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China

Looking Ahead 8th edition

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China – Looking Ahead

INTERNATIONAL TAX REVIEW

Editorial

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China may have been in the headlines this year for its trade dispute with the US, but there is much more happening across the country's tax landscape than that.

The eighth edition of KPMG's *China – Looking Ahead* guide chronicles a busy 2018 for China's tax system. In the following chapters, KPMG's tax experts explain how tax systems in mainland China, Hong Kong and Taiwan continue to evolve.

One of the notable highlights of 2018 was the merger of the state tax bureaus (STBs) and local tax bureaus (LTBs), which previously existed in parallel in each individual tax district within China. The reforms have created a single tax authority hierarchy under the State Administration of Taxation (SAT). The merger, which offers substantial improvements in taxpayer services and a reduction in compliance costs, is also a key step in the SAT's *Fang-Guan-Fu* multi-year tax administrative upgrade programme.

The other key development of the past year was the implementation of the individual income tax reform. However, many questions still remain over its implications, and taxpayers hope 2019 will deliver clarity on its benefits.

The Belt and Road Initiative (BRI) is another key driver for many of the changes taking place. Since President Xi Jinping announced the BRI in 2013, China's overseas investments in BRI jurisdictions have grown faster than investments into the US, EU and other traditional investment destinations. The opportunities that this initiative offers are beneficial to outbound businesses, particularly in times of trade and investment conflict.

At the same time, who can ignore the digital tax revolution? The concern for China is the risk of a 'splinternet' emerging, whereby one global internet system is dominated by the US, and a separate system by China. Although this is just a possibility lurking in the shadows of digital tax reforms, China is engaged in the global conversations as the size and sophistication of its digital economy, as well as the number of digital enterprises, increases.

The 2018 Year of the Dog has been eventful. Given the rapid pace of developments, the coming Year of the Pig is likely to see more change. We hope that the eighth edition of KPMG's *China – Looking Ahead* will be a valuable tool in guiding you through the developments.

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International Tax Review is published seven times a year by Euromoney Trading Limited.

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ISSN 0958-7594

Customer services: +44 20 7779 8610

UK subscription hotline: +44 20 7779 8999

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China: Tax in the limelight

The Year of the Dog in 2018 has been a remarkable period in China's continuing story of economic growth and transformation. The year has been marked by a shifting inbound and outbound investment landscape, trade issues with the US, major overhauls of domestic tax law and administration, and the continuing rapid digitalisation of the economy. These are all impacting business planning considerations for foreign investors in China, as well as for Chinese multinational enterprises (MNEs) investing overseas. In this eighth edition of *China Looking Ahead*, produced in collaboration with *International Tax Review*, KPMG China's tax experts will examine the issues arising in 2018, as well as exploring the prospects for the Year of the Pig in 2019. It should be noted, however, that the content of this publication is not intended as predictions or forecasts of Chinese tax policies and should not be relied upon as such.

The China economic and investment context is vital for understanding the year's major tax trends. Following on from the recent years' huge surge in outbound direct investment (ODI), which saw China ODI overtake China inbound foreign direct investment (FDI) in 2015 and 2016, ODI moderated substantially in 2017. Indeed, for the year to date, ODI and FDI are much more in balance than in previous years. Ministry of Commerce (MOFCOM) data released in September 2018 showed non-financial sector ODI in the first three quarters to September was $82 billion and FDI was $98 billion. This represented year-on-year growth of 5.1% and 6.4%, respectively. Within these numbers, the notable trends are that:

- FDI has continued its shift towards more advanced manufacturing and services, with a noted surge in investment in medical equipment manufacturing, and other sectors for which foreign investment restrictions have been relaxed by China;
- In line with China government regulatory guidance, ODI shifted towards sectors with greater potential for integration and synergies with the investing Chinese enterprises. These included the automotive, health and biotech, and consumer products and services sectors. In parallel, ODI shifted away from speculative, and highly leveraged, investment in sectors such as property development, sports and entertainment; and
- Investment in Belt and Road Initiative (BRI) countries continued to grow as a proportion of total ODI. The composition of ODI in developed countries changed significantly, with a substantial fall in net flows to the US. This meant that nine times more was invested in Europe than the US in the first half of 2018.

The tightening US government restrictions on Chinese inbound investment, which was partly responsible for this fall in investment, have been paralleled by the heightened trade tensions of recent months. As of November 2018, the US has imposed tariffs of $250 billion on Chinese exports, and China has reciprocated with $110 billion on US exports. As matters stand, there is also the possibility of further increases in the volume of trade covered by these tariffs, and in the rates applied. In another noted development, the newly agreed trade agreement between the US, Mexico, and Canada, replacing the North American Free Trade Agreement (NAFTA), includes a provision that could bar parties to this agreement from free trade agreements with China; it has been suggested that this could well become a feature of further US trade agreements. The medium term impact of these trends on MNE global supply chains, and on Chinese economic growth, remains to be seen.

Indeed, Chinese policymakers must now take these developments into account, as they continue to effect a broader, long-term economic rebalancing agenda. According to President Xi Jinping's outline of China's development priorities in an October 2017 speech to the Communist Party of China (CPC) Congress, the government has been seeking to address industrial over-capacity and reduce excessive leverage in the economy, while maintaining economic growth above 6%. This is in parallel with the pursuit of major goals relating to continuous 'green development', tackling inequality, and cultivating home-grown innovation. It is against this backdrop that the evolving China tax landscape in the Year of the Dog is to be understood.

The 15 thematic chapters of the eighth edition of *China Looking Ahead* explain how businesses operating cross-border with China need to factor in these developments.

Firstly, a major overhaul of the foundations of China's tax and regulatory systems is underway. The chapter, *One giant step forward in Chinese IIT reform,* will explain how this key structural reform, directed at addressing income inequality and shifting the structure of China's fiscal base, has major implications for high-net-worth individuals (HNWIs), as well as global mobility tax planning implications for inbound and outbound secondment arrangements. A further chapter, *R&D 2.0: Taking tax incentives to the next level in China,* explains how the government's innovation agenda, based around the 'Made in China 2025' strategy for building industrial strength in key sectors and the 'Internet Plus' action plan, is being underpinned by a marked upgrade to research and development (R&D) tax incentives. Complementing these changes, China's multi-year tax administrative modernisation programme is leveraging big data technology and a restructured institutional framework for radically improved enforcement effectiveness. The chapter, *Seeing the tax trees from the data forest – how does Chinese tax administration manage in the digital age?,* will note how this increased collection efficacy is also facilitating the tax administration to transition to a more mature and reasonable approach to dealing with the complex commercial issues, arising for taxpayers, in an increasingly sophisticated economy.

Secondly, the external context for China's economic development is changing rapidly. Twin chapters, *When America squeezes – implications of US tax reform for China* and *In the eye of the storm – how does China act and react in times of trade tension?,* will consider the dual impact of US tax reform, and the evolving international trade and customs landscape, on the global supply chains and MNE value chain structures linking China with the world. As noted above, ODI from China is rapidly changing in its complexion, with a greater focus on BRI and Europe, and a dedicated chapter, *Tax opportunities and challenges for China in the BRI era,* will look at the relevant outbound tax implications. In view of the altered flow of inbound FDI towards more technologically advanced sectors of the Chinese economy, a further chapter, *China FS sector opening up: Tax opportunities and challenges ahead,* will look at the impact of recently relaxed foreign investment rules, specifically for the financial sector.

Thirdly, alongside these chapters addressing areas of rapid change, attention is equally warranted for those arenas of long-standing and continuing tax complexity for doing business in China. Two chapters, *Coming of age – China's leveraging of BEPS* and *Now that we have data, what are we going to do? – New challenges and opportunities in TP in China,* will address the post-BEPS landscape for international tax and transfer pricing, respectively, with a focus on new trends and tools of enforcement. The chapter, *Not-so-old wine, in a not-so-new bottle – perennial tax challenges for M&A with new twists,* will address the coal-face issues of tax due diligence and offshore indirect disposal rules. The outdated nature of various domestic tax rules and administrative mechanisms, in the face of new digital economy (DE) business models, is also dealt with in a dedicated chapter, *A Sisyphean task? – Tax plays catch up with China's rapid digitalisation*. This also looks to the novel tax challenges confronting China's outbound DE investment and possibilities for compromise on new global DE tax rules.

Fourthly, the specific challenges facing the Hong Kong and Taiwan economies are addressed. Two chapters, *Implications of IFRS9 on financial instruments for tax in Hong Kong* and *Tax means business – Hong Kong's new tax policies to increase competitiveness,* consider Hong Kong's BEPS and transfer pricing changes, the commencement of tax information exchanges, and the impact of new accounting standards on financial institution taxation, while a separate chapter, *Taiwan's forward looking tax policies,* looks at Taiwan's new digital economy tax framework.

Lastly, looking further to the future, a chapter, *Pushing the digital frontiers of tax in China,* addresses how technological innovations in the VAT space in China may shed a light on how tax law and administration, as well as the tax advisory profession, could evolve into the future.

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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.

He is a frequent speaker at tax seminars and workshops for clients and the public, and an active contributor to thought leadership on tax issues. Khoonming is a fellow of the Institute of Chartered Accountants in England and Wales (ICAEW), a member of the Chartered Institute of Taxation in the UK (CIOT), and a fellow of the Hong Kong Institute of Certified Public Accountants (HKICPA).

Checklist of hot China tax issues for MNEs in 2019

In 2019, multinational enterprises (MNEs) should be alert for the following anticipated China tax developments.

- **Technology implementation to manage individual income taxes** – With the China individual income tax (IIT) reforms entering into full effect from January 2019, businesses are looking to implement technology solutions to help them efficiently manage the administrative burden of collecting employee information on IIT deduction eligibility. The reforms fundamentally change the basis upon which Chinese nationals, and their employers, account for, or withhold, IIT. Whereas previously Chinese nationals were typically taxed on their gross income, from January 2019 they will be assessed on their net income after taking into account a broad range of personal deductions. Foreign expatriates in China will also be affected, with new residency tests and modified rules on claiming various tax free allowances.

- **Employer duty of care for administering itemised deductions** – New itemised deductions for a range of personal living expenses have been introduced under the IIT reform, with a view to improving the lives of working people. While the starting point in the implementation guidelines is that individual taxpayers are responsible for the accuracy of their claims, it is clear that employers will also have a duty of care in the administration of the itemised deduction claims. This will add considerably to employer administrative burdens, as they will need to verify certain claims and track deduction limits.

- **Manage communications with employees** – Given the sweeping IIT reform changes, all employees, including both local-hires and foreign expatriates, are bound to have many queries. It is therefore important for companies to provide appropriate training to equip their HR personnel with relevant knowledge of the China IIT reform in order to handle queries, and manage the expectation of employees. To do so, companies will also need to review their current HR policies, determine how the IIT reform will impact them, and formulate appropriate changes to these policies, and corresponding administrative processes, in order to ensure compliance and optimal employee communication.

- **General anti-avoidance rules (GAAR)** – A key objective of the IIT reform is to close loopholes and protect the integrity of the tax base. To this end, a GAAR has been introduced for IIT. This empowers the tax authorities to adjust tax assessments for individuals involved in tax avoidance transactions or arrangements. Together with the adoption of the latest big data technology to perform data analysis, the Chinese tax authorities are now well equipped to detect and take action in relation to non-compliant taxpayers. As such, it is important that employers review their remuneration reporting processes, as well as any existing dual employment arrangements (where applicable), to check their compliance with the updated IIT rules in order to manage risk of being asserted as non-compliant.

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- **Increase in research and development (R&D) super deduction rate** – 2018 saw the expansion of the 75% R&D expense super deduction rate, which had previously been limited to smaller enterprises, to all qualifying enterprises nationwide; many of these had previously been limited to a 50% super deduction. While this is certainly welcome, taxpayers should take care to ensure full compliance with the qualifying criteria, and retention of the requisite documentation, as the tax authorities have been strengthening their follow-up inspections.

- **CIT super deduction for R&D outsourced overseas** – 2018 also saw a rule change, retroactive to January 2018, under which 80% of the amount of R&D activity-related payments made to an overseas service provider can now qualify for the super deduction. Companies who engage overseas subcontractors for R&D activities, due to lack of technical capacity or expertise in China, may benefit from this change and should review their existing arrangements.

- **Extension of loss carry-forward period** – In 2018 it was also clarified that, for high and new technology enterprises (HNTE) and science and technology small and medium-sized enterprises (STSMEs), unused enterprise tax losses, incurred in the previous five years, are allowed to be carried forward for another five years. This includes losses incurred prior to the enterprises qualifying as a HNTE or STSME. In consequence, technology enterprises can now enjoy a relatively long tax loss carry-forward period (i.e. 10 years, vs the standard five years), which should encourage them to make upfront investment where necessary.

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- **Large enterprise tax risk management** – With the expanded list of large enterprises under the State Administration of Taxation's (SAT's) supervision, ever more large groups with multi-sector operations, and with cross-border activities, will be subject to tighter financial and tax information monitoring by the tax authorities. It is a critical time for all large groups to enhance the compliance effectiveness and efficiency of internal tax management functions. It is also an optimal time for deploying high-tech systems to identify, evaluate and control tax risks.

- **Value chain management** – As many Chinese enterprises expand their operations into the upper and lower tiers of their industry value chains, they are facing more complicated tax compliance issues, but, at the same time, opening a path to tax efficient planning opportunities. Tax planning, whether directed at investment and financing structures, internal cash flow management need, or operational requirements, needs to reflect business objectives and business substance to mitigate tax risks.

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- **US-China trade issues and China response** – Since the beginning of 2018, the US government has announced a series of tariff measures directed at Chinese exports to the US. In response to the tariff measures, China has also implemented tariff measures of a similar scale and intensity, directed at products originating in the US. At the same time, the Chinese government announced several batches of tariff reduction measures covering pharmaceutical, automotive, consumer and industrial products. The overall average tariff rate on imports into China is set to see a reduction to 7.5% in 2019, as compared to 9.8% last year. This is in parallel with steady increases to Chinese goods export VAT refund rates to support Chinese exporters in the face of increased tariffs. The tariff measures have a potentially huge impact on import and export enterprises in both countries, particularly if the US proceeds with planned further tariff increases in early 2019. Enterprises need to review their compliance risks and, to the extent that the trade issues continue, plan strategically for their trading and supply chain arrangements.

- **Customs advance ruling regime** – In 2018, China Customs introduced an advance ruling regime which steers customs inspections, reviews and validation processes away from post-import disputes, and towards a more targeted and clearly defined administrative process and improved efficiency on customs clearance. Enterprises should consider how they might make the best use of the new regime.

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- **Pre-initial public offering (IPO) restructurings guidance** – Well run capital markets are essential to the continuous and sustainable development of enterprises in China. The listing process, however, can be quite time consuming and challenging. Particularly in the context of stricter initial public offering (IPO) scrutiny and risk-oriented tax administration, undertaking pre-IPO restructurings in a compliant and efficient way is vital for a successful IPO. China has introduced various tax rules governing onshore and offshore corporate restructurings, which are generally required pre-IPO. The rules provide for certain preferential tax treatments, such as special (tax deferred) reorganisations under Circular 59, safe harbour rules under the Announcement 7 indirect disposal rules, etc. However, the interpretation and application of tax rules by the local tax authorities can be inconsistent between different locations in China. Consequently, it is very important for companies, at an early stage, to identify and resolve contentious issues, as well as practical uncertainties, through thorough tax planning and analysis, and consultation.

- **Cross-border non-trade charges (e.g. service fee, dividend, royalty, etc.)** – The Chinese tax authorities have been reinforcing their post-filing investigation of contracts related to non-trade charges, utilising big data analytics and risk management-driven tax administration. At the same time, the 2018-issued Announcement 9 comprehensively updates tax guidance on the determination of beneficial owner for treaty relief purposes. This includes two major clarifications for accessing dividend tax treaty benefits: an extended scope for the safe harbour rule and the introduction of a new look-through rule under multi-tier holding structures. These facilitate overseas shareholders to access treaty relief on dividends, and should be examined by taxpayers to see if they can benefit.

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- **New approach to transfer pricing compliance** – A profit monitoring mechanism covering large MNEs and taxpayers with complex intercompany transactions was introduced in April 2018, to enhance the oversight of transfer pricing risk and compliance management. The mechanism, which was pioneered by the Jiangsu provincial tax bureau and is expected to be rolled-out nationwide, sets out a risk assessment framework that involves extensive data gathering by the tax authorities. Impacted taxpayers should ensure that they can keep pace with potentially increased data demands from the tax authorities and provide quality data that supports their transfer pricing arrangements. As the profit monitoring mechanism also incentivises taxpayers to engage continuously with the tax authorities, taxpayers should also consider their strategy in managing this interaction.

- **Mutual agreement procedure (MAP) and advance pricing arrangements (APAs)** – In 2018, there has been an increase in efforts by the SAT to deal with outstanding MAP cases, and to make progress with pending APA cases at competent authority meetings between China and other countries. The enhanced APA process introduced by the 2016-issued Announcement 64 is also expected to contribute to more rapid APA programme outcomes. The increasing openness in the SAT's approach and the enhanced regulatory process offer opportunities for taxpayers to seek assistance from the SAT to resolve double taxation and achieve certainty with respect to their transfer pricing arrangements.

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- **Offshore indirect transfers of Chinese taxable assets** – The calculation of the tax cost base for offshore indirect transfers of Chinese assets remains an area of uncertainty, which is still determined in an inconsistent manner across tax districts in China. In some instances, the local Chinese tax bureaus may allow the full acquisition cost, for the purchase of the overseas company, to be deducted in determining the capital gain on disposal. However, in other cases, only the registered capital of the indirectly transferred China company can be deducted. Foreign investors investing into China, through purchase of an overseas company, therefore have to ensure that the seller reports and pays tax under the Announcement 7 indirect offshore disposal rules. Alternatively, they need to reserve the right to report the acquisition to the China tax authorities and obtain a tax indemnity against any potential withholding tax (WHT) liability from the seller's failure to pay the tax.

- **WHT deferral regime for dividend reinvestment in China** – Issued in December 2017, Circular 88, introduced an incentive which defers the imposition of WHT on dividends paid out of China, provided that the amounts were reinvested in 'encouraged projects' in China. In September 2018, Circular 88 was replaced by Circular 102, which expanded the incentive to reinvestment in all sectors, not just encouraged sectors, except for those included in the negative lists for foreign investment. Foreign investors, especially multinational companies intending to make further investment in China, should monitor how these rules will be implemented.

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- **E-commerce platform needs to be prepared for growing tax compliance responsibilities** – The new China E-Commerce Law that enters into effect from January 2019 includes a provision to oblige all e-commerce platforms to report on the activities of traders and service providers to the tax authorities. While the implementation of this provision will very likely be relying on the finalisation of the new Tax Collection and Administration Law, which is still under drafting and is expected to be finalised in 2019, it nevertheless is expected to add to the tax compliance responsibilities of the platforms significantly in the near future. This development also coincides with the international trend, under which more countries are inclined to shift part of the tax reporting (and even tax withholding) responsibilities of the online traders to the platforms for the ease of administration and tax collection. Hence, whether the e-commerce platform is only conducting business domestically in China, or has expanded/will expand internationally, being prepared, whether in terms of platform IT infrastructure, or trader information collection and management policies and procedures, would be critical in the long-run.

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- **New VAT legislation** – Following the successful implementation in 2016 of the VAT reform pilot programme, the government is expected to commence the process for enacting formal VAT legislation during 2019 (and possibly into 2020). A key question will be the extent to which the government uses this opportunity to make changes to the VAT system, which may potentially include modifications to ensure closer alignment between the Chinese VAT system and OECD principles.

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One giant step forward in Chinese IIT reform

China's individual income tax (IIT) reform has finally been implemented. While it has brought benefits for some, others await further clarity from the authorities on the implications. Michelle Zhou, Jason Jiang, Murray Sarelius and Sheila Zhang outline the impacts of this major tax reform and key considerations for taxpayers.

In President Xi Jinping's landmark speech on October 19 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. As such, we had predicted in last year's IIT chapter, *This time it's personal: China IIT on the eve of a major revamp*, that the reform would be introduced in 2018, with measures to counter the economic trends driving inequality. Sure enough, on June 19 2018, during the third session of the 13th National People's Congress (NPC, i.e. Parliament), the Minister of Finance Liu Kun outlined the proposed IIT amendments to China's IIT rules.

Echoing the objectives mentioned by President Xi previously, Liu delivered two important messages about the IIT reform:

- The IIT reform is intended to reduce the tax burden on working people and deepen reform of the income distribution system. This is to be achieved by (i) raising the threshold at which IIT becomes payable, (ii) aggregating income of a similar nature in order to tax it on a consolidated basis, and (iii) introducing additional itemised deductions for taxpayers; and
- At the same time, the IIT reform is to revise existing rules that are not consistent with international practices, close loopholes, and protect the integrity of the tax base.

Subsequently, on August 31 2018, the standing committee of the NPC passed an amendment to the IIT Law (IIT amendment), which was promulgated through Presidential Decree No 9, and will take full effect from January 1 2019. In advance of this, revised IIT standard personal deduction and tax rates tables apply from October 1 2018. On October 20 2018, draft implementation guidance was issued for a brief period of consultation. At the time of writing the consultation period has ended but the final implementation guidance had not yet been released.

Key IIT reform changes

With the China IIT reform well underway, it is imperative for individual taxpayers and employers to understand the key changes.

Tax residence rule

The IIT amendment seeks to align China's IIT definitions for residents and non-residents more closely with China's treaties and with practices in other countries. Under the existing IIT Law, a key distinction revolves around a person being a domiciliary or non-domiciliary of China. A non-domiciliary

Figure 1

Existing tax law		The amendment	
Income	**Applicable tax rate**	**Income**	**Applicable tax rate**
• Income from salary and wages	• 3%-45% progressive tax rate (seven grades)	**Comprehensive income** • Tax residents will be taxed on an **annual basis** • Non-residents will still be taxed on **a monthly basis or as and when taxable income arises**	• 3%-45% progressive tax rate (seven grades) • Widening the tax brackets of lower levels • Maintaining the tax brackets for three higher levels
• Income from provision of independent personal services	• 20%-40% additive tax		
• Income from author's remuneration	• 20%		
• Income from royalties	• 20%		

of China is defined as an individual who does not habitually reside in China due to his family and economic ties being maintained outside China. Although at present, broadly speaking, an individual with a foreign passport might consider themselves to be a non-domiciliary for IIT purposes, this might not necessarily be the case. Questions of residence and domicile are likely to come under greater scrutiny as the reforms increase the focus on China's international tax boundaries.

Under the existing IIT rules, a non-domiciliary of China would only be treated as a tax resident of China if he or she spends nearly a full year within China. Specifically, they will be tax resident if they have not been physically away from China for more than 30 continuous days, or 90 cumulative days, within a calendar year. This was complemented with a further provision, set out in tax authority IIT guidance, that foreigners were only exposed to IIT on their worldwide income if they were resident in China for five full consecutive years. As explained further below, taking these rules in combination, maintaining a position of non-tax residence in China, over a long period, was generally workable for non-domiciled persons working in China, and they limited their tax exposures to income derived from China.

Under the altered rules of the IIT amendment, however, an individual who is domiciled in China, or a non-domiciliary of China who resides in China for 183 days or more, is considered a 'resident'. They are therefore liable to IIT on income arising within and from outside China. A non-domiciliary of China who does not reside in China or who resides in China for fewer than 183 days is considered a 'non-resident' and is solely liable to IIT on income derived from within China. The change in the tax residence rule modifies China's personal tax residence rule to a 183-day test from the existing one-year test. In other words, even a foreign passport holder will be considered a China tax resident, as long as he or she is physically in China for 183 days or more in a calendar year.

The amended legislation substantially lowers the hurdle to becoming a tax resident of China, which would expand the group of non-domiciled taxpayers subject to worldwide tax in China. The draft implementation guidance, which moderates these outcomes, was consequently received with a note of relief by many expatriates assigned to China, and foreigners based in, or commuting into China.

The draft guidance preserved the five-year concession and the tax break concept for a single trip out of China of more than 30 days (but not the break of more than 90 days in aggregate). As a consequence, the amended tax residence rule will have a less significant impact on many expatriates. The loss of the tax break for aggregated absences of more than 90 days may still create concerns for non-domiciled individuals who spend more than 183 days in China if they commute, say from Hong Kong into the Greater Bay Area (which includes the agglomeration of mainland cities situated beside Hong Kong, including Shenzhen, Guangzhou and others), with such frequency that they are not absent from China for more than 30 days at any one time. In such cases, the individual will need to turn to the double tax agreement between Hong Kong and mainland China to seek relief from China taxes on income from outside of China.

Consolidated IIT calculation

The IIT amendment has grouped four categories of labour income, including income from salary and wages, income from the provision of independent personal services, income from

Figure 2

Income from salary and wages			
Existing tax law			
Taxable income (annualised)	Marginal rate	Quick deduction	
Not in excess of RMB 18,000	3%	0	3%
RMB 18,000 to RMB 54,000	10%	RMB 1,260	10%
RMB 54,000 to RMB 108,000	20%	RMB 6,660	20%
RMB 108,000 to RMB 420,000	25%	RMB 12,060	25%
RMB 420,000 to RMB 660,000	30%	RMB 33,060	30%
RMB 660,000 to RMB 960,000	35%	RMB 66,060	35%
In excess of RMB 960,000	45%	RMB 162,060	45%

Comprehensive income			
	The amendments		
	Taxable income (annual)	Marginal rate	Quick deduction
3%	Not in excess of RMB 36,000	3%	0
10%	RMB 36,000 to RMB 144,000	10%	RMB 2,520
20%	RMB 144,000 to RMB 300,000	20%	RMB 16,920
25%	RMB 300,000 to RMB 420,000	25%	RMB 31,920
30%	RMB 420,000 to RMB 660,000	30%	RMB 52,920
35%	RMB 660,000 to RMB 960,000	35%	RMB 85,920
45%	In excess of RMB 960,000	45%	RMB 181,920

author's remuneration and income from royalties, into the scope of comprehensive income. Comprehensive income is subject to one set of progressive IIT rates; these rates are set out in the section on adjusting income tax brackets below. Figure 1 illustrates the changes from the existing tax law.

At the same time, two previously existing business income categories will be combined. The income from production or business operations, conducted by self-employed persons, and income from contractual or leasing operations for enterprises and institutions, will be reclassified as a new collective category of 'income from operations'.

Adjusting income tax brackets

Per the IIT amendment, comprehensive income will be subject to tax on an annual basis, instead of on a monthly basis, as was the case under the old IIT law for its constituent elements. The tax rates for comprehensive income will be based on the existing rates applicable to 'salary and wages'. Separately, it was also indicated that non-residents will still be taxed on their China income on a monthly basis, or on an 'as arises' basis, depending on the nature of the income.

One may wonder: does this mean that tax residents will cease to be subject to monthly tax withholding and filing? The answer is no. Withholding agents will need to use the applicable annual tax rate to calculate the annual tax liability and divide it accordingly for monthly withholding and reporting purposes. In addition, withholding agents must furnish tax withholding statements to individual taxpayers in order for them to lodge accurate annual tax reconciliation returns.

At the moment, only if an individual is a tax resident of China and earns RMB 120,000 ($17,400) or more per calendar year are they required to file an annual tax return. However, once the IIT amendment changes are in effect, the annual tax return filing will apply to all individual taxpayers. Also, the filing deadline for the annual tax return has been shifted from March 31 to June 30. That being said, the timeline for the annual tax return filing for income earned in the calendar year 2018 remains as March 31 2019.

Figure 2 illustrates the change in tax brackets from the existing tax law.

In addition to the changes to tax brackets, for income from the provision of independent personal services, income from author's remuneration and income from royalties, a deemed expense (i.e. fixed deduction) of RMB 800 or 20% of gross income, whichever is higher, will be allowed. The actual expenses incurred cannot be taken into consideration in the IIT calculation, except for commission expenses incurred in order to perform independent personal services. These can be deducted in addition to the fixed deduction, though they do need to be supported with official receipts. Going further, income tax on author's remuneration will be assessed on 70% of the net income, after deducting the 20% deemed expenses (i.e. 56% of gross receipts).

Similarly, the tax rates on income from operations will be set based on the existing tax rates applicable to income from the production or business operation conducted by self-employed persons and income from contractual or leasing operations for enterprises and institutions. Actual

Figure 3

Income from the production or business operation conducted by self-employed and income from contractual or leasing operations to enterprises and institutions		
Existing tax law		
Taxable income (annual)	Marginal rate	Quick deduction
Not in excess of RMB 15,000	5%	0
RMB 15,000 to RMB 30,000	10%	RMB 750
RMB 30,000 to RMB 60,000	20%	RMB 3,750
RMB 60,000 to RMB 100,000	30%	RMB 9,750
In excess of RMB 100,000	35%	RMB 14,750

Income from operation		
Adjustment		
The amendments		
Taxable income (annual)	Marginal rate	Quick deduction
In excess of RMB 30,000	5%	0
RMB 30,000 to RMB 90,000	10%	RMB 1,500
RMB 90,000 to RMB 300,000	20%	RMB 10,500
RMB 300,000 to RMB 500,000	30%	RMB 40,500
In excess of RMB 500,000	35%	RMB 65,500

costs and expenses are allowed to be deducted in determining the tax base, provided that the business is registered with the appropriate government authorities, and accounting records are properly kept. The tax rates for this category are set out in Figure 3.

Increased personal deductions for comprehensive income

The IIT amendment raises the personal deduction amount for comprehensive income to RMB 5,000 per month (i.e. RMB 60,000 per year; approximately $8,000). For reference, at present the average annual salary in Shanghai and, among China's richest cities, is approximately $17,000. Under the old IIT rules, an individual was entitled to a fixed personal monthly deduction of RMB 3,500. Foreign nationals (including overseas Chinese from Macau, Hong Kong and Taiwan) who are not domiciled in China were previously given an addition fixed personal monthly deduction of RMB 1,300). From the entry into effect of the IIT amendment (i.e. starting October 1 2018), the new personal deduction applies to all, and the step-up in personal deduction for foreign nationals will no longer apply.

Itemised deductions for personal living expenses

New itemised deductions for a range of personal living expenses are being introduced alongside the existing deductible items. This is reflective of the economic transformation which has occurred in China, since the 1980s, with private individuals in China increasingly responsible for covering outlays for education, health, housing for themselves and their families, and for the care of elderly relatives, as well as the increasing cost of meeting these expenses. Figure 4 provides details of the new itemised deductions introduced by the IIT amendment.

The new itemised deductions for personal living expenses will take effect from January 1 2019. They will complement the existing deductions for individual social security contributions (including basic pension and housing fund contributions), commercial health insurance premiums, enterprise annuity and commercial pension insurance contributions (the latter is still being piloted in certain regions). Some of the new itemised deductions are similar in nature to the special fringe benefit exemptions enjoyed by foreign employees and, going forward, the latter may elect to retain the tax-exempt benefits concessions they currently enjoy. In addition, where necessary conditions are met, foreign employees may also claim itemised deductions under the new system. However, they cannot enjoy tax exemptions on fringe benefits, such as children's tuition and housing rental, and simultaneously claim deductions for such expenses under the itemised deduction system.

IIT anti-avoidance rules

Three anti-avoidance provisions have been introduced to the IIT Law, including a general anti-avoidance rule (GAAR). Anti-avoidance provisions are a feature of many jurisdictions' tax legislation, and China already has a GAAR, as well as other anti-avoidance rules, in its corporate income tax (CIT) law. Furthermore, China has integrated anti-abuse rules into its double tax agreements with 107 jurisdictions. The introduction of IIT anti-avoidance provisions in the IIT

Figure 4

Item	Key qualifying conditions		Capping limit		Who can claim?
			Yearly (RMB)	Monthly (RMB)	
Children's education	Pre-school	Three years onwards	12,000	1,000	Each parent – 50% Or 100% to either parent
	Compulsory education	Primary & middle school			
	Intermediate education	High school, Vocational school			
	Higher education	Degree, Masters, Doctorate			
Further education	Formal education	As per above levels of education	4,800	400	Individual taxpayers
	Professional education	Technical/professional certificates	3,600	/	
Serious illness medical fees	Medical expenses > RMB 15,000		60,000	/	Individual taxpayers
Mortgage interest	Limited to first property only		12,000	1,000	If jointly owned, either husband or wife to claim
Housing rental	Not owning property in place of work	Big cities	14,000	1,200	If joint rental, either husband or wife to claim
		Mid-size (population) > 1 million	12,000	1,000	
		Smaller (population) > 1 million	9,600	800	
Supporting elderly	60 years or older parents or other obligations by law	Single child	24,000	2,000	Split between siblings; maximum claim is 1,000 per month for any person
		Not single child	12,000	1,000	

amendment signals the determination of the authorities to combat loopholes and deficiencies in existing IIT law and enforcement.

The new rules will empower the tax authorities to adjust tax assessments for individuals who are involved in asset transfers which are not at arm's length (i.e. a form of transfer pricing rules for individuals), in tax avoidance transactions using offshore tax havens (i.e. a form of controlled foreign company rules for individuals), and in arrangements lacking reasonable commercial purposes which lead to inappropriate tax outcomes (i.e. a tax purposes test for artificial tax planning arrangements).

The anti-avoidance provisions introduced as part of the reforms include a GAAR and specific provisions addressing related party transactions and controlled foreign companies. In preparation for implementation, certain terms have been defined, bringing greater focus to issues of control by a taxpayer and a taxpayer's purpose for entering into certain arrangements.

Related-party transactions

Related-party transactions need to be carried out at arm's length. In this context, related parties include a taxpayer's spouse, siblings and direct blood relatives (immediate family), but also entities for which the individual has direct or indirect control over matters such as the flow of capital, operations, or sales and purchases. There is also provision for other economic ties to trigger a related-party relationship, so potentially extending to financial dependents or people acting together in an economic context.

Controlled foreign companies

A controlled foreign company (CFC) is defined as:

- A foreign company that is owned by one or more China tax residents (individuals or entities) directly or indirectly, through holdings of at least 50% of the company's shares (including at least 10% of the shares which carry voting rights); or
- Effectively controlled by one or more China tax residents by virtue of share ownership, capital, business operations, or authority over purchase and sales related matters.
- Having an effective tax rate of less than 50% of the rate under China's CIT law; and
- Income of the CFC is not distributed back to China, and there are no reasonable operational needs for retaining it in the company.

Income of a CFC may be attributed to the China tax resident shareholders.

Figure 5

Income from salary and wages			Comprehensive income			
Existing tax law			The amendments			
Gross salary*	Tax payable	Effective tax rate	Gross salary*	Tax payable	Effective tax rate	Tax burden reduced by
RMB 5,000	45	1%	RMB 5,000	0	0%	RMB 45
RMB 10,000	RMB 745	7%	RMB 10,000	RMB 290	3%	RMB 455
RMB 20,000	RMB 3,120	16%	RMB 20,000	RMB 1,590	8%	RMB 1,530
RMB 40,000	RMB 8,195	20%	RMB 40,000	RMB 6,090	15%	RMB 2,105
RMB 60,000	RMB 14,270	24%	RMB 60,000	RMB 12,090	20%	RMB 2,180
RMB 80,000	RMB 21,270	27%	RMB 80,000	RMB 19,090	24%	RMB 2,180
RMB 100,000	RMB 29,920	30%	RMB 100,000	RMB 27,590	28%	RMB 2,330

** Itemised deduction/social security contribution has not been taken into account for the illustration*

GAAR

The GAAR allows the tax authorities to adjust the tax assessed where an individual enters into an arrangement lacking reasonable commercial purposes, leading to inappropriate tax outcomes. The implementation guidance indicates that an arrangement will be considered to lack the necessary "reasonable commercial purposes" if the main purpose is to reduce, exempt or defer the payment of taxes. This essentially replicates the wording of the GAAR under the CIT law.

Implications of the IIT reform

In this section, we will examine the IIT reform impact on various groups of individuals in China. These are categorised as the low to middle income working people, foreign/expatriate employees and high-net-worth individuals.

Low to middle income working people

This group of individuals will benefit most from the China IIT reform, in line with the overall policy objectives of the reform to improve income equality outcomes from Chinese economic development. It is estimated by the government that they will be able to enjoy from 10% to 100% reductions in IIT burdens as a result, once the changes are fully implemented. See the illustration in Figure 5 on a 'per month' comparison of IIT on comprehensive income before and after the reform.

For reference, the average monthly wages in Beijing and Shanghai in 2018 are approximately RMB 10,000 per month; these being among the highest average salary levels in China. Workers on the average Beijing wage would see their tax burden fall from 7% to 3% as a result of the reform.

Despite this good news for working people, many challenges still lie ahead to determine the effectiveness in practice of the various IIT amendment changes intended to reduce their tax burdens. For example, if the processes to claim the newly introduced itemised deductions are too complicated or tedious, many low to middle income people may struggle to fulfil the requirements. As such, they may not be able to fully enjoy the intended IIT reductions. In view of this, the tax authorities will likely depend on employers to assist in administering the deductions accurately and efficiently.

Another issue arises for the many working people who perform independent services for a living (e.g. taxi drivers, couriers, and plumbers). These are subject to tax under the IIT category of 'provision of independent personal services', which, as noted above, will become an element of 'comprehensive income' going forward. While the tax rates applicable to them have been lowered, practical issues concerning expense deductions have not yet been addressed.

At the moment, such taxpayers are allowed a fixed 20% deduction from their gross income. In many situations, such as for Didi Chuxing taxi drivers (a popular ride-sharing platform), this is not a good reflection of the expenses they have to incur in providing the services. Consequently, the effective tax rate on their actual income would be very high.

If they were to look to be taxed under the 'income from operations' category, this would demand that they fully

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

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account for all expenses incurred, and substantiate these with official tax receipts (*fapiao*). This would go beyond the capability of many such workers.

It may come as no surprise then that this impacts the compliance levels for such workers, as they have to choose between high effective tax rates under the 'comprehensive income' category, or unworkably complex tax compliance burdens taxed under 'income from operations'. This is a key 'work in progress' area for the Chinese tax administration, going forward, and one could imagine that technology (e.g. mobile scanning of invoices for upload to tax authority websites, mobile-based automatic IIT calculation software linked to tax authority systems, and blockchain-based digital tax invoice administration) may have a key role to play here.

Foreign/expatriate employees

Despite the initial concerned reaction to the law enacting the IIT reform, the subsequent release of the implementation rules has significantly reduced the concerns of foreign individuals and their employers, and helps to position China competitively to continue to attract and retain foreign talents.

Retention of the five-year rule

At the moment, expatriate employees are only exposed to China tax on worldwide income if they are resident in China for five full years in succession. However, in practice, even where foreign workers remain longer than five years in China, a consecutive five-year presence is commonly broken by a period of absence from China – known as a 'tax break'. This allows the expatriate to avoid liability to China IIT on his or her worldwide income. It requires the expatriate to be out of China for an aggregate of 91 days or more during a year, or for a single period of at least 31 days. This needs to be done before the expatriate 'crosses the line' of completing five full years of tax residence in China.

Given the change to the residence rule under the IIT amendment, initially many predicted that this 'five-year rule' would be abolished. However, to the relief of many foreign employees, it has been confirmed in the implementation guidance that the five-year rule will be retained. Although residence will be triggered based on 183 days, a single break in excess of 30 days within five years will continue to create a 'tax break' for determining whether an individual becomes taxable on worldwide income.

Nevertheless, as the five-year concession does not apply to a China domiciliary, we anticipate that 'domicile' may come under greater scrutiny going forward. This is supported by the fact that the implementation guidance provides that eligibility for the concession needs to be validated through a "put-on-record" filing. This may also cause those employed under dual contract arrangements and frequent business travellers to attract greater scrutiny.

Retention of tax-exempt benefits

Some of the new itemised deduction items (e.g. children's tuition and housing rentals) are the same as the fringe benefits provided to foreign employees (who are currently exempted from China IIT on the relevant portions of their income used for such outlays). While some commentators had predicted that the tax-exempt benefits concession would be abolished, the implementation guidance confirms that the tax-free allowances for foreigners will be retained. This mitigates the impact of the China IIT law's high marginal tax rates (at relatively low income brackets) and helps to keep China competitive in the global talent marketplace.

IIT anti-avoidance

The introduction of the IIT GAAR reinforces the trend, very apparent in 2017 and 2018, whereby the Chinese tax authorities significantly increased the frequency of IIT tax audits. The IIT filings of foreign workers in China have been particularly in the spotlight. There is a recent tax audit case, publicised by the national tax authorities, of an expatriate who is the chief representative of a renowned foreign law firm in Beijing. The remuneration he reported to the China tax authorities was significantly lower than his peers in the legal industry, and indeed lower than the local lawyers working under him.

The inconsistency in the reporting of income drew the attention of the Beijing Municipal Local Taxation Bureau during the inspection process. The bureau undertook extensive audit procedures such as collecting and comparing multiple sources of data and found out that the expatriate received payments outside of China for the management work he performed in China; these amounts were not reported. The tax authority then imposed a heavy fine for the under-reporting of income in China – the total tax underpaid plus fines totalled more than RMB 10 million. This shows that if an expatriate taxpayer's income declaration is unreasonably low, the authorities are much more likely, than was previously the case, to perform audit checks to verify the tax payable amount. The introduction of the IIT GAAR and other anti-avoidance rules brings new tax authority 'tools in the toolbox' into play, in this regard.

High-net-worth individuals

The introduction of the IIT GAAR is highly significant in combination with China's September 2018 commencement of the automatic exchange of financial account information (AEOI) under the OECD-led common reporting standard (CRS). These collectively point towards an increase in the rigour of China IIT enforcement *vis-a-vis* offshore assets beneficially owned by Chinese tax residents. Looking forward, the tax authorities may more frequently raise queries on how these assets were acquired, for example, whether the source of the funds for acquisition was China, and whether the income or gains, out of which these funds arose, were appropriately taxed if China-sourced. In view of this, China tax residents should review their global investment portfolio deployment and strategy, and historic tax compliance status, in order to manage any risk of being asserted as being non-compliant.

Since it signed up to participation in the CRS system, China has concluded bilateral competent authority agreements (CAAs) with several countries as well as activating bilateral exchange relationships with numerous countries through the Multilateral Competent Authority Agreement on CRS (CRS MCAA); the total number of exchange relationships activated through these channels now covers 87 countries and jurisdictions.

Coupled with the adoption of the latest big data technology to perform data analysis, the China tax authorities are now well equipped to supervise and detect non-compliant cases. Once an individual is being investigated, travel restrictions may be imposed causing much inconvenience.

In this regard, reference is frequently made to the high profile case of the internationally famous actress, Fan Bingbing, who has a level of fame in China equal to Jennifer Lawrence or Angelina Jolie in western countries. In June 2018, the Jiangsu Province State Tax Bureau opened a case against Fan concerning possible tax evasion and the use of so-called 'yin-yang' contracts; one contract presented to the tax authorities declaring income for IIT purposes, and a separate contract not declared. In October, after a three-month period in which Fan made no appearance publicly or on social media, she made a public apology over the Weibo social

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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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media platform for her non-tax compliance. She was levied with a $130 million bill for underpaid tax and penalties; penalties accounting for $70 million of this amount.

For high-net-worth individuals (HNWI), and the wealth management industry generally, these tax reforms signal a significant change to the landscape. The introduction of CRS and anti-avoidance provisions bring together in the hands of the tax authorities in China both the tools to challenge past structures and arrangements, and the information with which to aim those tools.

All investment structures and arrangements need to be reconsidered to confirm that they remain compliant after January 1 2019. Wealth management and investment planning will become more bespoke, and less commoditised, as the level of control and the individual's facts, circumstances and motivations all need to be considered in determining the proper outcome from a tax perspective.

As greater attention is drawn to the boundaries of the China tax net, matters such as residence and domicile will receive more attention. This has already been signalled by the introduction of the requirement to obtain tax clearance before a household registration (*hukou*) can be deregistered – a significant factor for determining domicile for a Chinese national.

Although the tax rules in China will become more challenging, they are simply moving into the space that tax regimes in many countries have already been operating, and this direction of movement is likely to continue.

It might be noted that, subsequent to the merger of the state tax bureaus (STBs) and local tax bureaus (LTBs) in 2018, the tax authority talent pools for IIT enforcement (e.g. the international tax departments at provincial tax bureau level) are merged with the resources used for CIT enforcement (these officials have ample experience with anti-avoidance rules, including TP and GAAR). As noted in the chapter, *Seeing the tax trees from the data forest – how does Chinese tax administration manage in the digital age?*, a more reasonable approach is increasingly being seen with respect to CIT in the first-tier cities. Many commentators foresee that, conversely, IIT enforcement, particularly *vis-a-vis* wealthy Chinese nationals, may see a significant uptick in severity in the years ahead. In addition, in parallel with the STB-LTB merger, responsibility for social security collection and enforcement passed to the tax authorities from the social security administration. This means that employers and employees need to watch out for more strict and effective enforcement.

Employers

The IIT amendment issues, outlined above, which face working people and expatriate employees also pose great challenges for the companies employing them. These issues are detailed below.

Additional administrative burden for employers

Under the IIT amendment, where tax resident individuals provide information relevant to itemised deductions to the withholding agents (typically their employers), the withholding agent is required to take these deductions into account in calculating tax withheld. The implementation guidelines introduced subsequently also confirm that employers will have a duty of care in the administration of the itemised deduction claims. If improper claims are discovered in the course of employer internal administration processes, the employer should remind their employees to correct the claims, and must notify the tax authority if the individual concerned refuses to make the corrections. Furthermore, the withholding agent is required to retain the relevant tax documents for tax audit purposes, and they will be notified by the tax authority if the authority discovers improper claims made by the taxpayers.

These requirements put some onus on employers to verify certain claims and track itemised deduction limits. Although the implementation guidance went some way to soften the impact for employers, it is likely that when withholding taxes are reviewed by the authorities, the level of itemised deductions for employees will need to be substantiated. In view of this, the IIT reform has certainly increased the administrative burden placed on companies; previously such burdens were limited to the relatively small number of companies handling such arrangements for their expatriate staff, who would also have typically been relatively few in number.

To handle the data collection and record retention to substantiate the claims for itemised deductions, companies will need to establish policies and procedures, and communicate these to employees. As the volume of claims, data and records could be significant, companies should explore the use of technology-enabled solutions to reduce the excessive workload on HR and payroll departments. An example of such a solution is the newly developed system by KPMG known as 'KTEC'. It seeks to:

- Effortlessly collect information on all deductible expenses;
- Seamlessly consolidate payroll information;
- Enhance internal control and thus minimise compliance risk; and
- Ensure timely filing of the monthly IIT return.

Such a tool has to be updated regularly and accurately for any updates to China IIT rules. Once implemented, it will reduce the need to increase manpower cost and increase work satisfaction for HR and payroll professionals.

Need to manage communication with employees

Given the significant changes, all employees (including local hires and expatriates) are bound to have many queries regarding the IIT changes. It is therefore important for companies to provide appropriate training to equip their HR personnel with relevant knowledge of the China IIT reform in order to handle the queries, and manage the expectations of the employees. HR should issue email updates to employees and assure them that appropriate actions will be taken by the company to look after their welfare.

Companies will need to analyse current HR policies, determine how the IIT reform will impact them, and formulate appropriate changes to HR policies and corresponding administrative processes to be compliant with the new system post-IIT reform. Once ready, the new policies and processes need to be clearly documented in the HR handbook and communicated to the employees early in order to educate them on the new processes and requirements. Companies should consider holding training sessions and have an online 'frequently asked questions' section on the new policies and processes relating to the IIT reform.

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Looking ahead

The introduction of the IIT amendment is an important milestone in the evolution of China's tax system. As noted above, the changes closely followed the two key objectives, which are to reduce the tax burden on working people and to safeguard the integrity of the national tax base. The effectiveness of the changes will, however, very much depend on the processes rolled out to implement them and supervise compliance. Further regulations and guidelines are expected from the State Council in due course. In coming years, along with updated administrative measures to ensure that working people can fully benefit from the new deductions and enhanced tax treatments, we can expect that the tax authorities across China will be strengthening their tax collection and administration over income from the transfer of properties and equities.


Global Mobility Transformed
Managing global mobility risk is no longer just about international assignees. Business traveller risk is not new, but in the past most businesses have not had a process to manage this risk globally. This is changing very quickly with many multi nationals putting a global process in place from this year.
KPMG China offers an integrated, centrally managed global compliance process. Our experienced network of professionals will not only strive to ensure that you have great technology, but also work alongside you for your global mobility needs – travel policies, payroll requirements, tax returns, certificates of coverage, compensation sourcing, visas and work permits, audits and much more.
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R&D 2.0: Taking tax incentives to the next level in China

A rapidly evolving domestic and international economic climate is pushing both the Chinese government and enterprises to accelerate their innovation efforts. To revitalise the country through science and technology, more tax policies have been introduced to support R&D-oriented enterprises. Bin Yang, Benjamin Lu and Liang Wu outline these exciting new developments.

As outlined in last year's *China Looking Ahead* chapter on research and development (R&D) tax, *Better smart than lucky: China R&D incentives 2.0*, innovation is viewed by Chinese policymakers as crucial to maintaining the momentum of China's economic development. Adding emphasis to this, in a series of speeches in 2018, President Xi Jinping and Premier Li Keqiang made clear that domestic development of new core technologies is a crucial national objective for the years ahead. This is particularly so in the face of the new international trends affecting globalisation.

President Xi has stated: "Given the increased size of China's overall economy, complete reliance on foreign countries for science and technology innovation is not a sustainable policy. While we will maintain unswerving commitment to the opening-up policy, we should also look to drive independent and indigenous innovation."

Premier Li has observed that "innovation is the main engine of economic development and shall be the centrepiece of the country's overall development strategy". Mapping to this statement, a national science and technology leader team, led by Premier Li, was recently established to drive innovation in key and core technologies.

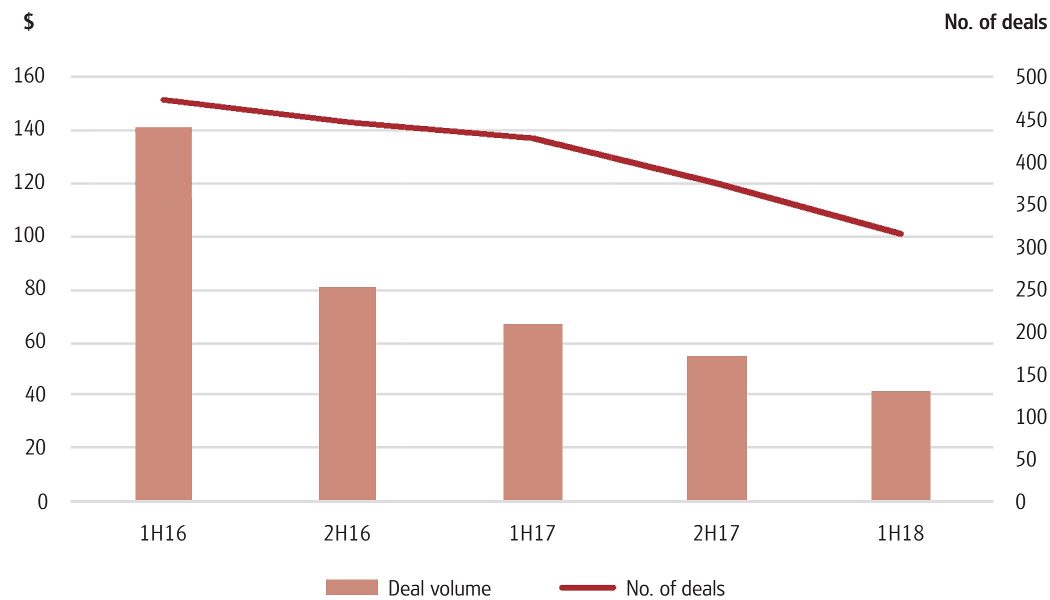
It is therefore in line with these statements that China has made a number of notable improvements to its innovation tax incentives in 2018.

Economic context for tax policies encouraging innovation

The economic context of China's updated innovation tax policies has both external economy and internal economy dimensions.

On the external economy side, as a result of the US tax reform in December 2017, further thought has had to be given to China's tax attractiveness for innovative activity. The income tax rate of US enterprises has been lowered, a 100% expensing of capital investment has been introduced (for a five-year period to 2022), and a type of patent box regime (FDII) has been promulgated; see the chapter, *When America squeezes – implications of US tax reform for China*, for further details. All these collectively make the US a more attractive location than previously for new investment in both high tech tangible investment (e.g. robotic factories) and new technologies. At the same time, the US base erosion and anti-abuse tax (BEAT) rule discourages the purchase of outsourced R&D services from overseas, potentially affecting the development of the R&D service export sector in other countries.

Diagram 1: China announced outbound M&A 1H16 to 1H18 – in USD and no. of deals



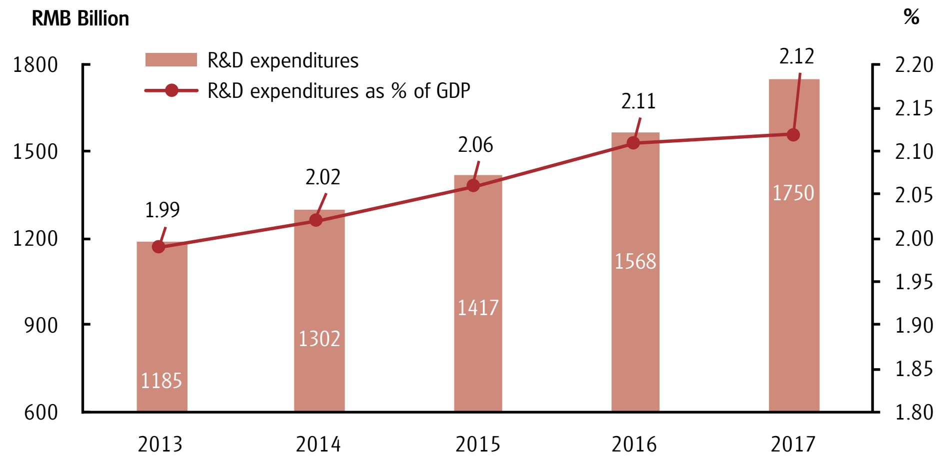
These changes, coupled with the US tariffs now being imposed on a broad range of Chinese exports (see the chapter, *In the eye of the storm – how does China act and react in times of trade tension?*), raise the question as to whether foreign investment in China, fostering technological development and economic upgrade, will diminish. It also raises the question of whether China's own domestic development of innovative new products and services for export will be stymied. Against this backdrop, China's innovation tax incentives are becoming ever more important.

A further consideration is that, while Chinese investment into European and US technology firms had rapidly increased in recent years, from 2018 Chinese enterprises have faced increased hurdles in obtaining access to key developed country technologies. This holds both in relation to technologies obtained by way of import into China (e.g. inbound licensing) or by way of Chinese enterprises purchasing developed country technology companies. The fall in Chinese outbound M&A, detailed in the Thomson Reuters statistics set out in Diagram 1, is reflective of the new challenges created for making these overseas acquisitions. Greater scrutiny from the Committee on Foreign Investment in the US (CFIUS), and moves in the same direction in Germany and the UK, have played a role here; though it is noted that the investment decline also reflects falls in Chinese investment in speculative real estate and entertainment assets as a result of tighter restrictions set by the Chinese government. This developed country regulatory trend compels Chinese enterprises to seek alternative routes to industrial upgrading.

Moving to the internal economy dimension, China's economy grew at 6.5% in the third quarter, the weakest quarterly expansion since 2009. At the same time, fixed-asset investment growth in the first eight months of 2018 dropped to its lowest level since 1995, at just 5.3%. This was a fifth consecutive record low. What is more, the IMF has estimated that in the worst possible outcome for the development of trade issues with the US, Chinese growth could decelerate to 5% in 2019. Looking ahead, President Xi and other top officials have repeatedly emphasised the importance of deleveraging the economy to reduce risks in China's financial system. This means that China cannot rely on expansive monetary policy, easy credit for large state-owned enterprises (SOEs) and local government infrastructure projects, and the real estate boom for growth, as in the past, and new drivers need to be explored.

It is in this context that China is taking action to leverage innovation as a response to its external and internal economic challenges. Policymakers are working from what is already a fairly solid base in terms of outlays on R&D the

Diagram 2: China's R&D expenditure 2013 to 2017 – in RMB billion and as % of GDP



effectiveness with which they are being used, and the financial support for innovative enterprises.

According to a 2017 statistical bulletin from the Chinese National Bureau of Statistics, in 2017, R&D investment in China reached RMB 1.75 trillion ($251 billion), and 2.12% of China GDP (see Diagram 2).

In the World Intellectual Property Organisation (WIPO) 2018 Global Innovation Index (GII) report it was noted that, since 2016, China has featured in the 'Top 25' group, being the only middle-income economy to do so. China has consistently moved upwards in the rankings, to 17th in 2018, meaning that it ranks ahead of developed countries such as Canada (18), Norway (19), Australia (20), and well ahead of other BRICS countries (e.g. Russia ranked 46). The WIPO also evaluated China as performing well at transforming inputs (e.g. investment in education, high R&D expenditure, etc.) into high-quality innovation outputs, performing better than Singapore, Japan, Canada, Norway, and others in this regard.

Also of key importance is the rapid growth of the Chinese venture capital (VC) industry. As the Chinese digital economy giants, Baidu, Alibaba, and Tencent (collectively referred to as the 'BAT') stand behind approximately 50% of all Chinese VC investment, there is a distinct channelling of funds towards digital economy innovation. According to the McKinsey Global Institute (MGI) report, 'Digital China: Powering the economy to global competitiveness', China is the leading nation for VC investment in the fintech sector and in the top two for each of virtual reality (VR), autonomous driving, wearables, and education technology. This puts the country in good stead for the future, and complements on the consumer side the efforts on the industrial side to upgrade manufacturing through automation and robotics, under the 'Made in China 2015' programme.

Many commentators now observe that the trade issues with the US may further accelerate the trend already well under way for low-end, low-margin processing activity for clothes, toys, and so on, to be relocated to Southeast Asia and India, and Chinese manufacturing to shift towards middle and high-tech production, including vehicles, electrical and construction equipment, as supported by automation and robots.

Behind these statistics and trends stand the Chinese innovation tax policies, including R&D super deduction, high and new technology enterprise (HNTE) and advance technology services enterprise (ATSE) incentives, expensing equipment of less than RMB 5 million, and so on. We set out below our observations on recent progress made with these measures, and potential future directions.

R&D expense super deduction expanded

As in many countries around the world, China uses an R&D bonus (or 'super') deduction regime to support enterprise innovation. The origins of China's R&D bonus deduction policy can be traced back as far as 1996, but the prevailing

Table 1: Comparison of effective bonus deduction rate

	China	Hong Kong	Singapore	Australia	New Zealand
Effective bonus deduction rate	75%	100% or 200%	150%	128% or 145%	45%

R&D bonus deduction framework was introduced in 2015, Caishui 2015 No. 119, (Circular 119).

Before 2017, China provided enterprises with a 150% corporate income tax (CIT) super deduction (i.e. a 50% bonus deduction) for qualifying R&D expenses. This meant an effective cash saving of 12.5% of the value of the eligible expenses incurred (assuming the 25% CIT rate applies). As outlined in last year's chapter, from 2017 the bonus deduction was raised to 75% for qualifying science and technology small and medium enterprises, and this was then expanded nationwide to all enterprises from 2018 according to the latest tax authority guidance issued in September 2018. This brings the cash saving to 18.75% of the value of qualifying expenses incurred. As we can see in Table 1 though, there is still room for further improvement to match the best in the ASPAC region.

While this incentive can be very attractive for businesses, in practice there are quite a few uncertainties and limitations on the relief, due to unclear qualifying conditions. In order to remedy for these, the State Administration of Taxation (SAT) released guidance between late 2017 and mid-2018.

In practical application, local tax authorities have limited the expenses they regard as eligible for the super deduction, in circumstances where the SAT guidance is unclear. For example, with respect to staff costs, the super deduction may be limited in practice to the cost of core R&D staff while other items, such as business trip expenses related to R&D projects, may be denied the super deduction. In SAT Announcement 2017 No. 40 (Announcement 40) and Circular 2018 No. 64 (Circular 64), a broader scope of super deduction inclusion is clarified:

- Costs of technical staff and R&D supporting staff, in addition to the core R&D staff;
- Salary payments actually made to outsourced R&D staff;
- Costs associated with share-based incentive schemes, to the extent generally deductible for CIT purposes;
- Other expenses, including staff welfare, complementary pension and complementary medical contribution;
- Costs associated with failed and aborted R&D activities; and
- Expenses incurred for contract R&D activities outsourced to overseas entities. There is a limitation that only 80% of sub-contracted R&D expenses can be entitled to the R&D bonus deduction, applying for outsourcing to both domestic, and foreign, service providers. This is coupled, in the case of outsourcing to overseas entities, with a further cap providing that foreign outsourcing expenses must not exceed two thirds of the qualifying R&D expenses incurred locally in China.

Building on these enhancements, the Chinese government is now working towards further upgrading China's innovation incentives. The following areas for improvement may be highlighted:

- Allow all industries to access the super deduction**:** The super deduction rules exclude enterprises in certain industries from accessing the super deduction. This is governed by a 'negative list' of industries, set out in Caishui [2015] No. 119 (Circular 119), and covers service sectors including tobacco retail, real estate brokerage, wholesaling and retail, accommodation and catering, leasing and business services, entertainment, and any other sectors stipulated by the Ministry of Finance (MOF) or SAT. It is widely considered unduly restrictive, given that there may be highly innovative companies in these sectors which the Chinese government should be fostering – for example, innovative technology to pack, seal and fill products for a longer shelf life, or innovative construction techniques. Indeed, given that China is looking to shift towards a service-consumption driven economy, this negative list should be abolished – this should help to ensure that China invests sufficiently in the knowledge based capital core to an advanced and successful service sector.
- Start-ups need R&D tax incentives to deliver cash refunds: Innovative start-ups generally run substantial losses while they build up their business. As such, they are not in a position to monetise R&D super deductions, which can only deliver benefits where there are taxable profits. Some countries (e.g. Australia, New Zealand, etc.) adopt a cash refund mechanism for such cases. For example, in Australia, the 43.5% tax offset, provided under their R&D tax incentive, is refundable in cash for loss-making entities with turnover less than A$20 million ($14.4 million). Subject to an evaluation of the fiscal impact, the China government should consider this approach. It might be noted that China recently took the measure of refunding excess VAT input credits to businesses in high-tech industries, showing a clear understanding by Chinese policymakers of these cash flow considerations.

- Progressive rates steer support to innovative start-ups: Under Hong Kong's new R&D incentive regime, a progressive bonus deduction rate structure provides a 300% deduction for the first HK$2 million ($255,000) R&D expenses incurred, and 200% for any remaining R&D expenses incurred. This maximises support to small-to-medium sized enterprises, and might be considered a better result than having the vast majority of government R&D subsidies flow to a smaller group of large enterprises. Such a progressive rate scheme might be considered by China in the next phase of innovation tax incentive upgrades.

Fine-tuning the HNTE incentive

Another important tax incentive for innovation in China is the HNTE status and the associated 15% reduced CIT rate. In order to obtain the HNTE status, the following criteria should be satisfied:

- IP ownership: The company must own the core technological IP which plays the key role in supporting its main products (services);
- Industrial field: The main products (services) of the company should fall within one of the eight specified industrial fields;
- R&D expenses: The ratio of qualifying R&D expenses to the total sales of the applicant in the preceding three fiscal years should meet the relevant minimum ratio (i.e. 3%, 4%, or 5% for different sales volume levels);
- HNTE revenue: The proportion of the revenue derived from high and new technology products (services) to the total revenue of the enterprise is more than 60%;
- Personnel: The ratio of science and technology personnel engaged in R&D and related technology innovation activities should be no less than 10% of total employees of the company for the year; and
- Innovation scorecard: A calculation of points is conducted using four assessment criteria for the HNTE candidate's operations. A company needs 71 points or more to qualify for the HNTE incentive.

Compared with the changes to the R&D bonus deduction policy, the changes to the HNTE incentive over the past year are relatively moderate with no ground-breaking reform:

- Clarification of R&D expenses calculation widens HNTE access: To qualify for the HNTE incentive, an enterprise's annual R&D expense must reach a certain percentage of the company's total revenue (e.g. 5% if the latest annual sales are less than RMB 50 million). This is a problematic rule for many enterprises given that the investment on R&D can fluctuate from year to year. Indeed the R&D expenses may be 'front-ended', and once the enterprise starts to monetise its innovation, after a lag of several years, the ratio may fall below the threshold. As such, if the ratio is assessed on an annual basis, the 15% HNTE incentive CIT rate may be lost at the point at which it would yield most benefit. To remedy this, in December 2017 the SAT clarified that the R&D expense ratio is to be calculated on a

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Bin Yang had 13 years of experience with the Department of Commerce, focusing on inbound investment policy advisory and investment project management. He then joined a multinational retailing company as the head of corporate development, legal and government affairs, and was responsible for providing professional opinions and services on development strategy, operational compliance and government affairs.

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 structures. With a sound understanding of 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.

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Benjamin, as the in-charge tax director on R&D related activities in central China, has rich experience in providing advisory and implementation services to various companies (including SOE, MNC and POE) across different industries. The assistance services include but are not limited to advice and assistance with bonus deduction on R&D expenses, assistance with HNTE application, assistance in ASTE application, etc.

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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.

three-year rolling basis. This is clarified in the guidance on the annual CIT filing as a three-year look-back, and should facilitate greater access to the relief.

- Extended life tax loss carry forwards for HNTEs: Innovation means uncertainty and potential failure, and the road from R&D effort to commercialised products takes time. Therefore, HNTEs can face a longer loss-making period than the general population of enterprises. Under the China CIT law, tax losses can be carried forward by an enterprise for five years at most. This may result in HNTE tax losses expiring before they can be offset against taxable profits. Caishui [2018] No. 76 (Circular 76) now extends the loss carry-forward period of HNTEs to 10 years. Furthermore, the 10-year carry forward is extended to losses incurred by a newly qualified HNTE in the five years before it qualified as a HNTE.

Further enhancements to the HNTE regime might be suggested, including:

- Group-level HNTE application: As the existing HNTE rules apply on a separate legal entity basis, this can frustrate access to the incentive where R&D functions and sales are distributed across various entities in a corporate group. While the group as a whole might meet the HNTE qualifying criteria, no individual entity may meet all of the requirements. Enterprises are thus confronted with the decision to structure their operations in a manner which is not commercially optimal in order to access HNTE or forego the relief. Further, from a commercial perspective, the company which conducts the R&D function may not carry out material manufacturing activities. However, a pure R&D centre without a manufacturing function may not satisfy the existing HNTE rule in practice. In light of the fact that the R&D super deduction rules have already been adapted to the commercial realities of corporate groups (e.g. qualifying R&D expenses incurred within the group can be allocated among subsidiaries), it would not be unreasonable to suggest this thinking be extended to HNTE rules. Indeed, going beyond this, it would be desirable if China were to introduce general CIT group consolidation rules similar to those that exist in many advanced economies and facilitate business activity.
- Expanding the HNTE incentive to all industries: One of the existing HNTE criteria is that the business of the applicant should fall into one of the encouraged categories of industries. The latest list was issued together with the latest administration rules for HNTE recognition in 2016. It includes eight industries: electronics and information technology, biology and new medicines, aerospace, new materials, high-tech services, new energy and energy-saving devices, resources and environmental protection, and advanced manufacturing and automation. Yet, the update to the encouraged categories is very slow. Given the manner in which new digital technologies, artificial intelligence (AI) and automation are driving an economy-wide transformation, cutting across all industries, such exclusion of many 'non-encouraged' sectors from HNTE appears to be a sub-optimal policy choice. A dynamic management of the encouraged categories should be established, or the incentive should be widened to all industries.
- Expanding input VAT refund to HNTEs: In mid-2018, the China government designated the first batch of enterprises that are entitled to the refund of their carried-forward input VAT, which could only be carried forward indefinitely under the existing China VAT regime. The assessment of the eligibility to such VAT refund policy is mainly based on the industry in which the enterprise is engaged. Given that large upfront investments are very common for HNTEs which could result in high input VAT carry-forwards; if the VAT refund incentive could be

granted to qualifying HNTEs, this would greatly improve the cash flow status of the HNTEs and consequently encourage re-investment by these HNTEs. The VAT refund incentive is just one example of the potential directional incentives that could be granted to HNTEs. If the governing authority could think outside the box, more directional incentives could be created to support the development of innovation.

Other measures and advice for taxpayers

Apart from the R&D bonus deduction incentive and the HNTE incentive, other innovation-related incentives will continue to be renewed or expanded in 2018. For example:

- A substantial VC and angel investor IIT investment incentive was renewed, and extended nationwide in May 2018 (i.e. Caishui 2018 No. 55). Under this, qualifying investments made in science and technology enterprises, seeking capital or start-up stage support, can be partly offset against the taxable income of the investor; and
- The incentive 15% CIT rate for ATSEs has been expanded nationwide from May 2018 (i.e. Caishui 2018 No. 44). This applies for both of the existing ATSE schemes, including the scheme for 'technically advanced service' providers, and the scheme for outsourcing enterprises.

These initiatives are clearly linked to the government's programme of fostering domestic mass innovation through seed capital, and fostering China's export of advanced services, particularly digital services, in which China already runs a trade surplus. For taxpayers to harness these incentives, and the other measures mentioned above, they should:

- Review the group's development strategy, and consider which firm business activities or models may qualify as new and creative;
- Keep a close eye on the latest refinements to tax incentives, and take them into consideration when planning new development projects; and
- Seek expert advice on how to make the best use of the incentives.

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Seeing the tax trees from the data forest – managing tax administration in the digital age

China's multi-year tax administrative modernisation programme is leveraging big data technology and a restructured tax authority for effective enforcement. Tracey Zhang, Fang Wei, Lilly Li and Anthony Chau explain how this increased collection efficacy is transitioning the tax administration to a more mature and reasonable approach to dealing with the ever more complex commercial issues.

In last year's seventh edition of *China Looking Ahead*, in the tax transformation chapter, *Adding wings to a tiger: data in tax enforcement in China,* we looked in detail at both advances in tax administration being made at governmental level in China, and at the parallel improvements being made in tax management controls and practices at taxpayer level. In this year's eighth edition, in view of the very important changes made during the year in the structure and organisation of Chinese tax administration, in this chapter, we focus on the governmental developments.

Specifically, we look at key developments in 2018 under the following five themes:

- The merger of the thousands of local tax bureaus (LTBs) and state tax bureaus (STBs), which previously existed in parallel in each individual tax district within China;
- The abolition of tax 'pre-approval' and 'recordal' requirements, and tax documentation clarifications, provided as part of China's transition to a more self-assessment-based tax system;
- Risk-based tax enforcement progress, with the rollout of the thousand enterprises initiative;
- Consolidated business registrations and new inter-agency collaboration agreements, facilitating information sharing and enforcement; and
- Online tax filing and digital tax invoicing enhancements.

Overall, we have observed that in China's advanced first-tier cities, such as Beijing, Shanghai and Shenzhen, the tax authorities have increased their enforcement effectiveness (e.g. data-driven tax enquiries/audits, taxpayer credit rating, etc.). At the same time, greater experience and training for tax officials have helped them to gain a better understanding of increasingly complex taxpayer commercial arrangements. These developments appear to have facilitated, in an increasing number of cases, a more reasonable approach by tax officials to dealing with taxpayer issues. China's tax law and formal guidance frequently leave many grey areas, and there is increasing positive experience of tax officials in these cities taking a more holistic view, and applying the law in a manner more sensitive to commercial realities and in line with original tax policy intent.

This is mirrored in the messaging adopted in public communications by the State Administration of Taxation (SAT) and provincial tax bureaus (e.g. through their website postings and WeChat news feeds), which in recent times have increasingly emphasised the concrete actions being taken to improve taxpayer services and support. It is hoped that this positive development continues, even if the economy slows in coming years and fiscal revenue raising becomes more challenging. It is also hoped that as data-driven tax enforcement approaches, and enhanced tax authority administrative structures and training, are rolled out to smaller, lower-tier cities, the positive trend towards greater commercial sensitivity is also reflected in their local tax enforcement practices. In this regard, it must be said that there is a complex interplay of these trends with the enhanced tax authority internal controls. The tightened controls have the good intention of limiting wilful non-application of tax law and SAT guidance, but may have made it harder for officials unfamiliar with commercially complex arrangements to apply tax rules in a commercially sensitive manner. Often, a 'face value' application of the rules is considered a personally safer approach for such officials. With such directionally different trends in play, it remains to be seen how tax administration practices evolve in future years.

Merger of the LTBs and STBs

Historically, China's tax administration and collection was conducted by thousands of tax offices, organised at province, prefecture, county and township levels (with slightly altered terminology for the different levels of tax authorities within major urban areas). At each level there were parallel LTBs, reporting to the local government at that level and collecting local taxes for local needs, and STBs, which collected the central government taxes and fell under the SAT. The complexities of the historic dual system created many challenges for taxpayers.

However, following a central government reform plan outlined in March 2018, from July 2018, LTBs were merged into STBs at each of these levels, resulting in a single tax authority hierarchy under the SAT, but which will involve some input from local governments. As a further step, the central government has also transferred responsibility for collecting employer and employee social security contributions (including housing fund contributions) to the tax authorities. These were previously administered by a variety of other government bodies, including the administrations for social welfare funds.

These reforms have a number of profound implications:

- Before these reforms, different government agencies dealt with different taxes and contributions, such as corporate income tax (CIT) (generally STB), individual income tax (IIT) (generally LTB), and social security (social welfare administration). With all impositions now falling under the SAT-led tax administration, this allows for more integrated and effective enforcement. For example, employee wages subject to IIT and social security contributions and availing of CIT deductions cannot be filed and paid inconsistently, as sometimes happened in the past. In particular, there used to be very poor enforcement of social security contributions in relation to small businesses; this is anticipated to change substantially going forward. This enforcement modernisation also complements the new IIT Law's modernisation of personal income taxation, as outlined in the chapter, *One giant step forward in Chinese IIT reform*.
- Improvements in taxpayer services, and reductions in taxpayer compliance costs, are also expected to arise from the STB-LTB merger. The SAT, in public pronouncements, has been referring to the merger as a key step in its *Fang-Guan-Fu* multi-year tax administrative upgrade programme, translated as one service standard, one administrative procedure, and one rule for law enforcement. Earlier tax administrative upgrade programmes, such as the spring breeze project and the blueprint for deepening the reform of collection and administrative systems of state and local tax administrations had, among other changes, directly required STBs and LTBs to set up common tax service halls and digital platforms. The STB-LTB merger clearly pushes this process further along, and should save taxpayers on having to shuttle between the different locations of LTB and STB tax offices within a tax district to deal with tax payments and recordals.
- The merger also facilitates the implementation of one-stop shop processing of all tax-related matters, which the SAT had already set out as an objective in 2017. The goal is that taxpayers can choose at will the location to complete tax-related matters, with progressive expansion of the scope of the arrangement from (i) handling tax matters concerning all tax districts in a given city at any tax office in that city, to (ii) handling tax matters concerning all tax districts in a given province at any tax office in that province, to (iii) handling tax matters, relating to any tax district within China at a national level, at any tax district within China. This is to be facilitated by the country-wide integration of online tax service platforms, culminating in a nationwide e-tax bureau by 2020, as underpinned by a national data sharing exchange platform.
- As detailed further in the chapter, *Now that we have data, what are we going to do? – New challenges and opportunities in TP in China*, the STB-LTB merger results in larger combined resources being at the disposal of the tax authorities. Cities such as Beijing and Shenzhen have already set-up new investigation bureaus focusing on special tax investigations, with expanded headcount levels well beyond those seen before the merger. Jiangsu province is also rolling out a similar bureau with an estimated headcount of more than 100 officers.

It might be noted that, as promising as these developments sound, there still are a lot of practical issues in relation to cross-tax district coordination and tax revenue allocation that remain to be resolved. For example, where taxpayers can elect with which tax authorities they wish to make filings and pay tax, issues arise concerning the allocation and transfer of tax revenues between tax authorities of payment, and those which might have a claim on the tax revenues as being the location in which income is sourced, or in which the taxpayer is registered (i.e. the responsible tax authority). In the absence of mechanisms for intra-authority tax revenue transfers, this can complicate taxpayer relationships with these tax authorities, who may demand tax payment 'on the double'. Such issues already arise in the cases where taxpayers can elect with which tax authorities they wish to pay and file, e.g. non-resident companies with operations in several tax districts in China.

Issues also arise due to the unique way in which China interlinks administrative approvals, recordals and processes from several government agencies. A foreign company disposing of equity in a Beijing company to a Shanghai company may find that, if they pay tax on the disposal gain to the Beijing tax authority (i.e. the source of the gain), the Shanghai purchaser is unable to process the consideration payment through a Shanghai bank. The bank may have no record of the tax being paid, as only Shanghai tax authority tax payments enter their reference system, and under foreign exchange authority rules, they may not be able to process the payment. Resolving the appropriate tax payment arrangements may require intensive discussions between the Beijing and Shanghai tax authorities, as well as the taxpayer.

As such, while the STB-LTB merger, and national taxpayer data integration arrangements, are promising, many more issues in relation to cross-tax district coordination and tax revenue allocation need to be resolved to ensure a genuinely improved taxpayer experience.

Abolition of tax pre-approval and recordal requirements, and tax documentation clarifications

In the past, China's tax administration relied heavily on 'pre-approvals' to control taxpayer behaviour and compliance. A very wide range of tax treatments, including tax incentives and restructuring reliefs, but also extending to more basic matters, such as recognition of asset disposal losses, required tax authority pre-approval. Furthermore, making various business-related payments out of China required tax authority pre-approval; banks would not process remittances unless a tax authority approval form was presented.

In the period 2013 to 2016, however, the SAT abolished practically all of these pre-approvals. These were substituted with recordals, filed with the tax authorities to enable follow-up procedures, but which should not, in principle, hold up the adoption of tax treatments or the processing of payments. Just seven matters were retained as pre-approval items, relating to minor administrative matters, such extensions of tax payment or filing deadlines (i.e. administrative licensing), and provision was made for these to be handled online.

This being said, many tax authorities across China continued, in certain cases, to treat the recordal process in the same manner as the previous pre-approval process. For example, SAT Announcement [2013] No. 40 had abolished the pre-approval for various payments (e.g. services, and licence fees) out of China and replaced it with recordals. However, the tax authorities in many locations refused to stamp the recordal forms to confirm their receipt before the taxpayer agreed the tax payable with the authorities. As such, lacking the stamped recordal form, it would not be possible to process the remittance with the banks. In addition, many authorities required extensive documentation to be filed with the recordal.

As part of a broad programme of reducing enterprise compliance burdens, but also going some way to addressing such issues, in April 2018 the SAT issued Announcement 23 [2018] abolishing the recordal requirement for certain CIT preferential items. This included items such as tax exemptions, tax basis deductions, super deductions, accelerated depreciation, tax credits, and tax rate reductions. In its place, a new simplified method is used, starting with the 2017 CIT annual filing (from May 2018). Changes made by the announcement aim to:

- Simplify procedures for claiming CIT benefits: Under the new simplified method to access CIT preferential treatments, taxpayers can determine for themselves whether they qualify for the CIT preferential treatment, and declare the CIT incentives they have enjoyed in the CIT annual filing. The taxpayers are required to maintain supporting documents in case of future audits;
- Classify supporting documents as 'principal' or 'other' documents: Taxpayers are required to collect and maintain on file the tax relief supporting documents, listed as 'principal documents' in the new 2017 list of CIT preferential items (set out in Announcement 23). Documents listed as 'other documents', by contrast, do not need to be maintained on file, but may need to be resourced by the taxpayer if and when the authorities request them in clarification of uncertain matters; and
- Focus on follow-up administration: Under Announcement 23, taxpayers in the software and integrated circuit (IC) sectors, who have claimed CIT benefits, must submit their principal supporting documents to the authorities before the deadline of the CIT annual filing (i.e. May 31). For other taxpayers, the follow-up tax administration requirements will be set out by their provincial tax authorities. Tax authorities will strengthen their follow-up administration.

Going forward, the intent is that tax deduction/exemption/incentive treatments provided for under the tax law will simply be adopted by taxpayers in their tax filings, based on their own assessment and evaluation. These can be audited and adjusted by the tax authorities at a later time if claimed inappropriately. These changes are allied to a nationwide campaign to remove excessive administrative discretion from local officialdom and may be viewed as allied to the government's anti-corruption campaign.

The Announcement 23 changes were accompanied by two further measures intended to bolster the transition to CIT self-assessment:

- The April 2018-issued SAT Announcement [2018] No. 15 simplifies the CIT declaration of asset losses. While the pre-approval of asset losses had earlier been transitioned to a recordal, this still required the provision of extensive supporting documentation. Under the new rules, a taxpayer is only required to submit a form, which accompanies the CIT annual filing, declaring the asset losses; supporting documents, such as accounting and tax-related materials can simply be kept on file with the taxpayer, to present in case of audit; and
- The June 2018-issued SAT Announcement [2018] No. 28 fills a major gap in the administrative framework to support the transition to a self-assessment system by setting out formally, for the first time, the supporting document requirements for CIT deduction purposes. Previously, China had no specific rules to regulate which supporting documents responsible tax authorities could demand. While there are certain relevant stipulations in the Tax Collection and Administration (TCA) Law, and the Administrative Measures for Invoices, and their implementation rules, many disputes over what constituted adequate documentation arose between tax authorities and taxpayers in practice. As such, the new guidance aims to increase certainty for enterprises.

Whether these fundamental changes to the operation of the Chinese tax system will benefit or hinder taxpayers is a matter of some debate, and will clearly depend on the circumstances of individual taxpayers. It might be noted that while the old pre-approval system could lead to extensive hold-ups, as taxpayers sought to persuade tax officials of the merits of their case, and could be seen as giving somewhat too much discretion to tax officials, there were advantages. Taxpayers, having received tax authority pre-approvals, could be reasonably sure that the tax position adopted would not be overturned during a later tax audit, assuming the officials who granted the approval remained in place. In addition, it should also be noted that, in each case where pre-approvals have been abolished, substantially more detailed filing forms and documentation are being requested from taxpayers to feed tax authority 'follow-up' procedures.

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With the moves towards self-assessment, it is ever-more crucial that:

- Tax certainty can be obtained through clarity in the law;
- SAT procedures are sufficiently detailed and actually followed by tax authorities in practice; and
- The risk of taxpayer internal error can be managed through tax risk management (TRM) systems and protocols.

The new system may bring benefits where, for a particular tax issue:

- The SAT guidance is very clear and specific with little room for local interpretative discretion;
- The SAT procedural guidance on filings in relation to the relief/deduction, and procedures for administrative review up to the SAT are highly specified and effective in practice; and
- The TRM systems and procedures of the taxpayer are sufficient to pick up and deal with risk areas.

Where any of these aspects are lacking, then the new system may simply heighten taxpayer tax risk, outweighing any potential benefits. In addition, it might be noted that new complexities have arisen with the rollout of better internal controls within the tax authority infrastructure, overseeing and verifying that lower-tier tax authorities do not act in an arbitrary manner, which diverges from the law and SAT guidance. Being under the scrutiny of such internal monitoring mechanisms, there is a tendency by some officials (particularly in some lower-tier tax authorities) to limit their personal exposure by taking a very conservative approach to the application of tax rules. Particularly where they lack

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familiarity with complex commercial arrangements, they may be reluctant to use their discretion to apply the rules outside the strict wording of the law and SAT guidance. This can result in commercially problematic applications of tax rules. Such outcomes might be seen to run counter to the more commercially-sensitive and reasonable application of the rules in grey area cases in the most advanced cities. As such, this is a key challenge for the future in the transition to a more self-assessment based China tax system.

It might also be noted that interrelated aspects of Chinese governmental administration, beyond tax, also need to change in line with these tax administrative changes. As highlighted in the example given above, on the disposal of equity in a Beijing company to a Shanghai company by a foreign company, to the extent that banks and other parts of Chinese governmental and financial administration continue to use tax recordals as key documents in their processes, then the abolition of tax recordals raises questions of how these procedures will be adapted. Time lags in adaptation can lead to complexity and road blocks for basic business activities.

Risk-based tax enforcement steps up – the thousand enterprises initiative

Since 2015, the SAT has been working on the thousand enterprises initiative (TEI initiative), whereby a more data-driven, risk-based, approach to tax administration is adopted for the largest enterprises in China. Work up to now has been focusing on data collection, industry tree construction, and so on. The SAT is conscious that many businesses just view TEI in terms of endless data demands and want to see benefits, and so, Deputy Director of the SAT Large Enterprise Department (LED) Wang Fukai's list of TEI next steps is directed at bringing those benefits, for example, consistent nationwide tax treatment across local tax authorities, advance resolution of tax issues on complex matters, and so on.

On November 24 2017 Wang, provided details of the latest TEI plans:

- The LED has started to perform a tax risk analysis for each TEI-covered group enterprise and their member enterprises. Based on the analysis, the identified tax risks of each member enterprise will be sent to local tax bureaus, via the Golden Tax III system, for further consideration and action. This will improve overall tax administration efficiency by providing better support for taxpayers who are proactive in tax risk management, as well as by helping tax officers to screen audit targets and risk areas.
- In collaboration with provincial-level tax authorities, the fifth branch of the Beijing State Tax Bureau has been assigned to support the SAT to work on the analysis of the TEI information.
- In the past two years, the LED has set up a risk indicator system and completed its upgrade from version 1.0 to 3.0. The key features of version 3.0 include:
  - Use of accounting indicators to measure enterprise operation status;
  - Use of tax collection indicators to monitor enterprise tax compliance performance; and
  - Use of industry indicators to identify enterprise tax risks.
- The SAT is looking to set up a communication mechanism to tackle inconsistency issues arising from the diverse application of individual tax policies by different local authorities. Under this mechanism, the SAT will communicate with the headquarters of the involved group enterprise to reach an agreement on the tax treatment of an issue before it is sent to local tax authorities for resolution.
- Tax risk analysis on TEI-covered enterprises focuses on completed transactions, rather than transactions which are still in progress. However, the SAT may conduct tax risk analysis for an enterprise on its in-progress and more complex transactions (such as mergers and acquisitions transactions) upon receipt of relevant information and data. The identified tax risks will be alerted to the enterprise to ensure that tax filing for the transaction is accurately performed. This may reduce the enterprise's risk of late payment surcharges and penalties.

With such developments in progress, the TEI initiative is set to become a far more important component of Chinese tax administration, both in terms of effective targeting and in audit, and in terms of resolving the types of tax uncertainties inherent in the design and implementation of Chinese tax law.

Consolidated business registrations and information sharing among government agencies

There has been a continuing programme, undertaken over several years, to simplify and consolidate the various business licences, registrations and permits which new enterprises in China must obtain. This falls under the 'five licences into one, one licence one code' programme, which has been rolled out on a nationwide basis since October 1 2016. This followed on from the initial 'three licences into one' reform in 2015, and the later 'five licences into one' reform in 2016. A new phase commenced in October 2017, when the State Council directed a large number of government agencies to take measures in the context of a new 'multiple licences into one' reform.

To this end, in March 2018, a '24 licences into one' programme was outlined for national implementation from June 2018, under Gong Shang Qi Zhu Zi [2018] No. 31 (Circular 31). The 24 licences, which may all be obtained simultaneously on business registration, include:

- Business licence (issued in the past by the administration of industry and commerce);
- Tax registration (issued by the local and state tax offices);
- Organisation code (issued by quality supervision, inspection and quarantine offices);
- Social insurance registration (issued by HR and social security offices);
- Statistics registration licence (issued by statistics bureaus);
- Recordal for a branch's business licence (issued in the past by the administration of industry and commerce);
- Certification for enterprises subject to inspection and quarantine for imports into and exports from China (issued by local entry-exit inspection and quarantine bureaus);
- Recordal for carving of official seal (completed with local MPS offices);
- Recordal for international freight forwarding agencies (completed with local commercial administrations);
- Recordals for FIEs (completed with local commercial administrations);
- Registration certificate for an enterprise engaged in customs declaration (issued by local customs offices);
- Recordal for an enterprise, and its branches, engaged in assets valuation (completed with local MOF); and
- Recordal for companies engaged in labour outsourcing, where setting up branches (completed with HR and social security offices).

The consolidation of these licences allows for enhanced information sharing between different government agencies. This sits alongside numerous other initiatives to pool, together with tax information, data from Customs, Ministry of Commerce (MOFCOM), Ministry of Finance (MOF), State Administration of Industry and Commerce (SAIC), public security bureaus, social welfare authorities and other bodies. Initially, in previous years, inter-departmental information sharing arrangements, some at a national level and others at provincial level, were set up on a rather ad hoc basis. A progressively more structured approach then emerged in recent years following the establishment of an overall framework in the September 2016-issued State Council Circular Guo Fa [2016] No. 51. The SAT has set up tax-related information sharing mechanisms with 14 government agencies, recent examples of which include:

- The April 2017-established cooperative framework agreement on information sharing and joint supervision between the General Administration of Customs (GAC), SAT and the State Administration of Foreign Exchange (SAFE). This framework underpins new mechanisms for information sharing, mutual recognition of supervision among the three authorities, mutual assistance of enforcement among the three authorities, as well as coordinated implementation of customs, tax, and forex rules in an efficient manner.
- The January 2018-issued Gong Shang Qi Zhu Zi [2018] No. 11 (Circular 11) between the SAIC and SAT.

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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).

Before joining KPMG, Lilly worked with the China Tax Bureau and the Australian Tax Office in the areas of international tax administration, tax audit and transfer pricing.

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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.

Following the merger of SAIC with several other government agencies earlier this year, to form the State Administration for Market Regulation (SAMR), the latter will take this forward. Under this arrangement, there will be enhanced SAMR-SAT information sharing and joint supervision activities.

- For example, if an enterprise intends to de-register, it must announce this via the national credit record information sharing platform for the 45 days before de-registration. The SAMR must 'push' such information to the tax authorities, via the provincial-level information sharing platform, within one working day of the announcement being made. For a taxpayer who still has outstanding tax matters, the tax authority will raise an objection to deregistration to SAMR and its subordinate bodies. Circular 11 also clarifies that SAMR and SAT will establish a collaborative mechanism to oversee the obtaining of VAT invoices, and will carry out joint supervision on 'blacklisted' enterprises as a result of breaching tax laws and regulations.

As a next step, the government information systems of each central government agency, including the tax authorities, will all be connected to the national data sharing exchange platform, bringing data-driven enforcement effectiveness to the next level. This data pooled, from across government agencies, sits alongside the increased volume of multi-sourced data being tapped into by the tax authorities for big data analytics-driven tax administration.

As was explained in the 2017 edition of *China Looking Ahead*, in the chapter, *Adding wings to a tiger: Data in tax enforcement in China*, the tax authorities have made considerable efforts to pool tax information from across the Golden Tax III System, and plan to merge this with data from financial institutions (once the TCA Law is finalised), from the common reporting standard (CRS) (exchanges commenced in September 2018), and from e-commerce platforms (once the relevant provisions of the E-Commerce Law become operational). The new dimension in 2018 is the pooling of individual income and property holding data from the personal income and property information system in connection with the IIT reform.

A new tax administration data system for individuals, improved in anticipation of the passing of the new IIT Law (passed in August 2018), was designed for connection to the national personal income and property information system (on which efforts commenced in May 2017). As the IIT Law introduces a consolidated tax calculation across income sources, and provides for a new range of personal tax deductions, for dependent children's education, continuing education, serious illness medical treatment, housing mortgage interest and rentals, alongside the already existing deductions for social security contributions and certain health and pension insurance contributions, the new system will help facilitate the implementation of the new rules from January 1 2019.

Online tax filing and digital tax invoicing enhancements

Measures have been taken in 2018 to make online tax filing simpler and more secure for taxpayers. In this regard, the March 2018-issued SAT Shui Zong Fa [2018] No. 32 (Circular 32) requires provincial tax authorities to upgrade their online tax filing systems so that:

- The online tax filing system can be connected to the taxpayer's financial/accounting system;
- The taxpayer's financial data could be automatically converted into data for online tax filing purposes;
- Tax payable can be automatically calculated by the authority's filing system; and

- Provincial tax authorities are required to ensure the security of the submitted data.

To ensure a harmonised national approach, the circular defines the reference criteria for the conversion of financial data (V1.0), with rolling updates to take place in future.

The online tax filing system enhancements occur in parallel with efforts to help taxpayers towards accurate input of information into these systems. The April 2017-issued SAT Announcement [2017] No. 10 instituted an optional tax service for taxpayers to assist them in identifying and correcting tax calculation errors, in advance of formally submitting CIT annual filing returns. The October 2017-issued SAT Circular Shuizongfa [2017] No. 124 provides, for VAT, a tool for cross-checking different sources of information, including VAT *fapiao*, returns, tax payments and other filing documents, for the purpose of identifying risks.

At the same time, in the digital tax invoice space, advances are being made in the use of blockchain. The Shenzhen tax bureau, supported by Tencent, in summer 2018 rolled out a pilot blockchain invoicing system that fully integrates transaction parties, payment service providers, WeChat invoice delivery, and the tax authorities. Using decentralised blockchain technology, an unalterable transaction record will lie behind the automatic generation of digital tax invoices (*fapiao*), triggered whenever a trader makes a sale and a customer pays (usually using WeChat Pay or Alipay). The customer can then use the digital *fapiao* received over WeChat for claiming relevant tax deductions, with the tax authority having received real-time information on all steps of the process of sale, payment, and tax deduction claim. Assuming such systems prove robust on pilot, their convenience will likely drive widespread registration by traders for the service. Coupled with the TCA Law plans to oblige all financial institutions, and potentially other payment providers, to mass report transaction information linked to taxpayer identification numbers (TINs) to the tax authorities, and supporting initiatives such as taxpayer social credit rating, it is anticipated that compliance by platform-based traders and service providers will progressively increase in future.

When America squeezes – implications of US tax reform for China

The passage of the US tax reform law ushered in big changes to the global tax landscape. Governments and businesses globally have since expended considerable efforts to understand and assess the wide-ranging impacts of these critical changes. Wade Wagatsuma, Xiaoyue Wang, David Ling, Shirley Shen, Koko Tang and Jennifer Weng, discuss the key changes and their impact on China.

On December 22 2017, US President Donald Trump signed into law the most significant US tax reform legislation in more than 40 years. In the months since, governments and businesses globally have expended considerable efforts to understand and assess the wide-ranging impacts of such critical changes in US tax policy.

By and large the US tax reform law amounted to a business tax reform. Its overarching framework clearly reflects the partisan nature of the bill (no Democrat in either the US House of Representatives or Senate voted in favour). It is also premised upon the fairly standard conservative tax view that in reducing the corporate tax burden, investors and businesses alike will take up the incentive to actively reinvest and undertake development initiatives that will grow the domestic market. On the flip side, such measures only serve to enhance the US's competitiveness in the global markets.

While boosting growth was a fundamental driver behind the US tax reform, equally paramount in concern was the closing of what had come to be been seen as gaps in policy that favoured the stockpiling of cash and division of labour outside the US. The end result is a law that implemented a sizeable reduction to the overall headline corporate tax rate, tempered with new measures that focus heavily on reducing profit shifting away from the US through a variety of new limitations and a major expansion of the rules applicable to foreign affiliates of US corporations.

The reaction in China was to establish a special task force to study the impacts of US tax reform, while at the same time moving forward with tax policy developments that had been planned long before the passing of the US tax reform. In particular, less than a week after the US tax reform was signed into law, China released Caishui (2017) 88 (Circular 88) and relevant interpretations, introducing a withholding tax deferral incentive for profit reinvestments in China. This circular, and its successor, Circular 102, are discussed in the chapter, *Not-so-old wine, in a not-so-new bottle – perennial tax challenges for M&A with new twists.*

Remaining focused on preserving China's competitiveness in the global market, in April 2018, at the Bo'ao Forum, President Xi Jinping announced plans for further substantial reforms to liberalise the investment environment for foreign investors, and encourage inbound investment. This included plans to create a free trade zone on the southernmost island of Hainan by 2020, and a free trade port by 2025. It is anticipated that Hainan might be used as a pilot zone for new fiscal policies to be potentially rolled out nationwide at a later stage. Other initiatives to maintain and enhance China's investment attractiveness, outlined further in the chapter, *Coming of age – China's leveraging of BEPS,* include:

- A reduction, from 63 to 48, in the number of economic sectors restricted for foreign investors under the 'negative list';
- Plans to abolish the requirements for foreign investors to have Chinese joint venture (JV) partners across a whole host of sectors, allowing 100% foreign ownership. These include transport and logistics, ship and aircraft building and repair, wholesale activity, professional services, energy and transport infrastructure, and, on a phased basis in the period to 2022, auto manufacturing and financial services;
- Plans to open further sectors to 100% foreign ownership in the foreign trade zones (FTZs), including a range of telecoms and internet services; and
- Recent enhancements to the tax incentives for advanced equipment investment (i.e. expensing of items less than RMB 5 million ($720,000)), the raised ceiling for staff education expense deductions (2.5% to 8%), the special individual income tax (IIT) treatment for 'breakthrough bonuses' to scientists, enhanced venture capital (VC) tax incentives, and increased research and development (R&D) super deductions; see the chapter, *R&D 2.0: taking tax incentives to the next level in China*.

It might be observed that discussion on the medium- to long-term impact of US tax reform on business activity and investment, cross-border into and out of China, is now frequently combined with discussion on the impact of the China-US trade issues, which increasingly look like they may continue for some time. In determining whether there is a need to restructure operations with China, foreign and Chinese MNEs will clearly have to consider the combined effect of these key business environment changes on their strategic options. The China-US trade issues are dealt with in the chapter, *In the eye of the storm – how does China act and react in times of trade tension?*

Reduced headline tax rate

The centrepiece of the law is the permanent reduction in the US corporate income tax rate (CIT) from a maximum 35% to a flat 21%. No distinction between investment income and business income earned by corporations is made for purposes of applying the 21% tax rate. When taking into account US state taxes, the US weighted average CIT rate is now 25.7%, down from 38.9% pre-tax reform. For reference, the standard China CIT rate is 25%, with lower rates for high-tech and small enterprises.

Over the past 30 years, the US had become an outlier in not reducing corporate tax rates. Combined with the complexity of the US worldwide system of taxation, the US corporate tax regime was often seen as a considerable barrier to foreign investment.

The corporate rate reduction under US tax reform is intended to make the US corporate tax rate more competitive with the rates imposed by other countries, putting the US statutory corporate rate more in the middle of the 'pack' of statutory corporate rates levied by central governments of major OECD nations. To what extent the change in law will increase the attractiveness of the US as a place of investment will factor on whether other countries will respond by further rate reductions on their part.

While the reduced tax rate is expected to be a considerable tax benefit for US corporations going forward, an immediate and notable side-effect of the rate reduction is a corresponding write-off of the deferred tax assets, due to the tax differential between the prior maximum 35% and new 21% corporate income tax rates. This has been estimated to trim at least $18 billion from the book values of leading US companies.

The result of the new law is a US corporate tax rate that now sits substantially below the top individual tax rate of 37%. Where prior law often favoured the conduct of business through pass-through entities for many US taxpayers, the corporate rate reduction effected by the new law will and has already been shown to affect the choice-of-entity decisions for some business entities, as the flat 21% corporate tax rate differs from the effective rate for domestic business income of individuals earned through pass-through entities, for which certain income is still taxed at individual rates (i.e. up to 37%).

Private equity firm KKR is a prominent example of a tax restructuring following US tax reform. KKR, which has long operated under a flow-through structure, announced in May 2018 that it would convert from a partnership to a corporation in July 2018. This means that KKR will now subject its revenue, including all performance-related revenue, to the 21% corporate tax rate, rather than pass such amounts up to be taxed solely at its ownership level as would be the case under a partnership structure.

Ultimately, choice-of-entity decisions will continue to depend on individual facts and circumstances. However, it is hard to argue that US tax reform has not swayed considerations in favour of business via the corporate form.

Of notable mention, the law provides for a further boost to the reduced corporate tax rate, albeit temporary, by implementing provisional measures that allow for the immediate and full expensing of certain business assets acquired and placed in service after September 27 2017, and before 2023. Technology and energy companies have already been noted as making use of this incentive and driving a rebound in US capital expenditure spending. This expensing regime goes beyond pre-enactment law by applying to both new and used eligible property, provided such property is new in the hands of the taxpayer. Such benefit applies through 2022, and then ratably phases down over the succeeding five years.

Shift in approach to taxing MNEs

The law makes fundamental changes to the taxation of multinational entities. In general, the law steps the US away from its historic system of imposing worldwide taxation with income deferral, to a partial participation exemption regime with a more comprehensive taxation of foreign income. To accomplish this, the law includes several features, including:

- A 100% deduction for dividends received from 10%-owned foreign corporations;
- A one-time transitional tax on the deemed repatriation of previously untaxed 'old earnings' of non-US affiliates; and
- A permanent minimum tax under the global intangible low-taxed income (GILTI) regime.

Furthermore, the US tax reform law includes substantial anti-base erosion measures targeted at cross-border transactions. Notably, the law includes provisions revising the tax treatment of hybrids, as well as a base erosion anti-abuse tax (BEAT) that imposes a minimum tax on certain deductible payments made to foreign affiliates.

A territorial tax regime (in part)

Under prior law, the operating earnings of a foreign subsidiary of a US corporation were generally subject to US corporate income tax when repatriated to its US parent corporation. To the extent a foreign subsidiary generated certain subpart F income (generally passive income streams, e.g. dividends, interest, or royalties), its earnings could potentially be taxed under the historic anti-tax deferral regimes. Nevertheless, the operating income of the foreign subsidiary would remain largely untaxed in the US until repatriated. The prospect of being hit by this additional tax burden upon repatriation had long been seen as a major factor dissuading businesses from repatriating income to the US, resulting in substantial offshore earnings remaining offshore.

The US tax reform law introduces a 100% participation exemption system for dividends received by US corporations owning 10% (by voting power or value, determined under complex rules) or more of the foreign corporation making the dividend distribution, which moves the US away from a worldwide tax system and closer to a territorial tax system for earnings of foreign corporations. While a truly territorial system cedes the taxation of foreign generated income to the foreign country in which such income is generated, the new law adopts a limited approach in shifting to territoriality, benefitting solely qualifying domestic corporations rather than cross-border investors on the whole.

Generally, a participation exemption regime effects a tax exemption by virtue of share ownership, and aims to reduce the double taxation generally applicable to corporate profits (i.e. at both the corporate and shareholder levels). Under the new law, a participation exemption has generally been adopted on foreign earnings, but only to the extent earnings are neither subpart F income nor subject to the new GILTI minimum tax. In practice, these exclusions mean that US companies can no longer avoid paying tax on non-US profits by keeping the money outside the US.

As under prior law, subpart F income generated by a US controlled foreign corporation (CFC) remains subject to tax on a current year basis to the US parent corporation, even when it is not repatriated to the US. Generally, a CFC is a non-US corporation with more than 50% of its stock in aggregate, directly or indirectly, owned by US persons owning at least 10% of such stock. While fundamentally the same rule as before, the scope of entities potentially classified as CFCs has been substantially widened, due to the expansion of applicable attribution rules and the inclusion of owners of non-voting stock (prior law defined ownership with reference to voting power only).

Expanding the potential income pool subject to current year taxation, the US tax reform law also imposes a new minimum tax on a CFC's GILTI. By application of deductions, the effective tax rate on GILTI is 10.5% for tax years 2018 to 2025, and 13.125% for 2026 and beyond. However, to the extent GILTI income is already subject to foreign taxes of at least 13.125% (16.4% for post-2025 years), foreign tax credits (FTCs) are generally available to offset the minimum tax in full.

In general, GILTI is described as the excess of a US shareholder's 'net CFC tested income' over its 'net deemed tangible income return', which is defined as 10% of its CFC's 'qualified business asset investment' (QBAI), reduced by certain interest expense taken into account in determining net CFC tested income. For many corporations in practice, GILTI generally amounts to a CFC's non-subpart F income in excess of the 10% QBAI threshold (adjusted by interest expenses taken). Although by name GILTI singles out 'intangible' income, the GILTI rules have a much broader application, not necessarily being limited to income from intangible assets, and looks to most of the CFC's non-subpart F income when applying the new minimum tax.

Under the new participation exemption system, a US corporation (other than a real estate investment trust and regulated investment company) that owns at least 10% of the vote or value of a foreign corporation is generally entitled to a 100% dividends received deduction (DRD) on dividends received from such foreign corporation. To qualify for the 100% DRD, the dividend paying stock must be held for at least 365 days within the 731-day period preceding the dividend payment, and the US corporate shareholder must likewise satisfy the 10% ownership requirement at all times during such period. Additionally, any hybrid dividend (generally defined as an amount for which the foreign corporation received a deduction or other tax benefit related to taxes imposed by a foreign country) will not be eligible for the 100% DRD. For any dividend allowed a 100% DRD, the

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Wade earned his bachelor's degree from the University of Hawaii at Manoa, where he graduated with distinction and was a member of Phi Beta Kappa. Wade holds a Juris Doctor from Case Western Reserve University where he was an editor of the Case Western Reserve Law Review, and was elected to the Order of the Coif. He also holds a Masters of Law in Taxation from New York University. Lastly, Wade served as attorney-advisor to Judge Arthur Nims, III of the US Tax Court.

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Xiaoyue Wang joined KPMG China in November 2016 and is the transfer pricing national leader as of December 1 2018.

Prior to joining KPMG, Wang had a long and distinguished career at the State Administration of Taxation (SAT) of China, rising to the position of deputy director general of the international taxation department. Wang was the top transfer pricing official at the SAT for many years. She represented the Chinese government in international negotiations on tax policy and administration. She led the development, drafting and implementation of all major transfer pricing, advance pricing arrangement (APA), and anti-avoidance initiatives, both in terms of legislation and tax administration, and developed a highly effective national structure for transfer pricing and anti-avoidance administration within the SAT.

Since joining KPMG, Wang has led many projects involving the resolution of bilateral and multilateral transfer pricing disputes, including APAs and mutual agreement procedure (MAP) resolutions. Her work has involved companies all over the globe and in a wide range of industries including the electronics, automobile, consumer goods, telecommunication, real estate, pharmaceutical, and luxury fashion industries.

Wang has a PhD in economics from the Renmin University of China and an LLM in taxation from Golden Gate University in the US.

US corporate shareholder will not be eligible to claim a FTC or deduction for any foreign taxes paid or accrued with respect to such dividend.

To facilitate the transition to the participation exemption regime, the new law imposes an additional tax burden for a US corporation's 2017 tax year on the accumulated, historically untaxed earnings of any 10% owned foreign corporation. This transition rule itself includes a participation exemption, the net effect of which is to tax a US shareholder's mandatory inclusion at a 15.5% rate to the extent it is attributable to the shareholder's aggregate foreign cash position and at an 8% rate otherwise. In effect, this one-time tax serves to reset the tax base and parameters by which the US worldwide tax rules will apply for US corporations. Existing net operating losses and FTCs of the US taxpayer may potentially be used to offset the resulting tax liability in 2017. China withholding taxes paid or accrued on the future distribution of such historic earnings to the US are expected to result in a FTC available in future years, but only in part (i.e. subject to a haircut).

Anti-base erosion measures under the BEAT

In drafting the law, the Republican lawmakers involved expressed the intention to incorporate new rules thought to level the playing field between US-headquartered parent companies and foreign-headquartered parent companies. The US tax reform law implements this principle by effectively creating a base-erosion-focused 10% minimum tax (the base erosion and anti-abuse tax, or BEAT) on large multinationals by clawing back the US tax benefit of deductions on cross-border related-party payments that are otherwise permitted, potentially resulting in an additional tax liability. From 2026, the effective minimum tax rate is increased to 12.5%.

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David joined an international accounting firm in the US in 1992 after obtaining his master's degree in US taxation. He was transferred to China in 1993 and has worked in the offices located in Hong Kong, Shenzhen, Shanghai and in Beijing where he spent most of his time. He was promoted to tax partner in 2002 and joined the KPMG Beijing office in the same year.

David has extensive experience in Chinese tax planning, tax advice and tax dispute resolution. When delivering corporate tax and transfer pricing services, David regularly assists multinational businesses in achieving their business goals in China in a tax-efficient manner, including tax planning for cross-border structuring to ensure tax efficiency, and the assessment of merger and acquisition risk from the Chinese tax perspective.

With in-depth understanding of the tax and regulatory system and the local practice in China, David is renowned for his expertise in helping enterprises overcome the tax complexities and challenges associated with business operation in China.

With 25 years in professional practice, David also has well-established relationships with various Chinese authorities at both central and local levels and assisted many foreign companies to secure favourable tax and other rulings.

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Shirley Shen started her career with professional accounting firms in Australia in 2004 and has experience in various disciplines including tax and accounting. Before joining KPMG in 2007, she worked in the tax department of another Big Four Firm for two years. Shirley is now a leader of the China tax centre in the US.

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 has also been actively involved in the VAT reforms in China, having assisted the legislative affairs office of the Budgetary Affairs Commission of the National People's Congress and the Ministry of Finance (MOF) since 2009. She has been involved in many VAT reform projects for multinational companies and state-owned enterprises and provides a full range of services relating to VAT implementation.

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.

Shirley is a noted speaker on tax issues and has presented at numerous seminars for various regulators, professional associations and industry groups on tax topics in China.

Shirley is a member of Certified Practising Accountants of Australia (CPA Australia). She is also a certified tax agent of China and a Hong Kong certificated tax advisor.

The BEAT applies to US corporations (other than S Corporations, RICs, or REITs) that are part of a group with at least $500 million of annual US (including effectively connected amounts earned by foreign affiliates) gross receipts (over a three-year averaging period), and which have a 'base erosion percentage' (discussed below) of 3% or higher for the tax year (or 2% for certain banks and securities dealers). The BEAT also applies to non-US corporations engaged in a US trade or business for purposes of determining their effectively connected income tax liability.

Base erosion payments are subject to the provision when they give rise to a 'base erosion tax benefit', meaning that it can have an impact in the tax year in which a deduction for the payment is allowed. The targeted base erosion payments generally are amounts paid or incurred by the corporation to foreign-related parties for which a deduction is allowable, and also include amounts paid in connection with the acquisition of depreciable or amortisable property from the foreign related party. Generally, the definition of a foreign-related party includes any 25% foreign shareholder of the taxpayer, related persons thereto, and any other person related to the taxpayer under general US transfer pricing principles. In practice, many taxpayers may find it difficult to identify related parties because shareholder ownership may not be readily accessible.

The BEAT includes within its scope almost every outbound payment made by corporations subject to the rule,

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She specialises in structuring of cross-border transactions, mergers and acquisitions (M&A), global tax planning and business model optimisation for multinational corporations, M&A-related tax matters (e.g. tax due diligence, deal structuring, post-deal integration, etc.), and accounting for income taxes under US and China generally accepted accounting principles (GAAP). She also assists Chinese domestic companies in restructuring their businesses for supply chain efficiency and initia public operating (IPO) purposes.

In addition, she provided tax advice to Chinese high-net-worth families on their estate tax planning, family trust, immigration, common reporting standard (CRS), stock incentive plans and partnership programmes.

Koko is a frequent speaker at tax seminars for clients and the public on high-net-worth family tax matters, privately-owned enterprises tax matters, and CRS. Koko has a master's degree in taxation from the University of Waterloo and a bachelor's degree in accounting from Fudan University. She is a member of the American Institute of Certified Public Accountants (AICPA) and the Chinese Institute of Certified Public Accountants (CICPA) as well as a certified tax agent in China.

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Jennifer is a member of the Chinese Institute of Certified Public Accountants (CICPA) and a Certified Tax Agent in China.

except for payments treated as cost of goods sold or otherwise as reductions to gross receipts. However, this exclusion in determining gross receipts is unavailable for taxpayer groups that 'invert' after November 9 2017. Other than for such inverted groups, the BEAT therefore does not apply, for example, to payments for inventory manufactured outside the US.

There are two main exceptions to the provision's scope for otherwise deductible payments. The first is for any amount paid or incurred for services that qualify 'for use of the services cost method' under US transfer pricing rules and that reflects the total cost of the services without markup. The second is for 'qualified derivative payments' for taxpayers that annually recognise ordinary gain or loss (e.g. mark to market) on such instruments, and is subject to several exceptions.

The base erosion percentage used for the 3% (or 2%) threshold requirement is generally determined by dividing the aggregate amount of base erosion tax benefits of the taxpayer for the tax year by the aggregate amount of the deductions allowable to the taxpayer for the year with certain exclusions.

Where applicable, BEAT effectively imposes a tax liability increase (i.e. a minimum tax) by disallowance of the tax benefit for in-scope related party payments. A complex multi-step formula is used to derive the BEAT minimum tax amount.

China considerations going forward

The reaction among Chinese tax policymakers has generally been that the US tax reform amounted to a fairly standard CIT rate reduction to bring the US more in line with the OECD average, an update to core CIT provisions (e.g. dividend exemption) to align closer to principles adopted by other OECD countries, and the implementation of a range of BEPS-focused measures (e.g. CFCs, hybrids, and interest deductions).

As such, policymakers have not made calls for any immediate dramatic overhaul of China CIT rules. Instead, China's policymaking in the period since the passage of the US tax reform law has focused on further enhancing China's innovation tax incentives and improving its VAT rules. China's institution of the dividend reinvestment incentive had already been in planning well before the US tax reform.

US MNEs with Chinese affiliates are undertaking organisational reviews to understand how the new US tax law impacts them, and what organisational changes can be made (e.g. reorganising their cross-border payments), if any, to mitigate any adverse tax impact of the BEAT. However, the precise impact of the US tax reform on the China operations of foreign MNEs and on Chinese enterprises, in both the cross-border context and in the context of their wider global value chains, will only become clear after detailed US tax guidance/regulations have been released and digested by the greater market (e.g. in relation to GILTI and the BEAT).

The final shape of these rules, together with the emergence of greater clarity on the medium term effects of developments in China-US trade relations, will likely feed into MNE supply and value chain (re)structuring. Once the state of play becomes more apparent, there may be further thought given by China tax policymakers on the way forward.

In the eye of the storm – how does China act and react in times of trade tension?

There has been rapid change in 2018 in the trade and customs space, bringing a multitude of challenges and opportunities for companies operating import and export businesses cross-border with China. Eric Zhou, Kevin Kang, Rachel Tao and Philip Xia describe the key challenges and opportunities faced by companies that operate global trade business with China.

Since the beginning of 2018, the US government has announced a series of tariff measures directed at Chinese exports to the US. In response to the tariff measures, China has also implemented tariff measures of a similar scale and intensity directed at products originating in the US. As of the date of this article, the US has already started collecting additional tariffs on products imported into the US from China with a value exceeding $250 billion, and China has responded with additional tariffs on US goods exceeding $110 billion in value.

The tariff measures have had a huge impact on import and export enterprises in both countries. In addition, the US has just reached an agreement with Canada and Mexico on a replacement for the existing North American Free Trade Agreement (NAFTA) – the US-Mexico-Canada Agreement (USMCA). The USMCA includes a key provision which could bar its members from entering into a separate free trade agreement with any non-market economy, which has been taken to refer primarily to China. As such, commentators have suggested that the discussions between China and Canada, on a potential trade agreement between them, might well be affected. This accounts for more than 80% of China's total imports from the US.

The sources of the trade issues between China and the US could be traced to many root causes, and are expected to be difficult to completely resolve in the short- to medium-term. Indeed, at worst, the situation could evolve into a longer term, chronic trade conflict with important implications for the international trade environment. There could well be a degree of ebbing and flowing to the tensions, with alternating periods of relaxation and intensification. Uncertainty may become a 'new normal' that enterprises have to face. In light of this, enterprises need to formulate reasonable strategies that suit their businesses and sectors of operation, such as their go-global strategies, financing structures, supply chain stability analyses, tariff impact analyses, and overseas investment. This should allow them to better cope with the complex international environment and market competition.

In an effort to ameliorate the economic impact and demonstrate that China maintains an open position towards economic globalisation, the China government announced several batches of tariff reduction measures in 2018. The first batches of tariff reduction were effective from May 1 and July 1 2018 respectively, covering pharmaceutical, automotive, and consumer products. The most recent batch of tariff reductions became effective from November 1 2018, and mainly applies to industrial products, textiles and construction materials. The overall average tariff rate on imports into China is set to see a reduction to 7.5% in 2019, as compared to 9.8% last year. The anticipated increased imports will in part cater to stimulated domestic consumption, as an increasing core driver of economic resilience and growth, and in part cater to economic upgrading. It is expected that the lower tariffs will force domestic manufacturers to respond to increased competition from foreign brands, and raise their game – this is an explicit objective of the measures. In light of the US-China countervailing tariffs, it is expected that China will buy more from the EU and other Asian suppliers and this could affect how global supply chains are structured.

Separate from the China-US trade issues, China has been revamping its institutional arrangements for customs supervision. Starting from April 20 2018, the China Entry-Exit Inspection and Quarantine Authority (CIQ) has been officially consolidated as a subsidiary body of China Customs. The CIQ was previously subordinate to the General Administration of Quality Supervision, Inspection and Quarantine of the PRC (AQSIQ), which is generally responsible for the inspection of imports and exports and quarantine. This restructuring is expected to lead to substantial changes to the import declaration process and monitoring mechanism enforced by China Customs, and the associated system set-up.

In addition, China Customs has taken a more proactive approach in terms of its participation in the World Customs Organisation (WCO). In October 2017, a new customs valuation case was approved by the technical committee on customs valuation (TCCV). It was subsequently approved by the WCO Council and issued as TCCV Case Study 14.2. It is worth noting that this is the first time that China has brought a valuation case to the WCO and this particular China solution is set to become part of the global customs valuation guidelines. The case is related to the use of transfer pricing (TP) documentation in customs valuation; gross margins of similar companies were compared in the case study to determine if the transactions with related parties were conducted at arm's length. This will be described in more detail later in this chapter.

In 2018, China Customs also introduced an advance ruling regime for various customs affairs. The introduction of this regime steers relevant customs inspections, reviews and validation processes away from post-import disputes, and towards a more targeted and clearly defined administrative processes and improved efficiency on customs clearance.

Last, but not least, in March 2018, China formally issued an important regulation with regards to 'enterprise credit management', which came into force on May 1 2018. The goal of the new rules is to facilitate those that act in good faith and in compliance with laws and penalise those that lose credit and break laws. Compared to the previous customs credit management regulations, there are enhanced rewards for high credit enterprises, while stricter measures are applied to penalise discredited enterprises. This system exists in parallel with, and operates on the same principles as, the tax authority-managed taxpayer credit system. The latter awards ratings to taxpayers in terms of compliance risk, and 'good' and 'bad' behaviour, and links to these to different levels of scrutiny and preferential access treatment. For further details on this system, see the chapter, *Seeing the tax trees from the data forest – how does Chinese tax administration manage in the digital age?*

US-China trade issues in 2018

Since the start of 2018, the US has released a series of steadily escalated tariff measures. These have included imposing tariffs on washing machines and solar panels in January 2018, 25% tariffs on imported steel and a 10% tariff on imported aluminum products in April, on the basis of section 232 of the Trade Expansion Act of 1962 (section 232 tariff measures). Subsequently, lists of various Chinese-originating products are being subjected to additional 25% and 10% tariffs, based on section 301 of the Trade Act of 1974 (section 301 lists).

The section 232 tariff measures have been enforced for imports of steel and aluminum products into the US, generally applying to imports from all countries, with some limited exceptions. The section 301 lists, however, have been solely enforced on products originating in China. These additional 25% and 10% tariffs have started to be levied on the products covered by the lists as of July 6, August 23 and September 24 2018. The section 301 lists focus on products from the industrial sectors that contribute to or benefit from the 'Made in China 2025' industrial policy, including mainly aerospace, information and communications technology, robotics, industrial machinery, and automobile products.

Correspondingly, the Chinese government announced its retaliation against US exports into China and additional tariffs at 5%, 10% and 25% have been levied on a series of lists of items from the same dates. As of the date of this article (October 16 2018), the lists of products in Figure 1 have been affected and their status is also mentioned. It should also be noted that China has steadily increased its goods export VAT refund rates to support exporters in the face of increased tariffs.

Undoubtedly, businesses operating throughout ASPAC and the wider world will see varied impacts from the trade issues between the US and China, depending on their sector, operations, and the distribution of their activities. Based on our observations, several actions can be adopted by companies whose import or export businesses are affected:

- Trade data collection: Companies need to ascertain exactly which imported products may be affected by new tariffs, and at which volumes these will kick in.

Figure 1

US list (imports from China)		China list (imports from the US)
• Steel articles • Aluminum articles (**23+ tariffs**)	**Effective from March 23/ April 2 2018**	• Fruit and pork • Seamless steel pipes • Recycled aluminium (**128 products, $3 billion**)
• Boilers, machinery and mechanical appliances • Electrical machinery • Auto, aircraft, ships and boats • Instruments and parts (**818 products, $34 billion**)	**Effective from July 6 2018**	• Agricultural products • Auto • Aquatic products (**545 products, $34 billion**)
• Lubricating oils/preparations • Chemicals (partial) • Iron or steel products • Electrical machinery • Railway products • Instruments and apparatus (284 products originally published, and amended to 279 products, $16 billion)	**Effective from Aug 23 2018**	• Chemicals (partial) • Medical equipment • Energy products (114 products originally published, and amended to **333 products, $16 billion**)
• Foods • Chemicals (partial) • Textiles • Auto parts (**6,000+ products, $200 billion**)	**Effective from September 24 2018**	• Agriculture products • Foods • Chemicals (partial) • Textiles and apparel • Metal products • Machinery (**5,207 products, $60 billion**)

Companies should organise and review their import and export data to obtain a full picture of their existing trade activities and understand the risks they face. Companies should identify and focus on their most affected products, so that compliance review and planning can be more focused and effective.

- Review to mitigate compliance risks: Additional tariffs are levied on particular tariff codes, published by the governments of the two countries, and are applicable based on the country of origin (as opposed to the country of the trading enterprise). As such, companies need to ensure that their customs reporting of tariff classifications and countries of origin are accurate. Specifically:
  - Importers and exporters in China and the US should carefully review the accuracy of declared tariff codes. In the event of uncertainty, it is essential to get an understanding of the advance ruling mechanisms and judicial review in the two countries as soon as possible, to ensure the accuracy of customs declarations;
  - Country of origin determinations can be challenging for certain companies due to the complex and varying rules of origin adopted by the two countries. The determination can also be complicated by fluctuations in production costs, selling prices of finished products, and the different bill of materials (BOM) components for a product. It is imperative that companies manage this action through automated processes and ensure that each determination process and result is audited and stored, to ensure that compliance risks are managed; and
  - Origin marks should be displayed accurately and clearly. For example, for non-US origin goods imported into China from the US, or non-Chinese origin goods exported to the US, companies could face delays and challenges if they do not mark packages and products correctly. Certificates of origin should be applied where possible, in order to avoid obstacles in customs clearance.
- Participate actively: If it is confirmed that the tariff codes of the goods are accurate and the country of origin is confirmed, companies should have a good understanding of the possibilities for applying to government authorities in the two countries for an exclusion of their products from the additional tariffs. The US has established a formal

application process, under which the office of the US trade representative (USTR) can be approached for an exclusion from the section 301 tariff measures. The Chinese government is also collecting written feedback from enterprises in selected industries and is expected to launch its own exclusion process in the near future.

- Strategic planning: With the above tasks generally considered to be short-term actions, companies are recommended to identify mid-term and long-term strategies to mitigate the impact of what might be continuing additional duty costs.

  For example, the US has a duty drawback regime that allows for the refund of 99% of the section 301 duties paid on goods imported into the US that are subsequently re-exported. Similarly, China has its free trade zones and processing trade regime that can be used to enjoy exemption from the duties that are payable on imports if they are to be exported, subsequent to storage or manufacturing. These regimes in both countries could substantially reduce the negative impact of the trade conflict for firms that can avail of them.

  In addition, a change of source for a single component of a BOM can impact the country of origin (COO) designation for a finished product. Companies can consider where to source their components, and which stages of the manufacturing should be performed in which country, by re-considering their overall supply chain and sourcing strategy.

  There are also various other regimes that can be considered. The US has a US goods return scheme, under which goods that were made in the US and are returned to the US may be eligible for duty-free treatment. The US also has a first sale scheme, allowing the importer to declare the 'first sale' value in a multi-tier transaction, which excludes a middleman's mark-up and other costs. China has a selective duty payment scheme, allowing manufacturers in certain special customs areas to pay duties based on finished products or raw materials. China also has an outward processing scheme, where duties are paid on the value added part only, when raw materials are sent out of China for processing.

Substantial reduction of import tariffs on imported goods

As noted above, while China has applied countervailing tariffs to imports from the US, its general import tariff policy has 'doubled down' on opening up, with some major reductions in overall tariff levels. As a direct follow-on from a keynote speech made by Chinese President Xi Jinping at the opening ceremony of the Boao Forum for Asia (BFA) annual conference on April 10 2018, the Chinese government announced tariff reductions on a total of four batches of imported goods in 2018, including pharmaceutical products, vehicles and auto parts, daily consumer products, and building and textile products:

- On April 23 2018, the Customs Tariff Commission of the China State Council issued the announcement on the reduction of import tariffs on pharmaceutical products, Shui Wei Hui Announcement [2018] No 2 (Circular 2), which reduced interim tariff rates on pharmaceutical products to zero from May 1 2018;
- On May 22 2018, the Customs Tariff Commission of the China State Council issued the announcement on the reduction of import tariffs on automotive vehicles and parts, Shui Wei Hui Announcement [2018] No 3 (Circular 3). This reduced vehicle tariff rates for a total of 139 tariff codes (from 20% and 25%) to 15%. It also reduced auto parts tariff rates for a total of 79 tariff codes (ranging from 8% to 25%) to 6%. The relevant tariff reduction for this second batch of imported goods was effective from July 1 2018.
- Following this, the Customs Tariff Commission of the State Council further issued Shui Wei Hui Announcement [2018] No 4 (Circular 4) on May 31 2018, which substantially reduces the import tariff rate for 1,449 types of daily consumer goods. As with the second batch of products, the reduction became effective from July 1 2018.

Circular 3 and Circular 4 are in line with the president's BFA speech.

Going further, Premier Li Keqiang announced another round of tariff reductions to be effective on November 1, covering 1,585 tariff codes that include industrial products, textile products and construction materials. It is expected that the average tariff rate will be reduced to 7.5% after this round of reductions, as compared to 9.8% that was the average tariff rate in 2017.

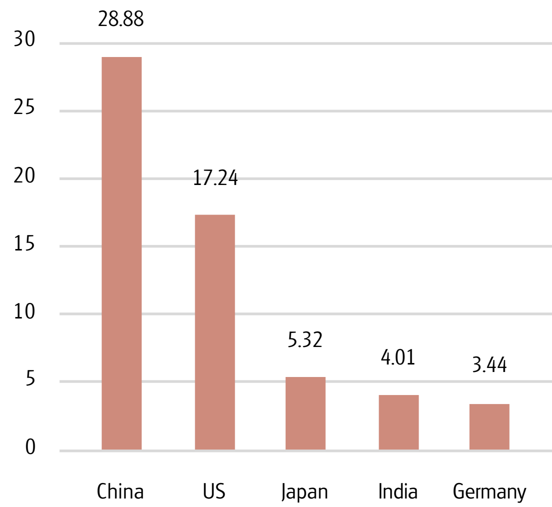
The effect of these measures in terms of improving the framework for China cross-border business-to-consumer (B2C) e-commerce is worth noting. A series of preferential tariff and tax treatments have been introduced in this space since 2014, as detailed in the customs chapters of previous years' editions of *China Looking Ahead*. The latest tariff reductions go further in the direction of encouraging Chinese consumers to buy desired overseas products for import into China, rather than travelling overseas to purchase them. The effect of the tariff reductions may be particularly pronounced for clothing, electronic appliances, products for infants, and so on, which Chinese consumers are particularly inclined to buy while travelling overseas.

Particular impact of tariff changes on the auto industry

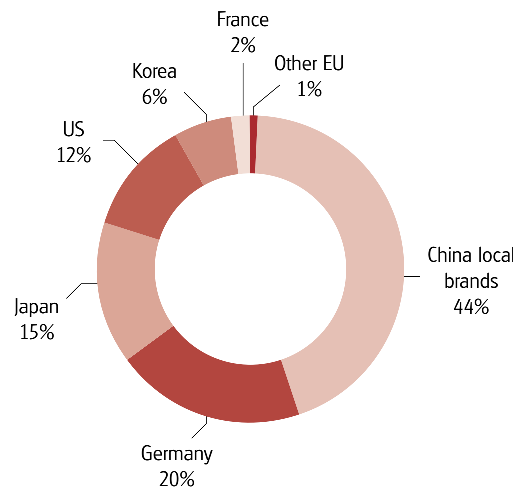
For the global automotive industry, the China market continues to offer huge potential, with continuing high consumer interest in foreign brands. Per official statistics, China's car sales volume had reached 28.88 million in 2017, even with the government's controls on licence plates.

Figure 2

Auto sales volume in 2017 (Unit: million)



Composition of China auto sales 2017 by country



Data source: China National Bureau of Statistics

The potential impact on enterprises engaging in importing and manufacturing vehicles and auto parts is considered below:

- China importers of automotive vehicles: Apart from the direct cut in the tariff costs brought about by the reduction in import tariffs, the consumption tax (essentially an excise tax) levied on goods imported will also be lowered, which is good news for vehicle importers. In addition, the contraction of the tax base for VAT purposes (through the reduction of these levies) will lead to a reduction in VAT payment obligations at the time of importing, thereby increasing the cash flow of vehicle importers. The numerical example in Figure 2 provides a snapshot of the potential change to taxes and surcharges.
- Manufacturers of automotive vehicles in China: For enterprises engaging in car manufacturing in China, there will be a reduction in the manufacturing costs due to the lower tariff costs of production parts after the tariff reduction. In view of this, manufacturers may consider increasing their purchasing of imported parts.
- Manufacturers of auto parts in China: The reduction of import tariffs on auto parts may weaken the price competitiveness of domestic manufacturers of alternative parts and components. This may in turn affect the bargaining power of domestic manufacturers of auto parts and downstream manufacturers of vehicles.
- Vehicle distributors and after-sale service providers (4S shops): Automobile retailers and repairs and maintenance

Table 1

Item	Previous taxes and surcharges		New taxes and surcharges	
	Tax rate	Value	Tax rate	Value
Example of import price		100.00		100.00
Customs duty	25%	25.00	15%	15.00
Consumption tax (with cylinder volume of 2.0L to 2.5L)	9%	12.36	9%	11.37
Import VAT (from May 1 2018)	16%	21.98	16%	20.22
Total tax burden	**59.34**		**46.59**	

(R&M) service providers may encounter pros and cons from the tariff changes. They will be able, on the one hand, to source cheaper imported automobiles and parts. At the same time, they may be pushed towards offering lower prices for end products.
- Vehicle parallel importers: China's automotive industry regulatory policies restrict the importing of vehicles. A given auto brand enterprise may only authorise one single company as its general distributor in China. However, a scheme for vehicle parallel imports has been launched on a pilot basis in selected free trade zones (FTZs) in China, under which distributors other than the general distributor can be used. The tariff reduction may have some impact on the competitiveness of parallel imported cars, but the positive aspect is that the cost of imported R&M parts and components will be decreased.

First WCO case study contributed by China Customs on the use of TP documentation in customs valuations

Following the issuance of case study 14.1 in April 2016, in which TP documentation was drawn on for customs purposes, the WCO TCCV approved a new case going in a similar direction in October 2017, concerning the use of TP documentation when examining related-party transactions under Article 1.2 (a) of the agreement (case study 14.2). Case study 14.2 has already been included into the 2018 edition of the Guide to Customs Valuation and Transfer Pricing published by the WCO (2018 guide).

Covering the topic of TP and customs valuation, case study 14.2 is the second issued by the TCCV and it drew extensive attention from the public. More importantly, case study 14.2 is the first time the TCCV has approved and published a case from China Customs. Therefore, this case study can be seen as a milestone which indicates China Customs' graduation to active participation in the formulation of global customs valuation guidelines.

As a referencing document which provides guidelines on the topic of customs valuation, case study 14.2 offers an important insight into global customs valuation practice. In case study 14.2, TP documentation was used as the basis for a customs valuation in order to assess whether the transactions with related parties were at arm's length. In particular, the gross margins of comparable companies were compared to determine if the value of transactions with related parties were at arm's length.

Case facts

Company ICO, located in country I, is a distributor for XCO, which engages in the design, production and distribution of luxury bags throughout the world. Company XCO is based in country X. ICO is the sole distributing agent for XCO in country I. XCO does not sell identical or similar luxury bags to unrelated buyers in country I. Thus, all luxury bags imported into country I are purchased by ICO from XCO. According to ICO's TP policy, the import price of all luxury bags was determined using the resale price method (RPM). ICO calculated the import price of luxury bags based on the resale price in country I and the targeted gross margin for the next year recommended by XCO, with the deduction of customs duties.

Based on the financial results of ICO, the company earned a gross margin of 64% in 2012. However, the TP report indicated that the inter-quartile range of gross margins earned by the eight selected comparable companies was between 35% and 46%, with a median of 43%. In other words, the import price of the bags was low relative to their onward sale price to customers in the country, meaning a low customs imposition on import. The TP policy required ICO to earn a reasonable gross margin per benchmarking study – clearly the gross margin of 64%, earned by ICO, did not fall within the inter-quartile range. When the customs authority of country I conducted a valuation audit, it determined that the import prices paid by ICO had been affected by special relationships, and did not meet arm's-length requirements.

Key facts of case study 14.2, leading to the above conclusion, were as follows:

- Since ICO, the exclusive distributor in country I, had failed to provide adequate test values, the customs authority of country I examined the circumstances surrounding the sale on the basis of TP documentation;
- When examining the import price determined under the TP method used, the customs authority in country I compared the gross margin of ICO with those of comparable companies to determine if the pricing method had been evaluated in a way that was consistent with the normal pricing practices in the industry;
- The TP benchmarking study was acceptable to the customs authority. Based on a functional analysis, there was no substantial difference between ICO and the other eight comparable companies. In addition, the products of the comparable companies were similar to those sold by ICO; and
- The gross margin earned by ICO did not fall within the inter-quartile range and ICO did not make any TP adjustments in this regard.

While the earlier case study 14.1 concerned the use of an advance pricing arrangement (APA) TP analysis report as a basis to examine whether transactions with related parties were at arm's length, the analysis in that case was carried out on the basis of operating margin levels. It used the transactional net margin method (TNMM), which draws on and is aligned with the principles adopted in general TP analysis, long used by developed countries. Case study 14.2, by contrast, focused on the use of the gross margin level, showing that the WCO technical committee is keenly focused on the concerns of all countries, especially emerging economies such as China.

With Chinese Customs paying increasing attention to TP arrangements, enterprises should consider the following:

- The TP policy of most trading companies in China is modelled on RPM or TNMM and their testing indicators are operating margins or similar financial indicators. However, due to the close attention that customs pay to gross margins, it is suggested that an analysis also be conducted on gross margins when preparing TP documentation;
- Given the implications for corporate income tax (CIT) revenue, and the potential for close tax authority scrutiny, where enterprise profit is lower than the inter-quartile range, enterprises are typically encouraged by their advisors to set out a special factor analysis (e.g. industry analysis, financial analysis and adjustments) in TP documentation for low profit cases. However, for customs, the concern would be that profits were set too high, and import prices and tariff payments consequently too low. Considering this difference in a customs valuation review, it is recommended that special circumstances be analysed as well if the profit is higher than the inter-quartile range;
- When submitting TP documentation to customs, companies should provide proper explanations regarding the nature and details of the documentation to avoid any misunderstanding of the information disclosed and methods applied; and
- It is recommended that a customs valuation report be compiled with reference to the TP documentation prepared for tax purposes. Such a report should use customs valuation language and logically present a comprehensive study by consolidating the information and materials that are required to be submitted to customs.

Integration of the CIQ into China Customs

As part of a government organisational reform, proposed during the 13th National People's Congress, the government agency responsible for inspection and quarantine for imports and exports (commonly known as CIQ) was incorporated into the General Administration of Customs (GAC) on April 20 2018. The CIQ previously fell under the authority of the AQSIQ.

Under the integration plan, the following measures have been announced, or are expected to be implemented, and these should increase efficiency of customs clearance and reduce company costs, such as storage fees and port surcharges:

- Declarations to Customs and CIQ will no longer need to be made in separate steps and can be completed through a single-window platform;
- Customs and CIQ officers will become a single team. They will perform on-site inspections and quarantine control on imported/exported goods at the same time, to simplify the whole clearance process;
- Information required by Customs and CIQ for import and export declarations is now consolidated into a comprehensive declaration for imported/exported goods; and
- When evaluating the risk level of the goods to be imported and exported, the relevant inspection requirements that are being enforced by CIQ will be taken into consideration when setting up risk parameters in the customs system.

Detailed measures will be announced and implemented step by step, and companies should make themselves aware of the changes to the procedures for Customs and CIQ declarations.

China Customs issues interim administrative measures on advance rulings

In the seventh edition of *China Looking Ahead*, we introduced the modernised national customs clearance integration regime, in which the enforcement of customs administration is expected to rely more on post-clearance review and audits. With this new regime, importers and exporters are hoping to have more guidance from Customs with respect to value, tariff classification, and country of origin information that they declare.

Responding to the high demand and also as a response from the Chinese government to the agreement on trade facilitation that became effective on February 22 2017, the GAC issued the Interim Administrative Measures on Advance Rulings (General Administration of Customs Order No 236 – the Administrative Measures) on December 26 2017, which came into effect on February 1 2018. It should be noted that the advance rulings system for Customs is in effect before the parallel tax advance rulings system, which awaits the finalisation of the new Tax Collection and Administration Law, anticipated early next year.

Based on the administrative measures, foreign trade operators are allowed to apply for advance rulings in respect of tariff classifications, country of origin determinations, and dutiable value-related questions.

Applicants can apply to the customs office directly under the GAC where their companies are registered for advance rulings. They can apply three months before the scheduled importing or exporting of goods, and the responsible customs office will review and make a decision within 10 days as to whether or not the application is accepted. Once the application is accepted, an advance ruling decision will be issued within 60 days.

As a general observation, disputes arising between the customs authorities and enterprises on valuations, classifications, country of origin, and so on, have been key factors

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that have hindered improvements to customs clearance efficiency. Disputes may further trigger potential risks, such as customs audits, import taxes (including both customs duty and import VAT) repayments and administrative penalties. In practice, enterprises have been seeking the customs authorities' verbal opinion in advance in order to mitigate compliance risks.

However, due to the fact that the verbal opinions of customs officials are not binding and different customs officials may possibly hold different opinions on the same issue, this has not been commonly recognised as an effective approach to improve the predictability of import and export operations. With the administrative measures coming into force, the customs authorities, by means of advance ruling, can review the tariff classification and country of origin elements of dutiable value and valuation methodology before the import and export of goods, so as to reduce disagreements and improve the efficiency of customs clearance.

New enterprise credit management measures issued by GAC

Based on the Provisional Administrative Measures on the Credit Management of Enterprises (Decree 225 of the GAC – Provisional Measures), in force since December 2014, the GAC divided registered enterprises into four categories.

- Advanced certified enterprises (ACEs);
- Generally certified enterprises (GCEs);
- Regular credit enterprises (RCEs); and
- Discredited enterprises (DEs).

Different levels of scrutiny and oversight, as well as varying customs administrative treatments, were applied to each.

The credit management system allows China Customs to grade companies that engage in the import and export business, and facilitates the application of varying levels of day-to-day supervision and monitoring. ACEs and GCEs are given preferential treatment, such as fewer inspections and simplified customs clearance processes. On the other

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hand, DEs are subject to much tighter supervision, which can substantially affect their business operations.

In March 2018, the GAC issued the Administrative Measures on Customs Credit Management of Enterprises (measures) to replace the provisional measures, which came into effect on May 1 2018. The measures provide much more clarity regarding benefits and punishments in respect of different companies. The key updates included in the measures are summarised as follows.

Treatment for enterprises with different credit ratings is updated

The preferential treatment for ACEs and GCEs as well as the strict administration measures on DEs are clarified and updated in the measures.

Preferential treatment offered for GCEs includes:

- Low average inspection rate on imports/exports (i.e. less than 50% of that on RCEs);
- Prioritised clearance treatment of imports/exports;
- Deposit amount can be decreased; and
- Other administrative treatments to be announced by the GAC.

On top of the preferential treatment applied to GCEs, ACEs will also enjoy the following administrative measures:

- Low average inspection rate on imports/exports (i.e. less than 20% of that on RCEs);
- ACEs can apply to customs for deposit exemption;
- Reduced frequency of customs audits and post-reviews;
- ACEs can declare exports before the goods have arrived at the customs supervision area;
- Assignment of a dedicated liaison officer;
- Preferential clearance benefits granted through the authorised economic operator (AEO) mutual recognition arrangements with China;
- Joint incentive measures granted by other governmental authorities (please refer to the 2016 edition for details);

- Prioritised clearance treatment once international trade is resumed following termination caused by force majeure; and
- Other administrative treatments to be announced by the GAC.

Adjustment to DE rules

The conditions for downgrading to DE credit status are adjusted in the measures. For example:

- Enterprises that cannot be located or liaised with, and which have been included on the list of enterprises with abnormal credit information for more than 90 days, will be downgraded to DEs; and
- While under the provisional measures, a company would be downgraded to a DE if penalties incurred in one year exceeded RMB 100,000 ($14,500), on more than one occasion, this provision was revoked under the measures.

In addition, under the provisional measures, DEs could not be upgraded to RCEs within one year following their downgrading. The above time limit is extended to two years in the measures.

In a nutshell, the measures pay more attention to the principle of facilitating those that act in good faith and in compliance with laws and penalising those that lose credit and act against the law. Compared with the provisional measures, one of the main improvements is that joint incentives and punishments, implemented by various authorities, are embedded in the measures. This shows that the Chinese government is putting more emphasis on enhancement of a comprehensive credit system. Additionally, the management measures applied for enterprises with different customs credit ratings are more specific and the gaps are widened.

Thus, credit status is increasingly important for Chinese enterprises, given that various authorities are now granting more preferential treatment to enterprises with higher credit ratings and imposing stricter treatment on those with poor credit ratings.

Tax opportunities and challenges for China in the BRI era

Chinese governmental authorities remain supportive of rational, well-ordered and healthy outbound investment. Michael Wong, Joseph Tam, Karen Lin, Cloris Li and Alan O'Connor look at key domestic tax and regulatory measures implemented to enhance the competitiveness of Chinese outbound investment on the global stage, including under the Belt and Road Initiative (BRI).

China continues to remain firmly in the spotlight of global investors, with a particular focus in media circles on Chinese outbound investment trends. In this regard, there has been a period of consolidation in Chinese outbound investment over the past 18 months, as Chinese investors have come to grips with greater government regulation both at home and abroad.

Outbound deals by Chinese investors decreased by 38% to $123 billion in 2017 from the 2016 record of $200 billion. This being said, the value of deals during the first nine months of 2018 ($82 billion) has remained relatively resilient in the face of a number of headwinds, including the continuing trade frictions with the US and increased scrutiny over Chinese outbound investment by foreign governments. There has been a notable impact from the interventions of the Committee on Foreign Investment in the US (CFIUS), leading to deal values from Chinese outbound investment to the US plummeting 81% from a record $57 billion in 2016 to $11 billion in 2017 and only $5.9 billion in the first nine months of 2018. There may be even tougher times ahead for US-bound investment, as it has been reported that the US Treasury is piloting arrangements which would impose mandatory CFIUS reporting requirements on deals involving investment in US businesses which produce, design, test, manufacture, fabricate or develop 'critical' technologies for use in one of 27 pilot programme industries.

Chinese authorities continue to express support for rational, well-ordered and healthy outbound investment, particularly BRI investment projects, as noted in the State Council's August 2017 notice on guiding and regulating the direction of outbound investment. This year (2018) is the fifth year since President Xi Jinping originally announced the launch of the BRI in 2013. As implementation of the BRI progresses, China's overseas investments in BRI jurisdictions have grown faster than investments into the US, EU and other traditional investment destinations. Statistics from China's Ministry of Commerce indicate that overseas mergers and acquisitions (M&A) in BRI countries increased 32.5% to $8.8 billion in 2017.

The Chinese authorities have announced a number of tax and regulatory measures to further support the competitiveness of Chinese outbound investment on the global stage. In this article we look at these key domestic tax and regulatory measures implemented by the authorities since late 2017, including the strengthening of cooperation with tax authorities in BRI countries, a broadening of domestic tax credit rules for foreign taxes paid on

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outbound investments, and the simplification of Chinese administrative measures for outbound investments.

Increasing cooperation and collaboration among BRI countries

In last year's seventh edition of *China Looking Ahead*, in the chapter, *A thousand miles begin with a single step: tax challenges under the BRI*, we flagged the issue that most BRI countries are emerging or developing economies. Their tax laws and regulations are not yet fully developed and are frequently subject to different local interpretations and unanticipated changes. Accordingly, Chinese enterprises operating in BRI countries can face difficulties in managing their overseas tax affairs, creating tax risks and costs, and consuming management time and attention.

With a view to enhancing collaboration among the tax authorities of the BRI countries, the BRI Tax Cooperation Conference was held in Astana, Kazakhstan, on May 14 to 16 2018. The event was co-organised by the Kazakhstan Ministry of Finance, the China State Administration of Taxation (SAT) and the OECD. The event drew 252 delegates from 49 tax jurisdictions, academics, and representatives from the UN, OECD, IMF and World Bank.

The conference considered four aspects of tax cooperation among the countries involved in the BRI: the rule of law, taxpayer services, effective and efficient dispute resolution mechanisms, and tax administration capacity building. Delegates considered how taxation should, from these four perspectives, support and facilitate deeper tax cooperation.

SAT Commissioner Wang Jun made a keynote speech in which he highlighted China's commitment to further opening up and increasing cooperation with other countries through the BRI. He noted that taxation is important to fostering trade and investment under the initiative.

The delegates of the conference achieved four common understandings:

- A more just and fairer tax environment, governed by the rule of law, should be built to boost trade and investment. Economic liberalisation and investment facilitation are to be promoted by implementing improved global tax rules and removing tax barriers;
- Efforts should be made to improve cross-border tax-related services, including through electronic interfaces between tax authorities and taxpayers, and build/improve taxpayer credit rating systems, so as to support economic growth and development;
- Multilateral and bilateral cooperation should be expanded to strengthen the capabilities of tax administrations, by sharing best practices and learning from each other; and
- Tax dispute settlement efficiency should be enhanced to increase tax certainty, optimise the business environment and strengthen investor confidence.

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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.

Delegates also agreed to set up an expert team for in-depth research on a new cooperation framework to supplement the existing systems for multilateral tax cooperation. Decisions on this are to be made at the BRI Tax Commissioners' Meeting in Beijing in 2019.

This conference shows that BRI jurisdictions are eager to harness their collective knowledge and to pool resources to support a growth-friendly tax environment. This is a positive development for the increasing numbers of Chinese enterprises looking to do business in these countries.

Favourable changes to China foreign tax credit rules

China's foreign tax credit (FTC) rules have presented continuing issues for Chinese outbound investors, with some of the problematic provisions including:

- Credits granted for foreign taxes paid were limited by 'country baskets', i.e. calculated on a country-by-country basis. This meant foreign taxes paid in higher tax countries, which may exceed the Chinese corporate income tax (CIT) on the same income, could not be used to offset the Chinese CIT arising on income from lower tax countries; and
- Credits were only available for 'underlying' foreign taxes (i.e. taxes imposed on income arising to foreign subsidiaries) down as far as the third tier of foreign subsidiaries, in which there was a direct or indirect 20% shareholding. This could lead to double taxation on profit repatriations from subsidiaries held below the three tiers of creditable foreign subsidiaries. It is not uncommon, in practice, for the investment structures used by Chinese outbound investors to have more than three tiers, meaning that loss of FTCs was a real risk.

In the past year, the Chinese authorities have moved to remedy this. Following on from plans set out in the August 2017-issued State Council Circular 39, the MOF and SAT issued Cai Shui [2017] 84 (Circular 84) on December 28 2017 to enhance the FTC rules. This retroactively applies from January 1 2017 and provides the following:

- Enterprises may elect into a *de facto* onshore pooling FTC regime. Under this so-called 'integrated credit method', income from all countries (and of all types) will be considered together for the calculation of the FTC limits. Alternatively, enterprises may stay with the existing country-by-country credit method. Once an election to adopt the integrated credit method is made, it may not be changed within five years; and
- Indirect tax credits may now be claimed down to the fifth tier of foreign subsidiaries.

These Circular 84 enhancements follow earlier clarifications on the claiming of FTC for overseas contracting projects by the SAT through Announcement [2017] 41 (Announcement 41) issued on November 29 2017. Under

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China's FTC rules, an FTC can only be claimed by the party which actually pays the foreign taxes on the foreign contracting income. This is an issue for overseas engineering, procurement and construction (EPC) projects involving a consortium of Chinese contractors and subcontracting arrangements. This is because an FTC is only available to the general contractor (or consortium leader) which paid the foreign tax while the other parties (e.g. sub-contractors) would suffer potential double taxation on their share of project revenues.

Announcement 41 now clarifies the procedures for claiming foreign tax credit for overseas contracting projects for corporate income tax (CIT) filings from (and including) the 2017 tax year:

- Where a Chinese enterprise (general contractor) embarks on an overseas project (including but not limited to engineering construction, and infrastructure construction) by way of a contract arrangement or a consortium, the subcontracting enterprise (or each party to the consortium) may claim the FTC based on the allocation of foreign tax paid. The subcontracting enterprise (or each party to the consortium) will be provided with a tax-paid allocation form issued by the general contractor or the leading party of the consortium for claiming FTC purposes;
- The general contractor or the leading party of the consortium must allocate the foreign tax-paid amount based on a reasonable ratio. Elements such as income and work undertaken by each party should be taken into consideration;
- The general contractor or the leading party of the consortium is required to perform a recordal filing with the Chinese tax authorities when issuing the tax-paid allocation form. A copy of the tax-paid allocation form should also be submitted by the contracting enterprise (or each party of the consortium) to the local tax authority when claiming the FTC; and
- The general contractor or the leading party of the consortium must separately account for each overseas contracting project.

These FTC rule changes and clarifications are a welcome development for Chinese outbound investors and contractors as they can reduce the double taxation exposure for their overseas investments and activities.

Updates to outbound investment administrative requirements

In last year's seventh edition of *China Looking Ahead*, in the chapter, *A thousand miles begin with a single step: Tax challenges under the BRI*, we looked at a number of regulatory announcements by the Chinese authorities in the second half of 2017 aimed at overhauling China's administration system for outbound investment. Regulatory updates in the outbound investment space have continued over the past 12 months, with the more notable ones considered briefly below.

In recent years, overseas investments by private-owned companies (POEs) have made up an increasingly larger share of China's total outbound investment. Overseas investment activity by POEs grew from around 30% of total Chinese outward direct investment in 2007 to more than 45% in 2016. This fast growth in private investment was not without its challenges, with highly leveraged and non-core business investment cases increasing. This prompted Chinese regulators to impose measures in late 2016 that increased the inspection and supervision of restricted investments, including those in sensitive countries or regions, as well as investments in certain industries such as real estate, hotels, film studios, entertainment, and sports clubs.

Despite these controls, the Chinese authorities remain supportive of outbound investment from Chinese POEs within appropriate limits. Accordingly, in December 2017, various Chinese regulatory authorities jointly issued Private-Owned Enterprise (POE) Outbound Investment Guidance under Fa Gai Wai Zi [2017] 2050. The notable guidance is as follows:

- The government supports POEs that possess the necessary capabilities to engage in outbound investment. Both POEs and state-owned enterprises (SOEs) will be treated on an equal basis by the government in relation to their conduct of outbound investments;
- POEs are encouraged, based on their capabilities, to make outbound investments, participate in the BRI initiative and international industrial capacity cooperation projects, and

promote the transformation and upgrade of the Chinese economy;
- POEs that plan to engage in outbound investments are required to: (i) set up an in-house department to administer their outbound investments; (ii) specify decision-making procedures for committing to outbound investments; (iii) establish a system to manage the set-up of overseas entities and improve their internal authorisation system; and (iv) establish a system to control outbound investment risks;
- POEs are required to (i) intensify supervision over their overseas entities in terms of fund transfer, financing, equity (and other interest) transfer, reinvestment and guarantees; (ii) exercise prudence when making highly leveraged overseas investments; and (iii) ensure that overseas derivatives investments are adequately monitored and managed;
- Where a POE's outbound investment is made in sensitive jurisdictions or industries (such as outbound investment in real estate, hotels, cinemas, entertainment, sports clubs and other specified restricted sectors), pre-approval from the National Development and Reform Commission (NDRC) is required. If this pre-approval is not required, the recordal filing applies (i.e. NDRC will subsequently review whether the outbound investment project complies with relevant law and regulations, on the basis of the recordal); and
- POEs are prohibited from engaging in foreign currency dealings, asset transfers, or money laundering, under the cover of simulated outbound investment transactions.

The NDRC also issued administrative measures for overseas investments by enterprises, which came into effect in March 1 2018. These new measures aim to improve the competitiveness of Chinese outbound investment by:
- Simplifying the filing and approval procedures;
- Eliminating the filing requirement of a project information report before commencing substantive work on the transaction;
- Limiting the government processing time; and
- Extending the validity of the filing confirmation or approval notice to two years unless there are any material changes in the key terms.

These regulatory changes and guidance, particularly those directed toward POE outbound investors, demonstrate the Chinese government's continuing support for overseas investment. We expect this will be important for supporting continued outbound investment growth given the transition to a higher proportion of POE outbound investment in recent years.

Not all good news – emerging controlled foreign company cases

Under the China CIT Law, in certain circumstances, a portion of the income of a controlled foreign company (CFC) must be included in the taxable income of the Chinese resident enterprise controlling the CFC. Specifically, this is where the CFC is established in a jurisdiction where the tax burden is substantially lower than 50% of the standard rate of 25% (i.e. 12.5% or below) and if the CFC does not distribute, or insufficiently distributes, its profits without justifiable operational/commercial reasons.

Chinese enterprises commonly use structures which have one or more overseas special purpose vehicles (SPVs) for their outbound acquisitions or green field investments; their usage will generally have valid commercial reasons. However, while in the past CFC risk was considered somewhat theoretical by taxpayers or professional advisors, since the SAT issued Circular [2014] 38 in 2014 the risk has become more real. Circular 38 required Chinese enterprises that had incorporated, participated in or disposed of an existing interest in a foreign company to provide information on foreign participation and foreign income. Leveraging this information, tax bureau CFC enforcement cases have become more common. Some of the most notable cases include the following:
- In a case reported in 2015, it emerged that in 2014 the Shandong State Tax Bureau (STB) had asserted that a Hong Kong subsidiary of a Chinese company lacked valid commercial reasons for not repatriating its profit to China. In this case, RMB 50 million ($7.2 million) in CIT was collected. Further notable cases in Hainan, Urumqi, and the Suzhou industrial park were reported in the years from 2015 to 2017; see the chapter, *Coming of age – China's leveraging of BEPS*;
- In a case reported by China Taxation News (CTN) in August 2017, the Beijing STB collected RMB 70 million in tax following a determination that a Chinese enterprise's Panama and British Virgin Islands (BVI) subsidiaries retained the profit generated between 2013 and 2015 outside of China solely for tax deferral purposes;
- In a case reported by CTN in February 2018, the Beijing STB opened another CFC case during its tax risk assessment work on an outbound enterprise. The Chinese enterprise had a BVI-incorporated holding company which did not employ any staff. The undistributed profits of the BVI company were composed solely of dividend income from its subsidiary, and it was unable to show the commercial reason for retaining its profits outside of China; and
- A further notable 2018 case, relating to a Qingdao, Shandong province-based company, is also detailed in the international tax chapter.

We expect that the Chinese authorities will continue to ramp up enforcement of the CFC rules as overseas profits earned by Chinese outbound investors continue to accumulate. This work is also set to be facilitated by the availability of information collected through country-by-country tax reporting and the common reporting standard exchange mechanisms. Companies with outbound investments should monitor the profit status of their overseas holding companies (particularly those in low-tax jurisdictions) to ensure they are positioned to support the reasonable commercial purposes of any non-repatriated profits.

More changes to come

Many of the recently announced tax and regulatory measures will no doubt be welcomed by Chinese outbound investors and contractors to mitigate the tax costs and administrative burdens of their overseas investments and activities. We also anticipate a future increase in demand, among 'going out' Chinese multinational enterprises (MNEs) for advance pricing agreement (APA)/mutual agreement procedure (MAP) assistance from the SAT. This will be stimulated both by transfer pricing challenges from overseas tax authorities, and by closer follow up, on the China side, with group service fee and royalty arrangements between Chinese MNE parents and their overseas subsidiaries. This issue is detailed further in the transfer pricing chapter, *Now that we have data, what are we going to do? – new challenges and opportunities in TP in China*.

China's Minister of Finance (at that time, Xiao Jie), in a People's Daily article published on December 20 2017, entitled 'Speeding up the establishment of the modern fiscal system', flagged plans for continued CIT system reforms to meet the requirements of continued globalisation, the BRI, and enhance the competitiveness of China's tax system. The 2018 escalation in trade tensions between China and the US, while challenging, has not appeared to affect China's plans for globalisation-supportive reforms, with Premier Li Keqiang noting at the World Economic Forum in Tianjin in September 2018 that that trend of globalisation was unstoppable and China's process of opening up would only quicken in the years to come.

China FS sector opens up: Tax opportunities and challenges ahead

Are you ready for the opening up of China's financial services sector? Henry Wong, Chris Ge, Jean Li and Tracey Zhang look at the latest regulatory relaxation measures, and give insight on industry issues which foreign firms should be aware of before jumping on the bandwagon.

China's financial services industry is now approaching a point where all sectors will be fully open to foreign firms in three years' time. The opportunities ahead for foreign institutions are potentially enormous, but each needs to take a hard look to see if further China market investment makes sense in their specific case. Domestic giants have already established dominance in many fields, many tax uncertainties are yet to be resolved, and the often disconnected policy application by different Chinese authorities can present challenges for new players.

During the last two decades, the China financial services sector has undergone immense change. It has evolved from a mainly state-owned, traditional banking and insurance business-driven sector towards a digital-focused sector, with e-commerce giants taking the driving seat on financial innovation. Many people now make investments, buy insurance products, and pay for goods and services with only a few touches of their mobile devices.

These enormous changes promise exciting opportunities for both domestic and foreign players. However, China's unique regulatory environment for financial services still creates many challenges. For example, rules are often released quickly, without advance public consultation, or may be rolled out without detailed implementation guidelines, leaving many question marks over what to do next. A unique China tax environment also exists for the financial service sector – many industry players are still having a challenging time to truly understand where the risks lie, and when they might surface.

As such, successful investments require a thorough understanding of the continuing changes in the regulatory and tax environment. In this article, we will first introduce the recent announcements by the central government on the opening up of China's financial services sector, along with the expected timetable. Then we will dig a little deeper into the tax and business challenges in certain key financial sectors to give you a flavour of what you need to be prepared for when entering China's financial sector as a foreign investor. Finally, we outline what you can do to be as prepared as possible for the exciting roller-coaster ride ahead.

China's opening up – the regulatory aspect

Starting in the early 1980s, China adopted an open-door policy to welcome foreign-owned, export-oriented, manufacturing businesses to set up operations in China, by providing tariff incentives and tax policies that favoured these foreign businesses. Then, in 2001, China made commitments, as part of its accession to the World Trade Organisation (WTO), to apply non-discriminatory treatment to enterprises of all WTO members who trade with China. China also made commitments to phase out restrictions on foreign investment and business activity in a broad range of service sectors. However, despite this, the China financial services sector remains highly regulated, with many restrictions continuing to be imposed on foreign investment. What is even more concerning is that, after all the years of gradual opening up of the market, foreign companies still face a range of challenges when operating in China. This can include inconsistent application of rules and regulations, as well as a degree of favouritism toward domestic companies for key sectors that are strategically important for China. These can include the telecommunications, medical, and military-relevant sectors, as well as the financial services sector.

The Chinese financial services markets are huge and Chinese financial service companies often rank among the largest in the world in terms of market capitalisation or total assets. For example, according to the latest survey from Forbes – three out of the five largest public companies in the world are Chinese state-owned banks and the world's largest listed insurance company is China's Ping'an Insurance Group. However, reports also indicate that foreign banks account for less than 2% of total banking assets within China. China has the world's third largest bond market, yet foreign holdings in RMB bonds are relatively small, when compared with the situation in the bond markets of other major economies, with less than 2% foreign participation in the Chinese bond market. Starting from this low base, the opportunities for foreign financial sector businesses are huge, especially for the securities and assets management sector.

China is now taking its opening up to the next level with the latest liberalisation measures and this could give foreign involvement a second wind. Specifically, on November 10 2017, the State Council announced plans to liberalise foreign ownership in certain types of Chinese financial institutions. Then on April 11 2018, Chinese officials set out a timetable for this opening up at the Boao Forum for Asia Annual Conference 2018. Table 1 sets out a snapshot of the key changes and related timetable.

These changes are likely to affect different parts of the financial sector in differing ways, and foreign firms will need to re-evaluate their China strategies. It should be noted that recently there have been many tax administrative changes in China, which could influence financial sector investment and operational plans. These include the activation of tax information exchange with other jurisdictions, as part of China's implementation of the common reporting standard (CRS) for the financial services sector. Also relevant are the forthcoming Tax Collection and Administration Law requirements on domestic financial institutions to provide information on resident account activity to the tax authorities. In addition, the individual income tax (IIT) reform is set to have a big impact on the wealth management industry for high-net-worth individuals (HNWIs); see the chapter, *One giant step forward in Chinese IIT reform*. As such, foreign firms should take all these into consideration when investing and operating in China.

In a further notable development in November 2018, a three-year exemption from CIT withholding tax (WHT) and value-added tax (VAT) was rolled out for China-sourced bond interest derived by overseas institutional investors. This Circular [2018] 108 (Circular 108) exemption, taking effect from November 7 2018 will be valid up to 2021. This significantly enhances the attractiveness of China's bond market to foreign capital, by limiting the tax leakages that would otherwise reduce their overall return, and is reflective of equivalent cross-border corporate bond investment tax treatment granted by a number of other major economies.

Next, let us take a closer look at some of the key financial services sectors and understand the opportunities as well as challenges, in particular the China tax perspective for foreign investors.

Banking and lending sectors

China's banking sector activity is mainly driven by state-owned banks. The People's Bank of China (PBOC) acts both as the central bank, as well as regulator, along with the China Banking and Insurance Regulatory Commission (CBIRC). The latter is a new body; before March 2018 two separate bodies regulated the banking and the insurance sectors. The tasks of PBOC and CBIRC include overseeing the China banking system, setting rules and regulations, conducting examinations, publishing statistics, and approving the establishment or expansion of banks, including foreign banks, as well as general troubleshooting.

Foreign banks have operated in China for more than a decade, with various different corporate structures ranging from wholly foreign-owned banking subsidiaries, China bank branches of the foreign banks, or representative offices. However, domestic Chinese banks still account for the majority of the market. According to 2015 government statistics, foreign banks account for less than 2% of total banking assets. While, given this low starting point, it may seem that there is great potential for foreign players to grab a bigger share of the China market, in reality this is difficult, because there are many commercial, regulatory and tax hurdles.

On the commercial front, there is tough competition from the domestic giants, as well as the emerging technological disruption from fintech companies for the traditional banking and payment sectors. This means that foreign players may find the China banking sector less lucrative than before.

Table 1

Banking sector		Planned timeline
Commercial banks in general	To remove the foreign ownership limit in Chinese commercial banks (which was previously limited at 20%). To allow foreign banks to open both subsidiaries and branches in China, in place of the existing position whereby foreign banks are excluded from having both at the same time.	June 30 2018
	To expand the business scope of foreign-invested banks, so that the rules that govern foreign and domestic invested banks will become the same going forward.	December 31 2018
Subsidiaries of banks	To remove the limit on the maximum foreign ownership in financial assets investment management and wealth management companies where they are established by commercial banks.	December 31 2018
Asset management companies	To remove the foreign ownership limit, which was previously set at 25% (asset management companies are primarily engaged in managing non-performing loans).	June 30 2018
Insurance sector		**Planned timeline**
Insurance companies in general	To remove the requirement for a foreign insurance company to have operated a China representative office, for at least two years, before it can establish a foreign-invested insurance company subsidiary in China.	December 31 2018
Life, health and personal accident insurance companies	To allow foreign ownership of up to 51% (up from 49%) and then remove such limit after three years (i.e. 2021).	June 30 2018
Insurance agents	To allow foreign investors to operate insurance agency business in China.	June 30 2018
Insurance brokerage	To remove the limitation on the business scope of foreign-invested insurance brokerage firms and give them equal treatment to the domestic firms.	June 30 2018
Securities and financial commodities trading sectors		**Planned timeline**
Securities companies	To allow foreign ownership of up to 51% (up from 49%) and then remove such limit after three years (i.e. 2021). To remove the requirement to have at least one Chinese securities firm as a domestic shareholder in a Sino-foreign joint venture (JV) securities firm (meaning that a non-securities firm Chinese enterprise could be the JV partner).	June 30 2018
	To remove the limitation on the business scope of Sino-foreign JV securities firms and give them equal treatment to domestic firms.	December 31 2018
Futures trading	To allow foreign ownership of up to 51% (up from 49%) and then remove such limit after three years (i.e. 2021).	June 30 2018

Table 1, continued

Investment management and other non-banking sectors		Planned timeline
Fund management companies	To allow foreign ownership of up to 51% (up from 49%) and then remove such limit after three years (i.e. 2021).	June 30 2018
Stock Connect schemes	To increase the quota size of Stock Connect between China and Hong Kong by quadrupling the daily amount of Hong Kong-listed shares that investors can buy through mainland Chinese stock exchanges from RMB 13 billion ($1.9 billion) to RMB 52 billion.	May 1 2018
	To launch a Stock Connect scheme between Shanghai and London.	December 31 2018
Bond Connect scheme	Bond Connect is a scheme that enables overseas investors from Hong Kong and elsewhere to invest in Chinese bonds through investment links between Hong Kong and mainland China. In August 2018, moves were made to fully implement a new settlement system known as real-time delivery versus payment (RDVP). RDVP ensures that payment and delivery of securities occurs simultaneously. It helps reduce or eliminate the exposure to settlement risk by the counterparties of a trade. This upgrade also enables international investors to join the scheme and seek investment opportunities in the China interbank bond market.	September 2018 and onward
QFIIs and RQFIIs	Removal of the three-month lock up period on the repatriation of principal, and the 20% annual limit on repatriation of principal and profit of qualified foreign institutional investor (QFII) investments. Removal of the three-month lock-up restrictions applicable to the investment principal under both the QFII and renminbi qualified foreign institutional investor (RQFII) schemes. Allow QFIIs and RQFIIs to enter into forex hedging transactions in China to hedge currency risks related to investing in China.	June 12 2018
Others	Encourage foreign investments in trusts, financial leasing, auto finance, currency brokerage and consumer finance.	December 31 2018

On the regulatory front, many foreign banks face challenges ranging from tough regulation, ever increasing compliance measures, lack of neutrality in the treatment of domestic and foreign banks, and capital controls affecting foreign debt and maintenance of foreign currency positions. There are also restrictions on providing cross-border services to HNWIs, and restrictions on foreign banks opening up China branches or subsidiaries. All these limit foreign banks from achieving the greater profitability needed to fuel their hope for China expansion. It is to be hoped that the recent announcements on the loosening of regulatory restrictions, set out in Table 1, by expanding the scope of services and activities permitted to foreign banks, and facilitating the establishment of further subsidiaries and branches in China, herald a general improvement in the China regulatory landscape for foreign banks.

On the tax front, foreign players are expecting a set of tax policies that foster the growth of the sector, instead of hindering it or causing uncertainties when doing business. They often find that many China tax rules and policies are not keeping pace with the rapid evolution of financial innovation. At the same time, they also find that, in certain cases, tax rule changes were effected too quickly, without sufficient advance public and industry consultation. In this regard the nationwide VAT reform in 2016 is a standout example, and worth focusing on here.

For many tax jurisdictions, a wide range of financial supplies are generally exempt from indirect tax. While certain banking services, such as advisory services and asset management services, fit reasonably well within value-added tax (VAT)/goods and services tax (GST) frameworks for taxable supplies and services, it is more difficult to apply this framework to deposit taking and lending. In the latter case, the bank is just acting as a facilitator for the use of money, and charges a 'spread' on the interest, reflecting the time-value of money. This is very different from the traditional concept of 'value-adding' activity for the manufacture and trading of goods, or the provision of services, for which one can readily observe and calculate the value added at each stage in the value or supply chain. VAT/GST exemptions for lending income are the practical response taken by many countries to the complexities arising. However, China decided to go in a different direction, by levying VAT on loan interest from 2016 onwards.

Even before the nationwide VAT reform came into effect for the financial services sector, the situation in China was already rather unique. China levied business tax (BT), a form of indirect or turnover tax, on financial services, charging BT of 5% on interest earned by a bank from providing loans. Consequently, the transition to imposing 6% VAT on the financial service sector was argued to preserve a continuity of approach, as well as maintaining tax revenues. However, even after two years of implementation, there are still many areas of complexity and uncertainty regarding VAT rule application to specific transactions, causing continuing pain for the financial sector. Notable VAT issues include:

- The applicability of VAT is to certain financial products. For example, banks often offer a type of bank deposit product that generates a higher yield than regular term-deposits. This is done by embedding certain financial derivatives (e.g. futures, swap, or options) into the product, in order to mimic similar investment returns of other higher-risk financial instruments. At the same time the bank provides a guarantee for the repayment of the principal, just like under regular deposit arrangements. The question therefore arises whether such a structured-deposit note should be viewed (on the basis of its 'form') as a bank deposit – in this case the VAT rules provide that the deposit interest income would be VAT exempt. By contrast, the investment return might be treated instead as interest on a loan – in such a case it would be subject to VAT on the basis that it is, 'in substance' a product providing a 'guaranteed return or capable of generating fixed income'.
- Inter-bank lending and funding transactions are essential for banks to maintain liquidity. In the age of globalisation and increasing cross-border transactions, banks need clear taxation policies that enable them to conduct cross-border funding transactions with certainty of tax outcomes. However, despite the broadening of the scope of the VAT exemption on inter-bank transactions to include cross-border funding transactions, this is still rather restrictively applied. The existing VAT exemption on cross-border inter-bank transactions is limited to lending between the Chinese branches (or subsidiaries) of foreign banks and their related offshore headquarters (parent company). The exemption also covers lending between a domestic bank and its related offshore branch (or wholly-owned subsidiary). The neutrality and logic of this treatment may be questioned as it negatively affects the tax treatment of transactions between the China operations of financial institutions and third-party, unrelated overseas financial institutions (including non-banking institutions).
- With respect to non-performing loans, China's VAT rules do not contain any bad debt relief. However, a specific concession was introduced for the financial services sector to deal with non-performing loans. In essence, where a period of 90 days or more has expired from when interest was receivable (but was not received), the lender is not required to continue accounting for output VAT on interest that otherwise accrued, until such time as the interest is actually paid. VAT accounted for interest accrued as receivable during the initial 90-day period cannot, however, be reversed, despite the fact that this interest may ultimately never be collected.
  It should be noted that this concession is only available to qualified 'financial enterprises'. These are defined to include commercial banks, credit cooperatives, trust companies, securities companies, insurance companies, financial leasing companies, securities fund management companies, securities investment funds and other entities that are established with the approval of the PBOC, CBIRC and the China Securities Regulatory Commission (CSRC). However, other credit institutions, such as small lending companies governed by local government financial service authorities, or leasing companies governed by the Ministry of Commerce are excluded from the definition of financial enterprises and cannot use the concession. This unfair treatment would definitely place small lending companies at a disadvantage when engaging in lending business. This is because they are mandated to serve mid-to-small enterprises and individual borrowers, where these borrowers are less likely to be able to repay, or are slower in repaying interest and principal. This means that small lending companies will very much need to pre-pay the output VAT on interest receivables that go past the 90-day threshold until interest is actually received.
- The State Administration of Taxation (SAT) recently released SAT Announcement [2018] 28, which strengthens the requirements for corporate income tax (CIT) deductions to be supported with official tax invoices (*fapiao*). Under these rules, to support their CIT deductions, a taxpayer must always obtain valid tax invoices, including for interest paid to banks. Traditionally, bank remittance slips could be used as supporting documentation for CIT

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Henry leads a large number of tax structuring and due diligence projects involving foreign acquisitions of Chinese target companies in different sectors, including financial services, real estate, manufacturing, retail and distribution, TMT, FinTech as well as healthcare sectors. He also participated in certain outbound related M&A transactions by advising domestic Chinese clients on the related tax implications and financing strategies on outbound investment, including investments into offshore private equity funds or real estate investment funds.

Henry serves many financial sector clients including banks, insurance companies, securities and brokerage, commodity trading companies, derivative and foreign exchange trading companies, as well as leasing, asset management companies and investors in non-performing loans (NPL). He also works extensively with various investment fund clients including private equity firms, mutual funds, fund management companies, QFII, QDII, QFLP, QDLP, hedge funds, and REITs, etc.

His involvement in the investment fund advisory sector includes all phases of the fund lifecycle, onshore and offshore fund formation and structuring advisory from tax and regulatory perspectives, profit repatriation planning for fund as well as its portfolio investment in China, investment entry and exit planning, executives/employees compensation/incentive planning, carried-interest structure planning as well as helping clients in addressing specific partnership taxation issues. He also provides tax due diligence services to private equity investment funds.

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deductions. However, going forward, it is expected a large number of taxpayers will now demand that banks issue tax invoices, radically increasing the operational burdens on banks relating to millions of interest payment transactions.

Securities sector

China's securities industry, including brokerage and underwriting services, is dominated by domestic firms. There are Sino-foreign JVs, but due to the regulatory restrictions, foreign ownership of a securities JV must not exceed 49%. In addition, the Chinese partner must be another Chinese securities company. This means that foreign firms lack control over their China securities JV operations and strategy, complicating expansion plans. For reference, the total income of the top eight domestic Chinese brokerages was more than eight times the total income of the top eight Sino-foreign securities JVs last year.

As the ownership restrictions are now set to be relaxed between 2018 and 2021, this may attract further foreign securities companies to enter the China market, particularly those with broader global businesses that include investment banking, brokerage and asset management. Foreign firms would be in a position to offer more complex products than those now available on the China market, as well as being in an advantageous position for offering cross-border services.

However, there are still uncertainties. As noted above, one of the liberalisation measures is that the government will remove the limitation on the business scope of Sino-foreign JV securities firms and give them equal treatment to domestic firms in terms of the scoping of their activities. Nonetheless, there are doubts as to whether Sino-foreign securities JVs will be able to widen their scope of activities within a short timeframe. Sino-foreign securities JVs will likely continue to be limited to conducting the activities covered in their underwriting licence, as it was approved at the time of their initial establishment. In order to bring new activities within the scope of their business licence, the Sino-foreign securities JVs will need to show that they have the capacity to conduct such activities. This requires the Sino-foreign securities JVs to meet stringent regulatory and compliance requirements, including minimum head count, local IT infrastructure and other operational setup requirements, before commencing the new activities. This means that foreign firms will need to make substantial investment upfront, with only limited profit-making ability in the beginning.

Similar to the businesses in the banking sector, securities firms also face many tax uncertainties. Some of the more commonly seen tax issues for the securities sector include:

- VAT input credit complications can arise for securities firms with headquarters registered in one district in China, and branches registered in different tax districts in

China. This is due to mismatches arising from the fact that expenses may be incurred, and booked, at branch level, in order to match to brokerage revenue, but the VAT invoices may be received (and paid for) at the headquarters level. For example, where stock exchange charges are billed to the headquarters, the latter cannot issue VAT invoices to each branch; this is in contrast to the position for trading enterprises and many service enterprises, for which such an arrangement would be possible. The end effect of this is that the headquarters may have excess and unusable VAT input credits, while the branches have a VAT payment obligation, which would have otherwise been limited if their output VAT could have been offset by the stock exchange charge VAT input credits.

- Uncertainty exists for securities companies on whether VAT is payable on their interest earned from deposits with the China Securities Depository and Clearing Corporation (CSDC). Securities companies often need to place substantial returnable deposits with the CSDC in relation to proprietary or customer securities trading and settlement transactions. It is unclear then if interest earned on these deposit balances should be considered as interest on a loan that is subject to VAT at 6%, or interest on a bank deposit that is VAT exempt. Many would argue that it is, in substance, more in the nature of a deposit placed with another financial institution, and interest should therefore be exempt. However, CSDC is not one of the financial institutions specifically mentioned in the SAT's VAT guidance, and uncertainties persist that result in increased costs of doing business in the securities sector.

Investment and fund management sector

China's asset management industry emerged in 1998. It started off from six fund management companies (FMCs) managing about RMB 10.4 billion of assets in 1998. This has risen to RMB 12.6 trillion of assets held by 132 firms today. Such a tremendous growth in assets under management (AUM) is expected to continue in the next 10+ years with forecasts that total AUM will hit around RMB 36.3 trillion by 2025. This would make China the second-largest asset management market in the world.

In addition to the substantial growth in AUM, there are also numerous types of new asset or fund management products that have been introduced in the last two decades. In general terms, asset and fund management products in China are mainly divided into 'public' versus 'private' products. Public products include open-ended retail securities investment funds (similar to mutual funds in foreign jurisdictions) that raise funds from the general public, while private products would be those that privately raise invested funds from qualified and institutional investors.

Private products are further designed to invest into standardised instruments like stock, bonds, funds-of-funds, and private equity funds. There are also non-standardised products that are specially designed for target investors. These non-standardised products can invest into debts and debt-like products, for example asset-backed securities, entrustment loans, specialised trust products, the buying and selling of acceptances, letters of credit, receivables, or equities products with repurchase options, and so on.

The range of fund-related products has also steadily expanded. In the early stages of the asset management industry, market players offered open-ended and closed-ended funds, qualified domestic institutional investor (QDII) funds that focus on offshore capital markets, as well as private securities investment funds that attract HNWIs and institutional investors. With China's strong economic growth and the growing population of middle-class individuals, the industry has moved to develop more sophisticated financial products that can provide higher yields for individual investors. However, with the greater complexity of higher-yield products, individual investors are frequently not fully aware of the underlying investment risks involved. There have been numerous reported cases of financial scams, as well as illegal fundraising activities, which have led the Chinese regulators to tighten oversight of the investment and assets management sector.

In terms of foreign participation in the asset management sector, there are approximately 40 Sino-foreign JV fund management companies in existence; for many of

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Jean has extensive experience in Chinese tax consultancy. With her strong accounting, auditing, taxation and legal background, Jean advises clients on their investment and development plans, business structures, merger and acquisition transactions, share transfers, liquidation processes, transfer pricing strategies, as well as customs and foreign exchange matters of business operations. Jean also maintains good relationships with both tax and investment related authorities.

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these, the foreign players hold minority stakes. For those who wish to have 100% control over how the asset management firm is run, foreign investors can now set up a wholly foreign-owned enterprise (WFOE) manager and raise private investment fund products entirely within China that target HNWIs and institutional investors. These private funds either invest into the Chinese capital markets or they may obtain special licences from the Shanghai financial services office or Shenzhen authority allowing them to invest into offshore master funds. These master funds must be managed by offshore affiliates of the foreign assets manager controlling the China WFOE manager. These offshore-focused products are commonly referred to as qualified domestic limited partnership (QDLP) funds or qualified domestic investment enterprises (QDIE).

Going forward, however, it will be more attractive to foreign players (from 2021) to launch mutual fund products with a WFOE manager licence. Using such arrangements, foreign firms will be able to serve the larger population of Chinese individual investors, instead of being limited to serving qualified institutional investors and HNWIs, as under the existing private fund regime.

From a tax perspective, the most relevant issue for the investment and fund management sector is (again) the national VAT reform. According to Circular Caishui (2016) 140, Circular Caishui (2017) and Circular Caishui (2017) 56, from January 1 2018, to the extent there are VAT taxable activities conducted by the asset management products, the manager of these asset management products will be the VAT taxpayer. The applicable VAT rate is 3%, charged under the simplified method (i.e. without the ability to claim any input credit).

Interestingly, the subjecting of asset management products to VAT is not common for other developed countries, especially for jurisdictions which exempt financial services from paying VAT. But what is even more interesting is that China decided to levy VAT on asset management products through use of a new deeming rule, which places the tax filing and payment obligations on the fund or asset manager. The main reason for doing so is because most, if not all, of the asset management products existing in China are structured as contractual relationships. There is no product issuing entity which may be treated as a legal person (aside from products organised through Chinese limited partnership or corporate funds). This means that an asset management product (or contractual fund) cannot be registered as a taxpayer under the existing Chinese tax administration system and therefore cannot directly pay the VAT.

Because the VAT rules for asset management products now deem the fund or assets manager to be the taxpayer, when the manager is managing multiple products at the same time, complicated VAT filing and calculation issues arise. For example, trading of financial commodities like listed securities, foreign exchange, derivatives and so on, are subject to VAT with the ability to offset gains and losses within a VAT reportable year. However, what if the asset pool underlying one asset management product (Product A) realises net gains on trading of financial commodities, while the asset pool underlying another product (Product B) realises a net loss? In such a case, the manager will need to decide how to allocate the net VAT liabilities to each product because it is the manager who aggregates all the VAT taxable activities together and pays the VAT on behalf of all of its products under its management. So far, there is still no clear guidance on how to deal with such allocation of VAT cost between products, except to leave it to the manager to decide on what is the most acceptable method to the investors from a business standpoint.

Another challenging issue for fund managers is the VAT treatment on gains from fund investments. The issue has two aspects: (i) whether gains on the transfer of interests in corporate or partnership form funds should be considered to arise from dealings in financial commodities, and be subject to VAT; and (ii) whether fund redemption events should be considered as financial commodity transfers and subject to VAT.

- According to the national VAT reform rules, set out in SAT Circular 36, the definition of financial commodities includes foreign exchange, securities, non-commodity futures and 'other financial products'. The latter refers to various types of asset management products listed as funds, trusts, financial management products, as well as various types of derivatives. However, Circular 36 does not specify whether the so-called funds category is meant to refer to contractual funds, corporate funds or partnership-form funds.

  Historically, the pre-VAT reform BT rules did not consider the transfer of unlisted private equity (i.e. non-listed shares and limited partnership interests) as part of the financial commodities category. This meant that trading gains on such unlisted private equity were not subject to BT (i.e. they were out of scope). Given that the VAT reform rules in the financial services space largely follow the former BT rules, it has been argued that the transfer of unlisted private equity should equivalently not be subject to VAT, post reform.

  Most, if not all, QDLP and QDIE products are invested in offshore private funds, which are organised as private companies or private limited partnerships. The position could be taken that VAT is not chargeable on any redemption gains related to QDLP and QDIE investments in these offshore private equities. However, given the ambiguity in the tax guidance, the tax authorities could also argue that offshore private equities are still to be treated as funds for the purposes of Circular 36, and therefore that redemption gains are VAT-able dealings in financial commodities. As matters stand, there is still no clear answer on the appropriate VAT treatment.
- A further issue relates to fund unit redemption. According to Circular 140, which imposes VAT on assets management products, gains from redemption, where assets are held to maturity, is not within the scope of VAT. According to Circular 36, any transfer of the ownership of financial commodities will be subject to VAT. This leaves a guidance gap for fund unit redemptions.

  Typically, investors will subscribe for fund units, and will divest their holdings through redemption by the fund. This differs from exits from listed share investments through equities trading markets. The general market view is that redemption is not a transfer, because there is generally no established marketplace through which one can buy and sell such fund units with another third party. Further, the fund units will not exist after the redemption directly with the fund. It is argued that the redemption should be viewed as a 'held to maturity' case and not be subject to VAT. However, ambiguity and uncertainty persists.

As noted above, the fund or assets manager is treated as the taxpayer for VAT liabilities arising in relation to the assets management products it manages. Therefore, to the extent there are any underpaid VAT liabilities, for example due to the ambiguous interpretation of financial commodities and the meaning of trading, the manager could end up bearing additional VAT liabilities.

There are many other tax issues that are yet to be resolved for investment and fund management:

- VAT rules stipulate that for investments that provide returns that are 'fixed, guaranteed or principal-protected', the returns should be treated as interest on a loan, and subject to VAT. However, in practice, there are still many ambiguities on the meaning of fixed, guaranteed or principal-protected returns, such as whether one simply looks at the contract terms, or whether a substance-over-form approach needs to be applied. This remains a challenging issue for asset management businesses when designing investment products.
- Apart from the above-mentioned VAT uncertainties, there are also IIT issues due to a lack of guidance on the treatment of privately offered contractual funds. For example, when contractual fund income is distributed to individual investors it is not clear whether there is an IIT withholding obligation for the fund manager. The recently announced IIT reform does not appear to address this issue and therefore fund managers will continue to walk a fine line on such matters.
- In relation to the new Circular 108 bond interest tax exemption, a question remains whether this will solely cover interest on bonds *per se*, or will also extend to other forms of tradable China debt instruments, into which

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overseas institutional investors are permitted to invest. Until such time as further clarifications are forthcoming, there are likely to be uncertainties arising from differing tax authority and taxpayer interpretations.

What's next?

The relaxation of regulatory restrictions for the China financial sector is certainly good news for foreign firms. However, as discussed above, there are still many areas of tax uncertainty, as rules struggle to keep up with the development of financial markets and investment product innovation.

For foreign firms seeking to operate in China, it is recommended to closely watch tax rule development, seek appropriate advice from tax professionals, fully understand market practices, and participate in industry association representations to the authorities' industry-wide tax issues. Care must be taken to carefully design any investment or financial products with regard to the often ambiguous VAT and income tax treatments and communicate clearly, to potential investors and customers, the underlying China tax risks and their tax compliance obligations. In China, changes to tax rules can often have retroactive impact and parties promoting or selling a product without any disclosure of potential risks in the relevant offering memorandum can end up responsible for the full amount of resultant tax liabilities.

It is to be hoped that, in tandem with the relaxation of restrictions on investment and operations in the financial services sector, the SAT will invest further effort and resources in understanding the operation of the financial services sector, at a commercial level, and refine rules to remove tax uncertainties and ensure the success of the liberalisation.

The authors would like to thank Aileen Zhou and Adam He for their contributions to this chapter.

Coming of age – China's leveraging of BEPS

Following years of rapid change to China's cross-border corporate income tax (CIT) rules and advances in enforcement effectiveness, a more measured approach has recently emerged, reflecting business environment changes and China's evolved position within the global economy. Chris Xing, Conrad Turley, Grace Xie, and William Zhang, trace the latest trends.

In last year's seventh edition of *China Looking Ahead*, the chapter, *China after BEPS*, considered how China's cross-border tax policies had begun to respond to the country's evolved role in the global economy. In particular, it was observed that:

- Outbound direct investment (ODI) from China had overtaken inward foreign direct investment (FDI) from 2015, and major external economy policies such as the Belt and Road Initiative (BRI) had come to strongly influence top level strategic thinking for China, and the nature of its international engagement.
- Against this backdrop, and to support the outbound investment trend, in 2017 China amended its foreign tax credit (FTC) regime, sought to improve its double tax agreements (DTAs) with BRI countries and other trade and investment partners, and invested resources in better mutual agreement procedure (MAP) assistance for China outbound investing enterprises.
- To counter the perceived stagnation of FDI, a measure was announced to defer the imposition of withholding tax (WHT) on outbound dividends, where the dividends were used to finance reinvestment in China. This accompanied announcements, in the 2017-issued State Council Circulars 5 and 39, of plans for major liberalisation of foreign investment restrictions for numerous Chinese industries.
- At the same time, there was no let-up in rigorous tax enforcement for inbound investment. In their work, the tax authorities were bolstered by new big data analytical capabilities and better information collection and pooling. Treaty abuse, indirect offshore disposal, transfer pricing (TP) and permanent establishment (PE) enforcement cases were prominently highlighted by the State Administration of Taxes (SAT) and provincial tax authorities through their websites and WeChat social media feeds, the ostensible aim being to let taxpayers clearly understand that they would be monitored and pursued proactively. BEPS rollout measures taken, and future plans in this space, were also frequently emphasised to taxpayers.

In 2018, while many of these trends have continued, two key developments originating in the US came to shape the broader context of China's external economic and tax policies:

- The major US tax reform passed in December 2017, and effective from January 2018, substantially increased the tax competitiveness of the US compared to its prior position; this is discussed in detail in the chapter, *When America squeezes – implications of US tax reform for China*.

- In parallel, in the course of the year the US placed high import tariffs on an increasing range of Chinese exports to the US. If further proposed tariffs are adopted by the US then virtually all Chinese exports to the US may well be subject to high tariffs by the start of 2019. China responded with countervailing tariffs on US exports to China. See the chapter, *In the eye of the storm – how does China act and react in times of trade tension?*, for further detail.
- The next steps in the stand-off remain uncertain, but it seems possible that the China-US trade issues may become the centrepiece of hurdles confronting the global economy. Under the replacement for the North American Free Trade Agreement (NAFTA), the US-Mexico-Canada Agreement (USMCA), a key provision (Article 32.10) can be used to bar members from entering into separate free trade deals with China (as a 'non-market economy'). Conceivably, the US could look to insert such clauses into its other trade agreements, such as with post-Brexit UK.
- China, in turn, may reorient trade and investment towards the trading partners and associated groupings of which it is part. As noted in the chapter, *Tax opportunities and challenges for China in the BRI era*, this is already happening. In the last year, Chinese investment in the US fell substantially, while BRI investment steadily rose. China is also committed to continuing negotiations on the Regional Comprehensive Economic Partnership (RCEP) together with the 10 ASEAN nations, Japan, Australia, New Zealand, Korea, and India, which would account for 29% of global trade. This happens as the US has pulled out of its earlier commitment to the ASPAC-focused Trans-Pacific Partnership (TPP).
- While political developments in the US and China could reverse this momentum, businesses and tax policymakers must now take into account scenarios in which there is a splintering of the hitherto dominant globalisation trend, and plan accordingly.
- In the medium-to-longer term, the US trade and tax developments raise questions concerning the future shape of global supply and value chains, and China's role in them as the 'workshop of the world'. Many commentators consider that these developments are likely to accelerate the trend, already well underway, for low-end, low-margin, processing activity for clothes, toys, and so on, to be relocated from China to South East Asia and India. Chinese manufacturing, in the meantime, is pivoting towards middle and high-tech production, including vehicles, electrical and construction equipment, as supported by automation and robots.

Against this backdrop, Chinese tax and regulatory policies, including in the cross-border space, have been evolving to accommodate these changes.

- Building on the investment liberalisation announcements in 2017's State Council Circulars 5 and 39, a further important speech by President Xi at the April 2018 Bo'ao Forum, and the June 2018 State Council Circular 19, a string of opening up measures were put into effect in 2018, or timetabled for implementation in the near future.
- The number of economic sectors restricted for foreign investors under the 'negative list' was lowered from 63 to 48. The requirements for foreign investors to have Chinese joint venture (JV) partners were signalled for abolition across a whole host of sectors, meaning that 100% foreign invested entities would be permitted to conduct these businesses. These include transport and logistics, ship and aircraft building and repair, wholesale activity, professional services, energy and transport infrastructure and, on a phased basis in the period to 2022, auto manufacture.

  Perhaps most prominently, on a phased basis in the period to 2021, foreign investment access to the Chinese financial services sector is seeing substantial liberalisation; the details of the latter are outlined in the chapter, *China FS sector opening up: Tax opportunities and challenges ahead.*
- Further sectors are set to be opened up to 100% foreign ownership in the foreign trade zones (FTZs), including a range of telecoms and internet services. The quotas for the various arrangements existing to facilitate portfolio investment cross border in and out of China (i.e. Stock and Bond Connect, QFII/RQFII/QDII) are to be expanded. Finally, a range of measures is promised to ease access to working visas, protect intellectual property (IP), simplify cross-border cash pooling, and involve foreign investors in state-owned enterprise (SOE) reform.
- It might be noted that FDI of $98 billion was reported for the first nine months of 2018, up 6.4% from the same period last year, reaching a new high for China inbound FDI. This being said, the past years have seen many high-level announcements of plans for investment liberalisation, only to be subsequently delayed, so foreign investors will be watching keenly to see if these are implemented as promised.
- On the tax front, in September 2018 it was provided that the application of the dividend reinvestment WHT deferral incentive would be further broadened; this is detailed in the chapter, *Not-so-old wine, in a not-so-new bottle – Perennial tax challenges for M&A with new twists.* November 2018 saw the introduction of VAT and WHT exemptions for China corporate bond investments by overseas institutional investors.
- A series of enhancements were made to China's innovation tax incentives in 2018, notably in relation to the research and development (R&D) super deduction; see the chapter, *R&D 2.0: Taking tax incentives to the next level in China*. This goes some way towards bolstering

the incentives for conducting R&D activity in China, even in the face of US tax changes which might make this relatively less attractive, such as the base erosion and anti-abuse tax (BEAT) and foreign-derived intangible income (FDII) measures.
- Furthermore, and as described below, in SAT Announcement [2018] 9, the SAT sought to bring greater certainty to the granting of DTA relief. Much more detailed guidance was provided than was previously the case, though at the same time the SAT decided not to diverge from the demanding commercial substance-focused interpretation of beneficial ownership, which they have adhered to since Circular [2009] 601 (Circular 601) was released.

At a broader and more intangible level, there has been a perceptible change in the 'tone at the top' with regards to the previous, highly assertive, China tax enforcement approach. Whereas in previous years the websites and WeChat social media feeds of the SAT and provincial tax authorities insisted vocally that they had the tools to enforce (e.g. big data analysis, information pooling and exchange mechanisms) and would do so vigorously (e.g. notices of enforcement campaigns, and highlighted enforcement cases), the last year has seen a decidedly softer tone. The emphasis in these communications is more on efforts to improve taxpayer services and ease access to incentives.

This is paralleled by observations, in practice, that at least in China's advanced first-tier cities, such as Beijing, Shanghai and Shenzhen, a more reasonable approach is being taken by tax officials to dealing with taxpayer issues; this is detailed in the tax management chapter, *Seeing the tax trees from the data forest – how does Chinese tax administration manage in the digital age?* China's tax law and formal guidance frequently leaves many grey areas, and there is increasing positive experience of tax officials, in these cities, taking a more holistic view, and applying the law in a manner more sensitive to commercial realities and in line with original tax policy intent. This may be linked to the greater experience and training of tax officials, which has helped them develop a better understanding of increasingly complex taxpayer commercial arrangements. It may also be a function of their increased enforcement effectiveness, as a consequence of the shift to data-driven tax enquiries/audits, use of taxpayer credit ratings, and so on, as this gives the authorities greater leeway for a more holistic approach. The recent general government policy on encouraging business activity and inward investment also forms an important backdrop, in this regard.

The TP chapter, *Now that we have data, what are we going to do? – new challenges and opportunities in TP in China*, reinforces this view with the observation that TP assessments dropped substantially in number and value over the last year. This was as a result of tax authorities in first-tier cities relying on advance data analysis to enter into early stage discussions with taxpayers on their tax positions, and reach agreement on changes to their positions, and forestalling the launch of formal audit procedures. The TP chapter also observes the countervailing trend, whereby in less developed cities and districts, the tax authorities have become, in some cases, tougher to deal with. Officials in these districts may lack the same experience with advanced commercial arrangements and advanced data analytical tools, and with tighter control and supervision being exercised over their operations from a central level than in the past, they may be reluctant to use their discretion to apply the rules outside the strict wording of the law and SAT guidance. This can lead, on occasion, to commercially problematic applications of tax rules.

Nonetheless, despite this, the broader trend and policy is increasingly clear. In light of the changing external economic environment, and in view of the priority placed on promoting inbound investment, at a central level the SAT has set a goal of facilitating business. Incentivising and supporting investment and business activity is the theme underlying new tax policies and the tone of tax authority-taxpayer interactions with better organised and better (data) equipped tax authorities expected to have the capacity to apply the tax rules effectively, without the need to 'bang the drum' of highly assertive tax enforcement. In the enforcement cases outlined below (which are largely obtained from tax media sources, as the authorities themselves report far fewer cases these days) the role of data analysis and information exchange come through clearly. Firstly though, a round up will be provided on the latest state of play with the BEPS rollout.

BEPS rollout

In September 2015, even before the release of the BEPS reports by the OECD in October 2015, the SAT issued an omnibus draft BEPS circular. This included elements covering TP, controlled foreign company (CFC) rules, and changes to thin capitalisation rules and the general anti-avoidance rule (GAAR). What is more, senior SAT officials indicated an intent to implement the BEPS permanent establishment (PE) changes, as well as anti-hybrid rules. As noted in last year's international tax chapter, however, events subsequently took a different path.

While overhauled TP rules and documentation requirements were subsequently set out, in 2016 and 2017, the relevant circulars were carved out from the September 2015 document. No developments have emerged with CFC rules, PE rules or hybrids, and only minor changes were made to thin capitalisation rules as part of the TP guidance. This situation, which we reported on in last year's international tax chapter, remains the same in this year's chapter.

China did sign the BEPS multilateral instrument (MLI) in 2017, and elected to have virtually all of its DTAs updated, to the extent they matched to elections by DTA counterparties. Initially, 48 Chinese DTAs matched, and this has now risen, with the adherence of further Chinese DTA partners to the MLI, to 55 (Barbados, Jamaica, Kazakhstan, Malaysia, Saudi Arabia, Ukraine and UAE are now also added). However, China decided to opt for the minimum updates possible, updating its DTAs with the principal purpose test (PPT) and associated new DTA preamble (i.e. that the object and purpose of DTAs is not to facilitate treaty shopping), but foregoing the PE updates, binding arbitration, and any of the hybrid-related changes. In fact, with the release of Announcement 9 (described below), it might well be asked what relevance the PPT update will actually have.

At an earlier stage (including in previous years' editions of this publication) it was speculated whether the SAT might look to disentangle the 'commercial substance' elements from the Chinese beneficial ownership concept, set out in Circular 601, leaving it as a test of control and disposition of assets and income (in line with the internationally understood concept of beneficial ownership). The commercial substance matters might then be considered in the context of a PPT or GAAR assessment of treaty abuse arrangements. However, with Announcement 9, the SAT has 'doubled down' on its commercial substance approach to beneficial ownership. As such, even when the PPT and preamble updates to China's DTAs come into effect (anticipated in 2020 and 2021, depending on when China and its DTA partners ratify the MLI), there may not be much consequential change in DTA anti-abuse enforcement practices.

Putting BEPS in the context of China's evolving position, both economically and from a tax perspective, this does, however, make quite a lot of sense. It has often been said that China was 'doing BEPS' in advance of the launch of the G20/OECD BEPS project in 2013:

- The use of concepts such as local marketing intangibles in Chinese TP enforcement practice since the mid-2000s, presaged the 2015 BEPS Actions 8 to 10 recognition of local contributions to intangible value creation under the development, enhancement, maintenance, protection, and exploitation of intangibles (DEMPE) framework. The 2017 updates to Chinese TP guidance, while introducing the BEPS TP concepts into Chinese rules, localised these rules to an extent that they largely copper-fastened the approaches already taken in enforcement practice.
- The tough China approach to treaty abuse, applied since 2009, came long in advance of the 2015 BEPS Action 6 proposals on PPT and limitation of benefits (LOB).

The measure recognised as the most important in the entire BEPS programme, the Action 13 CBC reporting, has been adopted by China. The Action 12 guidance on mandatory reporting of tax planning arrangements has also been reflected in recent guidance requiring China tax advisors to register their advisory activities with the tax authorities. China's incentives passed the Action 5 harmful tax practices review, and new procedures facilitate ruling exchange. Hybrids and debt planning remain harder to structure in China due to regulatory factors, including forex controls, and so the BEPS Action 2 and 4 changes were never going to be an overweening priority. For the other major BEPS items, being the updates to PE and CFC rules, the transformation of China's external economy position since the BEPS work commenced made it likely, in retrospect, that action in this space might be looked at again, through an altered lens.

China remains deeply engaged in the Action 1 digital economy work conducted through the BEPS inclusive framework; this is dealt with in detail in the chapter, *A Sisyphean task? – Tax plays catch up with China's rapid digitalisation*. Work on this may well have a strong bearing on future global standards on PE, TP and CFC rules – to the extent that global compromise can be reached in this space, including by China, such changes would also make their way into updated Chinese rules.

One final point worth mentioning in relation to cross-border anti-avoidance rules is the adoption, in the new Individual Income Tax (IIT) Law passed in August 2018, of a GAAR, as well as TP and CFC rules; these are detailed in the chapter, *One giant step forward in Chinese IIT reform*. While in many other countries CIT and IIT cross-border anti-avoidance rules have developed in tandem over the years, in China such rules grew quite sophisticated in the CIT space while remaining wholly underdeveloped in the IIT space. International tax practitioners in China consequently focused primarily on CIT. Going forward, IIT rules and enforcement are set to rapidly catch up with CIT, making them a key area to watch in the China international tax space. In this regard it is important to note that following the merger of the local and state tax bureaus (LTBs and STBs) throughout China, the international aspects of IIT and CIT enforcement are being dealt with jointly by combined international tax departments at the level of 36 provincial tax bureaus; IIT and CIT matters were previously dealt with separately by the LTBs and STBs. This means a more structured and effective approach going forward; the STB-LTB merger is covered in the chapter, *Seeing the tax trees from the data forest – how does Chinese tax administration manage in the digital age?*

Treaty guidance clarifications in 2018

In February 2018, the SAT introduced two important new circulars to clarify the application of relief under China's DTAs.

SAT Announcement [2018] 9 (Announcement 9), effective from April 2018, refines the interpretation of the beneficial ownership requirement in the dividends, interest and royalties articles of Chinese DTAs. As noted above, since the issuance of Circular 601 this has been a very challenging area in Chinese cross-border taxation. An evaluation of commercial substance, at the level of the DTA relief claimant, is applied alongside an evaluation of the claimant's control over the relevant income and assets, with reference being made to a series of 'negative factors'. While, with Announcement 9, the SAT has now conclusively decided to stay with a commercial substance driven concept of beneficial ownership, a number of aspects of the new guidance may help to improve access to DTA relief:

- The SAT interpretative guidance accompanying Announcement 9 sets out numerous detailed examples which give a much better sense of what level of commercial substance the SAT considers acceptable for accessing relief. As one of the main issues with the existing beneficial ownership concept is the great diversity in local tax authority interpretations on the appropriate level of substance, these examples will be useful in justifying taxpayer positions before the local authorities. This being said, in particular for investment funds, the substance expectations in the guidance could be viewed as quite challenging to meet. Interestingly, the indicative requirements bear some similarity to those outlined in Example K, in the PPT guidance of the 2017 OECD Model Tax Convention (MTC) Commentary, which has also been viewed by practitioners as commercially unrealistic for funds.
- An earlier circular, SAT Announcement [2012] 30, had provided a safe harbour under which listed foreign companies, and their local subsidiaries tax resident in the same jurisdiction, would not need to satisfy the 'negative factor' analysis to qualify as beneficial owners. Announcement 9 now extends this to companies, held by individuals and governments, and tax resident in the same jurisdiction.
- There is now a type of 'derivative benefits' test, under which regard can be applied to the 100% direct and indirect parents of a DTA relief claimant company, in making the beneficial ownership assessment. If the parent company is either tax resident in the same jurisdiction as the DTA relief claimant, or in a jurisdiction whose DTA with China offers equivalent benefits, and it does not breach the negative factors test, then DTA relief will be available to the DTA relief claimant. Multinational enterprises may find this of use (less so investment funds). The provision might be regarded as having parallels in the PPT discretionary clause, which is an optional element of the BEPS PPT rule; this also involves a derivative benefits based let-out. However, in the Chinese beneficial ownership case, this let-out is automatic, whereas under the BEPS PPT rule, granting of the let-out is at the discretion of the competent authority. It might be noted that in China's MLI PPT elections it chose not to adopt the discretionary clause.

It should be noted that, even with the clarifications to the meaning of beneficial ownership, DTA relief remains challenging to access in China in light of substantial deviations and inconsistency in the administrative procedures followed by local tax authorities. This is coupled with the increased challenges of obtaining tax residence certificates in some of the key holding company jurisdictions for China (e.g. Hong Kong and Singapore), which further complicate DTA access.

Separately, also in February, the SAT issued Announcement [2018] 11 (Announcement 11), which supplements the earlier DTA guidance provided in SAT Circular [2010] 75 (Circular 75). Circular 75 is the most substantive piece of China DTA guidance and draws heavily on the commentary on the OECD model tax convention. Minor clarifications are provided on service PE timeframe calculations, and DTA transport and artist articles, but the most notable clarification concerns the treatment of foreign partnerships.

It is provided that, unless there are specific provisions in a given DTA dealing with partnership transparency, then foreign partnerships themselves must qualify for DTA benefits for any relief to be available. This means that the partnerships need to show that they have registered with foreign tax authorities as tax residents and have paid tax as residents. One cannot just look through to the underlying partners and show that the partners paid tax, and then be able to claim DTA benefits on this basis.

At present, solely the China-France DTA has special provisions allowing for foreign partnership look-through. In practice, for other DTAs, taxpayers have, in the past, had case-by-case discussions with local tax authorities to agree foreign partnership look-through to access DTA relief. The new guidance would seem to close the door on this approach. Given that, in commercial practice (and particularly for investment funds), many partnerships are set up as flow-through entities, and the partnerships themselves are not registered as tax residents, this could create extensive China DTA relief complications. While China could, potentially, look to add new protocols to its DTAs to provide for look-through, this would not assist with the many Cayman and British Virgin Islands (BVI) partnerships used for China investment given the lack of relevant China DTAs.

These were the principal SAT DTA-related circulars during the year. In the meantime, taxpayers and local tax authorities are still coming to terms with the complexities of 2017's Announcement 37 guidance on WHT application and 2015's Announcement 60 guidance on DTA relief administration, both of which remain challenging in application. Apart from these DTA-related guidance developments,

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China expanded its DTA network by signing new DTAs with Gabon and Congo in 2018. These are the newest China treaties alongside the DTA signed with Kenya in 2017, and the November 2018 signed replacement DTA with Spain and DTA protocol with India, though they all await the completion of domestic ratification procedures before they can go into effect. The limited DTA signing activity of the last two years is partly owing to the fact that China already has one of the most expansive DTA networks in the world, and extensively updated many of its existing DTAs, particularly those with EU countries and some key BRI jurisdictions (e.g. Russia and Romania), earlier in the 2010s. As noted above, 55 China DTAs (and rising) are set for update through the MLI.

As a side note, the China-Chile DTA of 2015 was updated automatically in 2018, by virtue of a novel most favoured nation (MFN) clause included in the DTA. Chile's new DTA with Japan, which includes more favourable interest and royalty WHT rates than the China DTA, entered into force in 2018, and the MFN clause activated those better rates for the China DTA as well. No other China DTA, as yet, contains such provisions (it is rather Chile that has been including MFN clauses in its recent DTAs) but this shows a willingness by China to innovate in DTA design.

Enforcement efforts to further leverage off big data

As noted above, in the last year there has been a perceptible change in the 'tone at the top' with regards to the previous, highly assertive, China tax enforcement approach. The messaging from the SAT and provincial tax authorities is more about assisting taxpayers and providing access to incentives. It has also been observed that, in practice, in China's advanced first-tier cities a more reasonable approach is being taken by tax officials to deal with taxpayer issues. In dealing with the intersection of complex commercial arrangements (e.g. restructurings) and the frequent grey areas in China tax law and formal guidance, officials can be increasingly found to take a more holistic view, and apply the law in a manner more sensitive to commercial realities and in line with original tax policy intent. This may be linked to greater experience and training among the officials in these cities, as well as the echoing down of the new tone at the top. It may also be linked to the increased enforcement effectiveness, as a consequence of the shift to data-driven tax enquiries/audits, use of taxpayer credit rating, and so on. As observed above, and in the tax management chapter, this is by no means universal, and particularly in lower tier cities, managing interactions with tax officials may, in some cases, be even more challenging.

All these trends and developments come through in the selection of enforcement cases documented below. As noted in previous years' international tax chapters, relatively few cases go to court in China and so the main sources of information on tax enforcement cases are business and tax-specialist media. In previous years, the SAT and the local tax authorities also publicly highlighted many cases through their official WeChat social media feeds, with a view to raising taxpayer awareness of tax audit effectiveness, penalty strictness, and encouraging compliant behaviour. With the softer tone in communications this year, far fewer cases have been reported by the authorities, and there is more reliance on the media for details. However, as previously mentioned, the details available are generally limited, with fragmentary technical discussion. Also worthy of mention is that, in contrast to our coverage in last year's international tax chapter, there were no notable cross-border transaction-related court cases on taxation in the last year.

Treaty abuse cases

While the release of Announcement 9 in 2018 has refined the China concept of beneficial ownership, for the enforcement cases reported in the past year, the local tax authorities continued to apply the Circular 601 guidance, and its seven negative factors.

Dividends

- In a case reported by China Taxation News (CTN) in August 2018, the Wujing district tax office of

Changzhou (Jiangsu province) State Tax Bureau (STB) denied dividend WHT DTA relief to a Hong Kong (HK) company. In the case, a US company had established the HK company as a holding company for the Changzhou-based company. The Changzhou company in turn held equity in a further Chinese company, and its main source of income was dividends from this latter company. The whole structure appears to have been set up in April 2017.

- When the Changzhou company lodged DTA relief forms and documentation with Wujing tax office, the authorities noted from the Golden Tax III system that the company had an 'M' taxpayer credit rating, designating a newly established company; this piqued the interest of the authorities. On further scrutiny of the DTA filing documentation, they noted that the HK company operated out of a 100 square metre warehouse in HK's New Territories, and observed that its minor outlays on management fees and salaries, reported on the HK company's accounts, were dwarfed by the large dividends received by the company from China.
- Suspecting a contrived treaty planning arrangement, they initiated information exchange procedures with the HK tax authorities. The latter reported that, in fact, most of the time no-one was working at the warehouse and the costs recorded on the HK company's accounts were fees for daily operation of the warehouse. Presented with this information, the Changzhou company admitted that the arrangement was purely set up for treaty relief access purposes, and the warehouse arrangements were solely for the purposes of giving perceived substance to the HK operations which would support a DTA beneficial ownership assertion. The DTA relief filing was withdrawn, and full WHT of RMB 1.5 million ($215,000) was paid.
- In a further dividend DTA relief case, reported by CTN in December 2017, the Qingdao (Shandong province) STB denied dividend WHT DTA relief to two HK companies – RMB 30 million was recovered. 'Web crawler' software played an important role in the identification of the cases for follow up.
- The HK companies held equity in several Chinese companies, from which they received substantial dividend payments. The HK companies had made filings with the Qingdao STB in relation to their application of the reduced DTA 5% dividend WHT rate. The authority's web crawler software gathered information from various internet sources, indicating that the HK companies were thinly capitalised and had little operating assets/personnel, and 'red flagged' them for follow up given their substantial China source income. On investigation, the authorities found that the HK companies did not have an office, or any employees, in HK. In fact, all of their operations in equity transactions were undertaken by the employees of a Qingdao company within their corporate group. They concluded, on the basis of the negative factor analysis, that the HK companies did not satisfy the beneficial ownership test, and the DTA WHT relief was clawed back and late payment surcharges (LPS) imposed.

Interest

- Moving to DTA cases relating to interest WHT, in a CTN case report of November 2017, Anshun (Guizhou province) STB clawed back five years of interest WHT DTA relief claimed by a HK company and LPS. In addition, it had to make up for tax underpaid as a result of failure to adjust WHT for the tax gross up in the loan contract. A total of RMB 1.7 million was paid.
- The case was identified for follow up after the Anshun STB performed a comprehensive review of the outbound payments of companies in its district, with a focus on companies that had claimed DTA relief. The relevant interest payments for which the tax adjustment was made

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Conrad has worked with a wide range of companies on the establishment of cross-border operating and investment structures, restructurings and M&A transactions, both into and out of China. He is a frequent contributor to international tax and finance journals including the *International Tax Review*, *Tax Notes International*, Bloomberg BNA and Thomson Reuters, and was principal author of the 2017 IBFD book, 'A new dawn for the international tax system: evolution from past to future and what role will China play?'. He is also a frequent public speaker on topical China and international tax matters.

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covered the years 2011 to 2016, and the tax authority's position was grounded in the Circular 601 beneficial ownership negative factors. The authorities noted that interest payments from an Anshun-based cement manufacturing company to its HK parent were straight away paid on to the latter's BVI parent, meaning that the HK company did not have substantive control rights over the interest income, nor did it assume associated risks. In addition, the HK company had no fixed staff, no fixed office location, nor substantive operating activities, thus conclusively failing the Circular 601 tests.

Liquidation gains

- The variety of treaty abuse situations dealt with using the Chinese tax authorities' approach is highlighted by a recent corporate liquidation case. In a CTN reported case of June 2018, the Wuxing district tax office of Huzhou (Zhejiang province) STB denied dividend WHT DTA relief to a Singapore company which held 80% of the Huzhou company.

  The Huzhou based company lodged DTA relief forms and documentation with Wuxing tax office in August 2016. On checking the Golden Tax III system the authorities observed that the company had filed a notice commencing liquidation at the end of June 2016, and that the filed financial statements up to the end of June 2016 recorded substantial intangible assets. Enquiries revealed that this represented land use rights over unused land. On further enquiry with the company it was revealed that an agreement had been reached in June with the local government to buy back this land, and payment was received in July. The dividend payment in respect of which DTA relief was claimed primarily comprised the consideration received for the sale of this land.

  The tax authority then moved to push back on the DTA relief claim. Under domestic law tax guidance concerning liquidations, after a liquidation notification is filed with the tax authorities a tax period ends and a new liquidation tax period begins, and specific rules govern the tax treatment of subsequent distributions. Distributions out of amounts included in undistributed profit reserves at the time of the liquidation notification will be treated as dividends; beyond this, distributions of any amounts in excess of registered capital will be regarded as capital gains of the foreign equity investor. Under the China-Singapore DTA, dividends enjoy a 5% WHT rate, while capital gains for holdings above 25% of total capital are subject to the 10% China domestic WHT rate.

  The tax authorities took the position that the Huzhou company had accelerated the land use right disposal in order to secure the 5% WHT treatment; the company admitted as much. On the assertion that the arrangements were driven by a tax avoidance motive, and that the land use right sales proceeds should not form part of the pre-liquidation period profit reserves, payment of the supplementary WHT, representing the 5% WHT reduction previously secured (RMB 1.8 million), was demanded and received.

It is striking, in these DTA relief cases, how the authorities make increasingly effective use of their sustained investment in systems and technology. The cases show how taxpayer credit ratings, the Golden Tax III system, web crawler software, international information exchange, and pooling of data with other governmental authorities (e.g. with the forex authorities, in the third example above, for the purposes of an outbound payments review). This is a trend which will continue to grow in coming years. Starting from September 2018, China commenced automatic exchange of information (AEOI) via the OECD common reporting standard (CRS) mechanisms opening a new chapter in the targeted effectiveness of Chinese cross-border tax enforcement. This is expected to be a key dynamic in China tax administration in the years ahead.

PE cases

While SAT officials have made periodic statements about work on further China PE guidance, it remains unclear when this might be released and what it will contain. As noted above, China made a policy decision not to expand agency PE, with reference to the BEPS PE 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.

- In a case reported on the website of Penglai (Shandong province) STB, a German company had to pay an additional RMB 0.6 million in CIT and value-added tax (VAT) in respect of its PE in Penglai city. The German company was invested in a JV producing offshore oil platform equipment for export, and was providing expert supervisory services to the JV under a services contract. The presence of the relevant staff on the ground in China had given rise to a service PE, as this had exceeded the DTA time threshold. The supplementary tax matter, followed up on by the Penglai tax authorities, was the separate arrangement under which the German company was compensated for the travel, hotel and food costs of the relevant staff.
  These payments had been made out of China without need for recordal with the tax authorities, as they fell into a recordal exclusion. The authorities asserted that these amounts should be considered attributable to the PE, and form part of the base cost for the VAT and CIT calculations (a deemed mark-up of 40% on costs applies).
- In a case reported by CTN in May 2017, Dalian (Liaoning province) STB asserted that a foreign company, supplying equipment and providing installation services to a Dalian company, had a service PE in China. Through the Golden Tax III system, Dalian STB found that the Dalian company made a 2015 recordal filing, and payment of WHT (calculated based on recognition of a PE in 2015), in respect of a payment of equipment inspection service fees. However, there was no such recordal (or tax withholding) for previous years, despite the fact that the company appeared to be purchasing a large number of machines and equipment for assembling drilling platforms from the same foreign company in these years. On investigation, Dalian STB found that in the equipment sale contracts covering 2012 to 2014, while engineers were dispatched to the Dalian company for equipment installation work, there was no separate billing of the services and equipment sale. Enquiries with on-site engineers, and a review of the company records revealed the presence of the foreign personnel, and it emerged that the foreign company was engaged in multiple interlinked projects in China throughout the course of the year. With the time presence on connected projects exceeding 183 days, a service PE was deemed to exist and RMB 19 million in tax and RMB 3 million of LPS were collected.
- As described in the chapter, *Navigating through China's changing M&A tax landscape*, another noted PE enforcement development is the focus, by the Beijing tax authorities and others, on 'grandfathered structures' in the real estate investment space. Agency PEs have been asserted due to the fact that the local property manager was granted with broadly defined authority to act and contract on behalf of the foreign companies (e.g. overseas special purpose vehicles (SPVs) of real estate investment funds) which held title to the properties.

Drawing on the cases above, China is certainly getting more proficient at using data to track and challenge inbound PE cases. However, whereas at an earlier point in

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

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

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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. It remains to be seen in which direction China tax policy-makers seek to bring PE. In particular, it is still uncertain whether the SAT will put forward 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 continued in 2017 with the Suzhou Industrial Park case in the Jiangsu province.

In 2018 there were several further reported cases. In a further reported case from Shandong province, Qingdao STB imposed RMB 5.5 million in tax and late payment interest on a Qingdao company whose HK subsidiary had received, and retained overseas, substantial dividend income. Under Chinese CFC rules, the low taxed income of a CFC can still avoid CFC tax impositions if reasonable business purposes for retaining the income overseas (e.g. reinvestment in operations) can be provided. As no satisfactory explanation was forthcoming, and as the dividend income was exempt from HK tax, the income was treated as taxable under the CFC rules.

Further cases from Beijing, reported by CTN in 2017 and 2018, are detailed in the chapter, *Both sides, now – tax opportunities and challenges for China in the BRI era*.

Looking ahead

The future development of China's cross-border CIT rules is, as explained above, clearly contingent on the evolution of China's external economic position. The coming year will bear out whether trade issues between China and the US become a staple feature of the global economic environment. If so, then Chinese cross-border tax rules may well be shaped by the changes in global supply and value chains prompted by a changed global trade environment, and by shifts caused in the direction of Chinese outbound investment (e.g. more investment directed to BRI countries and Europe).

The outcomes of the digital economy work at global level will clearly also have an important influence on the shape of international tax rules, including China's relevant rules. There will be high interest in whether a global compromise on this matter can be reached against a backdrop of deteriorating relations in the trade space. As noted in the chapter, *A Sisyphean task? – Tax plays catch up with China's rapid digitalisation*, there has been increasing business media commentary on the potential future emergence of 'splinternet', whereby one global internet system is dominated by the US, and a separate system by China. We are certainly not at this stage yet, but there will be a keen focus on how matters develop in this space, and their implications for international tax rules.

At a China enforcement level, while the trend towards a more effective data-driven administration will clearly continue, the prominent question is whether the more reasonable approach, perceived to be adopted in first-tier cities in relation to complex commercial transactions, will seep down to lower tier city level. Such a development, if it eventuated, would greatly improve the business environment.

Now that we got data, what are we gonna do with it? – TP challenges and opportunities

China is consolidating and enhancing its transfer pricing regime. The State Administration of Taxation is strengthening its monitoring of multinational enterprises' TP arrangements and has committed to the international cooperation agenda. Cheng Chi, Patrick Lu, Choon Beng Teoh and Kelly Liao discuss the impact on taxpayers.

The introduction of new transfer pricing (TP) regulations by the State Administration of Taxation (SAT), through a series of public notice announcements in 2016 and 2017, brought about an overhaul of the Chinese TP regime. It is now a more rigorous and comprehensive framework for regulating TP arrangements of multinational enterprises (MNEs) in China, both for inbound and outbound activity. In particular, the SAT rolled out the following regulations:

- Announcement 42 on the enhancement of the reporting of related-party transactions and administration of contemporaneous documentation, issued in July 2016;
- Announcement 64 on the administration of advance pricing arrangements, issued in October 2016; and
- Announcement 6 on special tax investigations, adjustments and mutual agreement procedures, issued in March 2017.

These regulations adopt many of the recommendations from the G20/OECD BEPS project, but at the same time codify and reinforce many of the TP concepts that have been used for some time by the Chinese authorities in enforcement cases, and asserted to reflect unique features of the China business environment. The details of these Announcements were discussed in the 2016 and 2017 *China Looking Ahead* articles.

Following the legislative overhaul, the SAT swiftly trained its focus on ensuring that MNEs complied with the updated Chinese TP regime. The most noteworthy development on this front is the recent introduction of a profit monitoring mechanism covering large MNEs and taxpayers with complex intercompany transactions. This mechanism taps into big data analysis to carry out risk assessments so that more targeted administrative action can be taken. With the increased focus on compliance, the SAT and the local tax authorities are driving good governance among the MNE taxpayers with regards to TP arrangements and related disclosures. The goal of the profit monitoring mechanism is to create harmonious relationships with MNE taxpayers using less confrontational approaches to maintain control over tax collection. The tax authorities would likely resort to punitive methods only when engagement with taxpayers breaks down.

In consequence of this new approach, TP investigations have become less of a focus. Nonetheless, the tax authorities continue to prioritise the build-up of resources to tackle ever more complex tax avoidance arrangements. Cross-border service fees and royalty payments remain conspicuous focus points for TP audit in China, especially for those MNE taxpayers considered to be earning super returns from expanding consumption power in the China market, or which have a largely domestic supply chain. The tax authorities are also actively investigating related-party equity transfers in light of the vibrant M&A market. The merger of the local and state tax bureaus at the provincial level and below also provides an opportune moment for the tax authorities to add wide-ranging resources and new tools to tackle tax avoidance.

Hand-in-hand with these changes, China's continuing commitment to the global tax transparency agenda, and the resolution of mutual agreement procedure (MAP) and advance pricing arrangement (APA) cases, remains resolute. To this end, there has been a surge in China's efforts to resolve MAPs with numerous overseas competent authorities. There had previously been much concern that the backlog of MAP cases was affecting the processing of APA applications (MAPs and APAs are dealt with by a common team at the SAT level). These concerns have, to a large extent, been lessened, as many pending APAs are being added to the agenda at competent authority meetings between China and other countries. This demonstrates the SAT's commitment to promoting an open business and a transparent tax regulatory environment for MNEs operating in China, through engagement with its international counterparts.

This article examines each of these developments in turn.

Compliance agenda: Risk profiling and shifting of the audit focus

April 2018 saw the launch of a new profit monitoring mechanism by the Jiangsu Provincial Tax Bureau (JSTB), which will eventually be rolled out nationwide by the SAT. This latest move builds on a similar initiative introduced before the BEPS era, termed the 'transfer pricing comprehensive indicator system'. In comparison to the latter, the latest initiative is more comprehensive, and it is based on a matrix scoring system.

The new mechanism sets out a risk assessment framework that involves extensive qualitative and quantitative information collection. This enables the authorities to gain a high level understanding of the overall operations of the MNE group, perform risk-based testing using the related-party transaction information gathered, and rank MNE taxpayers according to their risk levels. Risk levels are based on the complexity of the intercompany transactions, as well as the taxpayer compliance level with respect to reporting and disclosure of intercompany transactions. The main thrust of the programme is to enhance the oversight of risk and compliance management, aided by big data analysis. Leveraging the JSTB's advanced IT infrastructure, the information collected by the JSTB will be entered into their systems, allowing them to produce various analyses within the tailored risk assessment framework.

Through the monitoring mechanism, selected taxpayers are expected to be constantly monitored and ranked on a risk matrix based on multiple quantitative and qualitative criteria. The authorities would selectively classify companies according to provinces, cities and districts for clearer identification of 'high risk' entities. The aim is to have swifter and more targeted regulatory actions instead of launching enquiries and investigations on all MNE taxpayers engaging in cross-border related-party transactions.

The latest initiative has some similarities with the previously introduced initiative known as the thousand enterprise initiative (TEI). This is discussed in the chapter, *Seeing the tax trees from the data forest – how does Chinese tax administration manage in the digital age?* The risk assessment conducted within the TEI framework is, however, primarily focused on the general tax administration of the biggest Chinese-based companies, albeit some foreign MNEs were selected as well. The profit monitoring mechanism, on the other hand, is focused more specifically on TP and on the application of anti-tax avoidance rules to inbound-investing MNE taxpayers.

As the pioneer for the roll-out of this initiative, the JSTB organised a couple of seminars in April 2018, attended by approximately 150 MNEs operating in the Jiangsu province, including their tax advisors, to introduce the profit monitoring mechanism. We have already seen the progressive expansion of the mechanism to other provinces in China; some provincial and major municipal tax bureaus have already begun to send out the initial information-gathering forms for MNE taxpayers to complete under the direction of the SAT. For example, the Shenzhen Municipal Tax Bureau (SZTB), in the Guangdong province, and the Sichuan Provincial Tax Bureau (SCTB) are gathering information from China holding companies (CHCs) and the headquarters of inbound and outbound-investing MNEs, with a focus on industry leaders with substantial numbers of cross-border related-party transactions. The tax authorities sent out nearly 70 survey and data collection forms to gather operational, financial and value chain-related data for the period between 2008 and 2017 (i.e. the 10-year statute of limitations period for TP cases). Such extensive industry statistical and financial data is believed to be used by the SAT for the trial-run of its own TP risk management system. It is understood that the provincial system may be integrated with the SAT system in due course.

Extensive information gathering

The risk assessment framework requires extensive tax and TP information gathering. The annual contemporaneous TP documentation (including master file and local file) and the annual tax returns (including the related-party transaction reporting forms), form the main sources of information for the tax authorities. The contemporaneous TP documentation is prepared and kept on file by the taxpayer for review by the authorities in the event of query or audit, or may otherwise be submitted to the tax authorities upon their request. In contrast, the related-party transaction reporting forms are part of the tax returns and are required to be directly filed with the authorities annually. The TP documentation disclosure requirements of Announcement 42 are rigorous and wide-ranging and provide extensive information to the authorities.

However, this is not all. The tax authorities are also able to gather information from other sources, such as through structured and regular cross-government department data exchanges, for example, information from the State Administration of Foreign Exchange (SAFE), and the State Administration of Market Regulation (SAMR). They also obtain data from enterprise group annual financial reports, filed and exchanged country-by-country (CbC) reports, securities analyst reports, general news reports (much of this collected through web crawler tools), and comparability analysis data in the tax authorities' internal databases, among other sources. All information harvested is entered into the tax authorities' IT systems as part of big data analysis processes, classified into various categories such as: MNE taxpayers' basic information, related-party transaction data, functional profile, industry environment, value chain information, compliance willingness evaluation, risk identification, risk response level, and management effectiveness analysis.

Selected MNE taxpayers have reported that they received requests from some provincial tax bureaus to provide data in a certain format (e.g. specific digital formats) that can be readily fed into the tax authorities' system to run the required analyses. The data requests frequently date back to 2008, when the TP regulations came into effect in China. While the majority of the data requests relate to information that can be obtained from the on-file contemporaneous TP documentation, or from the group CbC reports, they often also require MNE taxpayers to supplement this with detailed segmented information. This requires the MNE taxpayers to drill down into their financial reporting systems.

Dual level assessments – tax risk and compliance level

The analyses is churned out from the collected data feed into a multi-dimensional matrix to assess the tax risk and compliance level of the selected MNE taxpayers. The assessment is based on qualitative factors, with a total of 39 core and supplementary criteria, as well as quantitative factors. The latter have a specific focus on potential tax losses measured against available public data (e.g. external comparables), group value chain profit matrices, group segment financial data, and/or internal databases of comparables (e.g. secret comparable data). Announcement 6 reserves the right of the tax authorities to rely on secret comparable data.

The tax risk assessment focuses on overall group tax planning arrangements and intercompany transactions that are deemed complex. Particular attention is given to the risk of tax avoidance, while the compliance assessment focuses on the extent to which the taxpayer has met his/her compliance obligations with the timely and correct disclosure of relevant information. MNE taxpayers that meet many of the core indicators are categorised as high risk (i.e. the core indicators are described in the negative).

One interesting qualitative criterion worth noting is the compliance willingness test. This focuses on:

1) The extent of the group's global tax planning arrangements;
2) The quality of the reporting of related-party transactions;
3) The quality of the contemporaneous TP documentation;
4) The internal control of related-party transactions;
5) The responsiveness of the taxpayers to questions raised by the tax authorities and in providing solutions to the tax issues identified by the authorities; and
6) The willingness of the management of the MNE taxpayers to communicate with the tax authorities, and/or willingness to disclose relevant information regarding the entities' related-party transactions.

Each area is rated on a scale of one to five, whereby five denotes the MNE taxpayers' complete readiness to co-operate. While these tests may appear to be subjective, they are, nonetheless, one of the mainstays of the profit monitoring mechanism. It should be noted that it has not yet been fully determined how this system will relate to the separate taxpayer risk rating systems, which have been under development at SAT and provincial tax authority level, and which are being piloted in the free trade zones (FTZs).

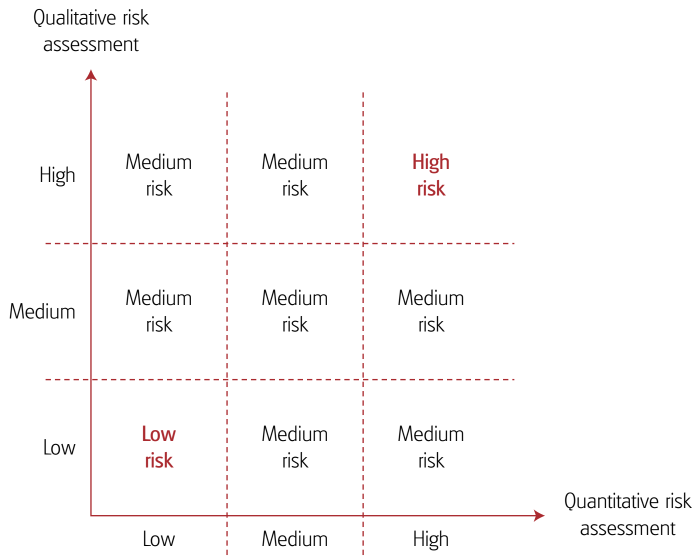
Integral to the risk framework assessment, the Chinese tax authorities are expected to continually focus on the Chinese entities' contribution to the MNE's global value chains and, therefore, the Chinese entities' appropriate share of global profits. Two key elements of the assessment include the following:

- The emphasis on the consistency between the functional profiles of the entities along the value chains and the profit attributed to these entities; and
- Chinese market factors that contribute to the value creation process throughout the value chain.

To this end, it would not be a surprise for the Chinese tax authorities to request as much data as possible (it could be either through the CbC reports or other additional data requests, for example, information on overseas operations across the value chain) to enable them to comprehensively assess the reasonableness of profits earned by the Chinese entities.

The tax authority risk evaluation is presented in a matrix in Figure 1.

Figure 1



Tiered response from the tax authorities; increase in engagement between taxpayers and the tax authorities

The taxpayer risk assessment results, produced through the risk evaluation matrix, will be subject to different response levels from the tax authorities in line with their response framework. This includes:

- Release of generic compliance guidelines to MNE taxpayers on a regular basis;
- Proactive communication with MNE taxpayers on the tax authority's position on what they view as 'tax risk points' with the taxpayer's cross-border arrangements;
- Issuance of tax risk warnings to MNE taxpayers, particularly for those who are rated as high risk. The warning may summarise the taxpayer's response to highlighted tax issues, and inform the taxpayer which specific tax risks are being treated as high by the tax authorities. The issuance of the warning notices would likely result in taxpayers proactively engaging with the authorities to address the risk issues, and may also result in taxpayers performing TP adjustments voluntarily; and
- Taxpayers that did not take any action would remain rated as high risk, under the risk matrix analysis, and may eventually be subject to formal special tax investigations (i.e. tax audit).

We expect that the new monitoring mechanism will lead to more dialogue between taxpayers and the tax authorities, and thereby reduce incidences of tax audit confrontation. The SAT has also made clear in a recent forum with Korean investors that MNE taxpayers which are compliant would receive:

- Preferential acceptance into the APA programme;
- Assistance to eliminate double taxation to minimise their tax burdens; and
- Other tax follow-up assistance.

Compliant taxpayers for this purpose are those rated as low risk, those which proactively reduce risks after receiving warning notices, and those which are cooperative during investigations.

Shift in audit focus

In parallel with the introduction of the compliance programme outlined above, a new trend is emerging, whereby the number of formal TP audits is declining, resulting in a shift of focus in the audits carried out. Statistics from the SAT show that the number of TP assessments dropped in 2017, with 196 cases recorded compared with 254 cases in 2016. The amount of additional taxes collected from TP assessments dropped by more than 40%, from RMB 9.6 billion ($1.4 billion) to RMB 5.3 billion over the corresponding period. The trend may continue as the SAT continues to drive towards creating a more communicative and cooperative compliance environment for MNE taxpayers, relying on compliant MNEs to pay their fair share of tax in line with the specific Chinese market conditions. The reduction in TP audits is a welcome sign of a maturing TP regime.

The trend, however, does not mean the authorities are loosening their grip on TP tax avoidance. As observed in the 2017 *China Looking Ahead* article, *TP in China: all the data in the world,* the Chinese tax authorities have, in audit campaigns, placed substantial focus on royalty or service fee transactions and this trend continues. The focus is centred more on taxpayers exploiting the Chinese market (e.g. food and beverage, clothing and other daily consumption goods). In particular, greater scrutiny is applied to taxpayers who pay a large amount of royalties and/or service fees to overseas related parties, despite having a largely domestic supply chain (e.g. buying, making and selling in China).

Such an audit focus is in line with the Chinese view that market access-related benefits, whether in the form of market premium or the contribution by the Chinese entity in promoting the products in China (i.e. the contribution to the market intangibles), should be captured in the taxable profits of the Chinese entity, to reflect the importance of such market features or functions. It has been reported that the SAT has successfully persuaded the competent authorities of a developed country to acknowledge the concept of market premium in a recent MAP case. It is expected that the Chinese tax authorities would have more confidence to play this 'market premium' trump card on the negotiation table in future audit cases and MAP/APA cases.

The emphasis on 'promotion'-based contributions to the value of market intangibles is set out in Announcement 6. Specifically, it provides that when determining the contribution of an enterprise and its related parties to the value creation of intangible assets, and the consequential economic benefits that can be enjoyed, the parties' contribution to the development, enhancement, maintenance, protection, exploitation and promotion (DEMPEP) of the intangible assets will be analysed. Royalty and service fees, which are usually justified by the contribution from overseas related parties to the development of the IP and the provision of the services respectively, are being challenged in audits as disproportional or inappropriate. The critical issue is whether the underlying intangibles or centralised functions are truly as valuable or beneficial in the Chinese market as claimed, especially *vis-à-vis* strategic market features, such as local purchasing power, and the efforts and responsibilities of the Chinese entity. On the other hand, companies that focus on production for overseas markets, which were primary audit targets for a long time (and which may be more geographically mobile with their operations), are now less often challenged by the Chinese tax authorities.

We are also seeing that the tax authorities are actively investigating related-party equity transfers. The increased interest in the equity transfers of Chinese entities is a natural reaction to the vibrant M&A deal environment witnessed in China as of late. In one recently concluded enforcement case in Zhejiang province (as reported in China Tax News in February 2018), the tax authorities concluded that the equity transfer of a Chinese entity by an overseas entity to a domestic related party was not conducted at arm's length. This was a case where a wholly-owned subsidiary had negative equity due to losses incurred, but owned land and other assets which had appreciated substantially in value. The target was first transferred within the group and then sold to a domestic third-party purchaser. The investigation, however, revealed that the group entered into a sale agreement with the third-party purchaser a few months before the related-party transfer, at a different sale price (the third-party transfer occurred at a higher value). The authorities concluded that the internal transfer did not occur at arm's length, resulting in a tax adjustment of approximately RMB 2 million.

In another equity transfer case reported by the Changchun tax authority in May 2018, the tax authorities insisted on receiving a purchase price allocation valuation report for an equity transfer of a Chinese entity, which was sold together with other group entities. While the tax authorities recognised that the sale by an offshore parent to an overseas third-party purchaser was at arm's length, there should have been a valuation report to allocate the purchase price to each of the entities that were transferred. As the Chinese entity was not able to furnish the relevant documents as requested, this prompted the authorities to conclude that there was an element of tax evasion with respect to the equity transfer of the Chinese entity. The taxpayer was required to pay additional tax due based on the valuation assessment of the tax authorities, including interest.

Increased resources through institutional reform of the state and local tax administrations

In line with central government efforts to increase the efficiency of public service delivery, the State Council recently issued the programme for the institutional reform of the state and local tax administration (reform programme), which merges the local and state tax authorities at provincial level and below. The merger concluded in July 2018. The centralised tax collection system created by the merger is intended to enable the integration of tax collection resources, the aggregation of big data-based tax resources, and the standardisation and centralisation of tax law enforcement and services.

The merger results in larger combined resources at the disposal of the tax authorities. Cities such as Beijing and Shenzhen have already set up new investigation bureaus focusing on special tax investigations with extended headcounts not seen before the merger. Jiangsu province is also rolling out a similar bureau with an estimated headcount of over 100 officers.

Coupled with the roll out of the profit monitoring mechanism discussed above, the additional resources

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allow more effective enforcement of TP and tax avoidance rules through better organised enforcement action. With the enlarged teams, the authorities are expected to also focus on areas such as individual income tax anti-avoidance (e.g. determination of individual related parties, share transfers between individual related parties, dividend distribution to Chinese nationals overseas, controlled foreign corporations (CFCs) and so on), and other anti-avoidance cases arising from VAT or consumption tax-related disputes.

China's transparency and international cooperation agenda

On the international front, China has been active in driving forward the global tax transparency and international cooperation agendas. It has gradually implemented globally agreed measures, such as the multilateral exchange of CbC reports. The UK, Germany and France were in the first wave of CbC exchange relationships activated by China with other countries, with the OECD notifying the activation of a further 41 in November 2018, for a total of 44 at present. This increases the potential tax exposures of Chinese outbound MNEs in foreign jurisdictions, especially those overseas subsidiaries remaining in a loss position over many years.

China has committed to implementing the G20/OECD BEPS minimum standards. A critical aspect of the Action 14 (dispute resolution) minimum standards is the peer review process, where the effectiveness and efficiency of a jurisdiction's MAP are assessed by its peer jurisdictions. The seventh batch of dispute resolution peer reviews was launched in November 2018 and covers China, among other jurisdictions.

The SAT has increased MAP/APA resources at central level, with a third division set up in 2016 to assist divisions 1 and 2 which primarily handle MAP and APA cases. Previously, SAT resources for these matters were stretched, due to the commitment of relevant personnel to BEPS meetings from 2013 to 2015. With the new organisational structure and resources, the SAT has begun to deal with a large number of MAP cases as a matter of priority. Market intelligence indicates that a number of pending MAP cases

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have been reactivated with the aim of reaching an expedited solution. On the APA front, it is expected that the enhanced process introduced by the 2016 legislation (i.e. Announcement 64) will contribute to more rapid programme outcomes; this is important as the number of applications continues to increase.

The SAT has shown encouraging progress on the resolution of MAP and APA cases. The SAT's statistics show that there were 14 separate discussions and negotiations in 2017 with competent authorities from eight countries, namely, Japan, South Korea, Australia, New Zealand, the US, Sweden, Denmark, and Germany, involving 35 MAP cases and a further 30 bilateral APA cases. Out of these, 12 MAP cases were resolved and 11 bilateral APAs were reached, eliminating a total double taxation amount of approximately RMB 1.2 billion.

The China APA programme still primarily deals with inbound MNE applicants, and there has been a slow uptake among 'going out' Chinese MNEs. At the same time, the SAT has started to pay attention to tax leakage due to Chinese MNE parents not charging out group service fees or royalty fees to overseas affiliates. In view of this situation, and the expectation that Chinese outbound investment will face more TP challenges by overseas authorities in the future, we anticipate an increase in Chinese MNE demand for APA/MAP to obtain double tax relief and tax certainty.

What lies ahead – ensuring data quality is key

There is a clear trend for the Chinese tax authorities to harness technology and data to manage tax risk and effect targeted enforcement actions at MNE taxpayers. As noted in this and other chapters in this volume, the SAT has made substantial investments in technology, including high capacity IT systems and data warehousing capabilities, to build an effective control system that integrates all industries, tax types, and taxpayers in a single platform.

The extensive information requests presented to MNEs, to feed the profit monitoring mechanism, may prove challenging for MNEs. This will be even more so the case for those with complex multi-faceted supply chains, and for whose IT systems cannot readily satisfy the authorities' requests for data (in this regard it might be noted that China has a 10-year look-back enquiry window for TP adjustments). The tax authorities have increasingly demanding expectations on the quality of the information that should be disclosed to them in the contemporaneous documentation, as well as in relation to subsequent information requests. Taxpayers will need to invest in compliance systems and resources to ensure that, going forward, they can keep pace with these ever-increasing demands, providing quality data that supports taxpayer TP arrangements.

The approach adopted by the Chinese tax authorities through the introduction of their compliance programmes provides an avenue for taxpayers to work collaboratively with them to achieve desired tax outcomes. This can provide the tax authorities with what they perceive as a 'fair share' of tax revenue, through more transparent engagement, while providing taxpayers with improved tax dispute management channels. With greater resources devoted to upgraded, data-driven, desktop audits, field investigations will likely become less frequent, but more incisive.

With the compliance programmes being put in place, MNE taxpayers may be incentivised to engage on a continuing basis with the tax authorities, with positive outcomes from the risk assessment framework putting them in a favourable position to access the MAP and APA programmes, and achieve further certainty in their TP arrangements. Taxpayers should also bear in mind that, in addition to ensuring that value creating activities and substance are aligned, areas such as related-party equity transfers, are now subject to greater scrutiny. Documentation for these needs to be strengthened, as the Chinese tax authorities are expanding their focus and capabilities, with the additional resources now at their disposal.

The authors would like to thank Alfred Wang for his contribution to this chapter.

Not-so-old wine, in a not-so-new bottle – perennial tax challenges for M&A

John Gu, Chris Mak and Fiona He explore the key tax issues and considerations of China inbound M&A deals, especially in the education and real estate sectors, including practical challenges for cross-border transactions in these hot sectors, and how an investor can best get prepared.

As the Chinese tax authorities continue to clarify the tax treatment of cross-border merger and acquisition (M&A) transactions, close monitoring of tax policies and appropriate tax planning are crucial.

In recent years, there has been a considerable increase in China M&A market activity. According to the Ministry of Commerce, foreign direct investment (FDI) into mainland China for the first three quarters of 2018 has risen by 6.4%, relative to the same period last year, to $98 billion. This may be partly because of a series of measures introduced by the Chinese government to open up China, such as revising the negative lists for foreign investment. Activity was particularly notable in hot sectors such as education, real estate, and high-tech related sectors in 2018, and is set to continue to soar for the rest of the year. However, the introduction of stricter policies on outbound investment and the tightening of capital remittance controls continues to affect outbound M&A from China, as discussed further in the chapter, *Tax opportunities and challenges for China in the BRI era.*

In terms of sectoral developments, the following is notable:

- While the growth rate of real estate M&A transactions in China has slowed down in the past few years, it has certainly revived in the period 2017 to 2018. This was due to a variety of reasons including tightening of credit controls, new business transformation, and the fact that a number of private equity (PE) funds entered their exit phase and disposed of assets. In addition, from a financing perspective, many property developers are turning to offshore mezzanine loans as the Chinese government tightens credit controls.
- Investment in education has played a substantial role in driving China's domestic economic transformation. Public and private market demand for education services has led investment in the education sector to become a noted trend, and we have seen remarkable growth in M&A and financing activities in this sector. However, with increased regulatory scrutiny and investment rule changes, investing in China's lucrative education industry is challenging for foreign investors, who may face restrictions, depending on the education subsector in question.

Turning to the tax issues of most interest and concern:

- The Chinese government has introduced various investment incentives in order to attract foreign investment into China. One of these incentives includes Caishui [2018] 102 (Circular 102) in 2018, which provides foreign investors with a withholding tax (WHT) deferral incentive for profit reinvestments in China. Foreign investors, especially multinational companies intending to make further investment in China, have shown much interest in the incentive.

- From a transaction structure perspective, we have continued to see an increase in the number of foreign investors exiting their investments via direct transfers of China wholly-foreign owned enterprises (WFOEs) to other Chinese entities or onshore funds. While this eliminates Announcement 7 indirect transfer issues (which are further discussed below), this could potentially result in the foreign seller having a lower tax cost base and, consequently, a higher capital gain tax liability on the sale.
- For those M&A transactions undertaken by way of offshore indirect transfer of Chinese assets (i.e. disposal of an offshore company which holds Chinese assets), Announcement 7 continues to be a contentious topic. This is mainly due to the uncertainty in the calculation of the tax cost base, which is still determined in an inconsistent manner across tax districts in China. In some instances, the local Chinese tax bureaus may allow the full offshore acquisition cost, originally paid by the disposer, to be deducted in determining the disposal tax on the capital gain. However, in other cases, only the China WFOE's registered capital (which is typically lower) can be deducted.

In this article, we will discuss typical tax due diligence (TDD) issues, including the challenges and opportunities in the real estate and education sectors, with a particular focus on the challenges with offshore indirect transfers. We will also discuss the Circular 102 WHT deferral incentive and share practical insights on securing it with the local tax authorities.

Typical TDD issues in the real estate and education sectors

Typical TDD issues in the real estate sector

Over the past two years, we have seen a rebound in M&A activity in the real estate sector. Domestic and foreign investors who are keen to partake in the explosive growth of this hot sector should give due consideration to the following tax issues when conducting a TDD:

- Lack of tax invoices to support the property's tax cost base: It is not uncommon with old or poorly managed properties, in particular, that the original tax invoices and payment receipts pertaining to the purchase or construction of the real estate assets are not properly kept, or have been lost. In this case, there is a potential risk that, for Chinese corporate income tax (CIT), land appreciation tax (LAT) and value-added tax (VAT) purposes, the buyer may not be able to deduct the tax cost base of the property upon future disposal, resulting in additional tax exposures for the seller. In addition, the continuing depreciation allowances on the land and property could also be challenged where tax invoices are not available. Therefore, a sample vouching of tax invoices in respect of the property costs is typically performed as part of the TDD procedures, to check whether the tax cost base of the real estate asset costs can be supported.
- The State Administration of Taxation (SAT) has, in 2018, provided further guidance on the supporting documents that are required for CIT deduction purposes. SAT Announcement [2018] 28 clarified that external documents such as payment vouchers, obtained from other enterprises or individuals, including invoices and tax payment receipts, are the most crucial for supporting CIT deductions. The worst that could happen, if the China tax authorities were to disallow the cost of the property due to a lack of valid support, would be that any future transfer of the property could be subject to additional CIT and LAT. The potential additional CIT and LAT exposure would be the consequently non-deductible cost of the property, multiplied by the CIT rate of 25% and the top LAT rate of 60%, respectively. In any event, as the TDD vouching test is normally only done on a sample basis (for practical reasons), for prudence, the buyer should request a tax indemnity from the seller. This should cover the potential tax exposures from any loss in tax cost base due to the acquisition/development cost of the property not being supported by valid tax invoices and other valid tax supporting documents.
- Calculation of real estate tax (RET): Owners of properties located in China are subject to RET using the following calculation methods:
  - The discounted original cost method is designed for self-use, vacant and/or unleased areas. RET is charged based on 1.2% of the property's adjusted historical cost; or
  - The rental method is used for leased areas. RET is charged based on 12% of rental income received.

Technically speaking, rental property owners who derive rental income from their properties should adopt the rental method for RET calculation and filing purposes. However, as the RET liability is generally lower using the discounted original cost method (particularly for older properties, which may have a very low historical cost), in practice, many rental property owners seek to adopt the discounted original cost method for RET calculation and filing purposes. This is typically achieved through case-by-case negotiation and agreement with the local tax authorities, unless it is blocked by specific local regulations requiring the use of the rental method for rental properties (e.g. in Beijing). Therefore, when performing TDD, buyers should check the RET calculation method and assess whether there are any potential RET

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exposures as a result of the adoption of a different RET calculation method in the historical period.

- Permanent establishment (PE) risk in China: Another common tax risk area particularly relevant for grandfathered structures (i.e. where the Chinese property is directly held by a foreign entity) is that the offshore real estate holding entities could be regarded as having a taxable agency PE in China. This could be due to the way the Chinese property is being managed and operated, for example, due to the appointment of a property manager in China with broadly defined authority to act and contract. Where the offshore real estate holding company has a PE in China, it could be subject to a 25% CIT on its actual profits, or on deemed profits calculated by applying a deemed profit rate to the gross rental income.

  What was formerly seen as a technical risk has become a real risk in practice in recent years. We have seen tax authorities, such as those in Beijing and Shanghai, increasingly presenting PE challenges to such grandfathered structures. They have gone ahead and imposed tax in several cases, particularly where the foreign holding company is located in a jurisdiction which does not have a double tax treaty with China and thus could not obtain treaty PE protection. In these cases, the Chinese tax authorities have generally applied a deemed profit rate of 40% to 50%; with the application of the 25% CIT rate which results in an effective CIT rate of 10% to 12.5% of gross rental income.

  It is noted that there could be an even more substantial tax impact on investment exit, when the foreign holding company which is deemed to have a PE in China is subject to disposal under an offshore indirect transfer. This is because instead of applying a 10% WHT rate on any gain derived from the offshore indirect transfer of the China properties, there is a risk that the Chinese tax authorities could impose CIT at a rate of 25%, imposed on an actual or assessment basis. This risk arises because Announcement 7 includes a provision calling for 25% PE taxation where indirectly disposed of assets are attributable to an existing Chinese PE.

  While we have not yet seen such cases in enforcement practice, in view of the potential tax risk during the holding period and upon future offshore disposal, it is crucial for buyers to analyse and assess the Chinese PE position of the offshore real estate holding companies during the TDD. They should also carefully review how their Chinese assets are structured and managed going forward. In any event, given this is an area that is increasingly being scrutinised by the Chinese tax authorities, a buyer should obtain appropriate tax indemnities to cover any potential CIT, penalties and surcharge exposures that may arise from a potential successful challenge by the Chinese tax authorities.

Typical TDD issues in the education sector

Since 2014, the education sector has been a hot topic in both the capital and M&A markets. Although financing activities of the companies in the education sector have been decreasing since 2016/2017, the China education sector, especially K-12 education, international education, on-line education and early education, still presents huge opportunities for investors and international operators. The typical tax issues in China education sector include:

- Tuition fees on diploma education, and qualified education fees received by kindergartens, can avail of specific exemptions from VAT. However, some of the schools or education institutions may have been claiming VAT exemption for non-qualified income (such as after-school class income);
- Some education institutions may pay salaries or service fees to tutors in cash or via the founder's personal bank account, without properly withholding any individual income tax (IIT). The institution could be held liable for the underpaid IIT if the tax authority cannot locate the tutor and this may also lead to penalties being imposed on the education institution; and
- Some tutorial education institutions which run overseas education programmes (such as overseas summer camps) may use their overseas entity (e.g. Hong Kong entity) to receive overseas school commission income and service fees and at the same time use their Chinese entity to receive fees from their Chinese clients (e.g. parents of Chinese children attending the overseas programmes). For the education institutions with the above structure, it is common

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practice that a limited number of employees or even no employees are actually working overseas but most of the revenue was recognised in the overseas entity to reduce the tax cost at group level. Consequently, the Chinese tax authorities may challenge recognition of this income in the overseas company; they may re-attribute the income to the Chinese entity based on the general anti-abuse rule (GAAR) which would lead to potential CIT exposures.

The government has also been making efforts to attract private sector capital to develop non-compulsory education. The new Law on Promotion of Non-Government Education, and its implementation rules for 'non-profit' schools and 'for-profit' schools, which came into effect on September 1 2017, present challenges and opportunities for investors and operators. Schools that do not teach compulsory education in China can be registered as for-profit schools, and given flexibility on their operating, dividend, and tuition fee policies. Before the issuance of the new law, foreign investors in existing schools could only repatriate profits through royalty fees and/or service fee arrangements, which are under stricter control in the education sector. Some foreign investors are considering changing their existing schools from non-profit to for-profit schools, which are eligible to distribute dividends.

In August 2018, the proposed amendments to the implementation rules on the Law on Promotion of Non-government Education were released. The key amendments include:

- Non-profit schools cannot be acquired or controlled through M&A, franchise chain and/or variable interest entity (VIE) arrangements; and
- State-run schools are not allowed to run for-profit private schools. State-run schools are allowed to run non-profit private schools but are not allowed to receive management fees and royalties from non-profit schools for use of the state-run schools' brand names.

Investors looking at targets in the education sector should consider the challenges of the target's business model under the new regulatory environment and the potential costs of changing their business model, post-deal.

WHT deferral regime for dividend reinvestment in China

With a view to encouraging overseas investors to expand their investment in China, the Ministry of Finance (MOF), SAT, National Development and Reform Commission (NDRC), and Ministry of Commerce (MOFCOM) on December 28 2017 jointly released Caishui [2017] 88 (Circular 88). Circular 88 states that profits derived by a foreign investor from resident companies in China may be entitled to a tax deferral incentive. Under this, dividend payments will temporarily not trigger WHT obligations, provided that they are reinvested in encouraged projects and where other conditions are met. On September 29 2018, Circular 88 was replaced with Circular 102, which expanded the incentive to reinvestment in all sectors (not just encouraged sectors), except for those included in the negative lists for foreign investment.

In order to qualify for the tax deferral concession, foreign investors must use distributed profits from China resident companies for new China equity investment in the form of capital increase, capital injection or share acquisition in enterprises engaged in projects which are not included in the negative lists for foreign investment. Profit reinvestment must be transferred directly to the bank account of the invested enterprise or equity transferor rather than by transferring via a third party.

This tax deferral measure is designed to incentivise multinational enterprises (MNEs) to retain their earnings in China for further investment. Under the rules, foreign investors can provide documentation supporting their satisfaction of the Circular 102 conditions, and the profit-distributing enterprise should automatically provide the relief. If the profit-distributing enterprise is of the view that the foreign investor meets those conditions after reviewing the relevant documentation, the profit-distributing enterprise can complete the recordal filing procedures with the relevant tax authority and tentatively defer withholding the relevant WHT. The relevant tax authorities will conduct follow-up administration in respect of the incentive.

In practice, given how the new regulation is written, it is unclear how it should be implemented. Some of the uncertainties include how the WHT would be clawed back from future disposals. In practice, local tax authorities may have different interpretations of the rules regarding the tax deferral benefit. Therefore, in order to enjoy the tax deferral, it is important for enterprises to proactively communicate with their relevant tax authority, as well as with other authorities such as the State Administration of Foreign Exchange (SAFE), MOFCOM and the banks.

Offshore indirect transfers of Chinese taxable assets

Lastly, as noted in the introduction, the calculation of the tax cost base for offshore indirect transfers of Chinese assets remains an area of uncertainty. We have seen cases where local tax bureaus (for example, in Beijing, Wuhan and Guangzhou) do not allow a step up in the tax cost base if no China tax has been paid on the previous transaction (i.e. on the acquisition of the offshore indirect investment structure by the disposer). Specifically, they would tax the gain on an offshore indirect transfer of Chinese assets based on the sales proceeds less the paid-up capital of the Chinese WFOE, instead of using as base cost the acquisition price paid for the previous offshore indirect acquisition of the Chinese WFOE, which is generally higher. This lower tax cost base would be applied even if there were valid reason(s) to not pay tax in a previous transaction, for example, even if the Chinese tax authorities had agreed that the previous transaction could be considered to have had reasonable business purposes and was therefore not taxable.

Based on our informal discussions with SAT officials, it appears that they are also of the view that if the previous transaction has not been taxed, the acquisition price of the previous transaction should be disregarded as the tax cost base. Consequently, only the Chinese WFOE's paid-up capital could be deducted in calculating the taxable gain. This would result in a higher tax liability for the offshore seller.

In view of the above, sellers would generally report to the Chinese tax authorities if there was a high risk that the offshore indirect transfer would be taxable under Announcement 7. However, there are instances where sellers may not have reported the offshore indirect transfers of Chinese assets for Announcement 7 purposes. In some of these cases, the Chinese tax authorities have been alert to these transactions through reporting in the media. For example, the Shenzhen tax bureau was alerted through media reports to an offshore indirect disposal of a Chinese WFOE (located in the Longgang district) to an offshore buyer. As the transaction was not reported by the seller, the Shenzhen tax bureau gathered information on the Chinese WFOE and imposed 10% Chinese WHT of RMB 322 million ($46.2 million) on the Chinese WFOE.

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It is therefore becoming even more important for the buyer to ensure the seller reports and pays tax under Announcement 7. Otherwise, the buyer should reserve the right to report the offshore acquisition to the Chinese tax authorities and obtain a tax indemnity against any potential WHT liability from the vendor's failure to pay the WHT liability arising from the offshore transaction.

Looking ahead

Going forward, in light of the Chinese government's revised foreign investment policy and recent regulatory reforms, we are optimistic and expect a further increase in inbound M&A activity.

In the course of such transactions, careful TDD and tax planning will play a key role. With the changing global tax landscape, it will be increasingly important for companies to understand the target's business models and the potential tax costs that may arise post acquisition and on integration of the target's business.

While the Chinese government is stepping up its tax measures to attract foreign investment into China, clarifications and guidance from the Chinese tax authorities are still needed to deal with uncertainties in respect of the interpretation of rules. In particular, further clarifications are much needed in respect of the implementation of Circular 102 and the calculation of the tax cost base for offshore indirect transfers.

The authors would like to thank Elaine Chong and Stella Zhang for their contributions to this chapter

A Sisyphean task? – Tax plays catch up with China's rapid digitalisation

The increasing size and sophistication of China's digital economy, as well as the rapid expansion of Chinese digital economy enterprises into foreign markets, is highlighting a range of complex tax issues, and the importance of policymaker efforts to resolve them. Khoon Ming Ho, Conrad Turley, Sunny Leung, and Mimi Wang explore the issues.

In last year's seventh edition of *China Looking Ahead*, the digital economy (DE) chapter, *China's 1.38 billion mobile phone users can't be wrong: Tax and the digital economy,* looked at many of the China tax compliance and administrative issues arising for new digitalised business models operating in the China market. This year's DE tax chapter, while updating on these matters, also looks to go wider. We look at the challenges facing Chinese DE enterprises with their outbound expansion, and the broader long-term implications of efforts at international level, to agree a new global tax framework updated for the challenges of digitalisation.

It should be noted briefly that terminology in this space is tricky. The term 'digital economy' is ambiguous and potentially misleading. As the OECD stated in its 2015 BEPS Action 1 report, "the digital economy is becoming the economy itself". Drawing a boundary between the digital economy and the traditional economy can be arbitrary. As such, the preferred term, also in recent OECD documents, is 'digitalisation'. Businesses can be said to fall along a spectrum from more highly digitalised to less digitalised, in the degree of digitalisation of their products, services, their internal processes and organisational structures, and the nature of the markets in which they operate. This being said, in common language, when people speak of 'digital economy enterprises' (DE enterprises) it is generally understood as a reference to businesses whose core offering is a digital product or service, or a digital platform. At the summit of these enterprises are, in China, the BAT enterprises (Baidu, Alibaba, and Tencent) and, in the west, the FAANG enterprises (Facebook, Apple, Amazon, Netflix, and Google). As such, we use the terms digitalisation, digitalised, and DE enterprises, alternately in this chapter, as the context requires.

With these considerations as a backdrop, this chapter looks at the following themes:

- An overview of structural developments in China's digital economy; this is crucial for understanding the emerging tax challenges;
- Building on last year's chapter, an overview of the key tax compliance and administrative issues for digitalising businesses operating in China;
- Issues facing China's digital economy enterprises, as they expand overseas, particularly in ASPAC countries; and
- The continuing global efforts to create a new international tax framework, overhauled to deal with digitalisation, and considerations for China.

Tax-relevant structural developments in China's digital economy

In understanding the practical issues for businesses operating within China's digital economy, and cross-border from and to China, as well as the considerations before tax policymakers, an overview of structural developments in China's digital economy is essential. We refer below to data set out in reports from the China Academy of Information and Communications Technology (CAICT), the Ministry of Industry and Information Technology (MIIT), and the China Internet Network Information Centre (CINIC), as well as a useful 2017 report from the McKinsey Global Institute (MGI), entitled 'Digital China: Powering the Economy to Global Competitiveness'. We firstly set out China economy-wide digitalisation developments before moving to the specific cross-border developments:

- China's digital economy was estimated to account for 30% of GDP in 2016, and to rise to 35% by 2020, per CAITC and MIIT. In this regard the statistics refer to the supplanting of physical stores through e-commerce, the growing share of mobile payments in overall transaction volumes, the growth in the production of various information and communications technology (ICT) products and services, including software, as a percentage of GDP, and the reorganisation of numerous markets, such as for transportation services, around sharing economy models.
- The level of digitalisation of China's economic sectors varies widely. Consumer services and retail are more highly digitalised than in the leading western countries, but industrial sectors see lesser degrees of digitalisation and automation.
- The online proportion of China retail is now 16.6%, a much higher percentage than the US at 9%. It is at an equivalent level to the UK, which shows the highest rate of online retail penetration among the developed countries. Given the size of China's economy, China now accounts for more than 40% of global e-commerce, equalling the EU and US combined.
- A key driver of the digitalisation of consumer and retail was the underdevelopment of the pre-existing physical retail infrastructure, and high inefficiency of the sector. This meant that new digital platforms could steal a march on traditional players, as Chinese consumption power rapidly increased, particularly in smaller cities where online players made many products and brands available for the first time. This was helped by the high willingness of Chinese consumers to adopt new technologies in their retail behaviour, including e-commerce and mobile payments. Government efforts to foster e-commerce volumes further are linked to the broader programme of shifting the economy from a reliance on low-cost, export-driven manufacturing, to a basis in domestic consumption and services activity.
- As noted, the growth of online retail has been paralleled, and supported, by the growth of mobile payments. This has been driven by the very widespread ownership of smartphones in China, now more than half the population, and a distinct preference for accessing the internet through mobile interfaces, which is set to account for virtually all online payments by 2020. In consequence of these dynamics, the China mobile share of e-commerce stands at 70%, versus 30% in the US. The use of mobile payments for offline transactions (online-to-offline, O2O), has now become ubiquitous in China, with 83% of Chinese internet users using O2O. With all manner of goods and service providers now accepting mobile payments, it is no surprise that 68% of Chinese internet users use mobile payments versus 15% in the US, and that the value of China mobile payments stands at 11 times the US level.
- This ubiquity of mobile payment adoption in turn facilitates the digitalisation of other sectors of the economy, where the inefficiencies of incumbent operators allows new digital players to jump over them, or compel them to develop their own digital offerings and improve services. The high inefficiency of the transport sector has led to rapid adoption of ride sharing platforms; the number of taxi-hailing app rides in Beijing is now eight times the number in New York. Financial services and healthcare are now also being transformed. Government statistics project the sharing economy will reach 10% of GDP by 2020, and 20% by 2025.
- On the other side of the coin, for industry, China's labour productivity in many sectors is still only 15% to 30% of the OECD average. China's manufacturing, which accounts for 25% by value of the global total, has productivity at 20% of developed country levels. This means substantial potential for digitalisation and automation driven improvement, a key focus of the government's 'Made in China 2025' and 'Internet Plus' programmes. It is noted that the progressive rollout of digital procurement, predictive maintenance, smart energy and inventory management, should all increase the cost efficiency of manufacturing, quite apart from the greater adoption of robots. Indeed, as part of the government's allied Internet Plus initiative, a target has been set to automate 80% of Guangdong province's manufacturing, by 2020.
- The digital transformation of Chinese economic sectors is being underpinned to a great degree by the services and ecosystems of China's BAT powerhouses. These arguably play a far more crucial role in the Chinese digital economy than the FAANG enterprises do in the West:
  - The BAT companies have effectively become 'critical infrastructure' for the Chinese economy. For example, Alibaba's e-commerce platforms, with 60% of the domestic e-commerce market, support approximately 10 million active sellers.

- Both Tencent and Alibaba have, at the core of their offerings and their relationship with their customer base, 'superapps' providing services relating to payments and finance, shopping, transport, social media and messaging, health, entertainment, dining, education, and much more. It is noted that Chinese users may spend the bulk, if not all, of their online time within these ecosystems, which cater to all their needs, whether the services are provided by Tencent and Alibaba, or by their third party business partners within the superapp ecosystem. Baidu has also built an extensive ecosystem around its search engine.
- The attractiveness and ease of use of these ecosystems has, for example, underpinned the degree to which mobile payments have come to dominate in China; the two principal mobile payment apps, Alipay and WeChat Pay, being central parts of the Alibaba and Tencent superapps. It also explains how an Alibaba affiliate came to manage China's largest money market fund, Yu'e Bao, based on balances in Alipay accounts.
- The diversity of contact points with users means that the richness of the data derived by these firms is considered to exceed that of the FAANG companies, given the relative narrowness of their operations. Indeed, the recent expansion by FAANG companies into parallel sectors (e.g. Amazon into food retail), has been remarked on as a measure of 'catch up' with the broader scope of the BAT companies.
- With such data, the BAT companies are in a position to provide crucial support, through data partnerships, to firms wishing to enhance their products or their targeting, optimise their supply chains, or determine the optimal geographic distribution of their stores. In addition, for sectors in which richness of data will be key to building full profiles of customers, such as for health tech solutions, the BAT firms clearly have an outstanding advantage. To take another example, Alibaba has taken a lead role in offering social-credit scores for individuals and businesses, basing this on superapp-derived information on ability to pay, credit history, and social network activity.
- The BAT companies also provide nearly half of the venture capital (VC) funding in China, in stark contrast to the position in the west where the FAANG companies play a far more limited role. This steers the Chinese VC sector towards investment in digital technologies such as big data, artificial intelligence (AI), and fintech companies, as well as giving them extremely valuable support with their vast data pools. Indeed, it is no wonder that Chinese fintech unicorns account for more than 70% of the value of fintechs worldwide.
- In addition to the above, the BAT companies also play a key role in spearheading the outbound expansion of Chinese digital economy players into overseas markets, as noted in the next section.

Understanding the developments outlined above is critical to understanding the tax issues delved into further below. The tax characterisation issues for sharing economy and other digital services become of ever greater importance when these now make up such a huge share of total economic activity; the impacts in terms of value-added tax (VAT) and individual income tax (IIT) are particularly important.

The centrality of the BAT enterprises as facilitators of commerce, with so many traders selling, and payments processed, through their platforms, explains why the tax reporting provisions of the new E-Commerce Law have attracted so much attention.

The remarkable gap between the high level of digital advancement of China's consumer sectors, and relative digital backwardness of manufacturing and other sectors, provides a context in which the BAT firms, which built their success on the consumer side, can now 'cross-pollinate' and contribute to advances in other industries. Certainly the VC-driven innovation backed by the BAT companies will be relevant in this regard.

It also provides a context for the recent raft of enhancements to the tax incentives for advanced equipment investment (i.e. expensing of items less than RMB 5 million ($720,000)), the raised ceiling for staff education expense deductions (2.5% to 8%), the special IIT treatment for 'breakthrough bonuses' to scientists, the enhanced VC tax incentives, and the increased research and development (R&D) super deductions.

The cross-border dimensions of China's digital economy

China's digital economy has multiple evolving cross-border dimensions, and understanding these is crucial to understanding the tax issues:

- Cross-border e-commerce made up 20% of China's foreign trade in 2016, the bulk of which is business-to-business (B2B). At the same time, cross-border business-to-consumer (B2C) e-commerce is steadily increasing, with 35% of Chinese online shoppers having bought products from overseas in 2015, and more than 5,000 cross-border e-commerce platforms now in existence.
- The increase in volumes has been rapid; B2C imports made up only 4% of the China B2C market in 2013 but this has now exceeded 10%, and is headed for 12% by 2020.
- An important framework element in the development of B2C e-commerce has been the establishment of special e-commerce zones through which imports and exports are

directed, ensuring that VAT, consumption tax, and customs duties are collected on inbound B2C activity (at incentivised reduced rates), while also facilitating efficacious clearance. In August 2018, China's State Council approved the setup of 22 further pilot cross-border e-commerce zones, bringing the total number to 35, showing further commitment to this approach.

- Another notable development has been the degree to which Chinese digital service exports have taken off. While China is better known as a goods export powerhouse, and runs an overall service trade deficit, the country runs a substantial and expanding digital services export surplus.
- In terms of digital service imports, one impactful regulatory development is the continuing rollout of the Cybersecurity Law. As this includes key provisions in relation to data localisation, requiring certain personal data to be stored and processed onshore and setting restrictive procedures for its transmission outside China, this will undoubtedly lead foreign digital service providers to move operations and infrastructure onshore. This has already occurred in relation to cloud services, and might be thought likely to also impact on app platforms. These developments have clear knock-on tax implications, and involve complex structuring considerations, given the continuing limitations on foreign invested entities being involved in certain sectors of the China digital economy.
- On the cross-border investment front, there has been a massive flow of capital to key foreign markets, with the BAT enterprises in the vanguard. Developments have been particularly notable in Southeast Asia, for example:
  - Alibaba has invested in Lazada, the leading e-commerce platform throughout Indonesia, the Philippines and other Southeast Asian countries with 550 million customers;
  - Tencent's overseas acquisitions have made it into the world's biggest games company;
  - Alipay and Wechat Pay (Tencent) already cater extensively to 120 million Chinese tourists travelling abroad each year, and debiting their RMB balances for payments settled in local currency;
  - Tencent also recently obtaining a licence to offer WeChat Pay services in Malaysia in local currency, its first such local currency venture overseas; and
  - Didi Chuxing, which accounts for more than 80% of China's ride sharing market, is now expanding into Australia, as well as Mexico and Brazil.

Other Chinese digital economy players have been opening up new markets overseas, such as the Mobike bike sharing app across Europe, though some commentators question whether the more restrictive US and European investment climate will dissuade some overseas technology acquisitions by Chinese digital economy players.

It might also be observed that the BAT company-backed China VC capital industry has been making major overseas investments, rising to 14% of global VC investment outside China in the 2014 to 2016 period.

This overview makes clear why, with e-commerce imports surging, related tax and customs collection mechanisms, bonded zone clearance regimes, and potential permanent establishment (PE) exposures, are so important. The data localisation moves hint at how structures for supplying digital services to China will need to change in future, with associated tax consequences. The rapid moves by BAT and other Chinese DE enterprises into other markets make clear why a stable and consistent set of international tax rules, updated for digitalisation developments, are so important for Chinese enterprises and policymakers. We now turn to the specifics of these issues.

Key tax compliance and administrative issues for digitalising businesses in China

Tax compliance and administrative issues faced by digitalising businesses in China are many and varied.

Regulatory and tax rules outpaced by digitalisation

While China's economy has digitalised rapidly, particularly in the consumer space and with the rise of the sharing economy, tax rules and guidance have barely kept up. As China's economy remains heavily regulated, the tax authorities have historically paid close regard to business activity regulatory classifications in deciding appropriate tax treatments.

So, for example, there is a lack of clarity over the VAT treatment of the commission income of ride sharing platforms. Such platforms could originally have registered as providers of information technology services with the government authority handling enterprise business registrations (now the State Administration for Market Regulation, SAMR), supporting the application of VAT at the 6% rate. However, after driver liability and ride safety considerations prompted new regulations, obliging platforms to register with the Ministry of Transport, many tax authorities switched to demanding VAT application at the transport services rate, currently 10%.

As noted above, platform models are radically restructuring the Chinese economy, including sectors such as health and finance, meaning that the form in which such services are delivered, and the players involved, will see rapid change and innovation; continuous 'fine-tuning' of the legal obligations and status of platforms can well be anticipated. Given the interplay between regulatory classifications and tax rules, the need for clear tax guidance will become ever greater.

Traditional tax administration needs to catch up with the shift to a platform economy

As explained in last year's chapter, officially-issued tax invoices (*fapiao*) play a central role in China's tax administration.

Enterprise payments will be ineligible for corporate income tax (CIT) deductions without a 'general *fapiao*', and no input VAT credit will be obtainable without a 'special *fapiao*'. While recently a number of local tax authorities have initiated pilot programmes allowing traders to register to issue electronic *fapiao*, for the most part businesses still need to shuttle to tax offices to obtain paper *fapiao*. The cumbersome nature of the processes, and the traditionally relaxed attitude of many small businesses to tax compliance, has meant that a lot of selling activity has been conducted without *fapiao* issuance and tax payment.

For platform businesses, particular issues arise because the tax authorities can, in certain instances, look to treat platform operators who typically function simply as transaction intermediaries as transaction principals. In consequence, they may view customer payments as gross receipts of the platform operator, rather than acknowledging that the platform commission is just an element of this amount. Tax authorities can have various justifications for this, such as regulations treating ride sharing platforms as liable for service quality, service platforms holding themselves out in marketing or contractual documents as master service providers, and certain platforms issuing, on customer request, *fapiao* for the full amount of consideration paid. The net result is that VAT and CIT burdens may indeed fall on the gross receipts of the platform business, as it may not be possible to get *fapiao* from the unregistered platform traders or service providers (e.g. taxi drivers) to secure VAT input credits and CIT deductions. The bigger e-commerce platforms do, it must be said, require traders to provide business licence and tax registration records on setting up a shop on their platforms, but this cannot be said of the thousands of smaller platforms.

Another factor that further complicates the issue is the domestic monetary policy restrictions on so-called 'double clearing accounts'. This refers to the circumstances under which the platform collects the proceeds from the end customers (first clearing), and then after deducting its commission/service fee, remits the net payment to the traders (second clearing). Technically, unless the platform has obtained an online payment licence (which is actually extremely rare), it is otherwise prohibited to conduct transactions that involve the use of double clearing accounts. Hence, many e-commerce platforms are under pressure to transform from a pure intermediary platform to a buy/sell principal in form.

All this being said, a number of developments may be set to substantially regularise the situation in coming years. The new China E-Commerce Law, which enters effect from January 2019, includes a provision to oblige all platforms to report on the activities of traders and service providers to SAMR and the tax authorities, which should push these towards higher compliance. The implementation of this provision will very likely be relying on the finalisation of the new Tax Collection and Administration (TCA) Law (currently still under drafting), so it may be later in 2019 that the precise outcomes are known.

At the same time, the Shenzhen tax bureau, supported by Tencent, in summer 2018 rolled out a pilot blockchain invoicing system that fully integrates transaction parties, payment service providers, WeChat invoice delivery, and the tax authorities. Using decentralised blockchain technology, an unalterable transaction record will lie behind the automatic generation of digital *fapiao*, triggered whenever a trader makes a sale, and a customer pays (usually using WeChat Pay or Alipay). The customer can then use the digital *fapiao* received over WeChat for claiming relevant tax deductions, with the tax authority having received real-time information on all steps of the process of sale, payment, and tax deduction claim.

Assuming such systems prove robust on pilot, their convenience could well drive widespread registration by traders for the service. Indeed it may also be noted that the draft new TCA Law plans to oblige all financial institutions, and potentially other payment providers, to mass report transaction information, linked to taxpayer identification numbers (TINs) to the tax authorities. With tax authority big data analysis capacities allowing for matching and cross-checking of billions of transactions, and with supporting initiatives such as taxpayer social credit rating set to further influence tax compliant behaviour, it is anticipated that the platform tax administration-related issues, outlined above, should be progressively resolved over time. However, this is far from the limits of platform tax challenges.

Platforms as tax intermediaries?

The manner in which platform operators have driven the disintermediation and disaggregation of existing supply chains means that, as some economists have described it, the 'invisible hand' of the market, based on price signals, is being replaced by the guiding hand of platform algorithms. The latter guides buyers and sellers towards their optimal matches and transactions, ultimately determining overall economic outcomes. Consequently, between the old dichotomy of the free market, on one hand, and the planned economy, on the other, one can speak of the 'planned markets' of the platform-led economy. The question with which tax authorities everywhere are wrestling, is whether this also means that platforms should play a role as intermediaries, in the collection of tax and assisting the tax authorities.

At a policy level, apart from the trader information reporting requirements in the E-Commerce Law and the e-commerce import reporting obligations set out in 2016's SAT/GAC Circular 18, it does not appear, at present, that Chinese policymakers plan to impose more extensive obligations on platform operators. Circular 18 did provide for expedited customs clearance for e-commerce imports where platforms facilitated customs duty, VAT and consumption tax collection for traders, but this was a voluntary arrangement.

This being said, some local tax authorities have actively pursued platform operators to withhold tax from platform participants. The issue has arisen, for example, in relation to ride sharing platforms being pursued for withholding of IIT from drivers' fares. This is asserted on the same basis as mentioned above; that the platform is viewed in some sense as an economic principal, and the drivers therefore as employees. Getting to a satisfactory outcome on this issue is complicated by the fact that the existing IIT Law makes full compliance very unappealing. Essentially the drivers could have their income taxed at a flat rate, but with their deductions capped at 20% of income (far less than their actual costs), or pay progressive rates and need to have sophisticated accounting, and *fapiao* support, for actual expenses (which is beyond their abilities). Unsurprisingly, many forego compliance, hence the tax authority's inclination to get the platforms involved in IIT collection. This issue clearly cuts across the entire spectrum of services provided in China's rapidly expanding 'gig' economy, driven by the disintermediation and disaggregation forces of platform economics.

As it happens, and as elaborated in the chapter, *One giant step forward in Chinese IIT reform*, China is putting the finishing touches to a wholesale IIT reform. While this would substantially lift the entry threshold for IIT for the self-employed, it would not, of itself, simplify the IIT calculation and administration process for gig workers. This being said, perhaps the answer lies, in the medium term at least, with the tax record generation and information reporting innovations mentioned above. Driver tax expense records and *fapiaos* could be underpinned by the nationwide roll-out of the Shenzhen tax authority blockchain example above. Furthermore, the forthcoming platform tax information reporting requirements might facilitate tax authorities to pre-fill tax returns for gig workers, as is already done in other countries. It might be noted that the 2018-issued SAT Announcement 28 goes some distance to clarifying and modernising on-file tax record requirements for taxpayers, including use of e-invoices, and this further supports businesses and individuals on their road to greater tax compliance and associated tax certainty.

Cross-border digital economy issues in practice

As noted above, the volumes of cross-border e-commerce and digital service activity into China has been increasing rapidly. Various government policies have sought to encourage this, in connection with the goal of shifting China to a consumption and services driven economy. However, incompleteness and ambiguity in the tax and regulatory framework lead to continuing issues.

Withholding tax (WHT)

Guidance is lacking on the appropriate WHT treatment for various digital services provided cross-border into China. For example, with no specific guidance on cloud services, many local authorities can seek to place related fees under the domestic law WHT categories of leasing income or licence fees, and then preserve this treatment under the royalty article of China DTAs. In other cases services characterisation may be accepted, and no WHT imposed. This inconsistency of treatment creates challenges in administration, contracting and in obtaining double tax relief.

Forex

Foreign exchange controls continue to lead to challenges for both relatively straightforward, as well as more complex business arrangements. Supplies of software cross-border into China provide an illustration. Sale of software into China would, in principle, not result in CIT WHT leakage, but in order for purchase payment out of China to meet foreign exchange authority mandated bank processing requirements, proof of import through customs needs to be provided. This is clearly not relevant for software, so the payment may be labelled as a licence fee, and WHT suffered, simply to fulfil these archaic forex requirements. At a more sophisticated level, multinational enterprises (MNEs) in advanced sectors, including digital economy businesses, may want to arrange cross-border technology development collaborations that call for transfer pricing (TP) profit splits to be applied. However, forex rules do not facilitate payments being made in relation to profit split adjustments, so complicating sensible commercial arrangements.

PE

Chinese PE guidance, while it draws on elements of the OECD guidance, does not cover server PE cases. The government has made moves to open up certain sectors of China's digital economy to foreign enterprises, but at the same time the new Cybersecurity Law demands the storage and processing of personal data onshore, and limits data transfer offshore. In this context, foreign players are compelled to build up their onshore server capacity – this is usually achieved in conjunction with Chinese business partners, typically leaving the foreign enterprises without direct interest in the servers, but with a measure of control over their usage and deployment. This leaves open technical questions on whether the authorities will later pursue the foreign enterprises for tax on a server PE basis.

Also in the PE space, foreign traders through web platforms are concerned about agency PE exposures. These could arise where the enterprise has marketing support related parties in China. While China has not adopted the BEPS PE updates, which widen the scope of agency PE, Chinese tax authorities at regional and local level have followed the BEPS developments with interest and can look to apply agency PE more broadly in a manner that could leave existing structures exposed. In the same vein, at the same time as China has been facilitating e-commerce imports with the proliferation of new special e-commerce zones, there are concerns that the authorities might, in the BEPS spirit, go more aggressively after bonded zone warehouse operations with fixed place PE assertions.

VAT for digital exports

As noted above, China is running an expanding digital services surplus. Incentives, such as the advanced technology service enterprise (ATSE) regime, which provides a reduced CIT rate for service outsourcers, are aimed at further fostering this. However, at the same time, VAT zero-rating only applies in very limited circumstances. VAT exemption may be obtained where certain services can be shown to be consumed outside China (itself complex in a digital services context) but none of the input VAT will be recoverable in such cases. These cross-border VAT issues are central tax policy concerns for China's major digital economy players.

Overseas tax issues for China's 'going out' digital economy enterprises

As noted above, it is widely agreed that the major global DE players are the US FAANG and China's BAT companies, and these are actively competing in several world regions. Southeast Asia and India, and increasingly Africa, are noted as key 'battlegrounds' for these enterprises. However, it might be observed that compared to the experience of the FAANG companies, whose initial overseas expansion in the 2000s was in the context of a relatively stable international tax environment, China's BAT enterprises are making their initial overseas expansion against the backdrop of numerous countries adopting unilateral DE tax measures. These have the potential to create substantial complexity and compliance challenges, given both the heterogeneity of such measures and the fact that Chinese 'go out' enterprises are still in the process of building up their tax team capabilities and experience.

Taking a sampling of Asian tax jurisdictions in which Chinese DE enterprises are active:

- India: India has a full spectrum approach to taxing cross-border DE activity. In addition to broadly applied CIT WHT rules, which catch many cross-border digital service supplies, 2016 saw the introduction of a 6% equalisation levy on digital advertising services, and 2018 the institution of a 'virtual PE' concept, with the significant economic presence (SEP) rule. This is in addition to India's adoption of the BEPS PE updates through the multilateral instrument (MLI), and the steady expansion of the existing PE threshold via court cases, including the endorsement of a virtual service PE concept. In September 2018 it was announced that Indian e-commerce marketplaces would be required, from October 2018, to withhold 2% of the GST payments on sales by third party retailers, under a 'split payments' measure. This requires GST registration in every Indian state of relevance.
- Indonesia: A variety of intermediary platforms have been reportedly under pressure from the authorities to (i) register PEs, or set up local subsidiaries, and pay CIT on their commission fees, and (ii) to collect and remit a 1% tax on the full value of transactions conducted through their platforms – this is done with a view to collecting the VAT and CIT perceived as being underpaid by traders/service providers through the platforms. The authorities have also been working on (yet to be finalised) rules which would compel the registration of a tax branch, on pain of having the enterprise's website blocked. It is noted that Indonesia has also opted for the BEPS PE updates through the MLI.

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- Australia: The Multilateral Anti-Avoidance Law (MAAL) of 2015, together with the diverted profits tax (DPT) of 2017, present complex and challenging new provisions for CIT enforcement of particular relevance to e-commerce businesses. This is alongside Australia's early move to make intermediary platform operators jointly liable for VAT of platform traders and service providers. Australia has also opted for the BEPS PE updates through the MLI.
- Taiwan: Foreign providers of e-services are obliged to register for CIT and VAT in Taiwan. In B2B cases the tax filing obligations fall, in the first instance, on the foreign enterprises. In the B2C case it is the platforms that are obliged to withhold CIT and account for VAT. Net basis CIT is however provided for, with allocable expense deductions allowed and it may also be possible to argue that a portion of Taiwan revenues relate to functions conducted overseas.

These developments are emulated in other Asian jurisdictions, with Vietnam, the Philippines, Malaysia and Pakistan widening WHT application to digital supplies, and Japan, Korea and New Zealand moving on BEPS PE adoption through the MLI. Chinese DE firms need to contend, in addition to such novel tax rules and enforcement approaches, with heightened enforcement efforts on more mainstream tax rules. The number of reported cases of PE and TP challenges for Chinese companies in India and other Asian jurisdictions is testament to this. A wide spread of Asian jurisdictions have also moved to adopt destination-based VAT rules for digital services and have sought to catch low-value tangible imports in the VAT net. As can be seen from the examples above, platforms are increasingly being drawn into intermediary tax collection obligations.

The diversity and complexity of new DE tax rules in Asia is mirrored in Europe, where Chinese DE firms are also increasingly active, and newly also in Latin America and Africa. The US is also throwing up complexity with the sales tax changes for DE firms, following on from the *Wayfair* case. The complexity that Chinese DE firms need to keep on top of is consequently rising at a hard-to-manage pace.

These developments occur in parallel with increasing numbers of cases in which the Chinese tax authorities have been reported to have applied the domestic controlled foreign corporations (CFC) rules against overseas operations of Chinese 'go out' enterprises; this is discussed further in the chapter, *Tax opportunities and challenges for China in the BRI era*.

In the round, Chinese DE enterprises, and particularly platform businesses, face an increasingly challenging tax environment, demanding particularly astute tax management.

Updating the international tax framework for digitalisation

As noted above, considerable efforts are being invested at global level to revamp international tax rules to deal with the tax challenges of digitalisation. The 124 jurisdictions of the OECD Inclusive Framework (IF) on BEPS have set an ambitious timeframe of 2020 to agree a global consensus solution. This may involve modifications to the existing jurisdictional nexus and profit allocation rules – indications of the shape of any such changes may even start to become apparent in 2019.

Already, in March 2018, the IF released an interim report on the tax challenges arising from digitalisation (interim report). This was published at the same time as both the EU Commission set out proposals for resolving the digitalisation tax challenges, and the UK government issued an updated position paper on the same issues; the Australian government followed with its own discussion paper in October 2018. The basic upshot of all these efforts, explicitly acknowledged in the Interim Report, is that there is, as yet, no consensus between countries on either the long-term solution for updating international tax rules, or interim measures for addressing perceived tax revenue losses arising while the long-term solution is in development.

The essential contours of the global debate and of possible solutions, in brief, are as follows:

- On interim measures, the usage of turnover taxes (whether termed as equalisation levies, excise taxes, digital services taxes (DSTs), or otherwise) is highly contested. India and a number of EU countries (notably France, Italy, and Spain), have been strong advocates. The UK also, in October 2018, announced its planned adoption of a DST from 2020 if no global solution can be found by then. They argue that without these levies on the revenues of major DE enterprises (with the focus clearly on the FAANG enterprises), market competition will be distorted, and tax revenues relating to value creation in their countries will be lost. Many other countries, including the US and China, have however expressed concern about the distortive impact of such taxes. As gross basis taxes, designed to operate outside the scope of treaties, they necessarily lead to double taxation and may undermine the economic benefits of digitalisation. Various other countries, such as Germany, have repeatedly shifted forwards and back on their support for such taxes; this lack of decisiveness one way or another, and the need within the EU for unanimity on tax measures, has meant that the likelihood of success of the EU's interim measure proposals has been a matter of running debate throughout 2018.
- For the long-term solutions, countries still take different views on what they consider to be the issue requiring resolution. Some countries still consider that the double non-tax, and distorted competition issues, remain only partly resolved after the BEPS work; they consider that the design of the tax and digitalisation long-term solution needs to address this. Other countries consider that the BEPS measures will ultimately succeed, when fully rolled out, in addressing the double non-tax issues. They consider that the focus of the tax and digitalisation long-term solution must necessarily be on a 're-thought' allocation of taxing rights between countries, under revised international tax rules, which takes on board new value creation dynamics.
- This thinking then feeds into the suggested solutions put forward by countries. Countries which consider that the double non-tax/distorted competition issue remains to be addressed have mooted ideas of minimum taxation (whether from residence or source country directions, or both) which ensure a global minimum effective tax rate on income; an OECD Tax Talk on October 16 indicated that Germany and France advocated such a measure. Countries concerned about distorted competition have also put forward proposals for very broad digital PEs, such as those put forward by the EU Commission and by India, which would capture cross-border provision of a very wide array of digital services; and in India's case, also supplies of tangible goods via digital interfaces. These broad digital PE concepts are driven by a line of thinking that where a foreign enterprise has a general level of involvement in the economic life of a country, including maintaining sustained and purposeful relationships and interaction with local customers, then the country of the customers should have a right to tax them.
- By contrast, those countries with more faith in BEPS to solve double non-tax issues, and who consider the rebalanced allocation of taxing rights to be the main issue, have put forward more narrow and focused proposals. However, these can also differ very substantially on the details.
- The UK government paper has become the 'flag bearer' for the idea that users, as distinct from consumers, may under certain highly digitalised business models make a very substantial contribution to value creation, and that tax rules need to adapt to factor in this dimension to value creation. Essentially, users can be viewed as 'integrated' into enterprise value creation processes, perhaps to the extent that they might even be viewed as 'quasi-employees'. For social media, search engine and intermediation platform 'network-driven' business models, intense user engagement and content generation is seen to be crucial to the existence of the business, which leverages

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user data and network effects to create value. The UK paper therefore suggests that part of the residual profits of a group enterprise would be attributed to user contributions, the proportion varying depending on the relative significance of this for the business model in question (i.e. more for social media models, less for intermediation platforms).

- It has been indicated by OECD and US officials, in public seminars and on the recent OECD Tax Talk, that the US has also tabled a proposal for discussion at the IF, which could allocate a greater share of an enterprise's global profits to market countries. While little has been publicly disclosed on this to-date, some commentators have suggested that the US approach might link customer-based intangibles of the enterprise to the location of the customer base. Further to this, part of the residual profits of the group enterprise might then be allocated to the countries to which these market-linked intangibles are attributed, in other words, to the countries at which marketing and sales efforts are directed. It is not clear whether this approach would also introduce some form of virtual PE, or would be limited to altering profit attribution rules where traditional physical presence PE (or a subsidiary) already exists. In any case, the approach would appear to go broader than just highly digitalised businesses, and could be relevant for many businesses with a strong reliance on marketing intangibles.
- Indeed, this points to another key dividing line between countries, which was explicitly highlighted in the Interim Report, that some countries consider that the issues pertain to digitalised businesses and new measures should be scoped accordingly, while other countries consider that, with the entire economy digitalising, any new profit attribution or nexus rules should not be ring-fenced to digitalised businesses.
- Beyond CIT, a further element of international work, also at OECD/G20 level, is on VAT/GST and the question of whether platforms should have tax information reporting or even tax collection obligations. The outcomes of this work stream remain to be seen.

As regards China's stance, the relevant Chinese government authorities (the Ministry of Finance (MOF) and the State Administration of Taxation (SAT)) have not yet set out any formal 'China position' in the manner of the UK (publicly), or the US (semi-publicly). This being said, a certain amount can be inferred by drawing on information in the public domain, including tax media reports on the IF deliberations, and public DE tax seminar presentations by government officials.

It would appear that China tax policymakers consider interim measures, such as gross basis turnover taxes, sub-optimal and distortive, and not a good path forward. They might be considered to favour work on a long-term solution which has its basis in the existing international tax framework, without ring-fencing the digital economy, and which could minimise double tax outcomes and additional burdens on businesses. This would be very much in line with the repeated statements by China's top leadership, including President Xi and Premier Li, concerning China's position as a strong advocate of continued globalisation, and economic digitalisation as a key element of this. It would also make sense in view of the blossoming overseas operations of the major Chinese DE players, and their rapid innovation of new service offerings attractive to consumers in overseas markets. Apart from this, the indications are that China takes an open mind to the shape of the long-term solution proposals, emerging from the work of the IF.

It remains to be seen what comes of the IF work, with much anticipated to emerge in 2019. However, given that the complex processes are underway with the digitalisation and intangible-isation of the economy, even if consensus is reached on new rules, this will be by no means the end of the story.

Continuing innovation in business models as new technologies are rolled out will no doubt demand a continuing process of updates to international tax standards; whatever changes are made in 2020 are very unlikely to be 'forever and always'.

A further key factor, separately discussed in the previous customs and international tax chapters, is the long-term impact of the continuing shift in China-US trade and economic relations. While the existing trade issues may ultimately turn out to be simply temporary, it cannot be discounted that they become a more enduring feature of the global economic landscape. As discussed in the previous chapters, businesses and policymakers will be watching closely to see if there is an emergence of a trend towards the creation of separate trading and investment spheres.

Some commentators have speculated that, at some point in the future, a 'splinternet' may arise, whereby one global internet system is dominated by the US, and a separate system by China. We are certainly not at this juncture yet, but as with other digital regulatory developments (including data localisation rules, data privacy requirements, and firewall policies), expectations of the future patterns of digital commerce may well feed into tax rule setting. The trend of these developments will be followed with interest in the coming years.

Tax means business – Hong Kong's tax policies to increase competitiveness

Hong Kong has seen substantial changes to its tax landscape in 2018. Curtis Ng, Michael Olesnicky, John Timpany and Ivor Morris discuss Hong Kong's tax changes for transfer pricing (TP) and research and development (R&D) aimed at enhancing Hong Kong's competitiveness and driving its economic growth.

In recent years, the OECD's BEPS project has been one of the fundamental drivers for countries to revise their tax policies. This will have a substantial impact on how businesses and multinational enterprises (MNEs) operate, and creates additional tax uncertainty for taxpayers. In addition, major economies such as the US and the UK are cutting their corporate tax rates to make their regimes more competitive globally. As a result of these trends, Hong Kong cannot rely on its simple and low-tax regime to attract investment.

The most important change to Hong Kong tax law in recent years is the introduction of the new BEPS and TP regime. The new TP regime codifies the OECD's arm's-length principle and documentation requirements, and affirms Hong Kong's commitment to implementing the measures set out under the OECD's BEPS project.

Over the past year, the Hong Kong government has stepped up its roll-out of tax policies to enhance Hong Kong's competitiveness, as promised in Chief Executive Carrie Lam's policy address in October 2017. One of the important changes in this direction is the introduction of a proposed enhanced R&D tax regime. This represents an important move by the Hong Kong government to encourage more R&D activities to be carried out in Hong Kong.

In this article, we will discuss the various tax changes in Hong Kong and the impact they have on businesses.

Transfer pricing regime

On July 13 2018, Hong Kong's new TP regime was enacted. It introduces a formal TP regime and TP documentation requirements, and will have retrospective application for years of assessment commencing on or after April 1 2018. The key points most worth noting are:

- Certain domestic transactions have been excluded, subject to certain conditions being fulfilled; and
- The documentation thresholds (in particular, the thresholds on the business size test) have been relaxed to alleviate the burden on smaller Hong Kong businesses of proving their compliance with the arm's-length principle.

While TP is still relatively new to Hong Kong, most of Hong Kong's trading partners have already implemented and updated their own TP rules since the OECD's BEPS Action Plan deliverables were finalised in 2015. The Inland Revenue (Amendment) (No 6) Ordinance 2018 (BEPS and TP Ordinance) is lengthy and relatively complex, which leads to uncertainties in interpretation and practical application.

Specific provisions defining a permanent establishment (PE) have also been introduced. Transfer pricing rules would apply to any non-resident who has a PE that carries on a business in Hong Kong. The authorised OECD approach (AOA) will be used to determine the income or loss attributable to a PE. However, only profits attributable to the PE that have a Hong Kong source will be subject to tax. The AOA will give the Inland Revenue Department (IRD) the power to assess a Hong Kong branch of a foreign corporation on the income attributed to the branch as if it is a distinct and separate entity. This is particularly relevant to financial institutions and insurance companies that typically maintain branches in Hong Kong. Given that PE profit attribution is rather complex, the application of the principle is deferred until the year of assessment commencing on or after April 1 2019. The IRD will clarify uncertain issues in an upcoming departmental interpretation and practice note (DIPN).

Another key change is the introduction of a deeming provision to target situations where a person in Hong Kong carries out value creation activities, such as development, enhancement, maintenance, protection or exploitation (DEMPE) functions in Hong Kong in respect of intellectual property (IP) but the income accrues to a non-resident. Local tax authorities will seek to put a value to DEMPE contributions by people in their own jurisdictions, against those elsewhere in the supply chain of the group. Differences of opinion between tax authorities may lead to double taxation. The existing wording of the deeming provision also creates a potential risk of double taxation, even though the IRD has reiterated that a person would not be subject to double tax in respect of the same income from any IP. The deeming provision remains silent on this.

Given the complexity surrounding its application, the effective date of this rule is deferred until April 1 2019. Clarifications by the IRD will be provided in due course. In the meantime, Hong Kong taxpayers will need to get prepared and have a clear view of where they think the value-added DEMPE functions are performed and how these functions contribute to the value of intangible assets.

Going forward, as taxpayers will be required to provide additional information to tax authorities, this may lead to cross-border tax disputes and result in substantial tax adjustments and potential double taxation. Global and Hong Kong businesses must have the flexibility to accommodate BEPS-related and TP changes in the coming years. In particular, the area of related-party transactions is one that is frequently scrutinised by tax authorities in Hong Kong and the region. Hong Kong taxpayers must therefore carefully revisit their TP policies and their related-party transactions with respect to their supply chains and related-party use of intangibles, to ensure that these remain appropriate for their group in Hong Kong and abroad, before deciding how to comply with the new TP regime.

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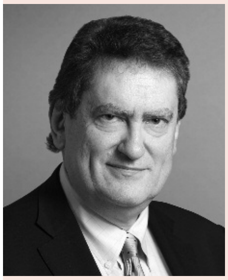
The MCAA and MLI

In recent years, international tax cooperation has greatly intensified. As a result, effective from September 1 2018, the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (Convention) will enter into force to allow Hong Kong to effectively implement the automatic exchange of financial account information in tax matters (AEOI) and to combat BEPS on a multilateral basis. Hong Kong has now become a signatory to both the MCAA on AEOI and the MCAA on country-by-country reporting (CbC MCAA), both of which have their legal basis in the Convention. By becoming a party to the MCAA, Hong Kong will be able to select other signatories with which it intends to enter into automatic exchange of information relationships (rather than having to negotiate individual agreements with states bilaterally).

In addition, many of the BEPS action points cannot be implemented without amending the tax treaties. As such, the multilateral instrument (MLI) was developed to swiftly modify bilateral tax treaties to implement tax treaty-related



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BEPS recommendations, such as the measures on treaty abuse set out in the BEPS Action 6 report. These include the principal purpose test (PPT), a simplified limitation on benefits (LOB) article, or a more complex LOB accompanied by either an anti-conduit rule or a PPT. Hong Kong has opted, through the MLI, to adopt the PPT only. The PPT denies treaty benefits if it is reasonable to conclude that obtaining a treaty benefit was one of the principal purposes of a transaction.

As of today, Hong Kong has entered into comprehensive double tax agreements (DTAs) with 40 tax jurisdictions (with the most recent being Finland). In June 2017, China became a signatory of the MLI and Hong Kong has obtained endorsement of the central government to extend the application of the MLI to Hong Kong's DTAs. It is expected that most of Hong Kong's DTAs will be covered by the MLI. However, the number of DTAs to be covered by the MLI will depend on whether Hong Kong's treaty partners are parties to the MLI and whether they will place their DTAs with Hong Kong under the coverage of the MLI.

In light of these changes, as Hong Kong is a common jurisdiction for MNEs to set up their regional holding companies, MNEs will need to ensure that their holding companies in Hong Kong have reasonable business purposes in order to enjoy the benefits under the Hong Kong DTA. Further, Hong Kong companies with cross-border transactions should also revisit their existing operating structures in Hong Kong, taking into account the MLI positions adopted by Hong Kong but also those adopted by Hong Kong's tax treaty partners.

R&D tax incentives

To boost Hong Kong's competitiveness and to promote more R&D activities being carried out in Hong Kong, the Hong Kong government proposed an enhanced R&D tax deduction. Once enacted, the new R&D tax regime will have retroactive effect for any expenditure incurred on or after April 1 2018.

This is a welcome tax incentive that will provide Hong Kong with a competitive advantage in promoting R&D activities to be carried out in Hong Kong. There are, however, a number of conditions that need to be satisfied in order to qualify for the enhanced tax deduction.

In order for the taxpayers to qualify for the enhanced R&D tax deduction, the bill broadly categorises R&D expenditure into two categories (Type A and Type B expenditures), which are deductible subject to meeting certain conditions. The bill is awaiting the Legislative Council's final approval.

Type B expenditure qualifies for the enhanced two-tiered tax deduction:

- A 300% tax deduction for the first HK$2 million ($255,000) of qualifying expenditure incurred by the enterprise, i.e. expenditure incurred by enterprises for in-house qualifying R&D, and payments made to 'designated local research institutions', i.e. outsourced qualifying R&D; and
- A 200% tax deduction for the remaining amount.

The critical element required to qualify for Type B expenditure is that the R&D activity is wholly undertaken in Hong Kong and generally only applies to those R&D activities that seek to achieve scientific or technological advancement and involve the resolution of some scientific or technological uncertainty.

Broadly, in order for expenditure on a qualifying R&D activity to be deductible, it must be incurred in relation to the Hong Kong taxpayer's business and must be:

i) paid to a designated local research institution; or
ii) an expenditure in relation to an employee engaged directly and actively in a qualifying R&D activity.

However, there are some exclusions where no R&D deduction is allowed. This includes where the R&D expenditure is undertaken for another person, where any rights generated from the R&D activity are not fully vested in the person who pays for it, or the costs are met by the government or another person. Certain activities are also excluded from qualifying as Type B expenditure, such as feasibility studies or market, business or management research.

Type A expenditure qualifies for a basic 100% tax deduction and includes a wider range of expenditure including payments to third parties, activities undertaken outside Hong Kong and capital expenditure.

Going forward, many Hong Kong companies will find that they are conducting quality R&D activities as part of their product and process improvement activities. It is important that there are systems and processes in place to correctly identify projects and classify their R&D expenditure in order to claim the new benefit. In addition, Hong Kong companies that are planning to engage in R&D activities in and/or outside Hong Kong should plan ahead and assess how to best structure their R&D arrangements in order to benefit from the enhanced R&D tax deductions.

Open-ended fund company (OFC) regime

The Hong Kong government recognises that the asset management industry is a fast growing sector within the financial services industry. The OFC regime will provide fund managers with the option of setting up a fund in the form of a Hong Kong company and is a key initiative to help diversify Hong Kong's fund domiciliation platform.

Broadly, an OFC is an open-ended collective investment scheme that is intended to operate as an investment fund vehicle managed by a professional investment manager. The OFC is set up in the form of a limited liability company but with the flexibility to create and cancel shares for investors' subscriptions and redemptions (which is not possible at the moment in the case of conventional companies).

However, the rules surrounding the OFC regime are complex and have a number of issues. Some of the key challenges include:

- The ordinance is silent on the stamp duty implications associated with an OFC. Under the prevailing Hong Kong stamp duty law, the allotment and cancellation of Hong Kong stocks (e.g. shares of an OFC) are not subject to stamp duty. However, the transfer of stocks of an OFC would be subject to stamp duty;
- The OFC must continue to pass the non-closely held test for 24 months after the first 24-month grace period beginning from foundation of the company. If not, the OFC will be taxable retrospectively from its start-up date;
- For carried interest distributions, there is a provision that deems dividends from a non-exempt OFC to be taxable to the extent they are in relation to services rendered in Hong Kong. It does not take into account any circumstances giving rise to a carry distribution in connection with an investment in the OFC; and
- The exemption does not apply to transactions in certain tainted assets, including gains on shares in companies where the underlying value includes Hong Kong real estate or substantial 'short-term assets'.

Given the relatively onerous and complex conditions that must be satisfied to qualify for the benefits, this is a missed opportunity and we expect little application of the regime in practice. Further enhancements are therefore required to make the regime more business friendly.

Two-tier profits tax regime

As part of the Chief Executive's promise to put tax reform on her agenda, the beginning of 2018 saw the introduction of a two-tier profits tax regime. Under the two-tier profits tax system, the first HK$2 million of assessable profits of corporations and unincorporated businesses will be taxed at one-half of the prevailing standard rates (i.e. 8.25% and 7.5% respectively), and the remaining profits will continue to be taxed at the prevailing tax rates of 16.5% and 15%. There are anti-fragmentation measures where only one company in the group of companies can be nominated to benefit from the progressive rate for a given year of assessment. This tax incentive is particularly aimed at small and medium-sized enterprises to help relieve their tax burden.

Taxpayers who have elected into other preferential half-rate tax regimes (e.g. professional reinsurance companies, captive insurance companies, corporate treasury centres and aircraft leasing companies) are excluded from the two-tier tax regime.

Shipping lease incentive

The maritime industry has traditionally been one of the pillar industries of Hong Kong but this has changed in the

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past decade. Given the importance of the Belt and Road and the Greater Bay Area initiatives, the development of the maritime industry should be a key focus for the Hong Kong government. In order to revive this industry and to further enhance Hong Kong as a location for shipping business, some of the key recommendations that have been proposed by the Financial Services Development Council include:

- Capture more commercial principals, capital providers and lessors who are willing to base meaningful activities in Hong Kong by allowing qualified investors to access market-ready credit and liquidity enhancement products;
- Encourage the growth of shipping and maritime-related support and management services by providing tax concessions (such as a reduced tax rate of 8.25%) where relevant businesses activities such as maritime and ship leasing management and maritime and shipping-related supporting services activities are carried out in Hong Kong; and
- Conclude more double tax agreements with major shipping jurisdictions, in particular, with Brazil and Australia.

Future developments

Further tax incentives and proposals

The Hong Kong government has introduced various tax changes this year. Some of these affirm Hong Kong's commitment to boosting Hong Kong's competitiveness and set the scene for further changes to come in the near future.

While the Hong Kong government is committed to introducing tax policies, the IRD may not always implement tax rules which are in line with the spirit of the Hong Kong government's policy, which may present difficulties for businesses to overcome. In view of further tax changes to come, businesses must review and assess their current capabilities and remain flexible to adapt to change.

Various industry and professional bodies in Hong Kong have also called for the government to introduce tax incentives to promote and diversify the economic development of Hong Kong. Some of the key tax proposals include:

- Using tax measures to foster the ship leasing business in Hong Kong and providing tax relief to promote the development of marine insurance and the underwriting of specialty risks in Hong Kong;
- Tax incentives to boost the specialty insurance and reinsurance industry including a new offshore profits tax exemption with details to be released later;
- In September 2017, the Financial Services Development Council introduced a proposal to introduce a group tax loss relief regime that would serve to encourage entrepreneurial risk taking and innovation; and
- In October 2017, KPMG prepared a report, 'The case for a Hong Kong RHQ tax incentive', proposing to introduce a regional headquarters (RHQ) tax regime in Hong Kong to enhance Hong Kong's competitiveness as an RHQ location in the Asia Pacific region.

Implications of IFRS9 on financial instruments for tax in Hong Kong

The adoption of IFRS 9 (financial instruments) in Hong Kong represents a substantial change to the financial reporting of banks. Its adoption could give rise to unforeseen tax implications during the transition and future periods. Darren Bowdern, Johnson Tee, Matthew Fenwick and Malcolm Prebble outline the potential tax implications in Hong Kong.

International financial reporting standards (IFRS) 9 is the replacement for international accounting standards (IAS) 39 (Financial instruments: recognition and measurement). It is fully adopted in Hong Kong through Hong Kong financial reporting standards (HKFRS) 9, and becomes mandatory for annual periods from January 1 2018 onward for all companies in Hong Kong.

IFRS 9 substantially changes the approach taken to the classification and measurement for financial assets, and this can have a knock-on effect on the taxation of the financial assets. Specifically, there are implications in how the accounting classification, measurement and impairment would be treated for tax purposes, with some potential tax divergences from the accounting treatment, and there may be legislative amendments to narrow the gap, going forward.

New accounting rules in HKFRS 9 (financial instruments)

The development of IFRS 9 was a response to the April 2009 call by the G20, and followed a recommendation of the G20 Financial Stability Board (FSB). The push to introduce IFRS 9 was accelerated by the global financial crisis of 2008 and its aftermath, for which IAS 39 was unable to provide timely information on the credit impairment position of affected banks. Banks have long criticised IAS 39 for its complexity and the potential consequences of its approach to the mark-to-market measurement of financial instruments. IFRS 9 introduces a less complex, principles-based approach, which contrasts with the rules-based approach of IAS 39.

IFRS 9 rolls out a new, standardised classification and measurement model for financial assets, moving from an in incurred loss to an expected loss model, and applies an improved hedge accounting model. IFRS 9 also has certain features that converge with the US GAAP equivalent: US Accounting Standard Updates, ASU 2016-1 Financial Instruments – Overall (Subtopic 825-10), and ASU 2016-13 Financial Instruments – Credit Losses (Topic 326). The introduction of IFRS 9 will have the biggest impact on banks, though small and medium enterprises may also be affected.

IFRS 9 contains three main topics, which are dealt with below:

- Classification and measurement of financial assets;
- Impairment; and
- Hedge accounting.

Table 1

IAS 39	IFRS 9	
Classification	Classifications and measurement models	Measurement model
FVPL	FVPL	FVPL Financial assets should be measured at fair value with all changes recorded through profit or loss.
Held to maturity	Amortised cost	Amortised cost. Financial assets are initially recognised at fair value and subsequently measured at amortised cost.
Loans and receivables	Amortised cost	Amortised cost
Available for sale	FVOCI	FVOCI Financial assets are initially recognised and subsequently measured at fair value. Carrying amount movements are recorded through other comprehensive income (OCI), except for the recognition of impairment gains or losses, interest revenue and foreign exchange gains and losses, which are recognised in profit and loss. Where the financial asset is de-recognised, the cumulative gain or loss previously recognised in OCI is re-classified from equity to profit or loss.

IFRS 9 – classification and measurement

Under IAS 39, financial assets were categorised as held to maturity, loans and receivables, fair value through profit and loss (FVPL), and available for sale.

Under IFRS9, most financial assets should be classified and measured at fair value, with any fair value change recognised in the profit and loss account as they arise (FVPL). Only when specific criteria are met, are financial assets classified and measured at either amortised cost, or fair value through other comprehensive income (FVOCI). A high level comparison is shown in Table 1.

The classification is based on the expected cash flow of the financial instrument and the objectives of the entity's business model. In summary, only assets that meet the following criteria can be classified and measured at amortised cost or FVOCI, respectively.

Amortised cost

- The asset is held to collect its contractual cash flows; and
- The assets contractual cash flow represent solely payments of principal and interest (SPPI).

FVOCI

- The asset is held to collect its contractual cash flows and to be sold; and
- The assets contractual cash flow represent SPPI.

IFRS 9 – impairment

Under IFRS 9, a single impairment model will be applied to all financial instruments subject to impairment testing.

One of the key impacts for banks is the timing for recognising losses on loans. The new standard requires banks to be more forward thinking and to be better at estimating potential losses. Under IFRS 9, loan impairment recognition uses an expected loss model that focuses on the risk that a loan will default. This is in contrast to IAS 39 where credit losses were only recognised where there was objective evidence of impairment.

The adoption of IFRS 9 involves a degree of judgment by management, and more accurate financial modelling based on available data, past events and prevailing conditions. Impairment losses are recognised on the first initial recognition of the financial asset, and the impairment is reviewed and adjusted at subsequent reporting periods. The objective is to recognise the full lifetime expected losses on a more timely basis.

IFRS 9 hedge accounting

IFRS 9 revamped the hedge accounting requirements and introduced new criteria for hedge accounting. The new model more closely aligns with the risk management activities, and is less complex than IAS 39.

What does it mean for banks?

The adoption of IFRS 9 will have an important impact on bank financial reporting, affecting investors, regulators, analysts and accountants. IFRS 9 implementation requires changes to IT systems, processes and risk controls, and this presents an opportunity for banks to develop an efficient and timely reporting process.

The change in loss provision accounting, from an incurred loss model to an expected loss model, potentially creates problems for banks. Banks will have to take a position on the likelihood of recovery of a loan and adjust the loss provisioning on a regular basis.

The overall effect of IFRS 9 is that banks will report their losses sooner, though these may not necessarily be new losses. Such losses have been priced-in during the initial lending, and only the timing of their recognition is impacted.

Nevertheless, IFRS 9 presents some real challenges. Measurement of losses is very subjective because it relies on estimates, which could potentially lead to volatile results. Similarly, as banks may adopt different forecasting models, financial analysts will face difficulties comparing the performance of banks, as the banks may have a completely different outlook of the future. It will take some time for the rules to be fully integrated and for financial reports for banks to be fully understood.

Taxation of financial assets in Hong Kong

In Hong Kong, the tax treatment of financial assets and financial liabilities generally follows their accounting treatment. The starting point for the calculation of Hong Kong profits tax, as confirmed by the Court of Final Appeal in 2000 in *Commissioner of Inland Revenue v Secan Limited and Ranon Limited* (5 HKTC 266) (Secan), is the profits per the financial statements, subject to any adjustments required by the provisions of the Inland Revenue Ordinance (IRO), which sets out the Hong Kong tax statute.

In the past, the generally accepted position was that fair value gains or losses recorded in the audited accounts prepared in accordance with IFRS would be taxable/deductible, as long as they were Hong Kong-sourced and not capital in nature. However, this position is no longer as clear.

In November 2013, the Court of Final Appeal (CFA) held in the *Nice Cheer Investment Limited* (FACV 23/2012) (Nice Cheer) case that unrealised gains arising from year-end mark-to-market in respect of listed securities held for trading purposes were not chargeable to tax in Hong Kong. In giving his judgment on the case, Lord Millet NPJ emphasised the two basic tax principles that: "the word 'profits' connotes actual or realised and not potential or anticipated profits" and "neither profits nor losses may be anticipated".

Although the non-taxability of such unrealised gains is clear, the deductibility of unrealised losses was not as straightforward because the issue of unrealised losses was not under dispute in Nice Cheer. Section 16 of the IRO states that in ascertaining the assessable profits there will be deducted outgoings and expenses to the extent to which they are incurred in the production of the profits chargeable to tax. Lord Millet NPJ commented that a provision for diminution in value of trading stock would be tax deductible if the provision represented a "material and permanent fall in value" of the trading stock at the balance sheet date. If not, such a provision would only be anticipated losses and, as such, would not be tax deductible as the loss has not been "incurred".

Subsequent to the judgment of the Court of Final Appeal in *Nice Cheer*, the Inland Revenue Department (IRD) has agreed, as an interim administrative measure, to accept profits tax returns in which the assessable profits are computed on a fair value basis since the year of assessment 2013/14. That is, fair value gains and losses were taxable and deductible, provided these were Hong Kong sourced and not capital in nature. We would expect this concession to be accepted until such time there is a legislative amendment.

IFRS 9 impact on tax treatment in Hong Kong

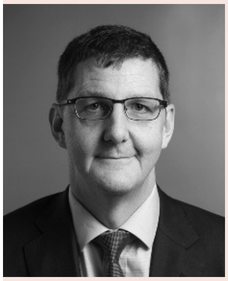
Deduction for impairment losses

The adoption of IFRS 9 (HKFRS 9 in Hong Kong) could result in timing differences between the accounting and taxation treatment of financial assets and liabilities for Hong Kong profits tax purposes. More importantly, tax deductibility issues for expected credit losses could lead to increased tax compliance and operational costs. While the adoption of IFRS 9 is not limited to financial institutions, its impact will be most substantial for banks given the volume and types of financial instruments that they transact.

For expected credit losses, IFRS 9 also prescribes new rules for calculating impairment losses. It employs a three-staged approach to determine the quantum of impairment losses.

At stage 1, the loan is performing and there is no sign of credit deterioration, thus a 12-month expected loss impairment allowance is applied. At stage 2, the loan is under-performing and there are signs of credit deterioration, thus a lifetime expected losses impairment model is applied. At stage 3, the loan is not performing, a lifetime expected losses impairment model is applied, and the effective interest rate is computed based on the amortised cost (the gross carrying amount less the loss allowance).

Based on prevailing law and practice, financial instruments should only be regarded as credit-impaired at stage 3, at which stage the impairment should qualify for a bad debt deduction under section 16(1)(d) of the IRO. There are a number of considerations that would need to be taken into consideration in determining whether a loan was impaired and that the impairment loss was tax deductible.



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Darren is also a regular speaker and writer on private equity related tax issues, and advises on establishing direct investment, private equity and other investment funds in Hong Kong and in the Asia Pacific region. He also advises on structuring tax efficient performance and co-investment arrangements for private equity funds, as well as effective remuneration and employment arrangements.

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A deduction for bad or doubtful debts is allowed to the extent they are estimated to the IRD assessor's satisfaction to have become bad. In practice, this provision is strictly enforced by the IRD. In many cases, the IRD only allowed a deduction in respect of debts that had actually gone bad (that is, where a loss had been incurred and a loan was irrecoverable – for example, debtor bankruptcy or a loss on disposal of the financial asset), and denied a deduction for specific provisions made merely in anticipation of a loss. While this is not entirely in accordance with the IRO, taxpayers have followed the IRD's practice (especially where it is only a timing difference).

The way in which the impairment allowance under IFRS 9 is calculated may come under close inspection by the IRD. In the absence of an identifiable impairment event mentioned above, a deduction claim may lead to queries being raised by the IRD on whether a loss was incurred, or whether the conditions under section 16(1)(d) were satisfied. Certain international cases, such as the Privy Council decision in *CIR v Mitsubishi Motors New Zealand Limited* (1995; 17 NZTC 12,351), suggests that a statistically estimated loan loss provision can be considered as incurred.

However, given the requirements of section 16(1)(d) and the IRD's position of denying general provisions for doubtful debts, it is unlikely that the IRD will allow a deduction for the impairment allowances for stage 1 and stage 2 impairment allowances. This was reiterated in Departmental Interpretation and Practice Notes No 42

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As well as 'business as usual' matters, Matthew has been involved in various significant engagements involving market entry, mergers and acquisitions, and divestment or restructuring of substantial businesses across various industries. This has included consideration of all aspects of the fund, investment and transaction lifecycle, as well as diligence on new markets and/or businesses.

Matthew graduated from the University of Otago with bachelor degrees in Commerce and a law. He is a member of the Hong Kong Institute of Certified Public Accounts and Chartered Accounts Australia and New Zealand. He was also admitted as a barrister and solicitor of the High Court of New Zealand.

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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.

Profits tax – taxation of financial instruments and taxation of foreign exchange differences (DIPN 42), in which paragraph 30 states:

> "HKAS 39 contains rules governing the determination of impairment losses. In short, all financial assets must be evaluated for impairment except for those measured at fair value through profit or loss. As a result, the carrying amount of loans and receivables should have reflected the bad debts and estimated doubtful debts. However, since section 16(1)(d) lays down specific provisions for the deduction of bad debts and estimated doubtful debts, the statutory tests for deduction of bad debts and estimated doubtful debts will apply. Impairment losses on other financial assets (e.g. bonds acquired by a trader) will be considered for deduction in the normal way."

Although DIPN 42 has no binding force in law, in practice, the IRD will generally follow the principles set out in their practice notes in determining the deductibility of impairment losses on financial instruments. Given that DIPN 42 was issued in November 2005, it is expected that the IRD will update the DIPN to reflect the substantial changes brought about by IFRS 9.

Whether the IRD could be convinced to allow a deduction on impairment losses (particularly at stage 1 and stage 2), is a matter for further consideration. The IRD has verbally stated that it will not change its assessing practice, notwithstanding the IFRS 9 changes. In the absence of changes to the IRD practice, taxpayers should consider the implications of having to calculate substantial deferred tax assets for disclosure in the financial statements.

Capital vs revenue

The accounting treatment of a transaction is not determinative of its tax treatment for the purposes of the distinction between capital and revenue, but it could be influential. In Hong Kong, capital gains are non-taxable and excluded from the calculation of profits tax. Whether gains are revenue or capital in nature is a question of fact. In this regard, consideration should be given as to whether the receipt relates to the disposal of an asset forming part of the permanent structure of a business or is a trading receipt, the former being capital in nature. Under IFRS 9, financial assets could be classified as amortised cost or FVOCI based on their contractual cash flow and business model. For these assets, it could be argued that the asset has remained part of a business model where the objective is to hold the assets for the long term and collect the contractual cash flows. This may support the argument that the gains are on capital account and therefore not taxable.

However, whether financial instruments are capital or revenue in nature (and thus whether gains or losses arising from the financial instruments are assessable or deductible for tax purposes) will still depend on the facts and circumstances of each case. This is particularly relevant as the IRD's starting position is that all assets of a bank are revenue in nature, unless proven otherwise.

Equity instruments accounted for through equity account

Under IFRS 9, an irrevocable election can be made to treat certain equity instruments as FVOCI, instead of FVPL. Upon election, only dividends are recognised in the profit and loss. All fair value movements are recognised in the equity account and never enter the profit and loss statement, even if the equity instrument is subsequently sold.

The IRD explained in the 2005 meeting with the Hong Kong Institute of CPAs, legal advice was sought from the Department of Justice, which advised that the fact that an item was not reflected in the profit and loss account (i.e. reflected in the equity account) was not determinative of the item's taxability or deductibility.

The IRD went on to say that an increase or a decrease in retained profits would be assessable or deductible in the year of assessment in which the prior period adjustment was recognised, if such profits or losses were revenue in nature and Hong Kong sourced. The IRD could, therefore, take the view that annual fair value movements through reserves should be taxed in the year in which they arise.

Transitional adjustments

On adoption of IFRS 9, there is no requirement to restate the prior period financials, unless the restatement can be done without the use of hindsight. If an entity does not restate comparative figures, any difference in carrying amounts should be adjusted against the opening retained earnings.

From a tax perspective, the IRD has stated in DIPN 42 that a prior period adjustment on trading assets to increase or decrease in retained profits should be treated as a taxable or deductible in the year of assessment in which the prior period adjustment is recognised in the retained earnings. The IRD also cited the case of *Pearse v Woodall-Duckhall Ltd*, [1978] 51 TC 271 that allows for the IRD to adopt this position.

During the adoption of IAS 39, the IRD did not allow taxpayers to defer the recognition of adjustments and to defer tax liabilities arising on the transition. To date, the IRD has not indicated how the IFRS 9 transition adjustments will be treated for tax purposes, but one would expect the same position that was taken in the transition to IAS 39.

Looking ahead

The implementation of IFRS 9 will be one of the most important accounting changes for banks in Hong Kong since the introduction of IAS 39. IFRS 9 will result in increased reported credit losses and more volatile movements, year-on-year, directly impacting a bank's regulatory capital requirements. The initial tax impact on the adoption of IFRS 9 will be apparent once the tax returns covering financial year ended December 31 2018 are filed in August 2019.

While the IRD continues to accept tax returns prepared on a fair value basis, this is an interim measure without legal backing. The Financial Services and the Treasury Bureau (FSTB) has submitted a proposed amendment to the Legislative Council (LegCo) for the adoption of fair value accounting for financial instruments for tax purposes. The FSTB is proposing to introduce an amendment bill to the LegCo in late 2018. One of the proposals is to allow taxpayers to make a one-time, irrevocable election for fair value reporting for tax reporting. The election would have effect in the year the assessment is made and for all subsequent years of assessment. However, there has been no mention of amending section 16(1)(d) to allow a deduction on impairment losses based on estimated losses prescribed under IFRS 9. The Hong Kong government is consulting the relevant stakeholders to provide their views on the proposed amendment to the IRO.

The proposed amendment by the Hong Kong government is a welcome move, and would provide clarity and certainty for practitioners and the general public. The IRD should also consider updating DIPN 42 to deal with the potential issues that would arise on IFRS 9's implementation, and to consider allowing a staggered recognition of transition adjustments.

Taiwan's forward looking tax policies

Taiwan refined its framework for taxing digital economy businesses in the past year, improved the tax rules for foreign enterprises operating regional logistics hubs, and updated transfer pricing (TP) provisions. Sherry Chang, Stephen Hsu, Hazel Chen, Ellen Ting, Lynn Chen and Betty Lee examine these important policy developments.

In view of Taiwan's rapidly evolving digital economy, the complex domestic imputation regime and the tax burden difference between domestic and foreign investors, the Taiwan government set out major tax reforms in 2017. This included imposing VAT on relevant foreign e-commerce service providers, as well as simplifying the corporate income tax (CIT) rules; the changes are described in last year's Taiwan chapter, *Taiwan: tax goes digital*. The tax reform rules were passed by the Legislative Yuan in January 2018, with some of the rules becoming effective from January 1 2018.

In 2018, tax changes continue to be adopted which affect the digital economy. Specifically, building further on the prior VAT changes, CIT is now also being imposed on foreign enterprises providing e-commerce services to Taiwan individuals. The Taiwan tax authority has also updated one of its key tax rulings relating to Taiwan-sourced income (TSI) derived by foreign business entities engaging in importing, storage, manufacturing and delivery of goods to domestic and foreign customers. Further, Taiwan continues to adopt the BEPS Action Plan changes, by amending its TP rules for the BEPS Action 13 measures on country-by-country reporting (CbCR) and the master file.

CIT regime extended to foreign e-service providers

Following on from the implementation of the new VAT regime for e-services provided by foreign e-services providers (detailed in last year's chapter), the Ministry of Finance (MOF) issued Tax Ruling 10604704390 (ruling). This addresses the income tax treatment for income derived by foreign e-services providers from e-services provided to onshore Taiwan customers.

Corporate income tax is applicable retroactively and covers transactions entered into from January 1 2017 onwards. Foreign e-service providers needed to self-report during the month of May 2018, in respect of the financial year ended December 31 2017.

There are two types of transactions addressed under the income tax regime: sale of e-services and services that are used with a specified physical location within Taiwan.

- The former refers to services that are provided and used through internet download or other electronic transmission to computer equipment or mobile devices. It also includes services that are provided and used online or via other electronic means (e.g. online games, online advertisements, and streaming services); and

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Stephen is an instructor both internally at KPMG in Taiwan, and externally at national Taiwan University's College of Management as a professor in the department of accountancy, and a lecturer at the training institute of the Ministry of Finance, ROC. Stephen serves as an advisor 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, ROC, and a member of the Government Information Office, ROC.

- The latter describes services that are provided through the internet or via other electronic means and used at a physical place, such as a hotel/lodging booking, or car rental services.

According to Taiwanese income tax rules, foreign entities are only subjected to income tax on income derived from Taiwan. For e-services, the following types of income are considered as Taiwan sourced:

- For the sale of e-services, income derived from services that are provided entirely outside Taiwan but require the assistance of a Taiwan-based individual or enterprise to complete the service provision; and
- For services that are used with a specified physical location within Taiwan, income derived from the use of services in Taiwan.

In terms of calculating the taxable income, the tax regime allows foreign e-services providers to claim actual costs and expenses incurred, or adopt a deemed profit ratio. The deemed profit ratio refers to the industry standard profit rate. As an example, if the taxpayer is assessed as a foreign platform service provider, the industry standard profit rate is 30%. The MOF also provided that where the relevant industry standard profit rate is not provided for the taxpayer, the default deemed profit ratio would be 30%. However, the use of the deemed profit ratio requires pre-approval from the tax authority.

In addition, the tax regime allows taxpayers to apply a 'contribution ratio', which can reduce the amount of revenue derived from Taiwan that is treated as Taiwan sourced and taxable. The contribution ratio divides income into a

Table 1

	Activities performed by foreign enterprises outside Taiwan		Activities performed by foreign enterprises in Taiwan				
#	Self-manufac-tured outside Taiwan	Procured outside Taiwan	Importing	Storage	Processing	Sales	Delivery
1	✓		✓	✓		Completion of sales while the goods are in Taiwan	To customers within and outside Taiwan
2		✓	✓	✓		Execution and completion of sales offshore	
3	✓		✓	✓	✓	Completion of sales while the goods are in Taiwan	To customers within and outside Taiwan
4		✓	✓	✓	✓	Execution and completion of sales offshore	

part deemed attributable to activities conducted in Taiwan and a part deemed attributable to activities conducted outside Taiwan. The taxpayer can determine its actual contribution ratio as supported by evidentiary documents (e.g. CPA audit report, TP report, work plan or records, etc.) Alternatively, it is to apply a 100% rate if the relevant transactions take place entirely in Taiwan, or if services are both provided and used onshore, for example, Taiwan advertisers only targeting Taiwan audiences.

Where neither the actual contribution ratio nor the 100% contribution ratio is appropriate, the 50% contribution ratio can be used. Although there is no prescribed reasoning on the use of the 50% contribution ratio, such ratio appears to take into consideration and balance both the foreign e-service provider's compliance costs and the Taiwan tax authorities' own review and assessment efforts. Similar to the utilisation of the deemed profit ratio, the use of the contribution ratio also requires pre-approval from the tax authority.

New calculation method for TSI for foreign businesses that import, store and manufacture in Taiwan

On April 17 2018, the MOF announced a tax ruling (No 10600664060) to interpret the new calculation method for TSI derived by foreign business entities with a fixed place of business (e.g. a logistic hub) engaging in importing, storage, processing, sales and delivery of goods to domestic and foreign customers with a view to encouraging more foreign enterprises to consider Taiwan as a logistics hub for the region. According to the ruling, the profit standard rate and contribution rate (simplified calculation method) could be adopted by foreign entities conducting the above-mentioned activities that are not limited to the areas of free trade zones or bonded areas (as was the case for certain such rulings in the past). The contribution rate has also been reduced substantially to create a more reasonable tax burden.

The transaction types eligible for this ruling can be broadly divided into four categories, as outlined in Table 1.

For transaction types 1 and 3, where the primary manufacturing activities for the foreign enterprise are outside of Taiwan, provided that the completion of the sales of the goods are in Taiwan, the profit contribution ratio in calculating TSI over the entire transaction flows will be reduced from 12% (from previous rulings) to 3%.

For transaction types 2 and 4, where the foreign enterprise procures its goods outside of Taiwan and then imports the goods into Taiwan for sale or simple processing in Taiwan, provided that the execution and completion of the sales of goods occur in Taiwan, then the profit

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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.

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

contribution rate (which cannot exceed 100%) in calculating TSI should be calculated based on the formula set forth under the ruling:

> Contribution rate = 3% + (costs and expenses of manufacturing and processing incurred onshore/total costs and expenses incurred onshore and offshore).

The new tax ruling enlarges the scope of applicability of the simplified calculation method for foreign business entities engaging in importing, storage, processing and delivery of goods to domestic and foreign customers. The contribution rate to determine the contribution of the activities conducted in Taiwan over the entire transaction flow is reduced for foreign entities who merely engage in logistics and manufacturing. Therefore, this tax ruling should be considered beneficial to taxpayers. Foreign business entities that may qualify under this ruling would be well advised to review their corporate income tax returns that have yet to be assessed by the Taiwan tax authority and seek the opportunity to claim a tax refund where appropriate.

In addition, one of the necessary criteria to constitute TSI under each of the transaction types is that the sales of goods are completed within the territory of Taiwan. However, further clarification should be provided by the MOF in relation to the detailed rules and applicable conditions to determine whether the sales of goods are completed outside of Taiwan.

Transfer pricing, CbCR and master file

In late 2017, the MOF announced amendments to the Regulations Governing the 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-tiered TP documentation as suggested by the OECD under BEPS Action 13. The latest amendments will apply to fiscal years from 2017 onward. The three-tiered TP documentation is composed of a TP report, which was already implemented from 2005, with the two new additions of the CbCR and the master file (MF). Major amendments include the multinational enterprises (MNE) that have members in Taiwan who may be

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required to file an MF and a CbC report. At the same time it might be noted that the substantive provisions of Taiwan's TP rules have not yet been brought fully in line with the BEPS changes, for example, the concept of development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE), and so on.

In view of the compliance costs for MNEs in preparing TP documents, the MOF further released safe harbour rules for the master file and CbC reports in Taiwan, after considering international practices, national conditions in Taiwan and public opinion. The content and covered entities involved are consistent with the OECD template.

Disclosure requirements

This year (2018), Taiwan adopted the three-tier TP documentation in local regulations. Hence, Taiwanese entities with annual consolidated group revenues that exceed T$27 billion ($880 million) will be required to disclose whether they will be the filing entity for CbCR in the TP disclosure forms as part of their CIT returns.

If the ultimate parent company (UPE) is a Taiwanese entity

When an entity in Taiwan is the UPE of an MNE group, it will be required to submit a CbC report for the fiscal year in the prescribed format, and submit the same to the local tax authority within one year after the end of the financial year.

If the UPE is a foreign entity

When an MNE group's UPE is located outside Taiwan, one of its constituent entities in Taiwan will be required to submit the CbC report to the Taiwan tax authority if one of the following conditions apply:

- The UPE of the MNE group is not obliged to file a CbC report in its country/jurisdiction of tax residence;
- The UPE has filed a CbC report in its country/jurisdiction of tax residence, but such country/jurisdiction does not have an agreement to exchange CbC reports with Taiwan by the CbCR filing deadline in Taiwan; or
- The UPE has filed a CbC report in its country/jurisdiction of tax residence and such country/jurisdiction has an agreement to exchange CbC reports with Taiwan, but

the Taiwan tax authority is unable to effectively obtain the CbC report in accordance with the agreement.

Thresholds for the master file and the CbC report

A Taiwanese entity that meets either one of the following conditions will be exempt from filing the master file:

- The Taiwanese entity's total annual turnover (including operating and non-operating turnover) has not exceeded T$3 billion; or
- The Taiwanese entity's total cross-border controlled transaction amount has not exceeded T$1.5 billion.

An enterprise in Taiwan that meets any of the following conditions will be exempt from filing a CbC report:

- The UPE of a MNE group is a Taiwanese entity with an annual consolidated group revenue of less than T$27 billion in the previous fiscal year;
- A Taiwanese subsidiary/branch has a UPE outside of Taiwan, and meets one of the following:
  - The jurisdiction of tax residence of the UPE has statutory provisions to file the CbC report, and also meets the exemption requirements to file the CbC report;
  - The UPE's jurisdiction of tax residence does not have the statutory provisions to file CbC reports, but the MNE appoints one of its members to act as a surrogate parent entity (SPE) to file the CbC report, which meets the exemption requirements for CbCR; or
  - The UPE's jurisdiction of tax residence does not have the statutory provisions to file CbC reports, nor does it appoint a SPE, but it meets the exemption requirements for CbCR in Taiwan (an annual consolidated group revenue during the fiscal year immediately preceding the reporting fiscal year that does not exceed T$27 billion).

For foreign entities in Taiwan, if the group's revenue exceeds the T$27 billion threshold or €750 million ($855.5 million), or a near equivalent amount in another currency, it is important to know whether the CbC report filed by the UPE or SPE can be successfully exchanged with the Taiwan tax authority.

In view of the fact that the 2017 tax year was the first year that Taiwan had implemented the requirements on CbCR, it has a reciprocal arrangement with New Zealand only. This came about under a recent tax ruling, whereby New Zealand could effectively exchange CbC reports with Taiwan as of April 27 2018. This means that any Taiwanese entity with a UPE or SPE located anywhere other than New Zealand would have had to indicate itself (or another MNE member in Taiwan) as the filing entity for the 2017 CbCR under the TP disclosure forms during the 2017 CIT return process.

It is possible that Taiwan's MOF may update the list of countries to allow an effective CbCR mechanism intermittently and without prior notice. Therefore, it is recommended that Taiwanese entities of foreign MNE groups seek advice from their tax consultants and monitor for any further developments regarding the list of treaty countries after the CIT filing. It is expected that further details/guidance on practical issues for CbCR will be released by the MOF in the near future.

Final thoughts

Given Taiwan's excellent geographic location and talent pool, the government has always encouraged foreign enterprises to invest in Taiwan. This is evidenced by the various tax changes that have taken place in Taiwan in recent years, including research and development incentives, more flexibility in share-based compensation schemes, a major reform to the imputation tax regime with a view to simplifying the system, and so on. Despite the increase in the Taiwan CIT rate from 17% to 20% effective from January 1 2018, the overall effect of the changes is to better align the Taiwan tax system with international practices. The new tax ruling issued by the MOF in April this year, for foreign businesses engaging in importing, storage, processing sales and delivery of goods, clearly sends a positive message to the market and to foreign businesses specifically.

For the changes discussed above, we are expecting more detailed guidance to be provided in due course. It is recommended that existing and potential investors closely monitor the development and implementation details of the changes to ensure that tax risks and obligations are appropriately managed and compliance requirements are met, while tax opportunities are appropriately secured. Further, as tax information becomes more accessible to the Taiwan tax authorities, increases in tax audits should be expected.

We note that many Taiwan MNEs have their manufacturing facilities in China. Given the increasing costs in China, the US tax reforms and the recent US tariff policies against China, Taiwan businesses are looking into the possibility of investing into the US and revisiting its manufacturing supply chain with a view to reducing the negative impact to their overall groups' profitability. As such, given Taiwan's continuing encouragement of foreign business, including welcoming the return of Taiwan enterprises' overseas operations to Taiwan, it may now be a good time for businesses to review their supply chains in the medium to long-term perspective.

Pushing the digital frontiers of tax in China

Drawing on China and international experience with the digitalisation of taxation, in particular as it relates to indirect taxation, Lachlan Wolfers, Vincent Pang, John Wang and Grace Luo chart out the possible future of tax rules, tax administration, and the tax profession itself.

The term 'digitalisation' is much like beauty – its meaning is in the eye of the beholder. This is even more evident when using the terms 'digitalisation' and 'tax' together, which can reasonably mean different things to different people, depending upon the precise context in which those words are used.

The term 'digitisation' refers to the taking of analogue information and encoding it to a digital form (for example, into zeroes and ones), so that computers can store, process and transmit such information. By contrast, 'digitalisation' refers to what happens to processes, with the digitisation of information facilitating this as a supporting step. Digitisation is seen to have been taking place for decades, whereas digitalisation is seen as relatively new.

By way of illustration, 'digitalisation' and 'tax' can refer to the way in which technology is deployed in managing tax obligations; it can refer to the ways in which digital economy businesses are impacting upon tax collections; and it can also refer to the ways in which tax administrators are advancing their digital agenda.

This article seeks to explore each of these themes and, most importantly, how they converge.

The inspiration for this article came from a KPMG colleague, who recently put forward this view in an informal discussion: "In the end, interpretation and judgment by the human brain will always be smarter than artificial intelligence". He was putting forward a view espoused many times by tax professionals, to the effect that there will always be an important place for judgment, for experience and for empathy, alongside knowledge in the management of tax functions.

As we plot a path to the future, the authors' wish to posit this question – what if tax rules and regulations and their administration change to such an extent that judgment, experience, empathy and knowledge diminish in their relevance? In other words, when we contemplate the future, we need to consider the impact not only of technological advances, but also developments in tax rules, regulations and their administration which will become increasingly digitalised.

A short example may be used to give this context. The authors were recently shown a demonstration of a technology product called the 'Tax Intelligence Solution'. This solution allows businesses to track their permanent establishment risk by reference to data and analytics carried out on transaction level data collected through a company's enterprise resource planning (ERP) system. What made this demonstration particularly interesting is that its creators had sought to reduce complex and somewhat nebulous concepts of permanent establishment to a series of data points. And then it dawned on us, if technology solutions can be developed to test complex concepts such as permanent establishment with a reasonable degree of accuracy, why should we not expect tax legislation to similarly evolve so that taxes are actually imposed by reference to data points? And even then, it's not difficult to foresee a step change to actually imposing those taxes on a transaction level basis. Corporate taxation, in its existing form, would be dead – a theme we revert to a little later.

This article is deliberately provocative, and whether readers agree or disagree with its conclusions, it is simply hoped that it inspires tax professionals to critically think, to challenge the status quo, and to start to change their future. To those readers who prefer to keep doing 'the same old thing', the future of the tax profession may therefore look rather grim (if indeed the future is correctly predicted here). However, the reality is that many tax professionals enter the profession because they are attracted to its fast-changing nature, and for them the future looks exceptionally bright. The challenge is to cast one's eyes to the future, but then to start now on a journey of self-learning and development.

Before we begin, here are a few key propositions or themes which run through this article:

- To understand the future of tax in a highly digitalised world, watch the progress of value-added tax (VAT) since it will guide many of the changes to other taxes too;
- The world of corporate tax will be completely upended over the next 10 years as it struggles to adapt to digital economy business models;
- In the future most taxes will be imposed by reference to a series of data points, designed to replace many forms of decision-making; and
- The challenge for the modern tax professional (whether working in an in-house or external role) will be to manage the data, identify any discrepancies or trends, and gain control and draw insights from it.

Let's explore these key themes now.

How things were 20 years ago

The famous quote that "history is the best guide to the future" (Bill Dedman) is the starting point for our journey. So let's look at how things have already evolved over the past 20 years or so.

Twenty years ago, libraries in professional services firms maintained looseleaf services in which tax professionals could look up legislation, recent case law and commentary on what the law meant. The information was stored in a 'looseleaf' service because the librarian could literally remove a 'leaf' or page from the book and replace it with a new page, as legislation, case law and commentary was updated. These updates typically occurred every three months or so, meaning that the 'most recent' changes were in fact about three months old.

Email was still relatively new, and telephone, facsimile and couriers delivering letters were the dominant means of communications with clients.

By and large, most tax advice given to clients consisted of looking up the relevant provisions and applying them in a straightforward simplistic way. In a sense, we had information which our clients did not possess. They paid us for this information.

Businesses were reasonably straightforward. Globalisation had yet to fully emerge, so most business models were domestically based, and they all had a physical office or factory or other permanent establishment from which they operated.

Progress over the past 20 years

Major developments in technology have already transformed the tax profession over the past 20 years, yet many of us do not even recognise them.

Take the earlier example of clients merely paying for access to information. Already, that has largely ended. The tax professional's role has quickly transformed such that we are paid for insights, for our experiences and for our professional judgment. The idea of simply passing on information ceased with the advent of the powerful search engines such as Baidu or Google. Put simply, those search engines gave clients the ability to access that very same information. However, understanding what that information means and how to apply it, has been the most recent wave of progress.

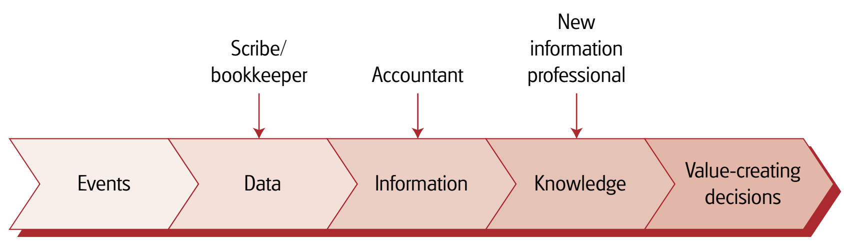
The progress chart in Figure 1, which dates back to a 2002 article in the American Accounting Association journal (by Elliott & Jacobson, entitled 'The Evolution of the Knowledge Professional'), provides a good overview of the evolution that has taken place in the accounting profession.

The speed of these developments has been hastened by tax authorities too, given the vast amounts of information they make available online. Whereas previously, such information could only be 'learned' through actual experiences, now tax professionals can often ascertain the local practices of tax authorities across China simply by the click of a button. In short, information is now more freely available and therefore more 'free' than ever before.

How things are today

As we have seen, the tax profession has already changed considerably in ways we rarely take the time to notice, with the major change being the way in which our clients consume information. Here when we refer to 'clients', they may comprise either the external customers of our organisation, or the internal stakeholders who rely upon our work.

Figure 1



Both of these categories of client are typically now less prepared to seek technical advice than they did previously. There are several theories which may be posited to explain why clients are now less prepared to seek such advice, including:

- In many developed countries, from the 1980s, there was a shift to 'purpose-based' tax rules. This saw the move away from literal interpretations of tax law, encapsulated in what is commonly known as the 'Duke of Westminster principle' (which allowed for greater certainty, but facilitated tax planning) towards more purposive based approaches. This was paralleled by many countries adopting general anti-avoidance rules. These developments resulted in less certainty in tax advice.
- A further development was the internationalisation of business, which brought with it the potential for greater instances of double taxation and disputes. Given that the main means of mediating these issues was through transfer pricing – a body of tax which is based on economic analysis that can be argued for and against without any single source of truth – this also introduced further uncertainty.
- The influence of accounting standards and tax provisioning, with probabilistic elements feeding into arriving at tax numbers, has also played a role in bringing the focus down to 'the number'.
- Additionally, the speed of tax rule changes across countries also means a more confusing and less stable tax environment.
- To the extent also that activities in emerging economies became more central to the operations of multinational companies, the fact that tax practices in many of these countries are based less around the law and more around local practices, a technical opinion also came to have less value.

Ultimately then, it might be said that a number of factors has contributed to undermining the possibility and relevance of legal certainty, and has led clients to a greater focus on probabilistic outcomes, with consequent implications for the assistance they seek from both in-house and external tax advisors.

This has led to a much greater tendency for clients to want 'just the answer'. In other words, they see tax decisions as coming down to the question of whether to put a number in a box on a tax return (or not). Uncertainties, assumptions and facts are merely hurdles to be overcome in this quest.

The next big trend, which is only really beginning to emerge now, is around benchmarking, where clients want to understand how they are positioned relative to others. Instead of asking what they should do, clients are now more likely to ask 'what do others do?' It is no coincidence that the rise of benchmarking has mirrored developments in how tax authorities manage risk too – increasingly they look for statistical outliers and then they use those as the basis to raise queries and to carry out audits and inspections. Expect this wave of benchmarking to continue for many years to come, simply because it is one form of data and analytical testing, which we explore further below.

A related issue is whether we have already reached the high watermark of tax authority cooperative compliance approaches with taxpayers. Over the past five to 10 years, these cooperative compliance models have benefited tax authorities in facilitating greater levels of voluntary compliance, and thus allowed tax authorities to dedicate their limited resources to other higher risk taxpayers. But in a data driven world of today (and tomorrow), what if the tax authorities no longer need our cooperation? What if they know the problem before we do? By way of example, in Brazil the tax authorities are nearly approaching this point through tax and accounting data which is fed into the 'SPED' system, with discrepancies between actual and expected results triggering taxpayer queries. Along similar lines, Poland has just announced that it will eliminate VAT returns because they will already have all of the data through the SAF-T reporting system.

Interestingly, while these developments have emerged over some time, curiously, when it comes to how we manage tax compliance obligations, progress over the past 20 years has seemed far more muted.

For example, many in-house tax professionals continue to obtain data from the company's ERP systems and from the Golden Tax System, they prepare reconciliations to that data, they make manual adjustments to scrub, cleanse and generally rid themselves of poor quality content, and then they proceed to prepare endless Excel spreadsheets and work papers which are shared and approved by reviewers. The documents are stored to provide a suitable audit trail in the event queries are raised.

And then those in-house tax professionals do exactly the same thing again the following month: an exercise which typically begins on day 1, and often ends around day 15 (or the relevant filing date).

All of this so that they can file a tax return with a reasonable degree of accuracy. This is carried out either monthly, quarterly or annually for most businesses filing VAT, corporate income tax (CIT) returns, individual income tax (IIT) withholding, stamp duty and other returns.

It hardly seems very advanced or sophisticated, does it?

As noted earlier, there has often been a gap (or in some organisations, a hierarchy) between tax advisory work and tax compliance work. A divide often created because this work has been performed by different people within the same organisation, resulting in very few insights and little analysis drawn from one area into the other. For example, in many large organisations, in-house tax advisory professionals have literally been advisors to the business, in responding to developments and tax issues raised by the business, without always being responsible or accountable for the tax returns and the amount of taxes actually paid. Many of them would argue they have too little assurance and control over the completeness and accuracy of the data driving those tax (filing) positions; with this responsibility often resting with other business functions. Separation and lack of ownership over tax compliance by tax advisory functions within an organisation is difficult to justify in a data driven world.

This will change, and this will surely be the hallmark of the next 10 years or more in the tax profession.

Put simply, tax compliance work will become very highly automated; it will become highly data driven; with data and analytics technology providing insights from that compliance work so as to drive the agenda for tax advisory work. The era of tax automation and digitalisation is just beginning.

And then the world changed

Now let's wind forward to the year 2040. Imagine ourselves sitting in our self-flying autonomous vehicles (because why limit ourselves to the road when there is a whole dimension called airspace we can occupy) and ponder this. We are telling our grandchildren about what we did in the olden times just over 20 years ago. We tell them about how we prepared tax returns back then and they laugh at the ridiculously inefficient and quaint way in which it operated. They chuckle at the extent of trust which underpinned our tax systems, at the enormous workload and manpower required to administer it, and of these funny things called invoices or *fapiaos*.

And then we tell them this is what we all did for a living, before one of the gigantic technology companies (we are not going to predict who), decided to disrupt the tax system once and for all.

This gigantic technology company figured that because they owned and controlled most of the world's transaction infrastructure, either through their platforms, their payment processing capabilities, or their cloud storage facilities, that they could automatically construct tax returns from transaction level data, automatically divert the funds from the proceeds of those transactions so that tax could be calculated, determined, inspected, audited and paid in real time. They did this not only for VAT, but they also developed transaction level analytics for CIT purposes, automated transfer pricing adjustments, and remitted IIT withholding on salaries and wages. In short, they built a 'total tax solution' because they owned the data, the infrastructure and controlled the means of payment to enable it, and they charged service fees for providing this valuable tax collection service to governments. Quickly governments around the world seized on the opportunity to reconfigure their tax rules – they recognised that if tax fit the way business was operating they would collect far more than if they maintained their same regimented tax systems which were becoming increasingly obsolete and divorced from a digitised world.

Is this idea far-fetched, or is it feasible? Let's explore this a little further.

It started with a VAT and then it moved from there

In this futuristic world of 2040, we have predicted the (near) total automation of taxation – every aspect from its scope, to its rules, to its collection, administration and enforcement will be digitalised. But it all started with VAT. Let's take a look at how VAT led the way.

Perhaps the most dramatic change to tax systems around the world in recent times has been the growth of indirect taxes. More specifically, VAT and GST systems have grown from being implemented in only a handful of (predominantly) European countries, to now being in over 160 countries around the world. Likewise, the proportion of total tax revenues raised from consumption taxes has nearly doubled from 11.9% in the 1960s to 20.6% in 2015, and the average VAT rate among OECD countries has now increased to

19.2%, based on data produced by the OECD in its 2016 Consumption Tax Trends.

In a typical supply chain in which a manufacturer supplies goods (or components of goods) to a wholesaler who in turn supplies finished goods to a retailer who then supplies to an end consumer, a traditional VAT system would produce the following outcomes:

- Three separate parties accounting for output VAT (the manufacturer, the wholesaler and the retailer), with only one of those parties (the retailer) raising any real revenue. The government is effectively 'at risk' as a creditor for the payment of the VAT from those parties;
- Three separate parties accounting for input VAT (the manufacturer, the wholesaler and the retailer), which again places the government at risk, though none of those parties is the person who is meant to economically bear the tax; and
- All of this is done so that when the end consumer purchases goods or services, the VAT which is embedded in the final price they pay is subjected to tax.

By describing in this way how a VAT works should be sufficient to identify its inefficiencies and its potential for technological disruption. However, rather than fearing the demise of a VAT, the authors take the view that it has several features which make it to be most likely to lead the way (among taxes) as we move towards this futuristic world of 2040. Consider this:

- A VAT seeks to tax final the private consumption expenditure of goods and services. It is collected from businesses, yet it is economically imposed on end consumers. The fact that it taxes the consumption of goods and services makes it about as certain to continue as any other form of taxation. While supply chains and the ways in which goods and services are manufactured, processed, sold and delivered may be disrupted, consumption is always inevitable;
- A VAT is a transaction driven tax. It is relatively more efficient to collect than many other forms of taxation; and
- It applies what is known as the destination principle – meaning, that the tax is collected from consumers in the jurisdiction in which the relevant goods or services are consumed.

Each of these features make a VAT far more effective in a digitalised world. Put simply, consumers will continue to consume, and the alignment created by a VAT between a business' self-interest in developing a market for the sale of goods or services and the collection of tax in the place in which those goods and services are consumed, prevents many of the same 'tax wars' which marked the period from 2020 to 2030 (as discussed further below). However, where there is misalignment in a VAT, it is in the process for its collection as described above – which is highly inefficient.

In the near future, VAT systems will evolve to being akin to single stage retail sales taxes which are collected at the point of sale from end consumers, with digital certificates being used to avoid the need to collect and remit on business-to-business transactions. Fundamentally, with these changes, indirect taxes should survive and even thrive as the level of VAT fraud is progressively reduced and the cost of collection decreases. In short, VAT is perhaps already the tax most digital-ready, and the evolution described above will remove the final impediments to its domination.

Why VAT is a useful guide to the future

Now let's look at a few specific examples to support why we say the pathway of a VAT serves as a useful guide to the future of taxation.

The first example is the way in which VAT rules are already being introduced to remove judgment and knowledge, in favour of digitised concepts. For example, in the EU (Council Regulation 1042/2013, Articles 24b(d) and 24f), to determine the place of supply of certain digitised services, the service provider needs to obtain two non-contradictory pieces of evidence about the location of the consumer. In other words, legislators have already recognised that determining the place of supply should no longer be based on nebulous concepts such as the residency of the consumer, or the place of the consumer, or even where the consumer has actually used or enjoyed the supply. Rather, it should be based purely on data points such as the customer's IP address, his/her delivery address, bank details or the country code of the SIM card being used.

Taxation based purely on data points rather than relying upon 'judgment' or 'knowledge' by an individual is, in the authors' opinions, among the next wave of change to sweep through tax regulations.

The second area in which VAT is evolving is in the imposition of liabilities on businesses which do not own the relevant goods or services, but rather, facilitate the transaction through their online platforms. We are referring here to the phenomenon of imposing VAT liabilities on online marketplaces – first introduced in Australia, and shortly to be adopted in places such as the EU, New Zealand, Singapore, and so on – consistently with the work carried out by the OECD's Working Party 9 on Consumption Taxes.

To be clear, the concept of collecting tax liabilities from a person other than the party earning the relevant income or deriving the gain is nothing new. Withholding taxes have worked on this basis for some time. But what makes this VAT phenomenon especially interesting is that liabilities are now being collected from non-resident (suppliers) in preference to collecting the VAT from resident (consumers). Literally the converse of what is ordinarily seen with withholding taxes.

How does this work?

While in its infancy, the underlying or implicit foundation for the operation of these rules is that online marketplaces will account for the VAT as a price for their licence to operate in that jurisdiction. If they fail to account for the indirect tax, they risk tax authority action (at the moment achieved through cooperation between their home jurisdiction and the jurisdiction in which they are transacting), they risk goods being stopped at the border, they risk their platforms being disconnected from consumers in that jurisdiction, but perhaps most of all, they risk reputational damage.

Interestingly, the digital economy was initially seen as a force which would sweep away traditional intermediaries and with it many of the traditional taxing points which could be leveraged by tax authorities for tax collection purposes. However, the recent emergence of online platforms has re-intermediated this activity, and provided a new optimal taxing point for tax authorities.

It does not take a big stretch to imagine tax authorities seeking to expand upon these concepts in requiring VAT to be collected by online platforms for purely domestic transactions too. The obvious attraction for tax authorities lies in the fact that they perceive the ability to better enforce compliance against a small number of large online platforms than to collect and enforce from a large number of smaller retailers.

Along similar lines, several South American countries (such as Colombia, Costa Rica and Argentina) are changing their indirect tax legislation to impose VAT withholding or collection obligations on debit or credit card providers – effectively a form of 'point of sale' tax collection. Similarly, several European countries are trialling the use of split payment methods. Ultimately, with the rise of payment providers or gateways, it would not be difficult to foresee the rise of tax collection taking place from them.

So what does this tell us about the future of taxation?

It tells us to expect the future digitalisation of tax regulations so that our tax rules will increasingly be aligned with digital business models. This may result in the imposition or allocation of taxes being based on fixed or objective data points rather than nebulous concepts. Thus the impetus for better managing data becomes ever more urgent.

Related to this is the belief that 'data managers' will be among the next wave of professionals sweeping through organisations. These are people whose role it is to go beyond motherhood statements around poor data quality; people who can identify the root causes of data problems and define how they may be overcome.

It also tells us to expect more and more taxes to be collected from third parties who merely facilitate or enable transactions. Another way of framing this is to speculate whether 'trust' is being removed from many indirect tax systems in favour of a 'follow the money' approach. Ultimately though, these are merely baby steps in a journey towards real time tax collection, which is expected to take hold once developments in the technology needed to support it evolves.

CIT challenges over the next 10 years

If VAT merely needs evolution to grow over the next 20 years, then CIT will require a revolution.

As mentioned earlier, VAT rules in most jurisdictions (including in China) apply the destination principle. As Professor Rebecca Millar recently noted (in 'The Future of VAT in a Digital Global Economy 2014'), there is a real contrast in the challenge for policymakers dealing with corporate taxes as compared with indirect taxes:

> "Yet the conclusion that 'something needs to be done' simply does not have the same significance for VAT as it does for income tax. This is not because VAT on global digital transactions is easy to collect: it is not. Nor is it because VAT raises different collection problems than income tax: for the most part, it does not. What is different about VAT is the almost universal agreement on the substantive jurisdictional principle that should be used to determine the tax base. Some countries might pay lip service to the destination principle, particularly countries with limited tax collection capacity and a high reliance on VAT to meet their revenue needs. Other countries – or their tax administrations and/or courts – might disagree about what the destination principle requires in particular circumstances. Nonetheless, there is little or no significant disagreement on the fundamental principle. Nor is there any significant disagreement about the most important aspect of the neutrality principle, which entails the notion that there should generally be no tax burden on business-to-business (B2B) transactions under a VAT. Thus, whatever it is that needs to be done, it is unlikely to involve a fundamental re-think of the jurisdictional basis upon which decisions are made about which country has the right to tax consumption. [Footnotes omitted]"

For many years, the corporate tax debate has centred on questions of 'residence' or 'source'. Questions around the extent of presence required before creating a permanent establishment were ever-present, and even then, once identified, the focus became one of determining or allocating the profits attributable to that permanent establishment.

With the growth of the digital economy, these concepts are now under more scrutiny and strain than ever before. That scrutiny arises because digital business models create the circumstance in which a company situated in country A can readily supply goods or services and derive profits from consumers in country B, without the creation of a permanent establishment.

There is perhaps no better recent example highlighting this scrutiny and strain than the US Supreme Court's decision in *South Dakota v Wayfair Inc* 585 US (2018). In that case, the majority of the court overturned settled law which had required the physical presence of a company in a particular state as a prerequisite for them incurring sales tax compliance obligations in that state. The view of the majority judges included the following:

> The "dramatic technological and social changes" of our "increasingly interconnected economy" mean that buyers are "closer to most major retailers" than ever before – "regardless of how close or far the nearest storefront." *Direct Marketing Assn v Brohl,* 575 US (2015) (Kennedy, J, concurring) (slip op, at 2, 3). Between targeted advertising and instant access to most consumers via any internet-enabled device, "a business may be present in a state in a meaningful way without" that presence "being physical in the traditional sense of the term." Id, at (slip op, at 3). A virtual showroom can show far more inventory, in far more detail, and with greater opportunities for consumer and seller interaction than might be possible for local stores. Yet the continuous and pervasive virtual presence of retailers today is, under *Quill*, simply irrelevant. This court should not maintain a rule that ignores these substantial virtual connections to the state.

While this case was about US sales taxes (coincidentally a form of indirect taxation in which this decision gave effect to its evolution), precisely the same arguments could be made from an international corporate tax perspective too. Yet curiously, nothing similar has been done.

In earlier stages of this debate, the OECD and government authorities focused on identifying the unique aspects of digital business models which enabled this phenomenon of being able to carry on business in one jurisdiction yet earning profits in another (without a physical presence). However, it soon resulted in a fruitless attempt at 'pigeonholing' digital businesses into particularly types. Moving forward, there is increased recognition that separately categorising digital business models runs the risk of premature redundancy as more and more 'bricks and mortar' companies develop similar features too.

Thus the new debate taking place in a CIT context tends to focus on three main questions:

- Where is value being created?
- How do we measure (or allocate) the value which is created?
- What does this mean for existing permanent establishment concepts?

In very simplistic terms, these questions are really asking about both nexus and profit allocation concepts. These are pretty fundamental issues.

Each of these questions focuses on the debate from a point of principle, and therefore from a theoretical or academic perspective, they are difficult to fault. But are they pragmatic? How would they be implemented by tax authorities in both developed and developing countries? How would they withstand the test of time? How will they be handled by politicians, keen to ensure their country gains a 'fair share' of tax revenue? And how will they be perceived by the general public, eager to ensure increasingly powerful technology companies pay tax in a way which bears a reasonable relationship to the revenues earned in their country?

Rather than set out in detail the academic arguments in this debate, in the authors' views, we consider it likely that pragmatic approaches will prevail. Academic arguments in this area tend to become problematic when one recognises that there are almost as many theories, arguments and positions as there are jurisdictions involved. Each of the academic arguments is seized upon by those seeking to pursue their own country's tax agenda – whether it be to protect their own businesses, or to assert a claim to tax revenue for their citizens. And furthermore, ultimately any solutions must be capable of measurement and implementation.

This divergence of opinion is best illustrated by Diagram 1.

The tax 'bingo' game taking place right now involves guessing which country can be assigned to which particular group – an outcome which can fairly easily be determined by asking whether that country is a net importer or net exporter of digital products and services to the world.

In 2018 the OECD attempted to lay forth both short-term and long-term measures to tackle the tax problems arising from the digital economy. The short-term measures, which involved the imposition of digital services taxes did not meet with support, yet has already triggered a first wave of EU countries seeking to go it alone.

The year 2020 is expected to be a watershed year in the development of tax solutions to the challenge of digitalisation, which coincides with the expected release by the OECD of its final report on the tax challenges arising from digitalisation. Either global policymakers will make a major breakthrough, and arrive at a cohesive framework which somehow binds together the above three disparate groups; or they will fail and countries will go their own way. The end result if an accord breaks down, is undoubtedly double taxation, and perhaps even the beginning of the 'tax wars'.

The Head of the OECD's Tax Policy and Statistics Division David Bradbury was recently quoted (in Tax Notes International, September 10 2018) as saying: "We're under no illusions as to how challenging it will be to reach consensus on these very difficult issues" – perhaps an understatement given that the Group 1 countries recognise the need for change while the Group 3 countries do not, yet the Group 2 countries see the problem as being much broader than that of the digital economy. In other words, there is not even consensus as to the scale of the problem, let alone consensus as to how to solve it.

Interestingly though, Pascal Saint-Amans, OECD director of the Centre for Tax Policy and Administration, is referred to in the same article as speculating that the

Diagram 1

Divergent Perspectives

The views of countries can be categorised into three groups

Group 1	Group 2	Group 3
• User participation is value creation • Targeted measures needed • Otherwise maintain existing international framework	• Digitalisation challenges existing international framework • Such challenges are not exclusive to DE	• BEPS appears to be effective • Full impact yet unknown • Satisfied with existing framework • No significant reforms

"debate would shift toward determining how to allocate taxing rights first, then defining a nexus for taxing the digital economy, instead of the other way around". This is the mathematical equivalent of seeking the answer (i.e. the amount of tax to be raised) before knowing the formula (i.e. the policy settings) to arrive at it.

In a pragmatic sense though, the authors agree with Saint-Amans. Countries (and their political leaders) will undoubtedly want to know how much tax revenue they would stand to gain (or lose) before they define the rules used to impose them. However, when it comes to defining those rules, we would speculate that corporate taxes which take on more of a destination basis as part of their tax base, and which are imposed on transactions, will need to prevail.

In the authors' views, destination-based transaction taxes will prevail for the very simple reason that they achieve a greater alignment in the collection of tax and business self-interest than traditional sourced-based taxation rules. However, whether that outcome is achieved through the expansion of permanent establishment rules, through the imposition of digital services taxes, though the imposition of alternative forms of minimum taxation, or even through changes to transfer pricing and profit allocation methodologies remains to be seen. Ultimately though, these are merely the mechanisms which produce the shift to more destination-based transaction taxation – a key feature of which has made the rise of indirect taxation systems throughout the world so effective. The next big challenge would then be to combine a destination-based corporate tax with an indirect tax into a form of super-taxation!

In short, for all of these reasons, we tend to the view that CIT will evolve so that it much more closely resembles indirect taxes in the sense that they will be collected in the place where consumption occurs, and on a transactional basis. Let's explore these reasons:

- As noted previously, while the future model is subject to much debate, we do consider that some change will happen. The ability for a company to be located in country A, yet carry out substantial business operations (and earn profits) in country B is well recognised. It may be the model that is being used by many 'pure' digital economy companies, but over time, its extension to areas such as fintech, the healthcare sector, traditional retailers, banks and other financial institutions, even professional services, can hardly be doubted. Thus, the argument for change has an air of inevitability about it.
- Both the OECD and the EU have recently issued reports examining the potential introduction of digital services taxes. These taxes, intended to be turnover based, are to be applied to three categories of transactions – advertising revenues, intermediation services and data transmission. Their goal is to collect and impose taxes on digital platforms able to derive substantial revenues (and profits) from consumers in a country without having a physical presence. What is interesting about these taxes is that in economic form they may be regarded as direct taxes, but in substance they rely on indirect tax collection methodologies. That is, in identifying the location of the consumer, the nexus between the type of service provided to that consumer and the revenue earned from that consumer. Jurisdictions such as India, Chile, Uruguay and Taiwan have made early forays into this realm of taxation, closely followed by a number of European countries. So already we are seeing a fundamental shift in corporate

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

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

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Vincent started his career with professional accounting firms in Canada in 1991 and has experience in various disciplines including tax, auditing and consulting. He arrived Beijing in 1998 and started to focus on providing China tax services to foreign investors in the areas of tax structuring, tax planning, general tax advice as well as tax compliance services.

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

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taxes to more closely resemble destination-based transactional taxes, applied to gross revenue amounts.

- Corporate taxation rates are falling around the world. For example, over 30 years ago we had more than 30 countries with rates of over 50%, yet only five countries have rates at this level today. The argument that something must be done, is again difficult to contend with given these statistics.

What this means for the tax professional of the future

When tax professionals think of the future, they commonly consider the impact that technology will have on tax collection by tax authorities – that is, the 'digitalisation of tax'. Many tax professionals also think about how the broader economy is changing through digitalisation of business models. But what many fail to consider is the likelihood that tax itself will change as a result of digitalisation in the way it is legislated, collected

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In his career as a tax consultant at KPMG, John has deployed his good working relationship with tax authorities to help multinational and domestic clients in a wide variety of industries in dealing with their tax issues. He has also assisted many companies in the holding and financing structures of companies doing outbound investment or IPO in both domestic or overseas market. He is also a frequent speaker on seminars on the topic of Chinese tax matters and serve as advisers for a few high-profile research institutions.

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Grace has been actively involved in providing tax efficiency planning, corporate restructuring, tax review and tax risk management advisory services to multinational and domestic clients. She has rich experience in assisting clients in communicating with tax authorities. In addition, she has abundant experience in various transfer pricing projects, including multinational and domestic transfer pricing audit and planning advisory.

Grace is also a key member of KPMG's Centre of Excellence for indirect tax advisory services, which was established to cater to the Chinese VAT reform. So far, she has been involved in many domestic and multinational companies' VAT reform projects, including financial impact analysis, contract review, and advisory services on preparation and implementation for the VAT reform.

Grace's clients cover a wide range of industries, including finance, automobiles, consumer market and retail, real estate, manufacturing and services, etc.

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and administered. The idea that taxes will be imposed by reference to various data points recorded in taxpayer systems; and furthermore, the concept that by aligning taxes with transactions in the place or jurisdiction in which the relevant goods or services were consumed, creates the circumstance under which long-term alignment between digital business models and the needs of modern economies. Similarly, at the other end of the spectrum, tax professionals are already being asked to transpose (often formal) tax requirements into data points, so as to automate taxes in their business ERP systems (mainly for transactional taxes). The combination of these factors will produce greater alignment between those tax requirements and clients' data in the future.

Ultimately though, the authors predict the end point of all of this analysis for tax professionals is pretty clear – it may be a cliché but it truly is 'all about the data'. How well do you know your data? How accurate is it? Can you control it? Do you really know how to analyse it? These are the questions every tax professional needs to focus on over the next few years as we embark on the digitalisation of tax.