China Tax Weekly Update

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Reference: Cai Shui [2018] No. 27
Issuance date: 28 March 2018
Effective date: 1 January 2018

Relevant industries: IC industry
Relevant companies: IC manufacturing enterprises
Relevant taxes: CIT

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

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Tax incentives for integrated circuit enterprises

On 28 March 2018, four government authorities including the Ministry of Finance (MOF), State Administration of Taxation (SAT), National Development and Reform Commission (NDRC) and Ministry of Industry and Information Technology (MIIT), jointly issued Cai Shui [2018] No. 27 ("new Circular 27"). The new Circular 27 continues the existing tax incentives for integrated circuit (IC) manufacturing enterprises as set out in Cai Shui [2012] No. 27 ("old Circular 27") and makes some amendments.

According to the old Circular 27, eligible IC manufacturing enterprises may enjoy corporate income tax (CIT) incentives, including:

- For IC manufacturing enterprises with circuit line width less than 0.8 micro-meters (inclusive), these will be exempt from CIT for the first two years and entitled to a 50% tax reduction in the statutory rate of 25% (i.e., 12.5%) for the third to fifth years (referred to as "exemption for two years and 50% reduction for three years"). The preferential tax treatment can be used starting from the first profit-making year (before 31 December 2017) until the expiration of the preferential period.
- For IC manufacturing enterprises with circuit line width less than 0.25 micro-meters or total investment of more than RMB 8 billion, these can pay CIT at a reduced rate of 15%. Furthermore, where the operation period exceeds 15 years, the enterprises will be exempt from CIT for the first five years and entitled to a 50% tax reduction at the statutory rate of 25% (i.e., 12.5%) for the sixth to tenth years (referred to as "exemption for five years and 50% reduction for another five years"). The preferential tax treatment can be applied starting from the first profit-making year (before 31 December 2017) until the expiration of the preferential period.

To supplement these policies, the MOF and SAT jointly issued Cai Shui [2016] No. 49 ("Circular 49") in May 2016 detailing the administration of the incentives (see KPMG *China Tax Weekly Update (Issue 17, May 2016)* for details).

Building on old Circular 27 and Circular 49, the new Circular 27 makes the following notable changes:

New CIT incentives	The new Circular 27 sets out the following new CIT incentives, which apply for smaller chips than under old Circular 27, reflecting technological advances: • The "exemption for two years and 50% reduction for three years" policy may be applied if an IC manufacturing enterprise/IC project is: ➢ Established on or after 1 January 2018; ➢ Engaged in producing circuit line with width less than 130 nanometers; and ➢ The operation period exceeds 10 years. • The "exemption for five years and 50% reduction for another five years" policy may be applied if an IC manufacturing enterprise/IC project is: ➢ Established on or after 1 January 2018; ➢ Engaged in producing circuit line with width less than 65-nanometers or with a total investment exceeding RMB 15 billion; and ➢ The operation period exceeds 15 years. The above-said preferential tax treatment is entitled starting from the first profit-making year until the expiration of the preferential period. Where an enterprise undertakes the IC project that is entitled to enjoy the new CIT incentive, the new Circular 27 clarifies that, the enterprise must meet the qualification conditions set out for IC manufacturing enterprises, and must be able to separately account for the IC project and reasonably apportion the periodical expenses.
Existing CIT incentive continued	• The new Circular 27 clarifies that, for an IC manufacturing enterprise established before 31 December 2017 but has yet to make profit, the "exemption for two years and 50% reduction for three years" or "exemption for five years and 50% reduction for another five years" policy may still be applied from the first profit-making year until the expiration of the preferential period if the IC manufacturing enterprise meets the conditions set out in the old Circular 27.
Eligible IC manufactur -ing enterprises	To be eligible for the preferential treatment, the IC manufacturing enterprise is required to meet the conditions set out in Circular 49. In addition, the new Circular 27 makes certain amendments: • Circular 49 stipulated that "in the year of CIT annual filing, personnel with college degrees and above who have employment contracts with the enterprise, must account for at least 40% of the average number of monthly employees of the enterprise…". The new Circular 27 now extends "having employment contract relationship" to "having employment contract relationship or labour outsourcing and recruitment relationship". • Circular 49 stipulated that "the enterprise is required to possess the core technology and carry out the businesses based on the core technology. Also the research and development (R&D) expenses incurred in the year of CIT annual filing, must account for at least 5% of the total sales (business) revenue of the enterprise". The new Circular 27 now reduces the threshold to "no less than 2%". This may allow more enterprises to meet the conditions.

The new Circular 27 takes effect from 1 January 2018 and solely applies to IC manufacturing enterprises. For IC design enterprises and software enterprises, the preferential tax treatment set out in the old Circular 27 and Circular 49 would continue to apply. For IC packaging or testing enterprises and enterprises engaged in manufacturing key materials or equipment specially used in the IC, they should apply to the tax incentive set out in Cai Shui [2015] No. 6.

Reference: Cai Shui [2018] No. 17
Issuance date: 23 March 2018
Effective date: from 1 January 2018 to 31 December 2020

Relevant industries: All
Relevant companies: Enterprises and public institutions
Relevant taxes: Deed Tax

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

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

Continuance of existing tax incentives for restructuring

On 23 March 2018, the MOF and SAT jointly issued Cai Shui [2018] No. 17 ("Circular 17"). This extends the existing deed tax (DT) incentive for restructuring of enterprises and public institutions as set out in Cai Shui [2015] No.37 ("Circular 37"), which was due to expire on 31 December 2017.

According to Circular 17, the DT incentive (including exemption or 50% reduction) will continue for a period of three years, i.e., from 1 January 2018 to 31 December 2020, for the following:

- Restructuring of enterprises/public institutions;
- Merge/split of a company;
- Enterprises bankruptcy;
- Transfer of assets (see below);
- Debt-for-equity swaps; and
- Transfer of corporate's equity (shares)

Where a parent company increases its capital in its wholly owned subsidiary through a title transfer of land use rights or real property, such transfer will be treated as "transfer of assets" under Circular 17 and DT exemption would be applied.

In respect of restructuring of central state-owned enterprises (SOEs), China's State Council issued the 'Implementation Plan on Corporate Governance Reform of Central SOEs' ("the Plan") under Guo Ban Fa [2017] No. 69 in July 2017. The plan clarified that tax incentives will be granted to central SOEs in restructuring which will provide tax relief for, inter alia, taxable gains on asset restructuring, including land transfer (see KPMG *China Tax Weekly Update (Issue 30, August 2017)* for details).

Reference: N/A
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Effective date: 1 July 2018

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

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

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

BEPS multilateral instrument in force from July 2018

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the Multilateral Instrument or "MLI") will enter into force on 1 July 2018, following the deposit of the ratification instrument by Slovenia on 22 March 2018. Earlier, the Republic of Austria (22 September 2017), the Isle of Man (19 October 2017), Jersey (15 December 2017), and Poland (23 January 2018) have deposited their instruments with the OECD.

MLI is the first multilateral treaty of its kind, allowing jurisdictions to transpose results from the OECD/G20 BEPS Project into their existing bilateral tax treaties, transforming the way tax treaties are modified. MLI has been designed to strengthen existing tax treaties concluded among its parties without the need for burdensome and time-consuming bilateral renegotiations.

The entry into force of MLI on 1 July 2018 will bring it into legal existence in these five jurisdictions. In accordance with the rules of MLI, its contents will start to have effect for existing tax treaties from 2019. This makes a significant step in international efforts to update the existing network of bilateral tax treaties and reduce opportunities for tax avoidance by multinational enterprises.

As at 22 March 2018, 78 jurisdictions, including China, have signed the MLI, and six others have expressed their intention to join in the near future. Signing the MLI only represents a country's commitment to its implementation, but not the instrument's ratification. According to its rules, the MLI only enters into force three months after five countries have ratified, accepted or approved it.

China signed the MLI on 7 June 2017. It is understood that the SAT is currently working on a new treaty guidance to complement the changes China will be making to its treaties through the MLI, and this is highly anticipated. The effective date of the changes will depend on the China and DTA counterparty timeframes for national ratification of the MLI, and further legislative procedures in certain cases. It remains to be seen when China will ratify the MLI.

With regard to the details of the MLI and its impact to China, you may access the following KPMG publications for more:

- *China Tax Alert: China signs Multilateral Instrument to implement BEPS reforms (Issue 19, June 2017)*
- *China Tax Weekly Update (Issue 23, June 2017)*

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OECD's additional guidance on PE profit attribution

On 22 March 2018, the OECD released the Additional Guidance on the Attribution of Profits to Permanent Establishments (PE) ("additional guidance") under BEPS Action 7.

The additional guidance responds to the mandate in the 2015 BEPS Action 7 report on Preventing the Artificial Avoidance of PE Status to develop additional guidance on how the existing rules of Article 7 of the OECD Model Tax Convention (MTC) would apply to PEs resulting from the changes to the definition of PE in Article 5 of the OECD MTC (in particular for PEs outside the financial sector), taking into account the revised guidance contained in the 2015 BEPS Actions 8-10 report on Aligning Transfer Pricing Outcomes with Value Creation.

Under this mandate, the Committee on Fiscal Affairs has issued two public discussion drafts on the attribution of profits to PEs in July 2016 and June 2017 (see KPMG *China Tax Weekly Update (Issue 26, July 2016)* and *(Issue 26, June 2017)* for details). Interested parties were invited to comment on the proposed additional guidance regarding the application of the rules in Article 7 of the OECD MTC to PEs resulting from the changes to Article 5 MTC. The additional guidance has been prepared taking into consideration the comments received and sets out high-level general principles for the attribution of profits to PEs in the circumstances addressed by the BEPS Action 7 report. Importantly, countries agree that these principle are relevant and applicable in attributing profits to PEs.

In particular, the additional guidance sets out high-level general principles for the attribution of profits to PEs arising under Article 5(5), in accordance with applicable treaty provisions, examples of a commissionaire structure for the sale of goods, an online advertising sales structure, and a procurement structure. It also includes permanent establishments created as a result of the changes to Article 5(4), and provides an example on the attribution of profits to PEs arising from the anti-fragmentation rule included in Article 5(4.1).

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