exit.

Maximising returns requires consideration of:

- Exit level: understand how and at what level the investors will look to exit (e.g. through an IPO or a future sale). A trade sale is more commonly used as an exit option as it allows planning to sustain maximum investment cost base at the level of acquisition, which will minimise the seller's tax liabilities on exit. A common pitfall in take-private or other M&A transactions is where a mismatch occurs between the amount of capital contributed by investors (e.g. at the acquisition company level or target company level) and the deductible cost base at the level at which investors intend to exit (e.g. at the onshore operating company level). The tax exposures can be mitigated either via tax planning or by modelling such future tax costs into the acquisition price.
- Potential buyer: it is important to understand the profile of the buyer (i.e. onshore or offshore buyer) as this may be relevant to regulatory restrictions, such as restrictions on foreign ownership in certain industries. Managing these hurdles may require a group restructuring in order to facilitate completion of the acquisition. The investment structure adopted post-transaction should therefore be flexible enough to cater to future



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buyers. To the extent that a restructuring of the target group is required to facilitate future exit plans, the restructuring costs should be considered and factored into the valuation model at the time of acquisition. Further tax considerations for offshore restructuring are discussed below.

- Exit planning: offshore and onshore level transactions are subject to different tax implications in China. Specifically, capital gains derived by Chinese companies are subject to 25% CIT and those derived by foreign sellers are subject to 10% WHT (unless exempted under a DTA). As noted below, there is a growing trend towards conducting exits onshore.

In summary, for M&A transactions, and specifically for take-private transactions, tax is a key consideration. Investors should clearly identify their investment and holding intentions to facilitate effective tax planning. This will contribute to maximising investor returns and improve the availability of external debt financing.

Recent SPA tax considerations – are you protected?

Tax filing/reporting obligations

Sale and purchase agreement (SPA) tax protection clauses are necessary to shield investors from the potential tax exposures identified during the TDD procedures, such as the examples above for TMT, the health sector and take-private acquisitions. Another common negotiation point in Chinese M&A transactions is the responsibility for tax payment and withholding. The relevant tax considerations depend on whether the seller is a corporate or an individual, and whether the seller, buyer and target companies are resident or non-resident. Tax payment and withholding issues have become increasingly complicated in recent years following the 2015 release of SAT Announcement 7. The notice stipulates that the buyer has a withholding obligation in relation to capital gains tax arising in an offshore M&A transaction. In consequence, the buyer has a perceived vested interest in flexible SPA provisions to ensure that the seller bears the cost of a crystallised capital gains tax liability and secure future tax cost base on exit. As such, core issues that should be clarified in the SPA include:

- Will the transaction be reported to the Chinese tax authorities, and if so, by whom and by when?
- Which party is to liaise and settle the tax payment with the Chinese tax authorities?
- What documentation will be provided to the buyer as evidence of tax reporting, filing and settlement?

A further issue is raised under the new Announcement 37. Under Announcement 7, where an indirect transfer of shares in a Chinese entity has been recharacterised as a direct share transfer, and WHT of 10% arises, the seller is required to pay the tax where the withholding agent fails to withhold it. No penalty interest would, however, be imposed, on top of the tax payable, so long as the taxes were settled before June 1 of the year following the year in which the transaction was completed. However, Announcement 37 states that the tax authorities will now prescribe a timeframe for sellers to pay tax where the withholding agent fails to do so, and that payment within this prescribed timeframe will be recognised by the Chinese tax authorities as being an 'on time settlement'. There is consequently a degree of uncertainty as to whether the late interest portion would be imposed on the seller if the tax was paid to the Chinese tax authorities within the prescribed timeframe (as set by the authorities under Announcement 37), but after the June due date, as stipulated under Announcement 7.

Further, it is noted that the Chinese tax authorities would typically request additional documents following the initial tax reporting, in order to determine whether or not the share transfer was taxable. Therefore, during the SPA negotiation process, aside from obtaining vendor SPA commitments to conduct the tax reporting and provide tax

settlement evidence, investors may need to go further. It may be worthwhile for the investors to consider obtaining most or all of the following documents (to the extent that these were not obtained during the TDD procedures). These would typically be requested by the Chinese tax authorities in an Announcement 7 review:

- Audited financial statements of the Chinese target company for the latest two to three years;
- Valuation and documentation in support of the transfer consideration;
- The business licence and certificate of incorporation of the various parties, including the seller, transferee and Chinese target company; and
- Evidence of any overseas income tax paid by the seller in respect of the share transfer.

The investor should also be aware of the ambiguity that exists concerning the appropriate local tax bureau with which to file the Announcement 7 report. This could impact on whether a document could be obtained from the tax bureau to confirm the successful filing.

Case study

In a recent Announcement 7 practical case involving an indirect transfer of a Chinese entity located in a Tier 3 city in Zhejiang province (Tier 3 city) to a Chinese buyer based in a Tier 1 city (Tier 1 city). The intention of the Chinese buyer was to make an Announcement 7 filing with the tax authorities in the Tier 3 city. However, the tax authorities in the Tier 3 city refused to accept the Announcement 7 filing, as they considered that the Chinese buyer had the obligation to withhold and remit the 10% WHT to its in-charge tax authorities in the Tier 1 city. After negotiating with the local tax authorities in the Tier 3 city, the Tier 3 city tax authorities ultimately agreed to accept the Announcement 7 filing but refused to issue any acknowledgement receipt to confirm their acceptance of the filing documents. The requirement of the authorities to issue such a receipt is provided for under a supplemental circular to Announcement 7, and is commonly required by buyers to be presented to them as evidence of the Announcement 7 reporting obligation being fulfilled. Ultimately, as an alternative to requiring the formal acknowledgement receipt issued by the tax authorities, the buyer finally accepted a written letter issued by the seller's third party service provider confirming that the Announcement 7 filing had indeed been done. Such issues should be considered when negotiating and drafting the SPA.

Announcement 37 now states that, if the withholding agent does not withhold tax for and on behalf of the seller, then the seller has the obligation to pay tax in the location where the Chinese company being transferred is located (in this example, the Announcement 7 filing would therefore be made to the local tax authorities in the Tier 3 city).



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Escrow arrangements

Apart from incorporating tax protection clauses in the SPA, escrow arrangements are commonly adopted for offshore transfers. In some cases, such escrow arrangements are designed to protect the buyer from certain historical tax exposures of the target. The buyer and seller will design a release schedule for the escrow to reflect these exposures. In light of the terms of the Chinese tax statute of limitations, and of local tax audit practices, it is generally reasonable to agree a gradual release of an escrow over a three to five year period.

Escrow arrangements may also be adopted to withhold the seller's potential transaction tax costs (e.g. income tax), especially for indirect transfers of Chinese companies. This can facilitate relevant tax reporting (whether buyer or seller) or tax filing/payment, in line with Announcement 7. This is a common arrangement as, while the tax reporting for Announcement 7 is due within 30 days of signing the SPA, in practice, Chinese tax authorities have no fixed timeframe to revert to the taxpayer with a tax basis position. To accommodate such uncertainty, the escrow period would also need to be negotiated.

Under Announcement 7, if the withholding agent does not withhold the payment for and on behalf of the seller, then there is a risk that the Chinese tax authorities would impose penalties on the buyer (although the tax payable should still be recovered from the offshore seller). However, Announcement 37 states that the Chinese tax authorities could now impose the tax payable on the buyer. Therefore, it becomes even more imperative for the buyer to negotiate



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principles of Announcement 7, where there is an indirect transfer of equity in a Chinese resident enterprise by a non-resident enterprise, and where the arrangement was undertaken without 'reasonable business purposes' with the aim to avoid CIT in China, the arrangement would be recharacterised as a direct transfer of equity in the Chinese resident enterprise. Under the China general anti-avoidance rule (GAAR), this recharacterisation results in the disposal gain being subject to tax in China.

However, there are safe harbour provisions under Announcement 7 that exempt certain indirect offshore transfers from tax in China. In particular, in order for an internal group restructuring to qualify for the safe harbour, it must satisfy all of the following conditions:

- A minimum 80% (100% for China land-rich companies) direct or indirect common shareholding relationship between the transferor and the transferee;
- The CIT on subsequent indirect transfers will not be reduced post-restructuring, when compared to the original structure; and
- The consideration is paid entirely in the form of equity.

In practice, it is difficult to satisfy all of the above conditions under Announcement 7. This is particularly true of the equity consideration requirement, since it may not be commercially realistic for many group restructurings. Nevertheless, even if the conditions cannot be satisfied, this does not mean the restructuring will automatically be subject to China tax. Instead, the 'reasonable business purpose' test would need to be further analysed to determine whether the indirect equity transfer, resulting from the group restructuring, was taxable under Announcement 7 (i.e. whether it was tax-motivated).

and agree with the seller on their respective reporting responsibilities and seek necessary protections and escrow from the seller during the SPA negotiation process.

Earn-out arrangements

Earn-out arrangements also have been commonly used in recent years. These can incentivise the seller's management and/or employees to remain in the acquired company. They are also useful given that very often (especially with privately owned targets) the level of historical tax compliance might be low, and it is generally unlikely that sellers will voluntarily settle tax payments with the Chinese tax authorities pre-closing. For such cases, an earn-out (and escrow) arrangement can ensure that the sellers retain an economic interest in the target, within the tax statute of limitations period.

Difficulties in qualifying for group restructuring relief under Announcement 7

Another contentious issue under Announcement 7 is qualifying for group restructuring relief. Under the general

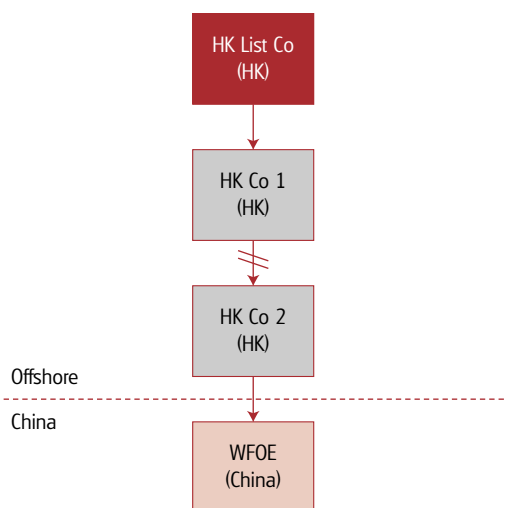
Indirect transfer case study

For instance, in a recent practical case, a Hong Kong (HK) listed group underwent an internal group restructuring, which resulted in an indirect transfer of a China WFOE located in a Tier 1 city. At the outset, the transferor (HK Co 1) indirectly held a China WFOE, via another HK company (HK Co 2; the transferred entity). HK Co 1 transferred HK Co 2 to its ultimate partner company, HK List Co (the transferee), meaning that the transaction in question was a subsidiary-to-ultimate-parent transfer. All of the relevant HK companies were HK incorporated and tax resident companies. The transfer would, prima facie, fall within the scope of the Announcement 7 indirect transfer rules.

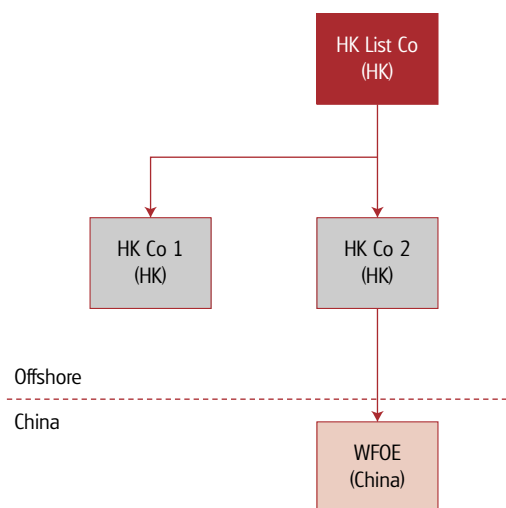
While the first two conditions of the safe harbour provisions were satisfied, it was not commercially feasible to satisfy the third condition, as the consideration for the share transfer could not be paid in the form of equity. This was because the primary objective for transferring the shares in HK Co 2 was to achieve the outcome that HK Co 1 would become a standalone entity (without any direct subsidiaries that were

Diagram 1

Pre-transaction structure



Post-transaction structure



Note: All shareholdings 100% unless specified otherwise

not relevant to its operations) in order for the HK listed group to meet and manage its various regulatory obligations. Therefore, it would not make commercial sense to have HK Co 1 holding the shares of HK List Co, its parent company, nor to substitute the restructuring with a direct transfer of the equity interest in the China WFOE, as this would not achieve the commercial objective of the restructuring.

While the internal group restructuring did not meet all the conditions for tax relief, the restructuring was ultimately not subject to tax. The China tax authorities were satisfied that the share transfer had reasonable business purposes, particularly given there was no change to the ultimate shareholder and tax position, post-restructuring. The non-taxation of this restructuring case is not unique, as long as the internal group restructuring has a strong business case.

Deal structure trends in the China M&A market – more domestic deals

The recent trend is that more deals are being done in China. However, the transaction period is getting longer. This is because both buyers and sellers are looking at different structures to mitigate some of the potential tax risks noted above. The choice of transaction structure (e.g. onshore

deal versus offshore deal, share deal versus asset deal) needs to be carefully considered, as this affects the tax result and impacts the investment return.

Onshore acquisition vs. offshore acquisition

In order to decide whether to use an onshore or offshore acquisition vehicle, the following factors should be considered from a tax and cash return perspective:

- Future exit – where the future investment exit is expected to occur at the onshore level, an offshore acquisition could create issues. It could result in a mismatch in the tax basis, giving rise to additional tax leakage for the investors upon future exit. Furthermore, differences in applicable tax rates should be factored in. An offshore transferor is subject to 10% WHT (potentially reduced to 0% under an applicable DTA) whereas an onshore transferor will be subject to CIT at a higher rate (the statutory CIT rate is 25%).
- Cash-trap – Chinese companies must retain 10% of their annual after-tax profit as a statutory general reserve. They must add to this reserve each year until the accumulated amount of the reserve reaches a certain level of its registered capital. This means more layers of onshore companies will result in more cash being trapped in China.

- Re-investment in China – to the extent the investor intends to recycle and reinvest China profits in other Chinese investments, potential tax leakages should be considered. Unless a China holding company (CHC) is used, the reinvestment in China would typically be deemed as dividend repatriation and then a capital investment, resulting in WHT leakages for foreign investors. However, on July 28 2017, the State Council proposed to temporarily permit the deferral of WHT on dividends where the relevant amounts were reinvested in ‘encouraged’ projects. This may facilitate the use of offshore platforms to make investments in China going forward, though detailed implementation rules are yet to be clarified.

Asset vs. share deal – which option is right?

There are broadly two options for onshore China deals: asset deal and share deal. In recent years, more and more asset deals were used, especially for acquisitions of privately owned enterprises (POEs) in traditional industries. This was due to the investor’s pressing need for investment, and the relatively low tax compliance level among POEs in China, which speak against acquiring the entity itself with its legacy tax exposures.

When deciding on deal structures, the following tax factors should be considered:

- Non-inheritance of the target’s pre-existing contingent liabilities and tax exposures in an asset deal versus potential retention of use of tax losses and subsidies etc. in a share deal;
- While tax indemnification can be sought to protect the buyer from the potential tax exposures in a share deal, it may not be ideal. Enforcement could be difficult, especially where sellers are individuals; and
- Asset deals typically give rise to relatively higher tax costs (potentially double tax under certain structures) for the seller, although the buyer will be able to step up the tax cost base of the assets acquired.

In addition, under Announcement 37, for transfers that involve multiple instalment payments, the obligation to pay tax would not arise until all instalment payments were made. However, Announcement 37 does not provide a clear definition on what qualifies as multiple instalment payments. As such, the buyer should consider whether the instalment payment terms in an M&A transaction should be specified in the SPA.

Where are we heading?

Since 2016, China has tightened its policies on outbound foreign investment. These measures have aimed to curb capital outflows from diminishing foreign exchange reserves and devaluation of the Chinese Yuan. However, going forward, with the Belt and Road Initiative (BRI), we expect a significant long-term increase in M&A transactions by Chinese companies in BRI countries. For further detail, see the chapter, *A thousand miles begin with a single step: tax challenges under BRI*. Therefore, careful TDD and tax planning will play a key role for companies investing onshore and offshore.

Further, in order to boost investors’ confidence in investment in China, it is hoped that the Chinese tax authorities will provide more clarity for uncertain areas, like Announcement 7 safe harbours and tax calculation for indirect transfers of Chinese assets. Clarifications are also needed for the tax treatment of Chinese partnerships, in view of the growing trend for foreign investors looking to setting up their own Chinese investment platform.

While Announcement 37 is welcomed and addresses some of the previous uncertain tax issues surrounding Announcement 7, it does create uncertainty in other areas as highlighted. It is to be hoped that the Chinese tax authorities will provide further clarity on these areas in the near future.

The authors would like to thank Elaine Chong and Alison Chen for their contribution to this chapter.

Adding wings to a tiger: data in tax enforcement in China

New data and technology-driven, risk-oriented, tax administration and enforcement approaches by the Chinese tax authorities are compelling taxpayers to up their game.

Taxpayers are developing enhanced internal tax risk controls and IT, and engaging with the tax authorities in a collaborative manner.

Tracy Zhang, Wei Fang, Anthony Chau, Lilly Li, discuss the latest trends and changes.

The first part of this chapter provides a review of the recent advances in tax administration being made at governmental level in China. We then share our observations on improvements in tax management controls and practices at taxpayer level, made in response to enhanced tax enforcement by the tax authorities. We then conclude with a summary of expected future developments in the tax management environment in China.

Advances in tax administration at governmental level

The 2017 developments in China tax administration have continued the trends mapped out in the 2016 edition of *China Looking Ahead*, in the chapter, *China tax – big data and beyond*. Key developments can be summarised under the following three themes:

1. Risk management-driven tax administration;
2. Taking advantage of big data; and
3. Embracing technology.

We will elaborate on each of these three themes in turn below.

Risk management-driven tax administration

In order to improve the effectiveness of tax administration, the State Administration of Taxation (SAT) has been exploring and promoting the adoption of advanced tax risk management concepts and methodologies by provincial and local tax authorities. Circular Shuizongfa [2014] No. 105, SAT Opinion on Strengthening Tax Risk Management, set out key tax risk management tasks for tax authorities. These include tax enforcement goal setting, information collection, risk identification, risk ranking, risk resolution, as well as risk management process monitoring, assessment and feedback. The tax authorities have calibrated their risk management policies separately towards large enterprises, and the wider population of taxpayers, as further discussed below.

Risk management for large enterprises

Following Shuizongfa [2014] No. 105, a series of tax circulars were issued, including ‘Tax Risk Management Guidance for Large Enterprises’ issued in 2014, dealing with specific tax risk management policies for cross-border investment, related party transactions, and equity transfers, as key areas of tax enforcement concern with large enterprises.

The Chinese tax authorities have taken an approach whereby they select a sample of large enterprises for analysis (on a pilot basis) in order to better

understand the relevant industry, business, and tax risks. They then use this knowledge to determine how best to calibrate the tax risk management mechanisms at tax authority level, as well as to determine what improvements to internal tax risk management controls to demand on the taxpayer side.

For example, the SAT launched the thousand enterprises initiative (TEI) in July 2015. This programme covers about 1,000 representative large group enterprises from different industries. Under this initiative the SAT collects data from the TEI-covered group enterprises and their member entities (through local tax authorities) for tax risk analysis. Based on the analysis, the SAT has built risk analysis models with risk indicators for different industries. This drives improvements in overall tax administration efficiency by providing better support for taxpayers on proactive tax risk management, as well as by developing better approaches for tax officers to screen audit targets and risk areas. The most recent TEI developments include:

- SAT Announcement [2016] No. 67 on the filing of financial statements upon submission of tax returns for ‘TEI enterprises’ and their member entities, was published on October 26 2016 and took effect from December 1 2016. This requires TEI enterprises to file financial statement information with the tax authorities, both at the time of filing periodic tax returns during the year (i.e. quarterly), and with the filing of the annual tax return (i.e. filed each May following tax assessment year-end). Financial statements (to be supplied in electronic form) include balance sheets, income statements, statements of equity changes, and their disclosure notes, for every legal entity of the group in China.
- SAT Announcement [2017] No. 7 on the management measures for collection of information on the ‘Thousand Group Enterprises’, was published on March 6 2017 and took effect from May 1 2017. This requires TEI enterprises to report certain entity information to the tax authorities on an annual basis (i.e. each May), which will be maintained on a data platform. This includes, inter alia, details of the taxpayer’s responsible tax bureaux, operating locations, industries of activity, parent company, tax payments in prior years, revenue in prior years, and listed status.

Overall in 2016, it was reported that data collection had been completed for 95% of the TEI-covered enterprises; the SAT had completed an industry tree based on TEI data; information sharing mechanisms had been set up between the SAT and the Ministry of Finance (MOF) and the State-owned Assets Supervision and Administration Commission (SASAC); and a risk indicator system and risk analysis platform had been set up. Following on from this initial TEI data collection stage, the authorities are now leveraging their progress to drive tax risk analysis, risk alerts and resolution. As reported by China Tax News in its December 7

2016 article, ‘Tax Administration of Large Enterprises Marked Highlights in 2016’:

- Six batches of TEI enterprises have been subject to follow-up regarding identified tax risks, leading to an additional tax adjustment of CNY 20.19 billion (\$3 billion);
- Branch 5 of the Beijing State Tax Bureau has been assigned to support the SAT to work on the analysis of the TEI information. As a result, 1,356 reports have been put together, covering 11 tax categories, 2,880 risk points, and involving additional tax adjustments of approximately CNY 66 billion.

As noted in tax administration articles in previous editions of *China Looking Ahead*, the large enterprise division of the SAT set out a framework of large enterprise internal risk controls as guidance for large enterprises in 2011. In May 2016, the SAT outlined their success with these efforts at the annual global meeting of national tax commissioners in the context of the OECD Forum on Tax Administration.

Risk management for all taxpayers

On April 18 2017 SAT Announcement [2017] No. 10 (Announcement No. 10) was issued, instituting an optional tax service to taxpayers to assist them in identifying and correcting tax calculation errors, in advance of formally submitting corporate income tax (CIT) annual filing returns.

Announcement No. 10 clarifies the following:

“After taxpayers complete the online CIT annual filing return (Form A, 2014 edition), they can select the ‘risk alert’ function, and the data and information declared will automatically be subjected to an automated screening and analysis. A tax risk alert message will be sent to the taxpayers within 30 seconds. Taxpayers may subsequently decide to revise filing information, or proceed directly to the next step of formal tax declaration, as they prefer.

The tax risk alert may be sent to resident enterprise taxpayers whose taxes are calculated on the basis of their financial accounts and declared through an internet filing. This therefore excludes non-resident taxpayers, taxpayers whose taxes are collected on a deemed basis, or whose taxes are declared through paper filing.

The tax alert will draw the attention of taxpayers to potential issues with the tax calculation, observed correlations between the tax data and financial data, and other analytical results which might prompt the taxpayer to reconsider their original inputs. The information on which the analysis is based will be drawn from a variety of sources, including the taxpayer’s tax registration, historic tax filings, financial and accounting data, record filings, and third-party and industry data.”

Taking advantage of big data

China's tax authorities have been seeking to pool tax information from a multitude of sources so that they can take advantage of big data analytics to facilitate tax administration. Such efforts include: (1) pooling tax-related data from sources including the taxpayers themselves, financial institutions, other government agencies, and overseas tax authorities; and (2) performing big data analyses, including 'visualisation' techniques, which use business intelligence tools to make sense of massive information flows and data sets.

Pooling of big data

As mentioned in the 2016 edition of *China Looking Ahead*, in the chapter *China tax – big data and beyond*, the SAT is engaged in a whole series of initiatives that maximise tax data resources including (a) moving taxpayers in the direction of completely digitised dealings with the tax authorities, rendering tax data in a form susceptible to pooling and analysis, (b) pooling domestic data from across domestic tax authorities and other government agencies, and (c) international exchange of information (EOI) initiatives. Such initiatives have continued in 2017, with the following notable developments:

- Pooling tax data via the Golden Tax III System: The Golden Tax III System, China's new unified national tax authority IT system, provides for centralised collection of national tax data from all taxpayers registered with the thousands of individual tax bureaux at all levels of government across the country. This covers both local tax bureaux (LTBs) – responsible for local government taxes – as well as state tax bureaux (STBs) – responsible for central government taxes. The Golden Tax III System aggregates data from all taxpayer-authority interactions, including tax and incentive filings, tax payments, tax audits/enquiries, records of outbound payments from China, tax invoice issuance/certification, and information from reviews of taxpayer internal tax controls. This is taken together with web crawler/public website searches on taxpayers, industry profiling information used to assess tax risks, information obtained from overseas tax authorities, and from other domestic agencies, e.g. the State Administration of Foreign Exchange (SAFE), the Ministry of Commerce (MOFCOM), and the General Administration of Customs (GAC). Tax officials in different tax bureaux across China can tap into this system to see the prior interactions that taxpayers have had with tax and other governmental authorities.
- Pooling tax data from financial institutions: Looking ahead, Chinese financial intermediaries are anticipated to become one of the key sources of tax information, especially under the upcoming Tax Collection and Administration (TCA) Law. The draft TCA Law requires



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Chinese financial intermediaries to bulk report client account transactions, exceeding a certain minimum value, to the tax authorities together with the relevant clients' tax identification numbers (TINs) to facilitate data matching (e.g. cross-checking of individual income tax (IIT) filings) by the tax authorities, and risk 'red flagging'.

In addition, SAT Announcement [2017] No. 14 on Administrative Measures on Due Diligence Checks on Tax-related Information of Non-residents' Financial Accounts, was published on May 9 2017, and took effect on July 1 2017. This provides the detailed rules under which China is rolling out the OECD's common reporting standard (CRS) for the automatic exchange of tax information – for further details see the separate chapter, *A brave new world in tax transparency: CRS in China, Hong Kong and Taiwan*. Financial institutions with operations in China are required to register on the SAT CRS web platform by December 31 2017, and must then report to the SAT tax information on the accounts of non-residents held with their institutions (including tax ID, balance, and receipt of different income types) by May 31 every year (starting May 2018).

Exchanges of tax information between the SAT and other countries participating in the CRS, with which China has established bilateral exchange relationships through the CRS Multilateral Competent Authority Agreement, will commence in September 2018 (China has already nominated 47 of these countries). This will provide a steady



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stream of information to the SAT on the overseas income and assets of wealthy Chinese individuals and Chinese corporate entities to drive enforcement and support the planned revisions to the IIT Law and the TCA Law.

We would also note that the People's Bank of China (PBOC) on August 4 2017 issued a notice requiring non-financial institutions, which provide online payment services (referred to as 'third-party online payment service providers'), to operate through a centralised clearing house, starting from June 30 2018 (they will need to connect to this by October 2017). Third-party online payment service providers, such as Alipay (under the Alibaba Group, which runs China's main e-commerce platforms) and Tenpay (under the Tencent Group, which operates China's most popular social media and messaging platform, WeChat), maintain separate bilateral relationships with commercial banks to facilitate payments to or from users' bank accounts. As it stands, banks have no access to payment details, such as the names and locations of merchants paid using Alipay or Tenpay. The new clearing system will facilitate PBOC oversight and may also, in time, give the Chinese tax authorities readier access to taxpayer online transactional data – it remains to be seen if the final draft of the TCA Law provides for this.

- Pooling tax data from e-commerce platforms: E-commerce platforms will also be obliged, under the TCA Law, to provide information on online trader transactions. In parallel, the requirement, in MOF, GAC, SAT, Circular 18 [2016], for e-commerce platforms and couriers to supply business-to-consumer (B2C) import information directly to the customs authorities has already brought significant cross-border e-commerce information on stream. This

information can be accessed by the tax authorities through their various information pooling arrangements with the customs and other authorities.

- Centralised IT system for income and property information and trust register: The central government has also been moving, since May 2017, to establish a comprehensive national system for the centralised collection of information on personal income and property holdings. While the set-up of the new system has a number of policy justifications, from a tax perspective it is intended to provide an underpinning for the next wave of planned national tax reforms.

Complementing this is a move to increase official access to information on asset ownership through trust arrangements. From September 1 2017 China's Administrative Measures on Trust Registration, issued by the China Banking Regulatory Commission (CBRC), come into effect, requiring China trust companies to register trust products that they have issued, including details of the beneficial owners of such products. The CBRC and other government authorities are set to have access to these records – it remains to be seen how much access the tax authorities would have. There is a global trend towards establishing obligations for the registration of the beneficial ownership of trusts with public authorities, with the EU and OECD both developing relevant frameworks. While the proposals in some EU countries look to establish public registers of trust ownership, the Chinese trust register does not yet go this far.

Performing big data analyses

The Chinese tax authorities have been rapidly ramping up their use of big data analytics for tax risk assessment, audit targeting, and audit performance, fuelled by their increasingly linked up, and richer, data pools and inflows. Notable usages are as follows:

- Understanding taxpayer businesses and their industries: The Chinese tax authorities have been seeking to better understand the businesses of taxpayers, and their economic and industrial sector context. This is so that they can better assess whether the tax data they have to hand is indicating unusual tax outcomes, so meriting further investigation. Historically, in order to develop such an understanding, the authorities had to spend extensive time on taxpayer site visits, conducting management and staff interviews as well as desktop reviews of taxpayer documentation. In some cases they also sought to organise semi-formal seminars, with taxpayers and their representatives (e.g. Big 4 tax experts), to gain a better grounding in the business and its tax issues. Such efforts could be very time-consuming and could meet pushback by taxpayers irked by the level of perceived intrusion into their business.

Increasingly, however, the tax authorities' rich data pools on individual taxpayers and their industries (e.g. entity level sales, purchases, expenses, suppliers and customers, financial performance against local industry outcomes, tax payments as compared with competitors, etc.) enable them to construct 'portraits' of taxpayers. These insights can then drive the focus of tax review and audit work. Going forward, big data analytics can draw together an even broader range of data sources, into ever more complete and nuanced 'portraits', driving a better understanding of the taxpayer business, its industry and competitors, while limiting intrusion and disruption for taxpayers.

- **Risk identification:** Within the framework of the Chinese tax authorities, two functional divisions in particular have been investing significant effort in the better utilisation of tax data to identify tax risks – the tax assessment functional division and the large enterprise management functional division. Every STB and LTB at municipal level and above, will have separate tax assessment and large enterprise management functional divisions. Both of these divisions take key roles in analysing the internal tax risk of enterprises, and take corresponding tax service and management measures to ensure optimal tax compliance outcomes.

In a reorganisation of tax authority divisions, undertaken several years back, tax assessment divisions were set up with the specific role of identifying tax risks based on the analyses of tax data. This was done with a goal of bringing a more scientific approach to tax risk identification, as well as to bring greater objectivity and neutrality to the identification of tax audit targets. It had been identified that, in some cases, tax auditors could be guided by overly subjective judgement in their selection and pursuit of particular taxpayers, with overly penal/lenient audit outcomes resulting, depending on the taxpayer-auditor historical relationship. The role and methodology of the tax assessment division in risk assessment/audit targeting has brought greater objectivity and professionalism to the process. It has also been coupled with other measures, such as the 'two randomness' auditing approach to the broad base of taxpayers, which involves random selection of taxpayers for audit and random selection of audit teams to conduct the audit.

Tax assessment divisions have been developing and optimising a comprehensive set of tax assessment indicators, as powerful tools to use tax data to monitor for and identify tax risks. The indicators use national tax data, segmented by industry, to set a range of benchmark effective tax rates (ETRs) for industries for a certain year. The tax assessment divisions screen taxpayers to identify those with ETRs outside the benchmark range – potential 'at risk' taxpayers will be subject to further qualitative analy-



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Over the years, Anthony has advised multinational clients on their expansion plans, holding structures, operations, cross-border transactions, as well as on their restructuring matters from taxation and business regulatory perspectives. He has also assisted numerous clients to negotiate with the tax/customs authorities throughout China on their daily compliance and audit matters.

In view of his experience in the various China locations, Anthony has gathered extensive local knowledge and expertise in assisting multinational companies in establishing the relevant types of entities depending on their business objectives and needs. He has also successfully assisted such companies to obtain tax and local financial incentives for their investments.

Anthony also works on numerous tax due diligence projects for both inbound and outbound investors across numerous industries.

ses, and explanation requests will be sent to taxpayers. The taxpayer may be prompted to make a 'self-adjustment', i.e. for the taxpayer to reassess whether the original self-assessed tax was correct and adjust where found not to be the case (formal guidance on self-adjustments is set out in SAT Announcement [2014] No. 54 and later SAT Announcement [2017] No. 7). Where there appears to be strong indications that a tax error may have occurred, and particularly where the taxpayer is not willing to contemplate a 'self-adjustment', a tax audit case may be initiated.

The large enterprise management functional divisions within tax authorities play a key role, alongside tax assessment divisions, in identifying tax risks specifically at large enterprise taxpayers. A formalised approach to large enterprise management divisions goes back to 2008, with



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Lilly provides China-based corporate tax advisory and transfer pricing services to multinational and domestic enterprises. Her experience covers a wide range of industries, for example, consumer markets, automobile, electronics, property and infrastructure.

Lilly has extensive experience in dealing with tax disputes and tax policy lobbying. For example she and her team have successfully assisted 13 Asia Games sponsors in applying for business tax exemption with the State Administration of Taxation (SAT); also they have assisted a number of listed groups in lobbying the SAT for the tax ruling which allows China companies to deduct stock option expenses before corporate income tax (CIT).

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the establishment of the SAT large enterprise tax division, and 2011 with the release (with SAT Guoshuifa [2011] No. 71) of guidance for large enterprises on the operation of tax risk management systems. As mentioned above, Branch 5 of the Beijing State Tax Bureau, the large enterprise management functional branch, which was assigned to conduct the analyses on the TEI, identified 2,880 risk items in their analyses in 2016.

As pooled tax data from all taxpayers, across industries and across government agencies, are now all shared in digital format, tax authorities are able to make vast improvements in the spotting of tax risks.

- **Audit target screening:** Taxpayers identified, in the analyses outlined above, as exhibiting significant tax risks may potentially be selected for tax audit. Risk assessments are passed from tax assessment and/or large enterprise management divisions to the tax audit function for further

investigation. The specialisation and more structured collaboration of different functions within the tax authorities is greatly improving the efficiency of tax administration.

Embracing technology

In 2017, the Chinese tax authorities continued to make significant investments in technology, including high capacity IT systems and advanced software applications. This builds upon very significant past investment that has already placed China at the forefront in the sophistication of its tax administrative technology capabilities.

- **Data warehousing technology:** Investment in data warehousing supports the storage and analysis of massive pooled tax data sets. For example, the Golden Tax III System is segmented into seven types of database, including a legal entity database, an individual database, a tax invoice (fapiao) information database, a tax bureau database, an HR database, a tax risk management database, and a tax regulations database. The data collection and processing activities of these Golden Tax III System databases require the support of powerful data warehousing technology.
- **Golden Tax III System:** As mentioned above, since 2016 the Golden Tax III System has provided a powerful platform for pooling tax data from all levels of tax bureau, across China, covering both central government and local taxes. Its user interfaces facilitate both taxpayer and tax authority engagement and input, and drive standardisation of certain key data inputs, for example, by requiring taxpayers to input defined goods and service codes before a tax invoice can be issued and printed by the taxpayer. Feedback from both taxpayers and tax officials is continually harvested to fine tune the system.
- **Upgraded invoice system:** The upgraded system requires taxpayers to input goods or service codes so that the authorities obtain standardised data on what goods or services have been covered by the invoices. This facilitates the tax authorities being able to closely monitor invoice creation to detect fictitious invoices, ensuring the integrity of invoice information and the authenticity of filing data.
- **Electronic invoicing system:** In December 2015, China rolled out a nationwide transition to the use of electronic VAT general invoices. These are invoices provided to consumers for which no input VAT credit is being claimed. Following success with this step, the next stage is the rollout of electronic VAT special invoices – these are the tax invoices provided to taxpayers to enable them to claim VAT input credits, which are more tightly controlled. With a fully electronic invoicing system in place, taxpayers will be able to access, through their online accounts with the tax authorities, complete digital information on their

invoices on a real-time basis, facilitating management of VAT input credit claims, system data verification, and VAT payments. Electronic tax invoicing also dovetails with the transition of businesses to more integrated systems of book keeping and accounting, which in future will automatically compile bank, tax and other payment and invoicing information to produce business records with much reduced human input.

Tax management advances at taxpayer level

Along with the developments in tax administration at governmental level, there have been many notable tax management improvements at taxpayer level in China, including:

1. Increasing use of tax internal controls;
2. Use of tax technology to improve tax management;
3. Centralisation of tax functions using tax shared services centres; and
4. Tax management transition from in-house back office function, out to market.

We review these developments individually below.

Increasing use of tax internal controls

Increasingly larger enterprises in China, especially large multinational companies and state-owned group companies, have started to build up tax internal controls by themselves or by engaging external advisers. This has been stimulated by the increasing tax authority demands for taxpayer self-inspections/adjustments, driven, as noted above, by their more sophisticated risk targeting. It has also been stimulated by the parallel efforts of the SAT to promote better internal tax risk management by taxpayers – taxpayers wish to show the tax authorities that they are responding to these prompts, and are working hard to improve the transparency and standardisation of internal tax management.

The focus of improved tax internal controls depend on the priorities of a given taxpayer:

- **General tax management framework:** Framework documents can be drafted to ensure that the in-house tax function and business, legal and finance functions, are all clear on the firm-wide tax management goals and their required collaborative roles in achieving the goals.
- **Standardised tax work flows and control points:** These provide step-by-step instructions to ensure a high level of work quality for each tax action (e.g. tax filing or fapiao issuance) with specific guidance and reminders for persons acting as critical control points.
- **Tax handbooks tailored for specific business lines or tax categories:** These provide transparency and standardisation for tax related tasks. They can be used as a reference guide by tax people to understand business operations, and so provide better support to front-end business staff, when carrying out their tax tasks. They can also be used by front-end business staff for a general understanding of

the potential tax implications of different business actions. This can guide them in involving tax people at the right point of time so as to factor tax considerations into business decisions.

- **Standardisation of tax accounting:** Chinese enterprise groups have been increasingly seeking to standardise their group tax accounting, including the set-up and use of tax related accounts. The increasing complexity of VAT tax accounting has given a push to this development. Following the completion of the transition from business tax to VAT reform in May 2016, the MOF in December 2016 released Circular Caikuai [2016] No. 22 on VAT accounting regulations setting out how more than 18 accounts should be used for VAT accounting. Standardisation of tax accounts help to facilitate tax work by decreasing the need for making book to return adjustments and decreasing the scope for errors as well.

In addition to setting up internal controls for domestic tax management, some state-owned enterprises engaged in increasing outbound investment have extended these to overseas tax management. While, at an earlier point in time, internal tax controls were set up to rely on manual procedures (e.g. written guidelines, workflows and handbooks for in-house tax people to follow), it was quickly acknowledged that, very often, internal control documents were just being put on the shelf without being referred to regularly. This has led to a greater push to utilise technology to embed standardised tax workflows, control points, and tax treatment in the enterprise business environment, through tailored, IT-based tax management systems.

Utilising tax technology to improve tax management

Certain advanced taxpayers are building tax management software solutions customised to cater to a range of IT-based tax functions/modules:

- **Invoice management:** This module can include both output invoice management and input invoice management functions. An output invoice management module typically connects operational software to an enterprise's transactional business data in order to conduct functions such as automated invoice issuance, VAT calculation and even VAT accounting data processing. The latter function directs the accounting system to make revenue recognition ledger entries. The module can also be directed to automatically generate VAT liability vouchers. Input invoice management can include the collection of input invoice data through using a scanner or manual input. Alternatively, input invoice data can be downloaded from the central invoice database maintained by the tax authorities. The function can also automate the verification of invoices.
- **Tax filing:** The tax filing module aims to produce tax returns by connecting to the source data from finance or business systems, and doing the book to return reconciliations

automatically. Nearly all Chinese tax categories can be automated to a certain extent, including VAT, corporate income tax, and stamp duty.

- Tax risk assessment: The tax risk assessment module aims to help taxpayers to set up a system of tax risk assessment indicators. It can automatically identify tax risks for selected periods on a continuous basis. Such systems could, of course, be greatly enhanced if the Chinese tax authorities provided greater disclosure on their tax risk indicators, though there is as yet no indication from the authorities that they plan to do so in the near future.
- Other modules: Other modules such as statistical analysis, regulations pool, archival of tax documents, etc. are available for taxpayers.

Vendors of tax technology solutions typically come from two different service sectors: (1) traditional tax service providers, such as the Big 4, and (2) software solutions companies. The implementation of tax management software requires both the knowledge and expertise of tax advisers and that of the software vendors. Traditional tax advisers have started to hire IT talents to develop all-round tax management software solutions for clients. Conversely, software companies have also started to hire some tax people to oversee the tax part of the work, and in particular for engagement with the in-house tax teams of their clients.

Tax technology cannot be effective in isolation from other business information systems. Data flows between the existing enterprise resource planning (ERP) and finance systems and the tax management system must flow in two directions. The systems need to be integrated, a process spurred by the anticipated widespread automation of business, finance and tax functions. Tax automation through technology is expected to significantly increase tax work efficiency, and release tax people from time-consuming routine work, so that they can focus better on providing higher-end tax support to the company.

Centralisation of tax functions using tax shared services centres

While tax shared services centres have been in use by multinational companies, such as General Electric and Siemens, for some time, they are still uncommon in domestically owned Chinese companies. However, together with the progressive adoption of tax management software solutions by Chinese enterprises, certain state-owned or private-owned groups have seized the opportunity to centralise their tax functions by setting up tax shared services centres.

In line with the centralisation of finance functions, where accounts receivable, accounts payable and expense reimbursements would usually be centralised, one or more of the following functions can be moved into the tax shared services centre:

- Invoice management;
- Tax filing;

- Tax accounting; and
- Tax advisory.

Setting up a tax shared services centre is an organisational change. It involves the restructuring of tax functions, relocation of people, change of reporting lines and change of work allocations. While it is not suitable for all taxpayers, it can work very well for large groups with great tax leaders and tax talents.

Tax management transition from in-house back office function, out to market

Another notable China development has been the decision, by the in-house tax teams of some large Chinese enterprises, to go out to market to provide tax services to other companies. This can be, for example, a service to design the functions, flows and interface of tax management software solutions for other companies.

Traditionally, external tax advisers have been criticised for not having a sufficiently robust understanding of particular businesses, or existing in-house practices. It has been asserted that where advice does not have sufficient regard for how the internal tax function connects to and interacts with other business functions, this advice may not be fully actionable. Consequently, the provision of tax management technology/platforms by other companies within the same industry has a certain appeal. This development is certainly stimulating traditional tax advisers to refine their service offerings to get closer to the core needs of businesses.

Expected future developments in the tax management field in China

Building on our analysis above, we foresee the following notable developments in the near future.

Two-way transparency between tax authorities and taxpayers

As noted above, the Chinese tax authorities have been pushing taxpayers to disclose more information so that they can better understand taxpayer businesses, financials, and industries, and thereby interpret more precisely tax data to drive enforcement action.

We consider that, complementing this, a commitment to two-way transparency by the Chinese tax authorities, such as in relation to tax authority work methodologies, would bring benefits for both tax authorities and taxpayers. For example, if tax authorities disclosed to the taxpayers how they set tax risk indicators to screen for tax risks, and/or share the summary conclusions of industry-wide investigations or TEI analysis results, this could encourage taxpayers to do self-review and self-adjustments, lessening the demands on tax investigation resources at tax authority level.

Greater transparency by the tax authorities could be considered for the following items:

- The risk indicators used by the tax authorities to identify tax risks (including those for specific industries) – disclosure of these would provide guidance to help taxpayers set up their own tax risk indicators to prevent or detect tax risks;
- The cross-checking methodology used by the tax authorities in comparing tax return and financial statement data (e.g. as used for the tax risk alert services for corporate income tax annual filing) – disclosure of this would enable taxpayers to cross-check these items by themselves before a tax submission;
- More guidance for taxpayers on how to set up tax internal controls or tax risk management systems.

Two-way transparency would greatly assist in promoting more effective and efficient tax administration and tax management, at the level of both tax authorities and taxpayers.

Embracing tax technology to move tax functions up the value chain as a true business partner

As discussed above, we are seeing both tax authorities and in-house tax functions embracing tax technology at an accelerating speed and scale. For taxpayers, embracing tax technology releases tax people from routine tax work, making them available for more sophisticated tax work requiring tax expertise and tax professional judgement. In this regard a very valuable contribution is the role of tax people as business partners, providing timely tax advice to front-line business staff. This moves the in-house tax function significantly up the value chain in Chinese enterprise groups – a very positive trend development for the future, as Chinese enterprises become more sophisticated and expand into foreign markets.

A brave new world in tax transparency: CRS in China, Hong Kong and Taiwan

Increasing cross-border business and investment has made the holding of assets overseas through offshore accounts increasingly common. This has become a new tax battleground for businesses and governments. Charles Kinsley, Henry Wong, and Eva Chow look at the latest developments regarding these efforts in China, Hong Kong and Taiwan.

The background to the existing wave of global initiatives in the exchange of tax information space goes back to an initiative launched in the US in 2014. The US Congress, driven by concerns that taxpayers had achieved sophisticated means of investing offshore to potentially avoid US taxation, enacted the Foreign Account Tax Compliance Act (FATCA) effective from July 1 2014. The FATCA, as a unilateral reporting mechanism, required the identification and reporting of US taxpayers by foreign financial institutions (FFIs), being institutions located outside of the US, to the US Internal Revenue Service (IRS). This has since evolved further, through intergovernmental agreements (IGAs) with other countries, into a more bilateral-based system. The FATCA imposes a penal withholding tax of 30% on US-sourced withholdable payments made to FFIs and other foreign entities that fail to comply with the disclosure requirements.

In response to the need for having a global mechanism for the periodic exchange of financial account information, the OECD formulated the automatic exchange of information (AEOI) standard to standardise the approach on information exchange between participating jurisdictions. The AEOI standard comprises two parts: the model competent authority agreement (MCAA) and the common reporting standard (CRS). The MCAA, which can be bilateral or multilateral, is the operational document on how to conduct the automatic exchange of information among tax authorities in different jurisdictions. It also provides the legal basis for those countries or jurisdictions that wish to participate in the exchange (as will be noted later in this chapter, China has opted for a multilateral approach). The CRS stipulates the identification requirements and reporting obligations of financial institutions (FIs), as well as the related requirements and procedures for collecting and reporting information of foreign tax-resident individuals and entities to domestic tax authorities.

Since the release of the AEOI standard, it has attracted attention and support globally and more than 100 countries/jurisdictions have already committed to it. More than 50 'early adopter' countries/jurisdictions implemented the AEOI standard with effect from January 1 2016, while others ('late adopter' countries) have generally implemented the standard with effect from January 1 2017. It is worth noting that while early adopters had their first information exchange in September 2017, late adopters will have their first information exchange in September 2018. It should be noted that the US is not yet a CRS participant country.

Table 1

Key dates	Tasks to be completed
Up to and including June 30 2017	Financial institutions need to identify those financial accounts (both individual and entity) that are pre-existing as of this date and to adopt a different level of due diligence and remediation procedures based on the account balance thresholds as stipulated in Announcement 14.
Starting from July 1 2017	Financial institutions are required to conduct due diligence and adopt new account opening procedures for newly opened individual and entity accounts starting from this date, including the completion of a mandatory self-certification form as part of the account opening procedures.
By December 31 2017	Financial institutions need to complete due diligence and remediation procedures on any pre-existing individual high-net-worth financial accounts (with an aggregate balance exceeding \$1 million as of June 30 2017). Announcement 14 also requires FIs to log-on to the SAT's AEOI portal to complete their registration for CRS purposes by December 31 2017.
By May 31 2018 (and every year after)	Financial institutions are required to submit required financial account information to the Chinese authorities.
In September 2018	The SAT will exchange the first batch of reportable account information with other nations (or jurisdictions) that are participating in the AEOI standard and have agreed to information exchange.
By December 31 2018	Financial institutions need to complete due diligence and remediation procedures on the remaining pre-existing individual low-net-worth financial accounts (with an aggregate balance of no more than \$1 million as of June 30 2017) as well as all other pre-existing entity financial accounts (with an aggregate balance exceeding \$250,000 as of June 30 2017).
In September 2019 (and every year thereafter)	The SAT will exchange the second batch of reportable account information with other nations (or jurisdictions) that are participating in the AEOI standard and have agreed to information exchange.
By December 31 of each year	Financial institutions should implement a continuous monitoring mechanism/process to identify any change of circumstances that may require renewed due diligence work and reporting of information to the Chinese authorities

CRS in China

Since the beginning of 2016, the China State Administration of Taxation (SAT) has conducted several rounds of consultation on the Chinese version of the AEOI standard with various regulators and representatives from large FIs in China. This was to ensure that the unique regulatory and operating environment of the Chinese financial industry would be carefully considered when implementing the AEOI standard.

On May 9 2017, the SAT along with the Ministry of Finance (MOF), People's Bank of China (PBOC), China Banking Regulatory Commission (CBRC), China Insurance Regulatory Commission (CIRC) and China Securities Regulatory Commission (CSRC) jointly released the 'Measures on the Due Diligence of Non-resident Financial Account Information in Tax Matters', Announcement (2017) No. 14 (Announcement 14). Announcement 14 stipulates the principles and procedures for FIs established in

China to follow, and to identify any reportable non-residents of China that hold financial accounts with the institutions and to collect the required financial account information for the Chinese authorities. Announcement 14 came into force on July 1 2017 (instead of January 1 2017 like most other late adopter jurisdictions of the CRS) with the first online registration deadline being December 31 2017, followed by an annual reporting deadline of May 31 of the following year.

The formal implementation regulations for Announcement 14 have not as yet been released by the SAT. However, we note that the PBOC has released draft consultation guidance for implementation of the CRS rules for the banking sector. For other financial sectors, no such guidance is available yet. A draft consultation on the reporting rules has also been circulated among large FIs in China. It is expected to be released towards the end of 2017 or early 2018. A public consultation on the

implementation and reporting rules might be released as well.

Highlights of China's CRS regulation

Announcement 14 has seven chapters and 44 articles that provide an overall framework for the due diligence requirements for both newly opened accounts and pre-existing accounts, compliance, reporting, and supervision requirements.

Financial institutions established and operating in China are required to conduct the due diligence procedures to identify any reportable non-resident account holders as well as the controlling persons of passive non-financial enterprises (passive NFEs), then report the required financial account information to the Chinese tax authorities. Overseas branches or subsidiaries of Chinese FIs, as well as overseas investment funds raised by Chinese firms are excluded from applying the Chinese CRS rules but should follow local CRS rules in their respective countries/jurisdictions where they operate.

Where an account is identified as reportable, the FI should collect and report the account holder's name, address, tax resident country (region), taxpayer identification number (TIN) issued by the resident country (region), place of birth and date of birth (where applicable), account number, year-end balance of the account, as well as income received by that account to the Chinese tax authorities.

On the same date that Announcement 14 was released to the public, the SAT also set up a special AEOI website in Chinese to provide an introduction to the Chinese CRS rules, the legal framework of the OECD's AEOI standard, reference materials including the taxation laws on Chinese tax residency for both individuals and enterprises, the statutory format of China's TIN system and FAQs. There is also a link to the online registration portal, however, at the moment, it is still under development.

In terms of the timeline, Announcement 14 and China's AEOI portal map out the deadlines and tasks to be completed by FIs shown in Table 1.

Comparison with the OECD rules

Given that Announcement 14 is largely based on the OECD rules, the major components of the rules basically mirror the OECD standard. However, similar to many new regulations released in China, they start with a high-level framework without detailed implementation guidance and therefore, FIs will face many issues at the time of implementation.

In terms of certain optional provisions or other pending matters, Announcement 14 has not addressed or provided sufficient details on the position taken. For example:

- There is no specific requirement for filing a nil return by a reporting FI to indicate that it did not maintain any reportable accounts during the year.



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He participates in a number of tax working groups/associations advising on tax matters and is a regular speaker at tax events.

His portfolio consists of a number of household names in the financial services sector with headquarters in the US, Europe and Asia.

- There is no mention of whether an extension of filing will be provided.
- The rules were only released in May 2017, less than two months before the July 1 2017 start date. Many of the FIs that are within the scope of Announcement 14 found themselves with insufficient time to implement the CRS.
- While Announcement 14 provides definitions of 'related entities' and the concept of 'control', it does not provide clarification on how 'related entities' will apply to investment entities like funds that are under common management. This could give rise to an issue of a pre-existing investor in a domestic fund being considered as a new-account investor when investing in a newly established domestic fund that is under common fund management.
- Detailed reporting and related schema have not yet been released but it is expected that the first round of reporting to the SAT will be due in May 2018, which again gives little time for FIs to prepare for the modification of systems and reporting of data.
- No specific guidance has been provided on what type of notices and how frequently FIs should inform their customers about the implementation of the CRS in China and the possibility that their information will be reported if certain conditions are met.
- The list of information exchange partners/jurisdictions is not addressed by Announcement 14. Instead, the list of



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activated bilateral exchange relationships for CRS purposes will be separately announced by the SAT and provided to the OECD. As of August 7 2017, exchange relationships were activated by China with 47 countries and jurisdictions – these include, inter alia, Australia, Canada, France, Germany, Ireland, Japan, Jersey, Korea,

Luxembourg, Mauritius, and the Netherlands. Globally, as of August 7 2017, there were more than 2,000 bilateral exchange relationships activated among 70 of the jurisdictions committed to the CRS.

- While Announcement 14 provides that an FI must establish and implement a monitoring mechanism to assess the effectiveness of the implementation of the rules on an annual basis, it fails to address how the Chinese authorities will be reviewing FI compliance and to what extent the monitoring mechanism will be considered to be effective.

Given that Announcement 14 is intended to be a high-level framework requiring FIs operating in China to follow certain due diligence procedures, detailed implementation guidance or reporting rules should hopefully be released soon to allow FIs to take action. Meanwhile, FIs implementing the CRS in China should take the OECD commentaries into consideration in resolving certain questions until the Chinese rules become clear.

Action plans for FIs

Announcement 14 will have a broad impact on the entire financial services industry and affect almost every business unit of an FI operating in China. Specifically in China, FIs should:

- Identify which part of the business will be affected by the CRS.
- While certain processes may be centralised by the head office like data processing and reporting, certain due diligence requirements like obtaining self-certification forms from account holders and direct communication with customers will still need to be handled by front line relationship managers and proper training should be provided to them.
- New customer onboarding processes will need to be updated to take into account the CRS due diligence requirements and to obtain customers' self-certification. Specifically FIs should produce client communication materials that sufficiently educate them on the reasons for the information collection and the responsibility between the account holders vs. the FIs.
- Evaluate how the new CRS due diligence process can be integrated into existing know-your customer (KYC)/anti-money laundering (AML) procedures and leverage any existing data obtained/processes already in place in order to maximise operational efficiency and minimise costs of compliance.
- An internal continuous compliance and monitoring process will need to be in place for the CRS, especially to monitor or detect any changes of circumstances to financial accounts and reportable account holders.
- Evaluate existing IT systems to identify whether they are capable of collecting, analysing, monitoring and reporting requisite financial and tax data to the authorities.

- Although it is unknown when the Chinese regulations regarding US FATCA will be announced by the SAT, FIs should still consider whether to combine the FATCA and CRS work. If combined, the gap between the FATCA and CRS requirements should be identified. If FIs have already prepared for US FATCA implementation, the incremental work resulting from the CRS should also be identified.

Given the complexities of the CRS compliance requirements and uncertainties in the actual implementation, FIs should continue to pay close attention to CRS developments in China as well as the subsequent releases of detailed implementation guidance and reporting requirements for FIs that are not yet covered in Announcement 14. It should be noted that the CRS will provide a key underpinning for Chinese individual income tax (IIT) reform, planned for 2018, and for the new China tax authority data pooling and analytics systems being progressively brought online.

Recent developments in Hong Kong

Hong Kong adopted the CRS as of January 1 2017 and will undertake the first exchange of information in 2018. The Hong Kong CRS due diligence and reporting requirements are largely consistent with the OECD framework.

Unlike most jurisdictions committed to the CRS, Hong Kong initially did not plan to sign a multilateral instrument for CRS implementation allowing for the exchange of information between the Hong Kong government and other participating jurisdictions directly. Instead, the AEOI in Hong Kong was to be conducted on a bilateral basis with jurisdictions with which Hong Kong had signed a comprehensive avoidance of double taxation agreement (DTA) or tax information exchange agreement (TIEA). Hong Kong was initially slow in entering into the necessary arrangements with other countries to provide information about accounts held in Hong Kong by residents of other countries. For the first CRS reporting period (due in May 2018), information was to be provided only to Japan and the UK where the CRS bilateral competent authority agreements (BCAA) were signed in 2016. Hong Kong therefore fell under pressure from the OECD to accelerate the pace of information exchange.

The Hong Kong Legislative Council passed an amendment bill in June 2017 for the expansion of the list of reportable jurisdictions under the CRS from two (i.e. Japan and the UK) to 75 to meet international expectations (effective as of July 1 2017). The newly added CRS reportable jurisdictions include all EU member states, all of Hong Kong's tax treaty partners that have committed to CRS, and other jurisdictions that have expressed an interest to the OECD in exchanging CRS information with Hong Kong. Financial institutions in Hong Kong are



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required to start collating information about relevant account holders from these jurisdictions from July 1 2017.

For these new reportable jurisdictions (except Korea), account information will need to be provided to the Hong Kong Inland Revenue Department (IRD) from July 1 2017 (compared with January 1 2017 for Japan and the UK and January 1 2018 for Korea). The IRD will provide the relevant information to the relevant jurisdiction only after it has signed a competent authority agreement with that jurisdiction or there is an extension of the multilateral convention on mutual administrative assistance in tax matters (MCAA) from China.

Apart from the expansion of the CRS reportable jurisdictions, some promoters had marketed the potential use of retirement schemes in Hong Kong to avoid CRS reporting earlier this year, in particular the employer operated occupational retirement schemes. The CRS legislation in Hong Kong provides that occupational retirement schemes registered under the Hong Kong Occupational Retirement Schemes Ordinance (ORSO) qualify as non-reporting FIs and hence CRS reporting is not required. The IRD subsequently issued a clarification in May 2017 stating that only

the occupational retirement schemes registered under the ORSO, as opposed to occupational retirement schemes exempted from registration, qualified as non-reporting FIs. Any scheme that was granted an exemption certificate under the ORSO remained a reporting FI for CRS purposes. The IRD also emphasised that the anti-abuse provisions under the Hong Kong CRS legislation would be applied to counteract arrangements where the main purpose, or one of the main purposes, was to avoid the CRS due diligence and reporting obligations.

Reporting FIs in Hong Kong are required to register on the IRD AEOI portal. Also, they are required to submit a notification of commencement of maintaining reportable accounts within three months after they commence maintaining a reportable account. Reporting FIs maintaining reportable accounts before July 3 2017 were required to fulfil the registration and notification requirements by October 3 2017.

An AEOI account can be registered and/or operated by service providers or the person maintaining financial accounts (if an FI is not a corporation), provided there is prior notification to the IRD of the details of the person authorised to register/operate the AEOI account under a specified form. The IRD is operating a trial run of the functions provided under the AEOI portal (including registration, notification and return filing) for the reporting FIs in Hong Kong tentatively up to the end of 2017.

In terms of FATCA, Hong Kong and the US signed a Model 2 IGA on November 13 2014. Under the Hong Kong-US IGA, FFIs in Hong Kong are required to comply with the required FATCA due diligence and reporting requirements. As Hong Kong is a Model 2 jurisdiction, FFIs are required to report the relevant account information of US persons directly to the IRS. Foreign Financial Institutions in Hong Kong should have completed FATCA reporting for years 2014 to 2016 by March 31 2017. We are aware that the IRD has issued a number of query letters to FFIs regarding their FATCA filing to the IRS, in particular to obtain details of the recalcitrant accounts that were reported to the IRS on a pooled basis. The IRD then exchanged such information with the IRS under the TIEA entered into between Hong Kong and the US.

Recent developments in Taiwan

The MOF of Taiwan issued a draft version of the CRS regulations for public consultation on August 8 2017. The draft CRS regulations provide information relating to due diligence procedures for FIs and govern the implementation of the CRS in Taiwan. The CRS is expected to be effective in Taiwan on January 1 2019, and the first reporting date will be before May 31 2020.

Due to Taiwan's ineligibility to become an OECD member, Taiwan cannot participate in the CRS MCAA.

Nevertheless, in order to prevent Taiwan from being viewed as a jurisdiction that fails to comply with the CRS, and therefore be included in the list of non-cooperative tax jurisdictions issued by the OECD, the MOF is committed to complying with the requirements set by the OECD and implementing alternatives to an MCAA. The alternatives include (i) entering into bilateral agreements with other jurisdictions, and (ii) amending Articles 5-1 and 46-1 of the Tax Collection Act.

With respect to Articles 5-1 and 46-1 of the Tax Collection Act, the Legislative Yuan of Taiwan passed the amendment on May 26 2017 (effective from June 14 2017). Under the amendment, the MOF has the authority, on a reciprocal basis, to effect the automatic exchange of tax and bank account information with other jurisdictions for tax matters. The amendment specifies details regarding the type of information to be exchanged and the proposed timing of such information exchange. This amendment provides the legal framework for the CRS draft regulations in Taiwan.

The CRS draft regulations in Taiwan are based on the OECD CRS, and the 'wider approach' is adopted to identify the tax residence of each account holder. However, FIs in Taiwan are only required to report information concerning the 'reportable jurisdictions' to the competent authority, which potentially refers to the jurisdictions with which Taiwan has signed a CDTA. As of 2017, Taiwan has signed CDTAs with 32 jurisdictions (including Singapore, Australia, Canada, and Switzerland). The MOF is actively liaising with its tax treaty partners and hopes to sign a BCAA and commence the first information exchange in 2020.

Final takeaway points

The new global standard on the AEOI aims to reduce the possibilities for tax evasion via offshore investment platforms. It provides for the exchange of non-resident financial account information with the tax authorities in account holder countries of residence. Participating jurisdictions that implement the AEOI automatically send and receive pre-agreed information each year, without having to send a specific request.

The AEOI will enable the discovery of previously undetected tax evasion. In the new world of tax transparency, tax evaders will have few places to hide. Apart from enabling governments to recover tax revenue lost to non-compliant taxpayers, the AEOI may increase voluntary disclosures of concealed assets, with amnesty programmes playing a key role. Forward-looking FIs could take this opportunity to enhance their business models, improve data quality and analytics capabilities, resulting in more efficient operations and a better customer experience.

We would like to thank Aileen Zhou for her contribution to this chapter.

This time it's personal: China IIT on the eve of a major revamp

In 2017, we saw significant new China individual income tax (IIT) enforcement trends in relation to outbound and inbound expat tax monitoring and audit, as well as equity incentive schemes. **Michelle Zhou, Jason Jiang, Sheila Zhang, Angie Ho, and Murray Sarelius** highlight areas to watch for in the future.

As 2017 comes to a close, the indications are that the IIT reform, initially anticipated for 2017, will now not happen until 2018. Nonetheless, 2017 has still seen notable IIT developments, with employees and employers facing increased IIT exposures and challenges arising from business expansion, transformation, restructuring, and overseas deployment, notably in the context of the Belt and Road Initiative (BRI). The continuously strengthened IIT administrative capacity of the Chinese tax authorities means that taxpayers need to repeatedly upgrade their management of IIT matters.

BRI outbound expansion increasing China outbound expatriate tax issues

The 2016 Statistical Communiqué on China's foreign direct investment was jointly released by the Ministry of Commerce, the National Bureau of Statistics and the State Administration of Foreign Exchange on October 9 2017. This observed that, by the end of 2016, 24,400 Chinese investors had made direct investments in 37,200 overseas enterprises in 190 foreign countries and territories. The accumulated total net outward investment was estimated to be \$1.36 trillion. While there was some tempering of outbound investment in 2017, due to limitations imposed by the Chinese government on investments in certain sectors and asset types, the long-term trend continues to be towards expanding foreign investment (see the chapter, *A thousand miles begin with a single step: tax challenges under the BRI*).

In tandem with this overseas expansion, including into BRI countries, Chinese enterprises have been dispatching staff from China to overseas subsidiaries to cover management, technology, marketing and other roles. Attracting, deploying and managing a global workforce is a key element in enterprises undertaking 'go out' strategies.

Unfamiliar and varied overseas business environments, laws and regulations are creating significant challenges for human resource management in 'go out' enterprises. These challenges include, but are not limited to outbound expatriate selection, retention and motivation, salary strategy, employment and payroll arrangements, onshore and offshore taxes, entry and exit immigration administration, social insurance, labour law, and permanent establishment risk management. Failure by enterprises to prepare, and inadequate responses to issues, in any of these areas, may result in commercial losses, departure of talented staff, and damage to enterprise reputation in countries of investment. If the issues are widespread across

Chinese ‘go out’ enterprises, this may hamper their overall engagement with globalisation.

The challenges arise not only overseas, but also within China, since Chinese citizens are subject to Chinese IIT on their worldwide income, including employment income derived during employment/assignment overseas. The ‘go out’ enterprise, as the home country employer dispatching its Chinese employee to its overseas subsidiaries, may still be responsible for monthly tax withholding and timely reporting of the employee’s overseas employment status to the Chinese tax authorities. The individuals may be required, in the year-end tax reconciliation, to report their offshore taxable income, and may look to claim foreign tax credit on tax paid overseas on the foreign sourced income.

The China filing obligations for overseas employment income were, in the past, overlooked by a lot of Chinese nationals while working overseas, as well as by their dispatching employers. However, with the progressively higher use of tax information exchange mechanisms by Chinese tax inspectors, and the planned implementation of the common reporting standard (CRS) from 2018, the authorities are increasingly equipped with more powerful tools for supervision of such enterprises and individuals – see the chapter, *A brave new world in tax transparency: CRS in China, Hong Kong and Taiwan*. Recently, we observed that some Chinese companies who have been sending Chinese employees overseas were required by the local tax authority to report both details of the outbound assignees’ contracts and activities, as well as their IIT reporting status. Obviously, this could become one of the core focus areas of tax audit/inspection in the future.

To better deal with the above challenges, ‘go out’ enterprises should consider taking the following steps:

- Pre-assignment: Get well prepared by setting up outbound staff dispatch-related policies (i.e. salary determination, employment and payroll arrangements, tax policies, etc.), standard operating procedures for dispatched employees, and secondment budget planning;
- During-assignment: Minimise the compliance risks in respect of labour law, immigration, tax, social security, etc. through full assessment and continuing monitoring of the local requirements; and
- Post-assignment: Review the compliance status of the assignment on completion, and draw on lessons learned to improve the policies and procedures for subsequent assignments.

Enhanced IIT enforcement for China inbound assignees and foreign workers in China

Over the past year, the Chinese tax authorities have significantly increased the frequency of IIT tax audits and self-inspections, with IIT treatment of foreign workers in China particularly in the spotlight. Foreign employees in China,



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

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both those assigned from overseas and those with local employment contracts, benefit from IIT exemptions on certain specified benefits (e.g. housing costs, meal/laundry expenses, relocation costs, home leave travel fares, child and personal tuition costs). These exemptions, which need to be claimed with supporting tax invoices (fapiao), lower the effective IIT rate on the income of foreigners from the high Chinese marginal tax rates (i.e. 45% top rate) that kick in at relatively moderate levels of income.

In conducting tax audits on such claims, tax auditors have focused on the ‘reasonableness’ of the claim amounts, the nature of the payment, and corresponding accounting treatment of the expenses in the books of the employing enterprise. The authenticity of the supporting



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He has assisted multinational enterprises operating in China with managing their individual income tax compliance processes and is experienced in advising clients on:

- 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.

Jason is also a regular speaker at KPMG and public seminars and workshops.

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documentation (e.g. fapiao and rental lease agreements) has also been scrutinised.

Based on the local tax authorities' internal investigation guidelines, the authorities have identified and focused on the following common issues.

Meal and laundry expense claims

Certain tax bureaux in northern China have, in the course of tax audits, determined that meal invoice claims in excess of certain amounts are unreasonable and the IIT exemption claim is consequently invalid. Different tax bureaux may set different standards – we have observed cases where one tax bureau set CNY 1,500 (\$226) per invoice as the ceiling for determination of the reasonableness, while another set CNY 2,000. Audited employers have consequently been instructed to withhold the tax arising from the full amount of such invalid invoices, with retroactive effect. However, as there is still no unified standard to assess the reasonableness of invoice

amounts this is subject to the relevant local tax authority's discretion, heightening the compliance challenges for employers.

Property management fee for housing rental

Rental lease agreements in China typically combine a housing rental fee, a property management fee, as well as other administrative fees, into a bundled fee. According to the existing IIT regulations, only rental fees can be claimed as non-taxable benefits. We have observed that in certain cases, where there have been no supporting documents to certify the amount of the housing rental fees, separately from other related costs, the tax authorities have been rejecting the total rental cost claim (i.e. the bundled fee). Consequently, the total rental cost reimbursed by the employer has, in these cases, been included in the employee's taxable income subject to IIT.

Home leave travel costs

In the course of tax audits, issues have been raised that some employee home trip flight ticket expenses are significantly higher than for other employees at the same level. The employer was then required to validate the flight tickets and explain the reasons.

The above requirements on meal costs, property management fees and home leave costs were not specified either under the existing tax regulations or any guidelines released by the tax authorities, but were simply asserted by the tax authorities as a function of their right to interpret the IIT regulations. As such, companies should exercise extra caution when implementing benefits programmes for foreign employees, retain full supporting records for tax inspection purposes, and keep up-to-date on the latest IIT administration developments. Further areas requiring close attention are the following.

Overseas insurance

Insurance (including both social insurance and commercial insurance), purchased overseas by domestic or overseas enterprises for expatriate individuals employed in China, needs to be consolidated with wages and salaries and subjected to China IIT. This includes social insurance contributions made by both employers and employees to overseas social security regimes. Notably, the authorities have also been subjecting these contributions to IIT in cases where the employers/employees are exempt from making Chinese social security contributions according to China's international social security agreements, including those with Germany, Korea, Switzerland and others. Enterprises need to ensure that they have properly consolidated overseas commercial and social insurance and subject it to IIT.

IIT preferential commercial health insurance

The Ministry of Finance (MOF), State Administration of Taxation (SAT) and China Insurance Regulatory

Commission (CIRC) jointly issued Cai Shui [2017] No. 39 (Notice No. 39) earlier this year, introducing nationwide favourable tax treatment on premiums paid for qualified commercial health insurance products. The programme was rolled out from July 1 2017. Individuals will be allowed to claim up to CNY 2,400 per annum (or CNY 200 per month) as IIT deductions in respect of premiums paid for qualified commercial health insurance products.

So far, CIRC has identified batches of insurance companies that are permitted to sell qualified commercial health insurance products. Companies can obtain such lists from the official website of CIRC, and assist their employees to purchase qualified commercial health insurance products.

Employing companies, as IIT withholding agents, are obliged to establish mechanisms to administer the tax deduction claim for allowable premiums and file the necessary documents in the Golden Tax III system. This is to ensure that IIT deduction claims are made in accordance with Notice No. 39 and the requirements of local tax authorities.

Compliance requirements on equity incentives

Although no new tax regulations have been issued in 2017 in relation to equity-based incentive plans, companies (including both listed and unlisted companies) are getting ever more interested in such schemes. They are looking either to the implementation in China of equity incentives, which have been adopted on a global basis by their enterprises, or to the design of a local China plan for long-term incentives for key employees. Subject to conditions being met, equity incentives can be taxed preferentially in China:

- Deferral of taxation of equity awards until time of disposal – this can reduce the marginal tax rate from 45% to 20%; or
- Equity awards may be taxed as a separate source of income from the employee's regular monthly salary and wages. This can lower the applicable marginal tax rate by averaging the taxable value of the award over the period for which the income is attributable (capped at 12 months). If an award is added as normal, and in full, to the income of the month in which it is granted, this would readily push the taxpayer into the highest 45% tax bracket, leading to a loss of much of the award value through tax. By subdividing the value of the award over, say, 12 months, the taxpayer may avail of lower marginal rates on each part of the award; or
- Equity awards can be averaged and taxed over a maximum period of six months. For example, an individual may add one-sixth of the taxable gain to his monthly ordinary salary and wages and compute the China IIT on the combined income over a consecutive six-month period. In such cases, the taxpayer may not only pay IIT in six instalments but also avail of lower marginal rates on each instalment.



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However, for implementation of an equity incentive plan in China, the employer may also be subject to certain compliance requirements, including:

- An equity incentive plan, with other relevant details should be registered with the local tax authority throughout the lifecycle of the plan; and
- An equity incentive plan could also be subject to foreign exchange rules in China where the underlying awards are publicly listed overseas. This is because the outward remittance of funds, for acquisition of awards by employees, and the inward remittance of funds, as payments are made to employees after the disposal of awards, are all regulated by the State Administration of Foreign Exchange (SAFE).

Appropriate tax planning should be conducted before the implementation of an equity incentive scheme in China. Organisation restructuring (i.e. M&A and/or spin-off), should also prompt a revisiting of the tax implications (including tax, foreign exchange, etc.) to ensure tax administrative and compliance requirements are met, and to make necessary employee communications. Without appropriate arrangements in advance, we have observed cases where:

- Penalties were issued by the respective authorities for non-compliance;
- Companies were denied preferential tax treatment for equity based income, resulting in a higher tax bill; and



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- Remittance and repatriation of foreign exchange for the implementation of the plan could be complicated.

Necessary advance planning should be conducted and a set of standard operating procedures should be formulated for continuing administration and fulfilment of reporting requirements.

Revamped immigration permit system for foreigners working in China

There were significant changes to the foreigners' China work permit application requirements and processes in 2017, which aimed to simplify the application process, improve efficiency of the administration, and enhance the continuing monitoring of application procedures. At the same time, the Chinese government is looking to encourage the inflow of more high-skilled talents, while controlling the influx of lower-end foreign labour resources.

Attracting high-skilled foreign graduates

Effective from January 6 2017, it has been possible for eligible foreign graduates who have completed a master's programme or above within the last year from either a domestic university or a well-known international institution to obtain a work permit in China. The previous regulation required foreigners, who intended to work in China, to have

at least two years of related working experience, putting an obstacle in the way of enterprising young foreign workers who sought opportunities, post-graduation, in China.

Simplifying the work visa application process

Effective from March 13 2017, foreigners wishing to apply for a work visa (also known as a 'Z visa') have no longer been required to submit a government-issued invitation letter as one of the visa application supporting documents. Foreign applicants can apply for a Z visa with an overseas Chinese embassy, consulate or air/sea port visa office by submitting their passport or equivalent ID, and a work permit notification letter issued by the respective labour bureau in China. This change, along with a series of other recent administrative enhancements, is expected to reduce the lead time for Z visa applications by approximately one to two weeks.

New employment permit

After six months of trial implementation in 10 provinces, the new nationwide administrative measures on foreigners' applications for employment permits (officially known as the notification of employment permit for foreigners) were launched on April 1 2017. A foreign national should obtain both an employment permit and a Z visa/work-type residence permit to work in China. According to Waizhuanfa [2017] No. 40, the former alien employment permit and foreign expert certificate, which were issued by two different government authorities, have been consolidated into the new single permit, and this will be issued in electronic form. The new employment permit is in line with the goal of 'one lifetime code per person', which provides the foundation for the nationwide administration of foreigners' employment in China.

The new system administers the issuance of employment permits using a points-based methodology. This refers to factors including age, annual salary level, educational background, working experience, Chinese language ability, working location in China, etc. The system classifies foreigners into the following categories:

- Category A: highly-skilled talents;
- Category B: professionals; and
- Category C: others.

Foreigners who attain more than 85 points, or meet one of the special conditions in the classification standard (e.g. world-renowned award winners), fall into Category A. The new points-based classification methodology reduces the extent of application documents required for Category A applicants, and simplifies the application procedures. A restrictive quota will be set for Category C applications.

Looking ahead

Looking to the future, China's top leadership are giving detailed thought to how to bring a new balance to the

next stage of China's economic development. In President Xi's landmark speech, on October 18 2017, to the 19th National Congress of the Communist Party of China, repeated references were made to the primacy of tackling inequality as a policy goal (quotes below). It is clear that the IIT reform will have a key role to play in this process.

"As socialism with Chinese characteristics has entered a new era, the principal contradiction facing Chinese society has evolved. What we now face is the contradiction between unbalanced and inadequate development and the people's ever-growing needs for a better life..."

"While China's overall productive forces have significantly improved and in many areas our production capacity leads the world, our problem is that our development is unbalanced and inadequate..."

"We will continue to follow the principle of distribution according to one's work while improving our institutions and mechanisms for distribution based on factors of production, so as to make income distribution fairer and more orderly...We will expand the size of the middle-income group, increase income for people on low incomes, adjust excessive incomes, and prohibit illicit income. We will work to see that individual incomes grow in step with economic development, and pay rises in tandem with increases in labour productivity...We will see that government plays its function of adjusting redistribution, moves faster to ensure equi-



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table access to basic public services and narrows the gaps in incomes."

In light of these objectives, the final shape of IIT reform is greatly anticipated in the coming Year of the Dog.

All roads lead to...: new integration regime in China customs

In 2017, the China customs authorities took major steps to revamp their existing national structures, with consequences for audit processes and enforcement approaches. In this chapter, **Eric Zhou, Rachel Tao, Cheng Dong, and Helen Han** explore the impact of these reforms.

In 2017 China made notable progress with the nationwide rollout of its modernised national customs clearance integration regime. This further steered the focus of customs administration work processes, away from the ad hoc inspection of goods before their release, towards a more automated system in which enforcement relies on post-clearance review and audit.

The customs authorities, following internal reorganisation, are now in a better position to conduct more frequent and targeted customs audits. To assist with this, customs auditors now have more data analytical tools at their disposal to better monitor the accuracy of the enterprise declarations. As such, enterprises importing/exporting goods into/from China need to enhance their internal controls over the import/export process, minimise manual handling errors, and ensure that customs declarations are accurate.

The new national customs clearance integration regime

Following a series of pilot programmes in selected cities in 2016, a new customs clearance integration regime was rolled out to the whole country from July 2017. This seeks to standardise customs enforcement and improve customs clearance efficiency nationwide. Two key elements, the ‘two centres’ and the ‘three systems’, underpin the new regime.

The term ‘two centres’ refers, in fact, to two types of centres:

- The National Customs Risk Prevention and Control Centres (RPCCs) are established in Shanghai, Huangpu, and Qingdao. The RPCCs provide high-level oversight and management of customs risk prevention and control activities, which are carried out at customs clearance points across China. These look to ensure the safe entry of goods imported by air, land and sea. The RPCCs are responsible for setting safe entry parameters for paperless clearance for import and export licences, certificates of origin, China compulsory certifications (CCCs), China inspection and quarantine (CIQ) certificates, as well as setting tax collection and administration standards.
- The three Tax Collection and Administration Centres (TCACs) are established in Beijing/Tianjin, Shanghai and Guangzhou. These verify the accuracy of tax filings for goods imported through all Chinese ports, examining the use of appropriate harmonised system (HS) code classifications (i.e. codes attributed to specific products), valuations, and country of origin declarations.

The ‘three systems’ refer to three fields into which customs clearance work is segmented, between the RPCCs, TCACs, and frontline



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Rachel has served clients in various industries. Her major clients include importers and manufacturers of consumer, electronics, pharmaceutical and automotive products.

customs offices. These three customs clearance regime systems are ‘one declaration with review in stages’, ‘reform of tax collection and administration procedures’, and ‘cooperative supervision’:

- ‘One declaration with review in stages’ separates the safe entry supervision and tax collection supervision process steps. At step 1, the RPCCs will analyse and verify the safe entry criteria for imported goods, such as product name, quantity, weight, and whether the goods are restricted/prohibited for import. Once the entry risk review is cleared, the goods are released upon the payment of import taxes or the corresponding deposit. At step 2, the TCACs will analyse and verify tax relevant matters such as tariff classification, valuation, and country of origin of the commodities.
- ‘Reform of tax collection and administration procedures’ reinforces requirements on enterprises to make truthful declarations and pay import taxes in full. The review of tax-relevant matters will no longer just take place at the customs clearance stage, but will be conducted throughout the whole import supervision process. The verification of customs declarations will no longer be conducted on each shipment at the time of customs clearance, but on selected shipments chosen by random check.

- ‘Cooperative supervision’ institutes a clearer ‘division of labour’ between the various entities within the Chinese customs administration. Port customs will mainly supervise transportation, importation of goods and personal articles, as well as customs special supervision areas. In-charge customs (i.e. the customs authority with which an importer/exporter registers) will mainly manage the customs audit, customs enterprise credit management and other post-importation supervision and compliance management. The customs audit team, the anti-smuggling team and the customs clearance supervision team (i.e. RPCCs and TCACs) will each play their specialised roles in coordination with port customs and the in-charge customs authorities.

With the ‘three systems’ in place, the customs administration of import/export declarations will follow three steps:

- Step 1 – Inspection before release of goods: the RPCCs will analyse whether imported goods carry safe entry risks, are restricted/forbidden items, give rise to patent and trademark infringement, or involve untruthful declarations of commodity name or description, specification and quantity. Instructions will be given by the RPCCs to on-site customs personnel to inspect specific batches of imported goods. The TCACs will conduct risk analysis of tax-related matters before the release of imported goods,



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

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Helen has a master's degree in economics.

and instruct on-site customs personnel to carry out on-site goods verification and examination in case of significant tax collection risk.

- Step 2 – Risk screening after release of goods: the TCACs will conduct post-importation batch review on tax-related matters in customs declaration forms, screen and select high-risk importations, and carry out verification work. The TCACs will reach out to the companies or instruct in-charge customs authorities to conduct audits, after the release of goods.
- Step 3 – Regular or special audit performed by in-charge customs: the in-charge customs authority will be mainly responsible for performing post-import supervision through regular or special audits.

With the rollout of the customs clearance integration regime nationwide, the majority of imported goods will be

released after the importer declaration passes the automated system review (i.e. after the computer system checks that all the relevant information has been included on the electronically filed customs declaration form). It is estimated that manual review of customs declaration documents will fall to less than 10% of imports. The TCACs will perform batch review on tax-related matters in approximately 20% of the importer self-declarations after the release of goods. Enterprises will benefit as follows:

- Declaration at a location different from the importation port: enterprises are now enabled to choose a suitable port and clearance mode for customs declarations. For example, an enterprise could import goods at port A while it declares with the local customs authority located at port B. Before the reform, imports and customs declarations needed to be conducted at the same port of entry,

or at the in-charge customs authority upon approval from the port of entry.

- Consistent law enforcement by customs: different regional customs authorities used to have different interpretations of customs policies and regulations. This resulted in the same imported goods being subject to different taxation treatment at different ports. Under the new regime, the three TCACs are expected to conduct uniform high-level inspection and risk review of importations nationwide to minimise the inconsistency of regulation enforcement by local customs. Enterprises can establish unified operating process standards, and centralise customs clearance procedures to reduce expenditure of time and operating costs. They can consequently shift more focus to customs risk control and internal process improvement.
- Improvement of customs clearance efficiency: according to the statistics from customs, average customs clearance time has been reduced by one third since July 1 2017. It is expected that the clearance time will continue to reduce. It can be foreseen that after the implementation of the national customs clearance integration system, customs will devote greater resources to post-import supervision. Enterprises are consequently expected to encounter more customs inspection and audit and are recommended to optimise internal processes, and utilise periodic self-inspections and voluntary disclosure mechanisms.

Impact of the latest China customs regime developments

The new Customs Audit Regulations released in July 2016 announced that the focus of customs audit work would be shifted from ‘inspection before release of goods’ to ‘supervision and review after post-clearance’. This is supported by the new national customs clearance integration regime. Enterprises should expect to encounter heightened customs audit activity:

- More customs audits: with the establishment of the three TCACs, customs audits focusing on specific categories of goods are likely to be centrally arranged by the TCACs as coordinated nationwide programmes. For example, an enterprise that imports certain types of luxury products (e.g. high-end shoes and bags) in Shanghai, and which maintains import records with the Shanghai customs authority, may find themselves audited by the Beijing TCAC, as responsibility for the corresponding HS codes may be allocated to the Beijing TCAC for review.
- New customs audit issues: customs audits in China are currently focused more on traditional tax-related issues, such as HS code classification, valuation of imported goods, royalty payment, related party transactions, and so on. It is expected that with more and more post-clearance review efforts, more audit issues will be added to audit scopes. For example, with the conclusion of more free trade agreements (FTAs), and more experience gathered from audits performed by customs in FTA contracting countries, China customs may start reviewing the trade benefits claimed by the importers in China. In this regard they may question whether or not the importers have reported an incorrect country of origin to enjoy the FTA preferential duty rates.
- Greater use of automated tools in customs audits and involvement of third-party intermediaries: customs audits are not limited to the review and verification of clearance-related paper documents, but extend to audit of the accuracy and completeness of electronic customs data. To enhance data verification capabilities, customs officials have been working with trade solution providers on data analytic solutions for more effective audits. The Customs Audit Regulations entitle customs authorities to engage out-sourced third-party intermediaries in customs audit activities. Qualified third party intermediaries include accounting firms, tax firms, and other qualified agencies with pertinent accounting, tax and customs competency in customs audit processes.

Automated solution systems strengthen internal control and compliance management

Under the new Chinese customs clearance administrative environment, enterprises take on greater responsibilities. While this brings challenges it also presents a unique opportunity for enterprises to enhance their competitiveness. It is noted that compliance status directly impacts enterprise ‘credit ratings’ and corresponding customs treatment. In our experience enterprises can usefully enhance their internal controls in the following manner:

- Identify control points and responsible employees throughout the import/export business process;
- Set up checklists for each control point and working protocols to standardise the detailed procedures;
- Ensure data accuracy at first input, or use an automated solution to generate customs declaration documents, and perform reasonableness checks before declarations are submitted to the customs authority;
- Establish risk communication mechanisms to enable self-review and self-reporting. This should help to avoid, identify and correct errors at each step of the process;
- Conduct regular health checks on customs compliance and put reporting system in place to check the enterprises’ overall compliance practice; and
- Where non-compliance is identified, use voluntary disclosure mechanisms, as encouraged by customs authorities, to access potential lenient treatment.

Enterprises may benefit from cooperation with third-party intermediaries, and can draw on their resources and capabilities to achieve the above objectives. Such interme-

diaries can act as an effective bridge, helping enterprises interface optimally with the demanding Chinese customs environment. In addition, customs risk management can be enhanced through an automated system solution, which minimises the potential for manual errors from daily customs handling. Leading global trade solution suppliers, and experienced tax and trade consulting firms have devel-

oped trade solutions and data analytic tools. These can assist enterprises to standardise working procedures, pinpoint import data errors, anomalies, and unmet payment obligations for China import taxes, as well as help with identifying potential savings.

The authors would like to thank Lina Hu for her contribution to this chapter.

One billion Chinese mobile phone users can't be wrong: tax and the digital economy

The disparity between China's rapidly developing and evolving digital economy and its largely traditional economy-based tax administration system is growing, and is creating challenges for both the tax authorities and taxpayers. **Sunny Leung, Benjamin Lu, Jessie Zhang, and Grace Luo** explore the issues.

China's digital economy has been rapidly expanding and evolving, with new operating methods and technologies continuously emerging and adapting at a breathtaking speed. Different government bodies have been making efforts to encourage the overall growth of the digital economy, while at the same time seeking ways to regulate and in some cases, restrain certain types of digital transactions. These developments have made it extremely challenging for the Chinese tax authorities to administer tax collection under the existing tax regulatory framework. This being said, the digitisation of the economy, and of the tax authorities' own work processes, hold out the promise of radically improved enforcement effectiveness in the future. This chapter examines a number of the notable challenges being posed by digitisation to China tax management, and evaluates its long-term impact on Chinese tax administration and enforcement.

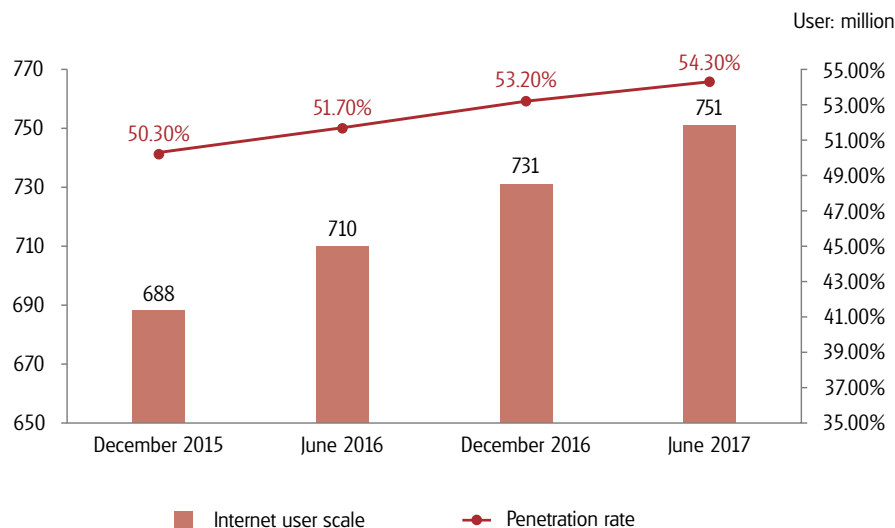
China's rapid digital economy development

In today's China, the internet has penetrated every corner of life, and digitisation continues to proceed at a breakneck pace. According to the 'Statistical Report on Internet Development in China', issued by the China Internet Network Information Centre in June 2017:

- China had 751 million internet users, with an increase of 20 million in the first half of 2017;
- The internet penetration rate reached 54.3%, up 1.1 percentage points from the end of 2016;
- The number of users of online shopping, online take-out business and online travel booking business increased by 10.2%, 41.6% and 11.5% respectively in the first half of 2017;
- China had 126 million internet wealth management users, with a semi-annual increase of 27.5%;
- Up to 61.6% of offline shopping transactions are settled via mobile online payment; and
- China had 144 million online education users, 278 million online taxi sharing users, and 106 million online bicycle sharing users.

The digital economy has completely changed the traditional ways in which many businesses are run in China and have become part of daily routine. This has an impact on the ability of taxpayers and authorities to effectively apply and enforce the existing, outmoded tax rules and guidance.

Diagram 1



Challenges with the tax classification of revenue

With the proliferation of new and unique digital business models, challenges have emerged with the tax classification of revenue, which is essential for applying the appropriate tax rate. This is true for many countries, including China, and is especially an issue for indirect tax. The following factors often contribute to these challenges.

Industry regulation and its tax impact

China has a highly regulated economy and the regulatory classification of industries, products and services has roll-on effects for their tax treatment. However, both the regulatory and tax regimes are struggling to keep up with the pace of China's digital economy evolution. This leads to many areas of conflicting interpretation and uncertainty when seeking to identify the appropriate Chinese tax treatment.

Online-to-offline (O2O) business models cover a vast array of situations in which a purchase is made online and consumed offline. Platform companies set out goods/service information, etc. to consumers via their online stores. Consumers select goods or services online and settle the payment online, then verifying and consuming the goods or services offline.

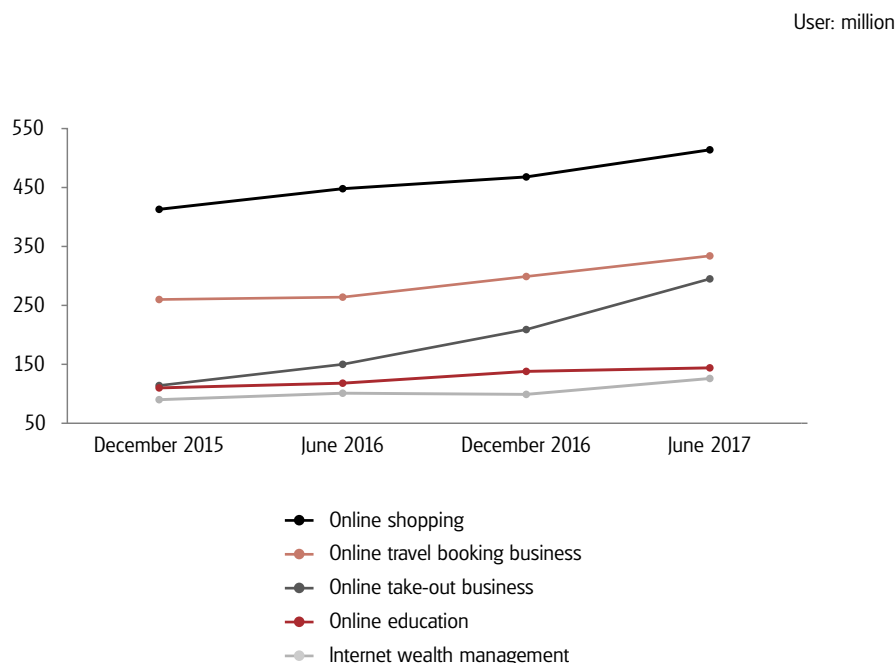
A typical O2O business model is the online car sharing business under which the platform company (e.g. Didi in

China, and Uber in many other jurisdictions) links a driver with a rider (i.e. customer) via its mobile technology/application. It is often debated in China whether the revenue earned by the platform companies should be classified as income from information and technology services (e.g. value-added services provided via information systems), or as agent commission, or as income from transportation services. Development in the industry regulation has played a role in the debate.

From the business perspective, the car sharing application owner just offers and operates a mobile application platform, by means of which the riders and the drivers can be matched with each other. The platform company itself does not own any cars or employ any drivers through which the transportation services are rendered. From a China legal/regulatory perspective, the platform company is typically registered as an information and technology service company, and applies to the Ministry of Industry and Information Technology (MIIT) for an internet content provider (ICP) licence for operating the mobile application platform.

The platform companies normally charge a platform service fee to the drivers, while the drivers derive the actual transportation service income. In the past, as an information and technology service company, the platform service fees

Diagram 2



earned were typically taxed, for VAT purposes, as either a technology fee or commission income in practice.

However, that changed completely due to the issuance, on July 14 2016, of the Ministry of Transport's new Provisional Rules for Administration of the Operation and Service of Online Appointed Taxis. According to the provisional rules, online car sharing platform companies will assume the transportation contractor's (i.e. the driver's) liability, ensure ride safety, and guarantee the rights of the riders. While an explicit requirement for the platform to obtain an operating licence for road transportation was removed from the final version of the provisional rules (this was included in the earlier draft), the obligations placed on the platform company still raised the question of whether the platform company should be treated as a principal for ride supply, and whether the revenue derived should be classified as a transportation service income of the platform.

The classification of the revenue is critical from a VAT administration perspective, as it directly impacts the real tax burden of the taxpayer. The existing applicable VAT rate for both information and technology services and commission income is 6%. The applicable VAT rate for transportation services is 11%. The tax administration's classification of revenues is impacted by various factors. The Chinese tax guidance on revenue classification is

quite limited, with itemised lists of service types set out in the guidance. For any type of income that is not specifically dealt with in the itemised list, the classification is very much left to the discretion of the in-charge tax authorities. These will typically make reference to the other related classifications, especially the accounting classification and the regulatory classification, for guidance.

As such, in the case of car sharing platform companies, as the industry regulator pushes the transportation-related responsibilities and obligations to the platform company, the tax authorities in turn have to assess whether the platform companies should be viewed as effectively operating as transportation companies. Consequently they need to evaluate whether the platform revenue should be classified as transportation service income for both industry regulatory and tax administration purposes. Different tax authorities in different parts of China can end up going in different directions on such revenue classification. As such, ultimately further State Administration of Taxation (SAT) guidance would usually be needed to ensure consistent outcomes. Even then, the business models may have moved on by the time the SAT gets around to this, which leaves a new open area requiring further guidance to be issued by the SAT. Therefore, more responsive and timely guidance from the SAT on these open issues is critical.



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Sunny has been extensively involved in advising clients on setting up operations in China, M&A transactions, and cross-border supply chain planning. She has been providing China tax advisory and compliance services to domestic and multinational companies in the TMT, as well as traditional manufacturing and service industries. Sunny has also been providing tax due diligence and tax health check services in China.

As more industry regulations are rolled out for new sectors such as vehicle-less transportation services (i.e. where a logistics company provides road transportation services without owning any of the trucks), and fintech, etc., there will be a similar need for a re-assessment of the existing tax treatments and how they align with new industry regulations.

Uncertainty on cloud service revenue classification

The National Institute for Standards and Technology (NIST) has set out the following definition of cloud computing: "Cloud computing is a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g. networks, servers, storage, applications and services) that can be rapidly supplied and accessed with minimal management effort or service provider interaction".

Cloud service models are typically segmented into three categories:

- Software as a Service (SaaS). The consumer is granted use of the provider's applications running on a cloud infrastructure;
- Platform as a Service (PaaS). The consumer is granted the use of a suite of programming languages, libraries, services, and tools, operated over the cloud infrastructure; and
- Infrastructure as a Service (IaaS). The consumer is granted the use of processing, storage, networks, and other fundamental computing resources, allowing the consumer to run software, including operating systems and applications.

If we look at the cloud computing models from the existing/traditional tax administration perspective, the classification of the cloud service revenue largely depends on whether the assets or the rights associated with the assets are transferred to the consumer.

The provision of cloud services, like the provision of most digital economy services, does not require material human input. It mainly relies on the utilisation of the hardware and technology, and the services are often rendered on an automated basis (i.e. with minimum or even no involvement of manpower). The assets through which the services are rendered remain as the assets of the cloud service provider throughout the whole process. Ad hoc manpower inputs are merely for the purpose of maintaining the equipment and solving technical issues, rather than for the purpose of directly carrying out the service operations, per se. As such, the cloud service revenue may potentially fall into the classification of equipment leasing, or software licensing under traditional tax rules.

The existing Chinese tax regulations generally define services as those rendered by human beings. In practice, many tax authorities in China still treat cloud service income as either leasing income or licence fees, given the limited human service provision. Nevertheless, it might be argued that this does not reflect the true character of the cloud service model. This approach, in practice, may increase the tax burden on the overseas cloud service provider as corporate withholding tax may be imposed on the payment from the Chinese service recipients. Withholding tax would be imposed on the basis that this is passive income – this may be considered inappropriate given that service income derived by an overseas service provider should not be subject to China income tax, unless such income is attributed to a permanent establishment in China.

With the fast developing artificial intelligence (AI) and robotic process automation (RPA) technologies, it is an inevitable trend that more and more services will be rendered by machines instead of by human beings (or by both operating in an integrated fashion). Looking ahead, Chinese tax rules may need to evolve to consider the underlying economic substance of the transactions and arrangements, and lessen their fixation with formalities such as whether the provision of services is mainly asset-driven.

Practical challenges with the taxation of intangible property transfers

When an intangible property or a right associated with an intangible property is transferred to a customer, the question arises of whether the revenue derived from such transfer should be classified as a licensing fee or as sales income. Both involve the transfer of a right associated with the intangible property (e.g. ownership, copyright, etc.). Technically speaking, where there is a property transfer,

the revenue classification will be assessed based on the intrinsic character of the right derived by the customer from the property transfer, and that assessment will be based on the review of the contractual evidence as well as the manner of settlement for the transaction. Controversy can arise in China in relation to software products. This is because software products do not have a single and exclusive tangible form. They could be easily transferred (i.e. no physical transportation is required) and duplicated with no restriction. Furthermore, given that software users will typically not purchase the software source code, there is a very blurred line between the purchase of software and the licence of the software. This makes the revenue classification very difficult in practice. It becomes even more challenging when it comes to the cross-border purchase of the licence of software, as both customs and foreign exchange regulations come into play as well.

Software licensing fees are subject to VAT at 6%, while the revenue from outright sale of software is subject to VAT at 17%. If the licence fee is paid to an overseas party, the Chinese licensee would need to withhold the VAT from the outbound payment. Licence fee payments made to overseas parties are also subject to corporate income tax withholding tax at 10% (subject to tax treaty relief). By contrast, inbound purchases of software are not subject to corporate income tax or withholding tax, and are only subject to VAT at 17%. A key distinction also arises in relation to the relevant taxing authorities: for the licence the tax will typically be administered by the tax authorities, for the software purchase (imported in physical form) the tax will typically be administered by the customs bureau.

With the enhancement of the internet data transmission speed, there is normally no longer a need for software to be physically transported from the seller to the buyer. Therefore, regardless of whether it is purchase or licensing of software, the Chinese customer can download the software directly from the internet. However, under the foreign exchange regime, where a purchase of software is in point, the Chinese customer would typically need to present a customs import document in order to remit the payment to the overseas seller. Unfortunately, there is no category of intangible product importation under the prevailing China customs regime.

This has led many companies, in practice, to either treat the purchase of software as a licensing arrangement, and withhold the 6% VAT rate and 10% withholding tax (unless reduced by a relevant tax treaty) accordingly, or, physically import a certain physical medium (e.g. CD, flash disk, etc.), declare the value of the medium to be that of the software, and pay 17% VAT accordingly. These practical issues may continue to exist for as long as the customs bureau, foreign exchange authority and the tax authority still separate the administration of software import versus licence.



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Benjamin has extensive experience in a wide range of industries including technology, media and telecommunications (TMT) (including digital economy, technology, media, etc.), consulting, industrial markets (including semi-conductor, chemical, automotive, etc.) and consumer markets.

The above are just a few examples of the challenges faced by the Chinese tax authorities when it comes to properly classifying revenue and applying the relevant tax treatments. With the ever-evolving new operating models in the digital economy, identifying the most appropriate tax classification will likely be a continuous process of exploration, education, and evolution pursued jointly by taxpayers and the Chinese tax authorities.

Issues with traditional tax administration mechanisms in the digital economy

The traditional tax administration approach in China relies heavily on the paper accounting records and vouchers of a taxpayer. Especially when it comes to the deduction of expenses, it is crucial that the taxpayer maintains traceable and verifiable proof in the form of official tax invoices (fapiao). These fapiao are so central to tax administration that bona fide expenses incurred during business operations will simply not be deductible unless there are fapiao to support them. This traditional system is less compatible with digital economy activity, and it can be extremely difficult for the Chinese tax authorities to verify the actual revenue and profits of a digital transaction, due to the following reasons:

- Digital transaction records come in a wide variety of electronic forms and can be scattered across numerous different systems. They are easy to duplicate, delete, or modify, and can be extremely difficult to verify;



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- Speed, low cost and lack of geographic constraints are some of the key competitive advantages of the digital economy. Hence, many transactions are concluded without formal contracts, and between parties that are not registered with the tax authorities; and
- Many transactions are with individual consumers, who do not seek tax deductions for their purchases and hence do not request formal tax invoices. This has limited the reach of the invoice system, which is one of the backbones of the Chinese tax administration system.

Especially for the vast number of individual customer-to-customer (C2C) sellers, given that they are often not registered either as a company (with the Administration of Industry and Commerce) or as a taxpayer (with the tax authorities), their online sales can occur in an information vacuum zone for tax administration purposes. The gap between traditional tax compliance requirements and tools and the manner of operation of businesses in the digital economy can lead to tax issues for both authorities and taxpayers, e.g. significant loss of tax revenues for the China tax authorities, or overpayment of taxes by taxpayers.

Challenges for the invoice-based tax administration environment

For digital economy companies that adopt the platform model, a continuing debate is whether their revenue will be recognised on a gross basis or on a net basis. That is, whether the income arising to traders/operators using the

platform should first be considered as revenue of the platform, with a corresponding deduction reflecting the payment to the traders/operators. Under a perfect tax system, no matter which basis is adopted, those companies' actual VAT and corporate income tax (CIT) burdens should not be affected. This is because even if the companies recognise revenue on a gross basis, they should be able to take deductions and credit for the services rendered by those service providers registered on the platform. Unfortunately this may not hold true under the existing invoice-based tax administration regime in China.

The real income of the platform companies is the platform service fee or commission fee collected from the service provider or sometimes from the end customer. However, the service payment flows generally do not directly reflect this. Almost all third-party payment systems (e.g. AliPay, WeChat Pay, etc.) directly interface with the platform companies. The total goods/service proceeds paid by the end consumers are remitted into the account of the platform companies via the third-party payment systems. After deducting the applicable service fees or commission fees, the platform companies will then remit the balance to the account of the service providers or seller of goods. Further, based on the legal documents used by those platform companies (especially for O2O service companies), it can be left unclear whether they are holding themselves out as a platform provider or a master service provider. Some platform companies, for the purpose of building up their brand names, tend to package themselves as the provider of certain services. End consumers often ask the platform companies to issue invoices for the gross service fee. In practice, in many cases, platform companies may end up issuing such invoices as requested and recognise revenue on a gross basis, although this may not reflect the real business substance.

A further issue arises with expense accounting and deductions. To ensure fast growth, many O2O platforms adopt a relatively open policy in soliciting service providers onto their platforms. Almost any individual, after satisfying certain minimum requirements, can register as a service provider on the platform and provide services to the end customers. Those platform companies normally do not have sufficient resources to request (or monitor) that those individual service providers issue tax invoices, obtained from the tax authorities (smaller businesses in China may not have their own tax invoice printing equipment, but may obtain tax invoices from the tax authorities, for customers, on an 'as needed' basis). When the platform companies are required to recognise their revenue on a gross basis for tax purposes (e.g. the full amount paid by the end customer, rather than merely the platform service fee charged to the individual service providers), they are relying on deducting the service provider remuneration for tax offset. If the platform com-

panies cannot obtain valid tax invoices from those service providers, in practice, the China tax authorities would deny the CIT deduction as well as VAT credit on such costs (even though they are bona fide service costs), which will significantly increase the CIT and VAT costs of these O2O platform companies.

In addition, many platforms and websites provide individual user incentives (in particular cash bonuses) in order to attract consumers and increase the click rate of the website. Individuals will not be issuing any invoices on the receipt of these cash bonuses, leading to tax issues. In particular it may be challenging to obtain a CIT deduction for the cost of the cash bonus. While we have seen cases where the tax authorities allowed taxpayers to take CIT deductions for such expenses based on the internal system log of incentives given (even though not substantiated with valid invoices), it is more common in practice that taxpayers would lose such deductions as a result of a 'lack of valid supporting documents'.

The above issues may be difficult to resolve under China's existing invoice-based tax administration system. With regards to ensuring collection of tax from the service providers operating through platforms, a mandatory withholding mechanism at the platform company level may be a quick solution although that may hinder the commercial development of China's SME sector, and slow China's economic digitisation more generally. But in the long-term, the change of the overall tax administration environment (i.e. from a paper based system to a technology oriented system) seems to be the ultimate solution. Fortunately, we are already seeing changes in China, such as the upgrade of the Golden Tax System, the rollout of electronic invoicing in e-commerce transactions, etc. The tax authorities are even exploring the use of blockchain technology in the tax administration system. As the tax administration system gains greater access to digital transaction data (from platforms and payment providers), and is in a better position to verify the completeness and accuracy of taxpayer submitted data, it may be possible to progressively resolve the tax administration issues above.

Individual income tax (IIT) issues

The popularisation of internet-based commercial activity provides opportunities to almost every individual to carry on business, whether on an ad hoc or more full-time systematic basis, via online C2C sales to O2O sharing services and much more. However, for individuals carrying on small scale business activity on an unincorporated basis, the existing, outdated IIT law provisions throw up various hurdles to appropriate taxation.

The issue may be illustrated with the example of an individual driver who offers O2O car sharing services. For such an individual driver, the leasing or depreciation expenses of his car, the gasoline expenses and the platform service charges normally account for more than 50% (sometimes even up to 70%



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or 80%) of the individual's total car sharing service income. According to the existing China IIT regulations, if such service income is treated as 'remuneration for personal services' for IIT purposes (this is one of several categories under which IIT can be imposed), the eligible expenses deduction cap is merely 20% of receipts, which is far below the real cost and expenses incurred by the individual driver. This leads to such a high IIT burden for the individual that it has caused many to seek ways to avoid paying IIT in the first instance.

It would be more appropriate to treat the individual driver as an unincorporated 'privately-owned business' for IIT purposes (a separate IIT taxing category). This would allow the taxable income of the individual to be calculated as the difference between the total service income and the actual

costs/expenses/losses incurred for the provision of such services. But the tax administration cost involved in being recognised as an unincorporated ‘privately owned business’ for IIT purposes, and the technical knowledge required to manage this, are generally perceived as too high to be feasible by O2O car sharing drivers and other small business operators.

The existing IIT regime was enacted more than 20 years ago, and has been slated for replacement by the government, possibly in 2018. Before the revamp of the IIT Law, it is up to the taxpayers and the local tax authorities to negotiate for a more reasonable taxation method (e.g. deemed profit) on a case-by-case basis. Before a sustainable and practical solution can be achieved, we will likely continue to see a large population of such service providers not fully complying with their IIT obligations.

Tax enforcement in the digital economy

While there may be gaps between the existing Chinese tax regulations and what is needed for the digital economy, the Chinese tax authorities have been endeavouring to improve the tax administration environment, so as to provide a fair competitive environment for players in both the digital economy and the traditional economy.

Tax registration

Tax registration is the foundation of the taxing relationship between the tax authorities and taxpayers. Most of the existing large e-commerce platforms (e.g. Tmall, Joybuy, etc.) require the sellers who wish to set up their online stores on the platform to provide business licence and tax registration records. Individual sellers, privately owned businesses or any companies that do not have proper business and tax registrations are not permitted to set up online stores on those platforms. Yet, apart from these large e-commerce platforms, there are quite a lot of other smaller platforms that do not impose any registration requirement on the merchants. Further, some merchants use their own web domains to carry out business, and the domains may not even be registered under the actual merchants’ names. This has made it extremely difficult for the tax authorities to enforce tax collection, leading not only to loss of tax revenue, but also to a competitive disadvantage for those merchants who have duly registered and paid their fair share of taxes.

The Chinese tax authorities are aware of this and in the draft revised China Tax Collection and Administration Law, it is stipulated that a taxpayer who conducts online business must disclose its tax registration information prominently on the homepage of its website or the homepage on which the business activities are carried out. It also requires all e-commerce platforms to report trader activity to the tax authorities. The requirement for financial institutions to report sizable transactions automatically to the tax authorities may also provide matching information to track and tax

e-commerce activity. In the long run, this should lead to a more equal and level playing field for all businesses.

Digitisation of invoices

In the digital economy context, as all contracts, orders and vouchers for internet transactions and services are kept in the form of electronic records or digital data, no paper invoice will be involved. Electronic records may be easily modified without leaving any traces. As a result, the tax authority is losing its most powerful and direct tool (i.e. the paper invoice) in tax collection and administration.

In response to such trends, the Chinese tax authorities have been rolling out the electronic invoice reform across China since 2016. In contrast to traditional paper invoices, electronic invoices cover the whole invoice administration process, which helps to provide reliable and traceable evidence for tax administration and collection, yet is easier and less costly to implement.

Certainly, challenges posed by the non-registration issue mentioned above as well as the ‘no-invoice’ ecosphere in many thin margin and less value adding industries still exist, and probably will not be resolved until the tax administration system is able to either effectively access and collect digital transaction data, or verify the completeness and accuracy of taxpayer submitted data.

Innovative enforcement measures adopted by other countries

A variety of innovative measures, leveraging new technologies and directed at digital economy tax challenges, have been adopted by other countries in recent years. These may also be indicative of the direction the Chinese tax administration could look to move in coming years:

- Use of blockchain to deal with the use of false identities and ensure effective registration and authentication of taxpayers;
- Blockchain use for security and reliability of sales/transaction records, e.g. for dealing with ‘sales suppression’ and other manipulation of accounting records relevant to tax;
- Linking regulatory requirements to tax compliance – e.g. obtaining a building permit for the second stage of a construction project may be made dependent on having uploaded all invoices/payments for the first stage of the project to the taxpayer’s personal tax account on the tax authority website;
- Obligatory electronic invoicing and instantaneous transfer of all sales data to the tax authorities;
- Obliging online platforms to mark down the ‘ratings’ of traders on their platforms that do not provide electronic invoices, or excluding them from selling goods through the platform altogether; and
- Tax authorities could seek to work with platforms to determine what data the platforms could give them in

bulk aggregated form, which would be useful for compliance efforts but which would not put an excessive burden on the platforms.

Advice to taxpayers

For companies operating in the digital economy, it can be very confusing and frustrating when faced with all the uncertainties and even seemingly unreasonable tax burdens. While the Chinese tax authorities at different levels are actively conducting their own studies and research to seek solutions to the existing issues, with all the new and evolving business models emerging and new issues surfacing every day, this is an uphill struggle.

To thrive in the digital economy and to stay tax compliant while avoiding excessive tax costs, companies may wish to consider the following:

- The company should review its operating model and supply chain so that business sustainability is built on commercial strengths, rather than on temporary advantages that exist merely because of a lag in the adaptation of the tax administration system to the digital economy.
- To potentially obtain a more reasonable tax treatment, companies may be better off proactively approaching the tax authorities, explaining their seemingly complex transactions, quoting the relevant tax framework, and drawing analogies to existing tax positions and treatments, in order to reach consensus with the tax authorities on the tax position. Given increasing tax compliance and anti-avoidance enforcement efforts, if the taxpayer and the tax authority each operate in their own silo, the lack of transparency and communication may simply lead to more uncertainties, and unsatisfactory outcomes.

The future is green: EPT in China

In accordance with China's 13th five-year economic development plan, which commenced in 2016, new policy tools such as the environment protection tax (EPT) and a reformed resources tax (RT) are being used to promote a 'green development philosophy'. Jessica Xie, Flora Fan, William Zhang, and Maria Mei explore these new developments and what they mean for China's greener future.

The vision of sustainable growth underpinning the Chinese government's 12th five-year plan (from 2011 to 2015) is being further advanced with the 13th five-year plan (from 2016 to 2020). This sets out a development philosophy that focuses on innovation, coordination, greenness, openness and inclusiveness, with the core goal of improving the quality and efficiency of growth. Quality improvement of the ecological environment is one of the seven main development objectives for these five years, and is elaborated as a 'green development philosophy'.

To this end, set out in a separate tax chapter of the 13th five-year plan, the Chinese government explains how it plans to use green tax policy tools, such as EPT, RT and consumption tax (CT), to control energy and resources consumption and encourage a "green production model and lifestyle norms".

The EPT was instituted in late 2016, replacing the previous pollution discharge fees, and will apply from January 1 2018. The EPT is expected to increase the cost burden of polluting behaviour, and is intended as a significant deterrent for polluting emissions.

Effective from July 1 2016, an expansion of the scope of RT provided for the taxation of almost all mineral resources to shift to an ad valorem basis from a volume basis. This aims to increase the cost of resource consumption and encourage the efficient utilisation of resources. A pilot programme for introducing RT on water resources was also initiated in Hebei Province at the same time in July 2016.

Policymakers have also been seeking to promote green lifestyle norms. Consumption tax was expanded to cover certain batteries and coatings, starting from February 2015. This aimed to control pollution caused by the production of certain batteries and the emission of volatile organic compounds. Moving in the other direction, CT exemption was granted to environmentally friendly batteries and coatings to promote their use.

Such measures are not intended to radically increase tax revenue in the near future. Policymakers recognise that additional tax burdens may impair the profitability and competitiveness of taxpayers and are seeking to carefully balance the long-term environment protection goal of taxation reforms and the immediate impact on the economy. The essence of EPT legislation and RT reform is 'levy-to-tax conversion', and thus the fiscal burden will not be significantly increased in the short term (the historic fiscal impositions on polluting behaviour are variously termed 'fees', 'levies', 'fund contributions', 'charges', etc.).

Table 1

Taxpayers	Enterprises, public institutions and other persons engaged in production, or any other business operations, that release pollutants into the environment directly in the territory of China, as well as in the sea waters under its jurisdiction
Taxable objects and tax base	<ul style="list-style-type: none"> • Air pollution: CNY 1.2 to CNY 12 (\$0.18 to \$1.80) per pollution unit • Water pollution: CNY 1.4 to CNY 14 per pollution unit • Disposal of solid wastes: based on the kind of the solid wastes (e.g. dangerous or other), tax rate ranges from CNY 5 to CNY 1,000 per ton • Noise pollution: dependent on decibel, tax rate ranges from CNY 350 to CNY 11,200 per month

Both the RT reform rules and the EPT legislation grant provincial governments the power to determine the detailed tax rates, to set an expanded scope for the taxes, and to modify specific aspects of the implementation rules. The local governments can tailor RT and EPT policies to local economic circumstances and environmental goals. In addition, the RT and EPT revenue flows directly to local treasuries after the reform, while a portion of the previous fees went to central government. This should enable and motivate local governments to apply these policy tools in the manner most suitable for their local districts.

Enforcement of the EPT

The Chinese government has demonstrated a strong ambition to tilt the balance between economic growth and environmental protection in the direction of the latter. The Environment Protection Law (EP Law), after the amendments in 2015, was called “the strictest in China’s history”. Furthermore, it is not just the wording of the law that has been strengthened: since 2016 the Ministry of Environmental Protection (MEP), from central government level, commenced enforcement of the strictest level of environmental supervision and examination in China’s history. In the past two years, millions of businesses were closed or penalised for non-compliance with the EP Law. When the prevailing ‘environment protection storm’ starts to blow over, it is anticipated that more stable and routine policy tools will be introduced to strengthen the daily administration and control of pollution emissions.

On December 25 2016, the Law of the People’s Republic of China on Environmental Protection Tax (EPT Law) was approved by the National People’s Congress (NPC). From January 2018 local taxes imposed under the EPT Law will replace the existing pollution charges levied by local branches of the MEP. The taxable scope of EPT, and the types of taxpayers subject to EPT, are basically the same as under the previous pollution discharge fees. Carbon dioxide emissions are outside the scope of EPT (see Table 1).

The EPT legislation seeks to ensure that, at least initially, the tax burden will not be increased after the transition from

pollutant discharge fees to tax. This is achieved by adopting the existing standards for pollutant discharge fees, as well as treating the payers of pollutant fees as taxpayers of EPT. It should be noted that while most of China’s taxes are still based on regulations issued at State Council (i.e. cabinet) level, the EPT has the status of a law, passed by the NPC; the fifth Chinese tax law. Consequently the EPT Law will, technically speaking, have a more binding force for EPT taxpayers than most other tax regulations. Another consequence of the status of the EPT as a law is that the regime and its enforcement mechanisms should remain stable over time, since any significant change would require NPC approval.

Although the EPT Law adopts the existing standards for pollutant discharge fees as a lower range, provincial level governments now have the authority to determine detailed tax rates within the statutory range, which may go higher. For example, in the case of air pollution and water pollution, the EPT Law provides the minimum tax rate and provincial level governments can raise tax impositions up to 10 times where the environmental situation in their districts merits this. By the end of September 2017 several provinces had determined, or at least proposed, the applicable taxable items and the specific EPT rates that would be used in their districts. Provincial legislatures at Fujian and Guizhou have already determined the detailed tax rates, while Zhejiang, Jiangxi, Jiangsu and Guangdong are still gathering public opinions on their proposals. In Guangxi and Sichuan, their tax plans are still being deliberated by municipal governments and local companies.

The approach to EPT localisation taken by localities in practice can be seen to be driven by (i) the carrying capacity of the local environment; and (ii) the previous pollution discharge fees level, which varies significantly across provinces. Some provinces like Fujian, Jiangsu and Zhejiang have decided to continue, under the EPT regime, with the same level of imposition as the earlier pollutant discharge fees. Guangdong and Guizhou have proposed to lift the tax rate above the level of the previous pollutant discharge fees in view of their limited environmental carrying capacity. Even with this, the EPT rate applicable in Guangdong and Guizhou is still much lower



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than that applicable in Jiangsu, which had higher pollutant discharge fees under the prior regime.

The EPT reform transfers an important government revenue source from the MEP, into the hands of the local tax authorities. Rather than training the tax authorities in EPT assessment and collection, the MEP has been putting its collection experience and professional technical knowledge in the administration on pollutant discharge fees, at the disposal of the tax authorities. In June 2017, the Ministry of Finance (MOF), the State Administration of Taxation (SAT) and the MEP jointly issued the draft Implementation Regulations for the Environmental Protection Tax Law (draft regulations) to solicit public comments. The draft regulations noted that the SAT will work with the MEP to set up a tax-related information sharing platform, and that the MEP will support the SAT in conducting tax audits for EPT. It is expected that the draft regulations will be formally issued by State Council by the end of 2017.

At the execution level, the SAT and MEP signed a cooperation memorandum on EPT collection on July 31 2017. The memorandum clarifies that the SAT and MEP will work together, inter alia, on the following:

- Publishing standards on EPT collection;

- Formulating EPT relief policy and its implementation rules; and
- Setting up the tax collection system and tax-related information sharing platform.

It is the first time that two government agencies have worked so closely together on tax collection and administration. Some local branches of the MEP have started passing profiles of entities paying pollution discharge fees on to the tax authorities. The cooperation mechanism could maximise the experience and knowledge gained by the MEP and smooth the transition from pollution discharge fees to EPT.

Milestones achieved with resource tax reform

Similar to other major economies in the world, the mining tax regime in China is complicated. On top of the ordinary corporate income tax (CIT), VAT and other taxes, RT has been imposed on the extraction and sale/use of mineral resources since 1984. Since 2010, the government had gradually moved forward a series of RT reforms, with four key objectives: expansion of the taxable scope, change of the tax base, adjustment of the tax rate and rationalisation of resources-related levies. As a result, a series of RT regulations has been issued since 2011.



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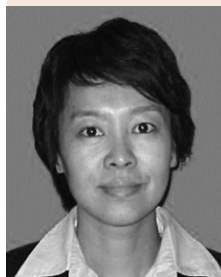
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In particular, William has assisted quite a number of multinational enterprises in industrial markets in, for example, high and new technology enterprise (HNTE) application review assessments, R&D bonus deduction applications and tax planning for restructuring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

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Resource tax reform started from the change of the tax base on crude oil and natural gas resources, then coal and rare earths. Effective from July 1 2016, the Chinese government has been expanding the taxable scope of the RT, transitioning it from a volume basis tax to an ad valorem basis tax, abolishing local charges and fund contributions, determining a unified tax rate range of mineral products as well as setting tax incentives.

The objective of "fully expanding the taxable scope" has been largely achieved. Coal bed methane (CBM) extracted from the ground has been included into the taxable scope of RT since July 2016, with a simultaneous abolition of the mineral resource compensation fee previously levied on CBM. However, a lower RT rate is applied for CBM than for natural gas and coal, with a view to encouraging the development of CBM production. In addition, the pilot programme for water resource reform was initiated in the

Hebei Province in July 2016. Provincial governments can decide, at their own discretion, to expand the RT scope to include the exploitation of forests, pastures and shoals (e.g. logging), subject to the approval of the State Council.

By making RT levels more sensitive to the pricing of resources on markets, with the move to ad valorem taxation, it is hoped that enterprises will be encouraged to improve their usage of resources. Particular encouragement is given to the more efficient use of resources through the special incentives and reductions in RT for use of certain grades of resources.

Similar to EPT, RT reform is also a 'levy-to-tax conversion' reform. Due to the lack of flexibility of the pre-reform (volume basis) RT, local governments had sought to impose various local levies on the exploration of mining resources, to supplement local revenue collection. However, since July 1 2016, the mineral resources compensation fee rate has been lowered to zero, the levying of the price regulating fund has ceased, and

various improperly levied local charges, and contributions to mineral resources funds (not sanctioned by central government), have been prohibited.

The RT reform is not, of itself, intended to radically increase tax revenues. The post-reform RT rates have been set so as to provide local governments with the revenue they previously obtained from the mineral resources compensation fees, and local levies, before their elimination.

Considering the expected decline of local financial revenues after VAT reform (this abolished business tax that was a key local government revenue raiser), RT is likely to remain a local tax in the medium term. In the long term, it remains to be seen whether the allocation of revenues between the central and the local governments will be adjusted.

Overall, the RT reform in 2016 was intended by the government to have a positive impact on the mining industry. The ad valorem based calculation method aims to build up an automatic adjustment mechanism and promote the utilisation efficiency of resources, together with the effect of relevant tax incentives. The abolition of various local

charges and funds is intended to achieve a rationalisation of resources-related levies.

Looking to the future

There are three years remaining to fully implement the 13th five-year plan. The RT reform in 2016 was a solid start, and the release of the EPT Law draft regulations in 2017 has sustained the momentum behind China's emerging green development philosophy. In his keynote address to the 19th Chinese Communist Party National Congress on October 18 2017, President Xi Jinping stated that the Chinese government would accelerate ecological reforms to build a "beautiful China". Following reform of RT and EPT, the focus turns to CT changes, with the existing administrative regime for oil set to be reformed to encourage lower consumption of non-renewable energy resources thereby limiting air pollution emissions. Continuing the drive towards greater 'rule of law governance', additional policy measures in this space are expected to take the form of new laws, as with the EPT.

Better smart than lucky: China R&D incentives 2.0

Yang Bin, Rachel Guan, Josephine Jiang, and Henry Ngai examine the refinements being made to China's innovation incentives, and their importance as a driver of continued Chinese economic growth.

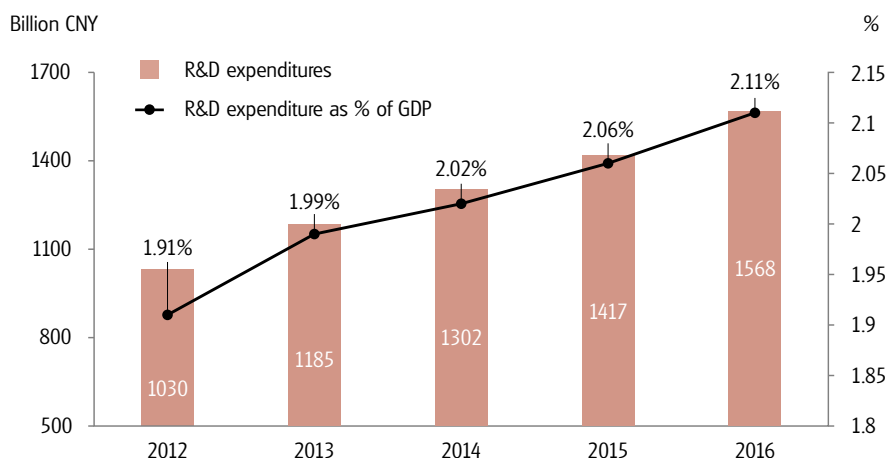
The Chinese government recognises that innovation is essential to sustaining the momentum of China's economic development, and supporting innovation is a key focus of the government's 13th five-year plan (2016 to 2020). President Xi's speech to the 19th CPC National Congress further emphasised the determination of the government to develop the national innovation system by establishing a market-oriented system for technological innovation in which enterprises are the main players. In this context the government will seek to ensure that the maximum synergies result from the joint efforts of enterprises, universities, and research institutes. The national innovation strategy will inter-link with the internet plus action plan, the national big data strategy, and the Made in China 2025 initiative.

New landmarks are being attained in national innovation metrics. According to a 2016 statistical bulletin from the Chinese National Bureau of Statistics, research and development (R&D) investment in China reached 2.11% of GDP (see Diagram 1). It is targeted to reach 2.5% of GDP by the end of the 13th five-year plan period. By the end of 2016, the total number of China-registered, valid invention patents passed the million mark, meaning China ranks third in the world, after the US and Japan. Progress is also being made in marrying economic development with innovation-driven ecological progress, as energy consumption per unit of GDP fell by 5% in 2016.

Over the past two years, China has made enhancements to its two flagship corporate income tax (CIT) innovation incentives – the high and new technology enterprise (HNTE) and R&D expense super deduction (super deduction) incentives. The resulting enterprise tax savings have been available for reinvestment into expanded R&D activities, equipment and recruitment, to increase enterprise core competitiveness. As per Diagram 2, based on figures from the National Bureau of Statistics, tax benefits granted in 2016 rose to CNY 48.91 billion (\$7.4 billion) for the super deduction and CNY 84.28 billion for HNTE, annual increases of 9% and 20%, respectively.

The Chinese government is pushing a programme of 'mass entrepreneurship and innovation', and has tailored many of its incentives to support small and medium-sized science and technology enterprises (science and technology SMEs). This includes the establishment of special innovation demonstration zones, the expansion of venture capital (VC) tax incentives to foster investment in technology start-ups, and enhancements to the existing innovation incentives for science and technology

Diagram 1: China's R&D expenditures 2012 to 2016 – in CNY billion and as % of GDP



SMEs (i.e. increase of super deduction bonus deduction from 50% to 75%). We set out below our observations on the progress made with these measures, and implementation issues arising in practice.

New HNTE rules demand better IP project management capabilities

The HNTE incentive provides qualifying enterprises with a 15% CIT rate in place of the standard 25% CIT rate. It also raises the ceiling for deduction of employee training expenses to 8% of employee compensation. The key qualifying conditions for the HNTE incentive were first set out in Guokefahuo (2008) No. 32 and updated in Guokefahuo (2016) No. 32. In order to qualify, the enterprise must:

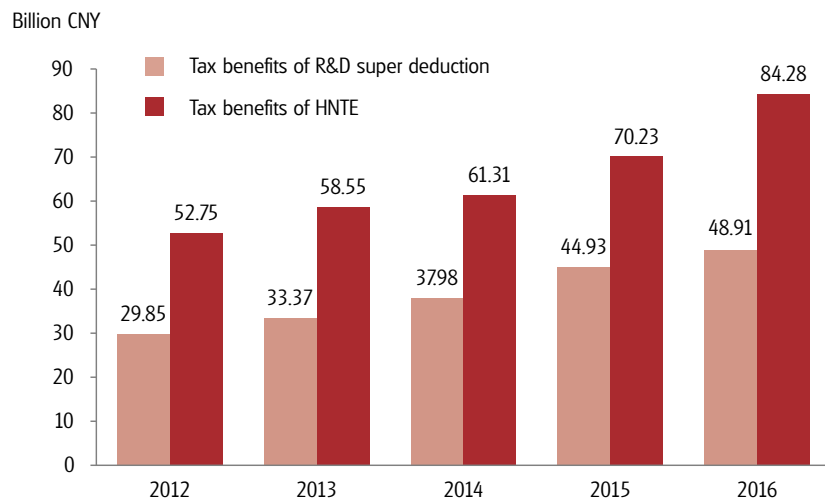
- Own the intellectual property (IP) for the core technologies underpinning the products and services it supplies;
- Fall within one of eight specified industrial fields;
- Have sufficient science and technology personnel;
- Perform R&D and incur sufficient R&D expenses;
- Generate sufficient revenue from high-new-technology products; and
- Meet a target number of 'points' reflecting the innovative nature of the enterprise.

The eight specified industrial fields are electronic information technology, bioengineering and new medical tech-

nology, aeronautical and space technology, new material technology, high-tech service, new energy and energy saving technology, resource and environment technology, and high technology for transforming traditional industries. The calculation of points is conducted using four assessment criteria for the HNTE candidate's operations: core IP sufficiency (maximum 30 points), capability to convert R&D findings into products and services (maximum 30 points), ability to execute and manage R&D activities (maximum 20 points), and growth of revenue and total net assets (maximum 20 points). A company needs 71 points or more to qualify for the HNTE incentive.

This latest iteration of the HNTE rules, effective from January 1 2016, tightens up the IP ownership requirements above. There is more rigorous assessment of whether the IP owned by the enterprises is relevant to the products and services it supplies, to stop enterprises holding IP irrelevant to its products/services from accessing the incentive. For example, in the automotive sector, an enterprise might possess IP for an innovative car seat design. While this IP might have a considerable value, if the enterprise business has pivoted towards engine manufacturing then the company will not be in a position to use its possession of these IP rights as a basis for claiming the HNTE incentive (such matters may have been more loosely scrutinised in the past). The new rules also focus more

Diagram 2: Super deduction and HNTÉ tax benefits 2012 to 2016



closely on the criterion of ‘capability to convert R&D findings into products and services’. The quality and ‘disruptiveness’, or transformational nature, of the IP embedded in the applicants’ main products will be a central point of scrutiny. The enterprises must demonstrate (including through their preparation of technical documents) that they are capable of analysing and planning the use of their patents and know-how for use in products and services.

From our experience we find that domestically-owned enterprises have additional work to do in building up their IP planning capabilities to meet the new HNTÉ criteria. Enterprises need to get better at identifying and categorising their technical IP, and at explaining and documenting its economic value. Enterprises should seek patents for their core technologies and key products/processes, which can be shown to be a notable advance over existing technologies. They should also initiate the patent application process once early indicators of research/production show clear promise, and not wait until full production is underway. This is because the patent application will typically take a long time and delays could risk the enterprise failing to meet the HNTÉ application deadline (patents should be registered already at the time of application). Enterprises should also ensure that their IP management teams are built up, and develop IP development roadmaps at a group enterprise level.

Super deduction for R&D support staff and outsourcing, and enhanced for SMEs

The R&D super deduction provides a 150% tax deduction for qualifying expenses, meaning a net saving of 12.5% for every eligible expense incurred in the relevant year of income (assuming the 25% CIT rate applies). The super deduction is generally more easily accessed than HNTÉ status because it does not focus on R&D expenses as a percentage of turnover, or on the percentage of revenue derived from hi-tech products. The incentive also does not require that core IP be registered and owned by the Chinese entity. Rather, it focuses on the expenditure incurred being relevant to the development of new knowledge and innovations, including improved products and/or processes.

Qualifying R&D activities may include the customisation and localisation in China of products and processes that result in technical improvements to know-how, which may originally have been developed offshore (e.g. manufacturing a modified product using locally improved technologies).

As with HNTÉ, the super deduction qualification rules have also been updated in Caishui [2015] No. 119, effective from January 1 2016. The super deduction rules now allow a deduction in respect of costs of technical staff and R&D supporting staff, in addition to the costs of core R&D staff, as long as relevant expenses can be accurately traced and



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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.

not previously qualifying for the super deduction, now also qualify under the clarified rules. In the latest, November 2017-issued Announcement 2017 No. 40, and in line with government efforts to continually refine the guidance, the SAT helpfully clarify, amongst other matters, the inclusion of stock option plan costs in qualifying R&D expenses.

The super deduction for outsourced contracted R&D activity is also clarified in Caishui [2015] No. 119, and 80% of related expenses can avail of the super deduction. The requirement for the contracted party to provide a detailed breakdown of contracted R&D expenses has been limited to related party transactions only. This update facilitates the implementation of the policy, as it protects third parties from disclosing business details/secrets.

In addition, the clarified rules require that R&D outsourcing contracts must be registered with local Science and Technology Bureaux in order for the deduction to be available. The reluctance of some subcontractors to undertake the registration themselves has caused issues for companies claiming the super deduction, and case-by-case discussions with the authorities are needed to resolve this. A further issue relates to variations in the subcontractor contracts used. Different local authorities expect specific contract templates to be used, and may refuse registration of contracts not in line with the local template. To resolve this, the Ministry of Science and Technology in September 2017 clarified in Shuizongfa [2017] No. 106 that a 'substance-over-form' approach should be taken and that subcontractor agreements containing the essential provisions should be accepted for registration, regardless of variations in the contract format from local templates.

It should be noted that the tax and science and technology authorities are applying more stringent supervision and follow-up audit procedures, so enterprises need to control their tax risks by designing and implementing effective tracking systems and procedures. In practice, some entities have designed detailed implementation manuals to manage their super deduction claims. The manual normally covers the functions and responsibilities of internal business departments, approaches to identifying R&D activities and projects, R&D project management procedures, R&D expense allocation methods and filing requirements. Tailor-made templates, i.e. R&D technical report and labour hour record templates, are also included in the manual. The manual is a useful tool to control the risks.

As noted above, the bonus deduction has been increased to 75% (from 50%) for science and technology SMEs. Such an SME is defined in Guo Ke Fa Zheng [2017] No. 115 (Circular 115) as meeting the following criteria:

- 1) It must be a tax resident enterprise registered within mainland China;
- 2) The total number of employees must not exceed 500, and neither its annual sales nor its total assets may exceed CNY 200 million;

allocated to enterprise R&D projects. On this basis, a project manager or engineering support team member that contributes to a R&D project may be eligible for inclusion as 'technical staff' or 'supporting staff'. Other expenses directly related to R&D activities, such as document translation expenses, business trip expenses and conference expenses,

- 3) The products and services provided by the enterprise must not be prohibited or restricted for supply under Chinese law;
- 4) The enterprise must not have been involved in any major safety incidents or quality issues, or any serious violations of environmental law or scientific research fraud in the year in which the enterprise makes its online service platform filing, or in the prior year. In addition, the enterprise must not be included on the lists of enterprises, maintained by the State Administration for Industry and Commerce, which have been involved in operational improprieties or fraud; and
- 5) The enterprise's comprehensive evaluation score must be no less than 60 points. This is calculated on the basis of a range of innovation-related evaluation indicators specifically set out for science and technology-related SMEs. Within this composite score, the enterprise's score on the scientific and technical staff indicator must be greater than zero points.

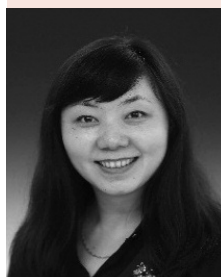
An enterprise that meets the requirements set forth in points 1) to 4) may be directly recognised as a science and technology-related SME if it also conforms to one of the following conditions (i.e. such enterprises need not satisfy the points requirements):

- 1) It holds a valid high and new technology enterprise qualification certificate;
- 2) It has won a national science and technology award within the past five years, and ranked in the top three among all the prize winners;
- 3) It is granted recognition as an 'R&D institution' by a science and technology administration at the provincial level or above; or
- 4) It has played a leading role in developing international or national technical standards in the past five years.

The above-mentioned criterion 5) includes the three categories: (i) scientific and technical staff, (ii) R&D expenditure, and (iii) scientific and technological achievement. A maximum score of 100 points is possible.

Establishment of innovation demonstration zones in China

The State Council on May 12 2016 issued Guo Ban Fa [2016] No. 35, mandating the establishment of entrepreneurship and innovation demonstration bases, and listing the first batch of 28 zones. This was then supplemented by Guo Ban Fa [2017] No. 54 that established a further 92 bases. The now 100-plus bases provide key support and backing to start-ups and research-driven enterprises. The coverage of the bases is wide. Of the 92 set up in 2017, 45 are set up in designated city zones, including Beijing Shunyi District, and Tianjin Binhai High Tech Industrial Development Zone; 26 are located at universities and scientific research institutions, including Peking University and



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Rachel also spent several months in Seattle in 2012, serving as the direct, on-the-ground resource for technical Chinese tax matters for KPMG's local clients in the US, specifically for hi-tech multinational companies.

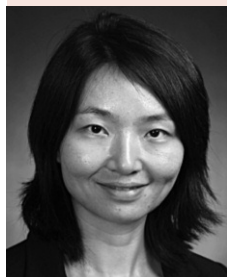
Rachel is one of the key members of KPMG's north China research and development (R&D) tax services practice. She is specialised in providing assistance with R&D tax incentive review and detailed restructuring or improvement implementation plan execution to help entities comply with the R&D tax incentive requirements. Rachel's R&D tax service clients include multinational companies and both state-owned and privately owned enterprises in the manufacturing, fintech, finance and banking, food and beverages, and electronics and IT industries.

Fudan University; and 21 are enterprises, including Aviation Industry Corporation of China, and Baidu, among others.

It is intended that the initiative will help to spread mass innovative activity across a wider range of business sectors and a large number of provinces in China. The demonstration zones are expected to set the bar with new rules on the protection of intellectual property rights, and to facilitate the commercialisation of research results. The State Council circular encourages demonstration zones to formulate flexible policies to attract high-quality personnel, and support entrepreneurial activity by Chinese returning from overseas.

Advanced technology services enterprise incentive to be expanded nationwide

An existing pilot programme of corporate tax incentives for advanced technology services enterprises (ATSEs) is in the course of being expanded nationwide. Qualifying ATSEs



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Josephine Jiang is KPMG's Beijing-based tax partner, focusing on research and development (R&D) tax, as well as mergers and acquisitions (M&A) and international tax. She has been practising tax for more than 15 years.

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

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

From 2008 to 2009, Josephine spent one year practising international tax in the New York office of another Big 4 firm with a focus on China inbound investments by US multinationals.

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

engaging in service outsourcing businesses are offered preferential CIT treatment, including:

- A reduced CIT rate of 15% (standard rate is 25%); and
- The ability to tax deduct employee education expenses up to a limit of 8% of total employee expenses (otherwise limited to 2.5%).

As regards the qualifying criteria, compared to HNTE, the IP ownership and R&D investment requirements are less relevant (and consequently less onerous), especially in relation to information technology outsourcing (ITO) and business process outsourcing (BPO). This being said, there are requirements concerning the education level of staff and the proportion of income from 'offshore advanced technology services' (at least 35% of annual income). At present the ATSE incentives are available for enterprises

registered in 31 pilot cities, mostly in the developed east of China, with some central and western region cities also in scope. The expansion of the scheme provides key support to China's economic rebalancing, away from simple processing activity, towards advanced, tech-driven services.

Technology start-up CIT and individual income tax (IIT) investment incentives

A crucial underpinning for China's expanding innovation economy is the development of new, flexible financing channels for technology start-ups and SMEs. China's largely state-owned banking sector remains very much oriented towards the needs of large, particularly state-owned, industrial enterprises, and small enterprises frequently face severe challenges in raising capital. To foster the development of VC enterprise and individual 'business angel' investor financing, the authorities have been developing supportive tax policies. The Ministry of Finance (MOF) and the State Administration of Taxation (SAT) issued Cai Shui [2017] No. 38 in April 2017 providing IIT and CIT incentives to be initially piloted in eight designated locations, including Beijing-Tianjin-Hebei, Shanghai, Guangdong, Anhui, Sichuan, Wuhan, Xian, Shenyang, as well as Suzhou Industrial Park. The rules provide that where investments are made in science and technology enterprises seeking capital or start-up stage support (technology start-ups), and where the investment is for a period of two years or more, then 70% of the investment amount can be offset against the taxable income of the investor.

Any unused balance may be carried forward and used against further future disposal gains from equity in the same enterprise. Where an individual investor makes investments in several technology start-ups in the pilot area, and the de-registration/liquidation of one of the invested technology start-ups limits the degree to which the 70% investment deduction for that start-up can be utilised, then this may be offset against taxable gains arising from disposals of equity in other invested technology start-ups. It is yet to be clarified whether these technology start-ups need to be within the same given pilot area or whether this covers invested start-ups in all pilot areas. This offset must be used within 36 months of de-registration/liquidation of the invested technology start-up.

The individual 'business angel' investors cannot be the founders or employees of the invested technology start-ups, there are percentage limitations on holdings, and the investments must be in the pilot zones.

Technology innovation underpins future growth

Technological innovation, particularly by small-to-medium enterprises (SMEs), is a driving force of Chinese economic growth, and a large number of government initiatives are directed at supporting this in the 13th five-year plan period.

Enterprises should keep informed of the latest refinements to these incentives so that they can make the most of them. For all the incentives, the manner in which innovation activity is planned and tracked/documentated within the enterprise is key. Expert advice should be obtained, where required, to ensure that inadequate systems and procedures do not result in enterprises being ‘locked out’ of these valuable benefits.



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Henry advises multinational clients on taxation, foreign exchange, customs and business regulations in respect of business activities in China. Taxation issues include corporate tax, individual tax, indirect taxes, such as value added tax, business tax and customs duties. Henry has also assisted many foreign investors in their tax due diligence projects and provided subsequent structuring or integration advice from a tax perspective.

Henry has provided various tax advisory and compliance services to multinational enterprises in different business sectors, such as pharmaceutical, industrial and hospitality sectors. He has extensive experience in advising clients in appropriate corporate structures for business operations.

With over 14 years’ China tax experience, Henry has helped many multinational enterprises to establish their company structure, improving tax efficiency of their Chinese businesses and providing tailor-made advice to their future operations.

Taiwan: tax goes digital

In 2017, the Taiwan government proposed imposing VAT on foreign enterprises providing e-commerce services to Taiwan individuals, expanding the Taiwan corporate income tax (CIT) nexus rule, and making personal income tax changes. It is also looking at abolishing and replacing the corporate-shareholder imputation tax system. **Stephen Hsu, Hazel Chen, Ellen Ting and Betty Lee** elaborate.

New VAT regime for foreign e-service providers

Since the OECD announced the BEPS Action Plan in 2013, Taiwan has actively been monitoring global international tax developments. Although Taiwan is not an OECD member, the Ministry of Finance (MOF) took actions to address the urgency of the BEPS tax issues, and their impact on the Taiwan investment and tax environment.

Taiwan's first BEPS legislative change was the amendment to the Value-Added and Non-Value Added Business Tax Act (VAT Act) to bring foreign e-commerce service providers into the Taiwan VAT net, in line with the recommendations of the BEPS Action 1 report on digital economy taxation.

Expanding digital economy drives changes to VAT regime

Previously, when Taiwan recipients purchased goods or services from foreign enterprises (without a fixed place of business in Taiwan), the Taiwan recipients would be obliged to compute and pay VAT to the Taiwan tax authorities (as appropriate) under Article 36 of Taiwan VAT Act. As the Taiwan buyers were required by law to self-report and pay the VAT, compliance was low in practice. As a result, foreign enterprises generated significant revenue through online sales to Taiwan without a Taiwan VAT burden.

Given the continuous growth in e-commerce businesses, the MOF decided to shift the VAT burden to foreign e-commerce service providers. This was done with a view to simplifying the tax collection administration, as well as providing a level playing field for both domestic and foreign online service providers and traders.

In response to the OECD BEPS recommendations and recent observations to changes in taxing cross border e-commerce transactions in the EU, Japan and Korea, the MOF proposed that all foreign e-commerce service providers that sell to Taiwan individuals online must register for and remit VAT to the Taiwan tax authorities.

Amendments to the Taiwan VAT regime

The amendments to the VAT Act were promulgated by the President on December 28 2016 and came into force on May 1 2017. Under the amendments, foreign enterprises (without a fixed place of business in Taiwan) selling e-commerce services (including digital products) to Taiwanese individuals must register for VAT. The vendor must pay VAT directly or indirectly through an appointed tax-filing agent, where its Taiwan sales revenue exceeds the registration threshold.



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Stephen specialises in the provision of financial services. He has assisted multinational enterprises in the tax evaluation of mergers and acquisitions (M&A), international tax planning and tax planning services for corporate investment and operation structures. He has also been actively providing global transfer pricing services to both foreign and domestic companies and assistance in tax appeal consultations and filings.

Stephen is an instructor, both internally at KPMG in Taiwan, and externally at the National Taiwan University's College of Management, and a lecturer at the training institute of the Ministry of Finance. Stephen serves as an adviser of the Taiwan Insurance Institute. He is also a member of the Taipei City CPA Association, a member of the Taxation Agency, Ministry of Finance, and a member of the Government Information Office.



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Hazel Chen joined the tax service department in Taiwan in 2006. Before her tax consulting career, Hazel was a former tax officer of the Taipei National Tax Administration, with more than four years of experience in the field of individual income tax and corporate income tax audit. Her experience has strengthened her understanding of the practices of the tax administration.

Hazel provides tax consulting services to both domestic and multinational groups in areas of transfer pricing, corporate investments and operational structuring, as well as tax audit assistance. She also assists multinational companies in handling global transfer pricing and tax compliance issues. Her specialisation is in the technology, media and telecommunications sectors in both industrial and consumer markets.

Hazel has been involved in numbers of tax field audit projects for merger transactions conducted by multinational and large local companies. She also has extensive experience in corporation with many foreign KPMG teams through co-execution of various transfer pricing analyses.

Hazel is a frequent speaker at tax and transfer pricing seminars, and workshops for clients and the public.

The main foreign e-commerce-related changes to Taiwan's VAT law are summarised below.

VAT payer scope expanded to cover cross-border electronic services

The definition of 'business entity' is extended to include a foreign enterprise without a fixed place of business in Taiwan that sells electronic services to domestic individuals.

Further, where a foreign entity does not have a fixed place of business in Taiwan when selling electronics services to domestic individuals, the VAT payer will be the foreign entity itself or its agent. That is, the VAT taxpayer will no longer be the Taiwan individual purchaser.

Transaction scope

Pursuant to the Directions on the Levying of Business Tax on Cross-Border Electronic Services Transactions (VAT Directions on Cross-Border E-Services Transactions), 'electronic services' are defined as:

- Services used for downloading via the internet or other electronic tools and saving onto computers or mobile devices (such as smartphones, tablet computers, etc.) for use;
- Services used online or via other electronic tools without downloading onto any devices, including services used in digital form, like online games, advertisements, audio-visual browsing, voice frequency broadcasting, information contents (such as movies, soap operas, music, etc.) and interactive communications; and
- Other services supplied through the internet or other electronic tools; for example, services supplied through online platforms set up by an offshore electronic business entity and used at a physical location in Taiwan (e.g. booking Taiwan hotels and tours).

As the VAT scope specifically covers the electronic service transactions concluded with domestic individuals, the VAT Directions on Cross-Border E-Services Transactions also provide a definition for 'domestic individuals' and distinguish between utilisation with or without a physical place of business in Taiwan.



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Ellen Ting joined KPMG Taiwan in 2004. Before joining the firm, she worked for three and a half years with the KPMG Vancouver office, in the international tax department, focusing on US corporate and state tax.

Ellen has assisted many multinational companies in providing tax advisory services in respect of their operations and transactions in Taiwan. Her areas of focus include income tax and withholding tax on cross-border transactions, surtax, tax risk analysis, tax incentive planning and indirect taxes. She has been involved in a broad array of projects, including restructuring, tax due diligence, and has experience advising clients from the financial services industry including banks, fund houses and securities houses.

Her areas of focus also include global transfer pricing and she has participated in many transfer pricing projects encompassing planning, compliance, contemporaneous documentation and audit defence for multinational corporations from various industries.

Other than client responsibilities, Ellen is a frequent guest speaker for various foreign trade organisations and at taxation seminars.



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Betty Lee is an international tax director at KPMG Taiwan and is based in Taipei. She has over 10 years of professional experience gained in a number of jurisdictions, namely Australia, Hong Kong and Taiwan. She joined KPMG Hong Kong in 2007 where she provided corporate tax advice and compliance services to Hong Kong as well as multinational companies.

Betty joined KPMG in Taiwan in 2011 where she specifically provides international tax and investment consulting services for both domestic and multinational groups. Betty has extensive exposure and specialises in numerous facets of taxation to a range of clients. She is also experienced in identifying the needs of clients and providing the required solutions, including investment holding structuring and tax planning, group restructuring and relevant tax implications, and general tax compliance and advisory support.

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.

Where services purchased are used without a physical location in Taiwan, a person will be considered to be a domestic individual if:

- The person has their domicile or residence in Taiwan;
- The person purchases services through electronic means via devices located or installed in Taiwan;
- The person uses mobile devices to purchase services where the mobile phone number has the country code of 886 (i.e. the Taiwan international dial code); or
- There are other items of transaction information relevant to the transaction that indicate the purchaser is a domestic individual, e.g. buyer's billing address, bank account information for the payment, IP address of the equipment or devices, SIM card, etc.

Where services purchased are used in connection with a physical location in Taiwan, including electronic services that are:

- Purchased in connection with real estate (e.g. hotel services or building construction/repair related services, etc.) and such real estate is situated in Taiwan;

- Purchased and relate to transportation used within Taiwan;
- Purchased and relate to various forms of performances, exhibitions, etc. within Taiwan; or
- For other services used in connection with a physical location in Taiwan.

VAT registration threshold set by the MOF

Foreign enterprises having no fixed places of business within Taiwan that sell electronic services to Taiwan individuals will have to perform tax registration or appoint a tax filing agent in Taiwan to handle the VAT compliance requirements, if their annual sales exceed the promulgated threshold of TWD 480,000 (\$16,000). Therefore, foreign enterprises meeting the above requirements are obligated to apply for a taxpayer ID and file bi-monthly VAT returns.

Penalty for non-compliance

A penalty ranging from TWD 3,000 to TWD 30,000 will be imposed on foreign enterprises for non-compliance with the

tax registration requirement. The penalties also extend to appointed tax agents.

Transitional period given for issuance of government uniform invoices (GUIs)

Generally, businesses are required to issue GUIs in Taiwan. However, given that the VAT invoicing system is not yet fully set up to cater to the new e-commerce rules, and the related detailed implementation rules are still under discussion, a tax ruling number (10604506690) has provided some relief. The ruling provides that foreign enterprises are not required to issue GUIs during the period from May 1 2017 to December 31 2018.

Potential CIT developments

Although not officially announced, it is anticipated that there will also be future income tax developments in the digital economy space. The MOF is contemplating imposing CIT on business-to-consumer (B2C) e-service income (i.e. non-tangible goods/services) derived by foreign e-service providers. The adoption of a deemed income taxation method is also being considered. It is expected that the draft income tax rules for e-services will be available before the end of this year, with discussion sessions to be held with the industry and professional advisers. Depending on when the relevant legislation is promulgated, the first CIT filing could be as early as May 2018 to retroactively cover the transaction period from May to December 2017.

Other key tax developments and potential tax reforms

Amended transfer pricing rules for country-by-country (CbC) reporting and master file effective for 2017

On July 27 2017, the MOF released draft amendments to the Regulations Governing Assessment of Profit-Seeking Enterprise Income Tax on Non-Arm's Length Transfer Pricing, (TP Assessment Rules). The amended TP Assessment Rules include the three-tier transfer pricing documentation as suggested by the OECD under the BEPS Action 13 report. It is expected that the amended rules will apply to fiscal years on or after January 1 2017. Most major Taiwanese businesses have been anticipating this, and making preparations.

The MOF has yet to announce the threshold for reporting. It is expected that the reporting threshold for CbC reporting will follow the OECD suggested €750 million (\$888 million) and be translated into new Taiwan Dollars (TWD). The content and covered entities required are consistent with the OECD template.

In the future, the tax information of MNEs will be more transparent among tax authorities in different jurisdictions. Tax authorities, including in Taiwan, will be better able to understand and monitor a group's holding structure, profit allocation, operational substance and tax paid status. This

will not only feed into the tax authorities' assessment of a given group's transfer pricing audit risk, but will also enhance tax officers' ability to implement other Taiwan anti-avoidance measures, such as controlled foreign companies (CFC) and place of effective management (POEM) rules. Companies should immediately assess the potential impact and form strategies to respond to potential challenges from the Taiwan tax authorities.

Proposed changes to the imputation tax system

Under Taiwan's existing income tax rules, there is much complexity surrounding the calculation of the tax credit, granted against tax imposed on dividends under individual income tax (IIT), in respect of Taiwan corporate income tax (CIT). There have also been concerns raised over the imposition of the top individual marginal tax rate of 45% on dividend income of domestic investors, compared to a final dividend withholding tax rate at 20% (subject to tax treaty reduction) for foreign investors.

As such, the MOF has proposed a reform and simplification of the existing rules. The IIT rate structure, and the CIT and 'surtax' imposed on the undistributed earnings of companies, will all be altered. Under prevailing rules, a 10% surtax is imposed on a company's undistributed profits if the company does not distribute its after-tax profits within a prescribed period. When the company subsequently distributes the earnings to its foreign shareholders, 50% of the paid surtax can be set off against the dividend withholding tax borne by a foreign investor.

The draft bill was raised to the Cabinet for approval on September 1 2017 and was expected to be submitted to the Legislature in mid-October. The key points of the tax reform are summarised below.

IIT on individual dividend income (domestic individual investors):

- Abolish the imputation tax regime where the individual has to gross up the dividend income received then is taxed at the relevant tax rate (where the highest top marginal tax rate is 45%) and reduce the tax payable via the imputation credits attached to the dividends.
- Two alternative methods, Plan A and Plan B, are proposed for taxing the dividends:
 - Plan A will allow individual investors to be exempt from income tax on 37% of dividends they receive, with the remaining 63% to be included in their IIT return and taxed accordingly; and
 - Plan B will allow the individual investors to choose between two options, Option 1 and Option 2, whichever gives the individual a more favourable outcome.
 - Option 1 will tax all dividend income as part of the individual's income but they can then recognise 8.5%

of the dividend income as a tax deductible amount, (up to TWD 80,000 as the maximum allowable deduction amount for each household); and

- Under Option 2, the dividend will be taxed separately and not included as part of the individual's income (which is subject to progressive rates). The individual investor will be taxed on a flat rate of 26%, rather than at the progressive individual income tax rates. Progressive rates range from 5% to 45% – the 45% applies for taxable income exceeding TWD 10 million.

Withholding tax (WHT) on dividends to non-residents (foreign investors):

- Surtax paid on undistributed earnings can no longer be used to offset and reduce the WHT imposed on dividends distributed to foreign investors; and
- WHT rate on dividend income is to increase from 20% to 21% for foreign investors.

Other proposed CIT changes

Other changes planned for the CIT regime include:

- Increasing the CIT rate from 17% to 20%;
- Decreasing the surtax rate from 10% to 5%;
- No longer requiring companies to maintain an imputation credits account (ICA) due to the abolition of the imputation tax regime; and
- Ensuring dividends received by a domestic corporate shareholder from their investment in other domestic companies remain exempt from CIT.

Other proposed IIT changes

Additional changes to the IIT include:

- Abolishing the 45% tax rate bracket for net consolidated income of more than TWD 10 million. The highest tax rate bracket will be restored to 40% (the highest marginal rate before 2014); and
- Introducing an upward adjustment of the following three deductions. The standard deduction will increase by TWD 20,000, being raised from TWD 90,000 to TWD 110,000. The amount will be doubled for taxpayers with a spouse. The special deduction for income from salaries/wages and the special deduction for disabled and handicapped persons will increase by TWD 52,000, both being raised from TWD 128,000 to TWD 180,000.

Given the bullish implementation dates on the proposed changes (e.g. the raised withholding tax rate for foreign investors is to take effect from January 1 2018), the tax reform is anticipated to be a priority bill.

Final thoughts

In view of the various changes that have taken place in Taiwan in recent years as well as the proposed tax reform, we are expecting more changes to come. It is recommended that existing and potential investors closely monitor the development and implementation details of the upcoming and proposed changes to ensure that tax risks and obligations are appropriately managed and complied with. Overall, the changes are a big step forward for Taiwan's tax system to become more aligned with international trends and practice.

Hong Kong tax: Let the economy take the lead

Ayesha Lau, Darren Bowdern, Michael Olesnicky, John Timpany and Curtis Ng discuss Hong Kong's BEPS-related changes after the territory issued a consultation paper to codify and strengthen TP regulations, as well as joining the Multilateral Instrument (MLI). The Hong Kong government is also increasingly using tax policy to encourage economic development.

As part of Hong Kong's participation in the OECD's BEPS project, the government plans to implement legislation by the end of 2017 to introduce transfer pricing rules into Hong Kong's tax law. These rules will largely resemble the OECD's transfer pricing guidelines. In addition, Hong Kong has entered into the MLI. This was signed by the China government on behalf of Hong Kong. Local ratification of the MLI is expected in 2018.

Separate from BEPS, the Inland Revenue Department (IRD) has clarified the concessionary tax treatment of corporate treasury centres and regulatory capital securities, following feedback from various industry bodies, by issuing administrative guidance in the form of Departmental Interpretation and Practice Notes (DIPNs).

Towards the end of 2015, the Hong Kong government announced it was looking to enhance Hong Kong as a centre for aircraft leasing. After much consultation with industry bodies and various interest groups, a new tax regime for aircraft leasing legislation was enacted in July 2017. The previous tax rules had effectively blocked any use of Hong Kong as an aircraft leasing centre with respect to foreign airlines.

Multilateral instrument (MLI)

On June 7 2017, with 67 other jurisdictions, Hong Kong joined the MLI. Hong Kong submitted a list of 36 comprehensive double taxation agreements (DTAs) that it designated as its covered tax agreements (CTAs) to be amended through the MLI mechanism. (The tax arrangement between Hong Kong and mainland China was not included and is expected to be updated through bilateral negotiations in due course.)

The positions taken by Hong Kong with respect to the MLI provisions are shown in Table 1.

Transfer pricing

With the global BEPS programme, transfer pricing (TP) has become a key focus. Traditionally, Hong Kong has taken a 'light touch' with respect to transfer pricing regulation, using IRD guidance rather than specific legislation.

The Hong Kong government published a consultation paper on BEPS in October 2016, and subsequently released a consultation report summarising the responses on July 31 2017. Following this process, the government announced that it will introduce comprehensive transfer pricing rules and a TP documentation regime that will be largely based

Table 1

Article	Hong Kong's position
Article 3 – Hybrid mismatches	Hong Kong did not apply this to its CTAs
Article 4 – Dual resident entities	Hong Kong did not apply this to its CTAs
Article 5 – Application of methods for elimination of double tax treaties.	Hong Kong did not apply this to its CTAs.
Article 6 – Purpose of a CTA	Hong Kong applied this to its CTAs (with an exception with respect to its CTA with Belarus which already contains the relevant preamble language).
Article 7 – Prevention of treaty abuse	Hong Kong specifically opted to apply the principal purpose test (PPT) but not a limitation of benefits test (with exceptions with respect to its CTAs with Belarus and Pakistan that already contain such provisions).
Article 8 – Dividend transfer transactions	Hong Kong did not apply this to its CTAs.
Article 9 – Capital gains from alienation of shares or interests of entities deriving their value principally from immovable property	Hong Kong did not apply this to its CTAs.
Article 10 – Anti-abuse rule for permanent establishments (PEs) situated in third jurisdictions	Hong Kong did not apply this to its CTAs.
Article 11 – Application of tax agreements to restrict a party's right to tax its own residents	Hong Kong did not apply this to its CTAs.
Article 12 – Artificial avoidance of PE status through commissionaire arrangements and similar strategies	Hong Kong did not apply this to its CTAs.
Article 13 – Artificial avoidance of PE status through the specific activity exemptions	Hong Kong did not apply this to its CTAs.
Article 14 – Splitting up of contracts	Hong Kong did not apply this to its CTAs.
Article 15 – Definition of a person closely related to an enterprise	Hong Kong did not apply this to its CTAs.
Article 16 – Mutual agreement procedures (MAP)	Although Hong Kong's CTAs already contain MAP provisions, it agreed to supplement these provisions.

on the OECD's three-tier approach (including a master file and local file) and is likely to be introduced from the 2018/19 year of assessment.

The key points from the latest consultation report include:

- The proposed thresholds for enterprises to prepare master and local files will be based on: (i) the size of business; and (ii) the quantum of related party transactions. This should relieve the administrative burden for smaller taxpayers.
- Purely domestic transactions between Hong Kong entities will be covered by the new transfer pricing regime.
- Penalties for incorrect tax returns prepared using non-arm's-length pricing will be the same as those that apply for under-reporting in other tax contexts. This means that a penalty could amount to up to 300% of the tax

undercharged where the taxpayer acted without reasonable excuse.

The government plans to introduce a bill to codify the new TP rules by the end of 2017, with enactment likely in the earlier part of 2018.

Aircraft leasing regime

To put Hong Kong on the global stage as an aircraft leasing jurisdiction, a tax incentive for this industry was enacted on July 7 2017. This became effective on April 1 2017.

The main benefits of the aircraft leasing concessions are as follows:

- An effective tax rate of 1.65% will be levied on profits earned by 'qualifying aircraft lessors'. This rate is



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

Ayesha is the chairman of International Fiscal Association Hong Kong Branch and a member of the joint liaison committee on taxation. She was the chairperson of the HKICPA's taxation faculty executive committee and its former taxation committee.

Ayesha has been appointed by the Hong Kong SAR government as a member of various advisory bodies. She is the chairman of the joint committee on student finance and a non-executive director of the Mandatory Provident Fund Schemes Authority. She is also a member of the Council of the University of Hong Kong, the Public Service Commission, the Legal Aid Services Council, the financial infrastructure sub-committee of the exchange fund advisory committee and the policy research committee of the Financial Services Development Council.

Ayesha was appointed as a Justice of the Peace on July 1 2013 and an accounting adviser of the Chinese Ministry of Finance in May 2016.



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achieved by applying one half of the normal tax rate of 16.5% to 20% of the gross rental receipts less deductible expenses, but excluding tax depreciation;

- A concessional 8.25% tax rate will apply to profits from 'qualifying aircraft leasing management' activities.

To be a qualifying lease, the lease should satisfy the following conditions:

- It must be a dry lease (i.e. a lease having a term of more than one year under which the lessor is not responsible for the airworthiness of the aircraft and does not employ any member of the crew);
- It must not be a (i) funding lease, (ii) hire purchase agreement, nor (iii) conditional sale agreement. This means the lease must neither contain a purchase

option nor an arrangement under which title to the aircraft might pass to the lessee.

The definition of 'qualifying aircraft leasing management activities' is wide. It includes standard lease management activities such as procuring and leasing aircraft, a range of financing activities such as providing loans to associated companies to acquire the aircraft, providing loans to airlines to acquire the aircraft from qualifying lessors, providing residual value guarantees, etc.

To benefit from these tax concessions, 'qualifying aircraft lessors' and 'qualifying aircraft leasing managers' must not be aircraft operators (e.g. airlines), and must conduct only qualifying activities (although leasing managers can conduct some non-qualifying activities). They must be cen-



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With more than 20 years of experience in KPMG's tax practices in Hong Kong and New Zealand, John Timpany provides the full range of tax assistance and advice to multinational companies across the Asia Pacific region and beyond. A number of John's clients use Hong Kong as the location for their head office and John advises these organisations on managing their tax affairs regionally and globally.

His role involves advising on issues relevant to the establishment and restructuring of investment holding and operating structures for companies operating in diverse industries and countries. John has extensive international merger and acquisition experience and is seasoned in advising clients in a wide variety of industries, including, financial services, consumer markets, telecommunications, real estate, transportation and logistics.

trally managed and controlled in Hong Kong, with all of their profit generating activities conducted in Hong Kong.

The IRD will clarify uncertain issues in an upcoming DIPN. These include the ability to obtain a tax residency certificate, utilising foreign tax credits in Hong Kong and other corporate structuring and operational issues.

Regulatory capital securities (RCS)

Amendments enacted on June 3 2016 clarified the tax treatment of RCS. The IRD issued DIPN 53 – Tax Treatment on Regulatory Capital Securities – in February 2017 to provide guidance on the application of these new rules.

To satisfy the revised regulatory capital standards as prescribed by the Third Basel Accord published by the Basel Committee on Banking Supervision, financial institutions may issue qualifying RCSs to meet the requirements for classification as Common Equity Tier 1, Additional Tier 1 and Tier 2 capital under the Banking (Capital) Rules or under the equivalent laws or regulatory requirements of another member jurisdiction of the Basel Committee.

Broadly, RCS that satisfy the prescribed conditions (subject to certain specific anti-avoidance provisions) will be treated as follows for Hong Kong tax purposes:

- RCS will be treated as debt securities;

- Distributions (excluding any paid-up capital) made by the issuer on the RCS will be treated as interest;
- Gains and losses in respect of RCS will not be treated as trading gains/losses (and therefore will not be taxable/deductible); and
- No Hong Kong stamp duty is payable on the purchase and sale of RCS.

Corporate treasury centres

Specific tax concessions were introduced in 2016 for corporate treasury centres. Broadly speaking, this refers to a corporation that is centrally managed and controlled in Hong Kong and which carries on qualifying activities in Hong Kong. Those activities include carrying on an intra-group financing business, providing corporate treasury services or entering into corporate treasury transactions.

Where these conditions are met, the corporate treasury centre will be taxed at a concessional tax rate of 8.25% on its qualifying profits.

Interest deduction relief for intra-group financing activities

New provisions in 2016 provide for interest paid by a corporation that carries on a business of intra-group financing, where the interest is paid to an associated overseas corporation, to be tax deductible in certain circumstances.



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Curtis is well versed in the complexities of delivering compliance and advisory services to multinational clients in various sectors. His experience includes a depth of expertise in cross-border business activities, and coordination and liaison with specialists to provide the most efficient and effective services.

Curtis received his BSc degree in economics. He is an associate member of the Hong Kong Institute of Certified Public Accountants (HKICPA) and the Taxation Institute of Hong Kong. He is the vice chairman of the executive committee of the taxation faculty and a member of the tax specialisation development working group of the HKICPA. Curtis is also a Certified Tax Adviser (Hong Kong).

To explain this, generally, interest paid to an entity that is not a financial institution is not deductible in Hong Kong (unless the lender is subject to Hong Kong profits tax on such interest). This new provision therefore expands the ability of a corporation, which carries on an intra-group financing business, to obtain a deduction for the interest it pays to offshore related parties.

The condition for deductibility is that the lender must be subject to tax in its own jurisdiction at the statutory tax rate equal to Hong Kong's own 16.5% rate (or 8.25% if the borrower qualifies for the corporate treasury centre concession described in the previous section).

In DIPN 52, the IRD clarified that a corporation will be treated as carrying on an intra-group financing business if it satisfies the following conditions:

- The corporation has four or more borrowing and lending transactions per month;
- Each of these borrowing and lending transactions exceed HK\$250,000 (\$32,000); and
- Lending and borrowing transactions are conducted with four or more associated corporations during the relevant year.

That being said, failure to meet these benchmarks does not necessarily mean that the corporation is not carrying on an intra-group financing business.

The requirement for the lender to be taxed in its own jurisdiction has been clarified in DIPN 52. The IRD states that this condition will not be satisfied where:

- The gross interest income of the lender is not taxable due to utilisation of tax losses or having direct expenses, ultimately resulting in the interest not being chargeable to tax; or
- The lender has tax losses that partially offset its taxable profits.

While the Hong Kong taxpayer may not be required to provide tax returns or tax computations of the overseas lender to claim this interest deduction, DIPN 52 requires it must have a reasonable degree of certainty that the tax payment has been or will be made by the overseas lender. The IRD may request documentation of the lender if it challenges the interest deduction.

Open-ended fund companies

On June 28 2017, a bill was introduced to provide a tax exemption to privately offered Hong Kong open-ended fund companies (OFCs), which are essentially mutual fund companies. The existing proposal is that three broad conditions will need to be satisfied at all times by the OFC to qualify for the exemption:

- The OFC must be resident in Hong Kong (i.e. its central management and control must be exercised in Hong Kong);
- The OFC must not be closely held; and
- The OFC must predominantly carry out transactions in specific asset classes.

To be regarded as 'not closely held', the requirements are as follows:

- The OFC is required to have a minimum of at least 10 non-qualified investors and the participation interest of each of these investors must exceed HK\$20 million; or, if the OFC has one qualified investor, it must have five investors in total (including non-qualified investors). The participation interest of the non-qualified investors must exceed HK\$20 million, and of qualified investors must exceed HK\$200 million;
- The participation interest of non-qualified investors must not exceed 50% of the OFC's issued capital; and
- The participation interest of the originators and their associates must not exceed 30% of the OFC's issued capital.

The bill is still going through the legislative process.

Future developments

Direction of Hong Kong's new administration

A new chief executive took office on July 1 2017. She has signalled that tax reform will be a priority in her agenda. Tax policy, and how it can be used to grow Hong Kong's economy, will likely take on a central role in her administration.

Some new tax policy initiatives have already been announced, including:

- A two-tier profits tax rate. The first HK\$2 million of profits of a group will be taxed at 8.25% (with the remainder subject to tax at 16.5%); and
- A super deduction for research and development expenditure. A 300% deduction will apply for the first HK\$2 million of such expenditure, and 200% thereafter.

Harmful tax practices

As part of the OECD's and EU's initiatives regarding harmful tax practices, a number of Hong Kong's tax regimes have been identified as constituting harmful tax practices. These include the concessions for corporate treasury centres, offshore reinsurance and captive insurance. Any necessary changes will likely be implemented during 2018.

Tax boosts for Hong Kong funds industry

Darren Bowdern, Matthew Fenwick, and Malcolm Prebble explore the various initiatives that the Hong Kong government has introduced to boost Hong Kong's position as a regional management hub in Asia. While Hong Kong is making positive changes to attract more funds to domicile in Hong Kong, more tax certainty is needed to convince fund managers to move.

In recent years, the Hong Kong government has been introducing various initiatives to bolster Hong Kong's position as a regional management hub in Asia. The asset management industry plays a key role in maintaining financial stability in the challenging market and economic environment.

According to the Fund Management Activities Survey 2016, published by the Hong Kong Securities and Futures Commission (SFC) in July 2017, the combined fund management business in Hong Kong represented HK\$18,293 billion (\$2,343 billion) as at the end of 2016, and achieved an annual growth of 5.2% and a five-year cumulative growth of 45.3%. The SFC survey also showed that a total of more than 2,200 funds were domiciled in Hong Kong, an increase of 12% compared with three years ago, while the number of Hong Kong domiciled SFC-authorized funds had increased by 50% to 735. These figures reflect the Hong Kong government's initiatives in promoting Hong Kong as an international asset management hub.

Hong Kong has also overtaken Singapore, a key regional rival, as the third leading global financial centre according to the 2017 Global Financial Centres Index (GFCI) published in September 2017. London and New York remain the top and second global financial centres, respectively.

In order for Hong Kong to continue to maintain its competitive edge as a global financial centre, the Hong Kong government has introduced various initiatives to reinforce Hong Kong's position as Asia's leading asset management hub. The most significant legislative change affecting the funds industry has been the extension of the offshore fund tax exemption to private equity (PE) funds in July 2015 (offshore PE fund tax exemption) to exempt offshore PE funds from tax in Hong Kong in respect of investments outside of Hong Kong. The key features of the offshore PE fund tax exemption include:

- Extending the offshore fund tax exemption to offshore PE funds by expanding it to cover investments in private companies incorporated offshore as well as both onshore and offshore special purpose vehicles (SPVs) that are established to hold offshore investments; and
- Waiving the original requirement in the offshore fund tax exemption for investments to be arranged by SFC-licensed persons.

While the offshore PE fund tax exemption was initially welcomed by the PE industry, it was noted by the Financial Services Development Council (FSDC) that there has been no noticeable increase in the number

of offshore PE funds managed from Hong Kong since the implementation of the tax exemption. This was due to practical limitations of the existing rules on the offshore PE fund tax exemption. The two key constraints are:

- The offshore PE fund tax exemption does not apply to investments in Hong Kong private companies and non-Hong Kong private companies with substantial operations in Hong Kong or which hold substantial real estate in Hong Kong. A single non-qualifying investment could taint the entire fund and disqualify the fund from being exempt; and
- The permitted functions of an SPV are only limited to holding (directly or indirectly) and administering one or more eligible offshore private companies or another SPV – however an SPV is not permitted to undertake any other management activities.

Given the importance of the role that PE funds play in raising capital for businesses, and in order for Hong Kong to maintain its position as Asia's leading asset management hub, the Hong Kong government should enhance its tax initiatives to make it more business-friendly and favourable to the PE and venture capital industry. As a result, further proposals have been made by the FSDC to:

- 1) Extend the offshore PE funds tax exemption to cover investments in Hong Kong businesses; and
- 2) Extend the offshore PE fund tax exemption to cover investments in onshore privately offered open-ended fund companies (OFCs).

Proposals for extension of offshore PE fund tax exemption to Hong Kong businesses

Hong Kong is facing keen competition from other jurisdictions such as Singapore, Hong Kong's closest competitor in the Asian region, where Singapore's assets under management (AUM) were up 7% to \$2.02 trillion in 2016 according to the Monetary Authority of Singapore compared to Hong Kong's AUM of \$2.34 trillion in 2016. As Singapore continues to make headway by introducing tax and regulatory incentives to grow and promote its own financial hub, Hong Kong must continue to benchmark itself against fund management centres regionally and globally, to be more competitive and attractive for fund managers to domicile in Hong Kong.

In light of the market environment and to increase Hong Kong's competitiveness as a global asset management hub, the FSDC initiated certain proposals in July 2017 including:

- a) The extension of the offshore PE fund tax exemption to cover investments in Hong Kong private companies and non-Hong Kong private companies with substantial operations in Hong Kong, with the exception of those holding substantial Hong Kong residential properties;
- b) Remove the tainting legislation. Under the existing legislation, where a qualified PE fund holds multiple investments and one of its investments fails to qualify as an



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- c) Introduce legislation to treat any gains derived from the disposal of a non-qualifying investment mentioned in (b) above as capital in nature if such investment has been held for more than two years; and
- excepted private company, the profits derived by the fund from the disposal of its other investments would not enjoy the tax exemption. This is because one of its investments has 'tainted' the other investments. The FSDC proposes amending the rule such that an offshore PE fund investing in a non-qualifying investment would only be subject to tax, in respect of the investment income derived from such non-qualifying income, to the extent the investment income is Hong Kong sourced revenue gains;



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Matthew Fenwick has provided tax advisory and compliance services to many multinational clients over a number of years, having worked for the KPMG tax practices in New Zealand, the UK and Hong Kong.

Matthew's clients include a wide range of organisations operating in Hong Kong and across the Asia Pacific region. He has a focus on both Hong Kong specific and regional tax issues, meaning that he regularly liaises with colleagues in other jurisdictions on the myriad of tax related issues his clients face.

Matthew's experience includes advising many funds and fund managers on the establishment and continuing operation of their businesses.

Matthew's work covers the full spectrum of tax advisory and compliance services, including the provision of advice in relation to the tax implications of changes or other developments in relevant tax, accounting and regulatory law and practice.



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Malcolm Prebble has extensive experience in advising on regional merger and acquisitions projects including a number of tax due diligence and structuring projects for acquisitions by fund organisations and other professional investors. Through this work he has developed significant expertise in issues associated with cross border structures and is familiar with specific structuring issues associated with investments into a number of countries within the Asia Pacific.

Malcolm has also assisted a number of organisations with the establishment of new funds focused on investments in the Asia Pacific region, or reviewing existing fund structures to recommend improvements to mitigate tax risks for the fund, sponsors and/or carried interest participants.

Malcolm has advised clients in a wide range of industries, including manufacturing, infrastructure, real estate and private equity.

d) Expand the scope of the allowable activities of an SPV.

The proposed changes should encourage investments into Hong Kong portfolio companies and place Hong Kong and non-Hong Kong portfolio companies on a level playing field to qualify for the offshore PE fund tax exemption. If the legislative process is implemented and finalised as already proposed, this initiative would make the offshore PE fund tax exemption more attractive and more aligned with the Hong Kong government's policy to promote 'home grown' local new business start-ups so as to increase Hong Kong's competitiveness as Asia's leading asset management hub.

Draft legislation for extension of offshore fund tax exemption to onshore privately offered OFCs

On June 23 2017, the Hong Kong government proposed to extend the offshore fund tax exemption to onshore privately offered OFCs. The proposed OFC regime exempts gains derived by certain Hong Kong based privately offered OFCs from profits tax (onshore private OFCs tax exemption).

This is another important initiative of the Hong Kong government to further promote Hong Kong as a leading investment asset management hub. The objective is to encourage fund managers to domicile their funds in Hong Kong instead of in one of the alternative and more estab-

lished jurisdictions such as the Cayman Islands. The proposed OFC framework therefore must be commercially attractive and one that is, at the very least, on par with the more established fund jurisdictions so that Hong Kong is considered as a viable alternative jurisdiction in which to domicile.

However, the proposed OFC framework, in its existing drafted form, is generally viewed as not commercially competitive with the more established jurisdictions and therefore is unlikely to be used by fund managers. If the proposals are enacted as drafted, this would likely be a missed opportunity by the Hong Kong government to introduce an OFC regime that would make Hong Kong a competitive alternative, and one that would put Hong Kong ahead of its regional rivals. In particular, the key limitations in the June 2017 bill are:

- Strict ownership requirements – the OFC has to have at least 10 investors, or if it has at least one qualified investor it has to have at least five investors in total. A 'qualifying investor' in relation to an OFC is defined (subject to meeting certain conditions) as: an institutional investor; a collective investment scheme under the Securities and Futures Ordinance; a registered scheme (or its constituent fund) under the Mandatory Provident

Fund Schemes Ordinance; an entity established to provide retirement, disability or death benefits to beneficiaries that are existing or former employees; a government entity; or a fund established by a governmental entity, international organisation, central bank or the Hong Kong Monetary Authority to provide disability or death benefits.

The investor commitment thresholds for an exempt OFC for 10 investors have to be at least HK\$20 million each or where the OFC has one or more qualified investors, the participation interest of at least four other investors has to be at least HK\$20 million each; and each qualified investor has to exceed HK\$200 million. More critically, the OFC must continue to meet the not closely held test for 24 months after the first 24 month period. Otherwise, the OFC will be taxable retrospectively from its start-up date i.e. as if the tax exemption had never been granted – generally funds would not be willing to take on this risk.

- Inclusion of a provision that deems dividends from a non-exempt OFC to be taxable if the dividends are regarded as consideration or remuneration for services rendered in Hong Kong. This is a rather simplistic approach to address the issue of taxation of carried interest and fees in Hong Kong, which has been a complex and fact-specific issue in Hong Kong. There are obvious concerns that this new rule could have wider implications for the asset management industry in Hong Kong.
- Qualifying investment classes are only limited to securities, futures contracts, foreign exchange contracts, deposits made with banks, foreign currencies, certificates of deposits, cash and over-the-counter derivatives. However, some popular classes of alternate investments – e.g. real estate investments and loans are not covered, and a single non-qualifying investment could taint the entire fund and disqualify it from being exempt.

Consistent with the offshore PE fund tax exemption introduced in July 2015, the proposed onshore private OFC initiative announced in the 2017-18 budget was in principle strongly supported by the industry. However, after the release of the June 2017 bill, there is broad consensus within the industry that the proposals as drafted in the bill may be an initiative that would not be widely used by the industry in Hong Kong. In order to bolster Hong Kong's appeal as an international financial centre for funds to use as a domicile, further refinements to the existing limitation in the June 2017 bill would need to be addressed and refined.

Concluding thoughts

Despite the challenges facing the asset management industry, the Hong Kong government is making positive changes in promoting Hong Kong as Asia's leading asset management hub in the coming years.

Proposals from the FSDC for the extension of the offshore PE fund tax exemption to Hong Kong businesses is a positive step. It helps with identifying practical limitations of the existing tax rules, and proposing remedial action to better align the rules with the Hong Kong government's policy. However, it remains to be seen how these measures will eventually translate into legislation.

Draft legislation introducing the onshore private OFCs tax exemption is another supportive step to implement the initiative announced in the government budget to attract more funds to domicile in Hong Kong and build up Hong Kong's fund management capabilities. Legislative procedures are expected to refine the draft tax rules and address their limitations such that the initiative can compete with other global asset management centres.

Until Hong Kong provides better tax benefits/incentives to inspire international investors' confidence to domicile in Hong Kong, fund managers domiciled in other jurisdictions will be resistant to move into Hong Kong.

Securing R&D tax incentives in China

Preferential tax policy for encouraging innovation is an important means of implementing innovation driven national development strategy in China. For enterprises based on China for operation and development should always pay attention to the development and changes of the relevant preferential R&D tax policies, making full use of the benefits of such policies to enhance the enterprises' core competitiveness and well managing the compliance risk. KPMG has an established practice and the capabilities to assist your company to identify eligible R&D entitlements, such as the R&D expenses super-deduction, HNTE and ATSE status.

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