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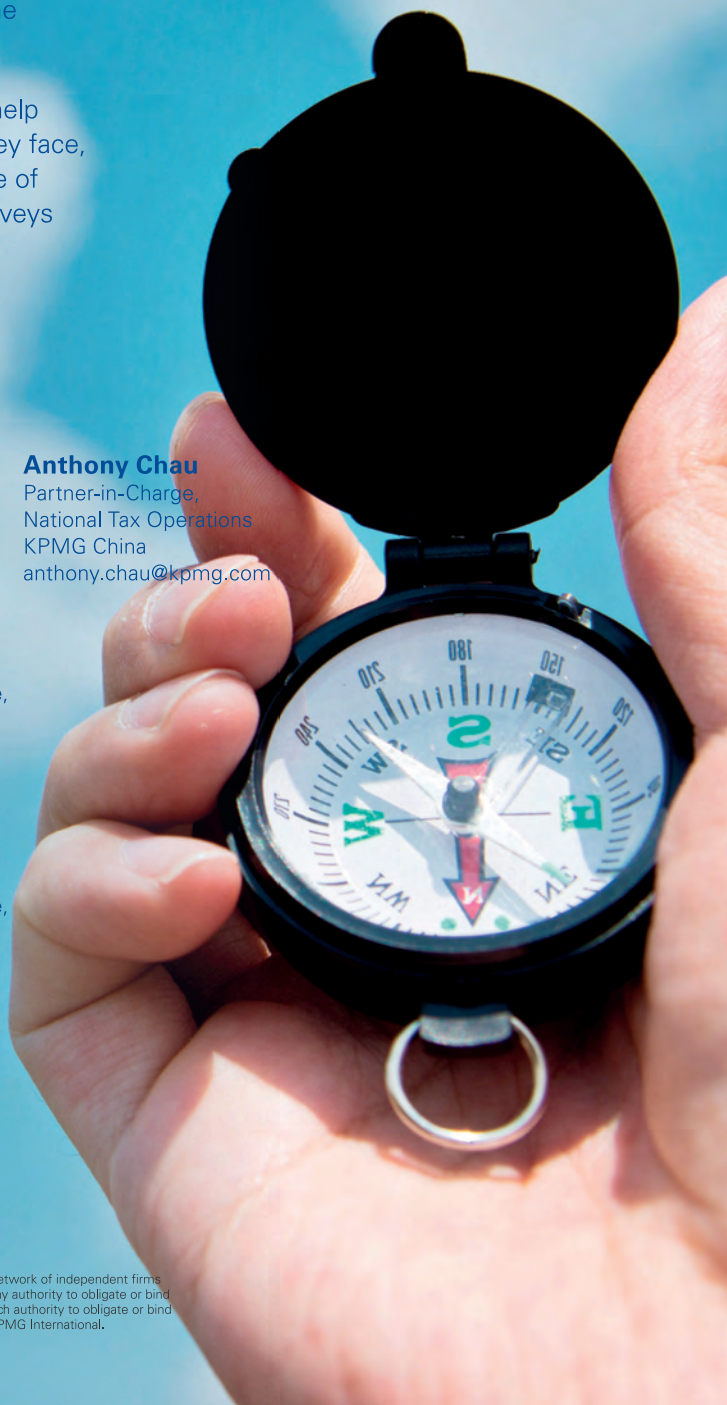
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Editorial

As the Chinese zodiac cycle moves into a new 12-year cycle, the changes across the tax landscape are transitioning in a similar fashion.

The ninth edition of KPMG's *China – Looking Ahead* chronicles a busy a year. It also provides an insight into how the tax policies are being designed to interact with international developments. In the following chapters, KPMG's experts explain how tax policy is evolving in mainland China and Hong Kong SAR.

2020 is the Year of the Rat, an animal that is believed to be clever and successful – much like the innovative data and analytics techniques being developed by the State Taxation Administration. There also has been a shift from document-based analysis carried out by tax auditors, to more efficient digital tools. This guide's VAT chapters make some bold predictions about how data and analytics will grow stronger in the coming year, indicating how taxpayers may need to adapt.

With the year of the rat also symbolising wealth and surplus, it is apt that the Chinese government is continuing its efforts to open the economy to inbound and outbound investment – particularly as part of the Belt and Road Initiative (BRI). However, this guide's outbound chapter, as well as the chapters on Hong Kong SAR, M&A and R&D, covers the



Anjana Haines
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tax challenges Chinese companies face along the BRI countries.

Separately, achieving the quiet and peaceful life that the rat represents may be difficult amid continuing trade tensions with the US and disagreements across the Inclusive Framework on how to tax the digital economy. This guide's digital economy chapters dive into China's high-tech sector and how look inward at domestic tax law and administration issues to be resolved for the country's digital industry.


Meanwhile, the topics of customs and trade policies, as well the evolution of transfer pricing arrangements and tax treaties are explored across a range of chapters.

The past 12 years and the 2019 Year of the Pig have been eventful, but the momentum will continue into 2020. We hope that the ninth edition of KPMG's *China – Looking Ahead* will be a valuable tool in guiding you through the developments.

China Looking Ahead

A changing global environment

This edition of China – Looking Ahead comes at a precarious and symbolically charged time, with the 12-year Chinese zodiac cycle about to end and a new one about to begin. KPMG China's Head of Tax **Lewis Lu** highlights the key topics.



The 2019 Year of the Pig has been a striking period of evolution, both for China's domestic economy and for its trade and investment relationships with the wider world. This has implications for the China tax environment.

China's economy is on course for a GDP growth rate of 6.2% in 2019, the lowest in 30 years. This is providing added impetus to structural reforms that include an accelerated liberalisation of restrictions on inbound investment, and efforts to cut red tape and improve the business environment.

The number of sectors subject to foreign investment restrictions has been reduced from 63 in late 2018 to 40 at present, and down to 37 in the free trade zones (FTZs). A further six FTZs have recently been created, to reach a total of 18 FTZs in 2019, with a raft of new tax incentives set out in parallel. A concerted campaign to reduce regulatory hurdles resulted in China's ranking in the World Bank's Doing Business report rising from 78th to 31st out of 190 countries, from 2017 to 2019.

In the context of a challenging international trade environment, certain foreign and Chinese manufacturers have been examining possible restructures to their supply chains and the relocation of manufacturing facilities. Against this backdrop, China outbound direct investment (ODI) has continued to shift towards the 65 Belt and Road Initiative (BRI) countries, estimated by certain research institutes at 21.6% of total ODI in 2018. In parallel with this development, a BRI Tax Administration Cooperation Mechanism (BRITACOM) was established in 2019 to address tax policy and administrative deficiencies and improve coordination.

A new cycle awaits

Against this backdrop, in this year's ninth edition of *China – Looking Ahead*, KPMG China's tax experts examine the issues that have arisen

during this Year of the Pig and review the prospects for the 2020 Year of the Rat. Thematic articles explore the issues relevant to businesses operating cross-border with China. 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 key issues explored include:

- The emerging international tax framework being developed at OECD/Inclusive Framework level, often referred to as BEPS 2.0, and its implications for China
- The new China trade facilitation policies being rolled out against the backdrop of the changing and challenging global trade environment;
- A raft of new China double tax agreements which introduce BEPS permanent establishment (PE) changes and tax transparency provisions for partnerships;
- The numerous tax challenges arising from China's booming digital platform economy;
- The transformed China individual income tax (IIT) compliance environment in the wake of major reforms in 2018;
- The evolving transfer pricing (TP) enforcement scene, with strategic and compliance implications for inbound and outbound activity;
- Focused chapters on tax due diligence challenges for inbound M&A, structuring trends for outbound investment, increasing scrutiny of China R&D tax incentive claims, and trends in VAT system technology and design; and
- Dedicated chapters on Hong Kong SAR's new TP rules and challenges for fund structuring deriving from new offshore economic substance rules.

The Year of the Pig brings to a close the 12-year cycle of the Chinese zodiac, with a new cycle on the cusp of setting off. It remains to be seen what this portends – will we see a ground-breaking global compromise on BEPS 2.0, or a resolution to global trade issues? All will be revealed in the Year of the Rat.



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Lewis is a frequent speaker at various international tax fora. He teaches international taxation for the master of taxation students at Fudan University. He is a member of the Canadian and Ontario institutes of chartered accountants and is a fellow of the Hong Kong Institute of Certified Public Accountants.

Checklist of hot China tax issues for MNEs in 2020

In 2020, taxpayers should be alert for the following China tax developments and trends.

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- **Electric vehicles tax support** – Electric vehicles are the future of the automotive industry. While the government subsidies that boosted the Chinese electric vehicle market in recent years are being withdrawn, a ‘dual-credit system’ will continue to support new energy vehicle development and a range of corporate income tax (CIT) incentives exist. These include, for high and new technology enterprises (HNTEs), a lower CIT rate of 15% (reduced from 25%) and an extended loss carry-forward period of 10 years (up from five years). This, together with the CIT super deduction for R&D expenses and other incentives, supports investment in the auto tech of the future. At the same time, auto players must have systems and protocols to ensure full compliance with relief conditions, as the tax authorities are reviewing more thoroughly whether these have been met.
 - **Auto financing** – While the China auto leasing market is still in its infancy, rapid growth is anticipated over the next 10 years. Auto financing, by enabling more competitive pricing and accelerating the car replacement cycle, boosts new car sales. Cars coming off-lease in turn drive the expansion of China’s used car business. At the same time, the market is becoming more defined, with different types of players (OEM-affiliated, dealer-affiliated and internet-affiliated) and different auto financing models. The latter includes lease-loan versus standard leasing (from the product design perspective), and direct leasing versus sale and leaseback (from an operational perspective). As a rapidly expanding and increasingly diverse sector, tax challenges arise, as do opportunities to realise potential tax savings as part of a winning strategy; for example deductibility of financing cost for VAT purposes, which is a tax refund when actual VAT liability exceeds 3%.

- **Consumption tax (CT) reform** – At present, CT on autos is generally collected from manufacturers. New reforms, announced in September 2019, would shift this obligation to wholesalers or retailers. While details are yet to be confirmed, enterprises in the auto industry should follow this closely, given the potential impact on the overall tax burden of the industry and the pricing strategy among auto market players.

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- **Proposed land appreciation tax (LAT) legislation** – A draft LAT bill was released for consultation in July 2019. Real estate sector businesses will need to closely monitor the progress of the LAT legislation in order to pre-emptively assess and manage any arising risks. Major features included within the scope of the LAT bill is the transfer of collective land use rights and real estate, and clarifications on the timing of LAT obligations and tax payment schedules.

- **Greater Bay Area (GBA) individual income tax (IIT) preferential policies** – Fiscal subsidies will be offered to attract and retain talented foreign staff to work in nine designated cities in the GBA. These include Guangzhou, Shenzhen, Zhuhai, Foshan, Huizhou, Dongguan, Zhongshan, Jiangmen and Zhaoqing. The subsidy is calculated to reduce the effective tax burden on the eligible personal income to less than 15%, and the subsidy itself is exempt from IIT. Enterprises are already starting to respond to the incentives with the planned deployment of staff to the GBA.

- **Tax rulings for urban renewal in the GBA** – Rapid population growth and industrialisation in recent decades means that much of the land in the GBA is already built up. Consequently, redevelopment of existing towns and industrial estates is necessary to unlock land resources for new development. Commercial arrangements to acquire the relevant land use rights can trigger complicated tax issues, and the tax authorities in the GBA have been attempting to resolve bottlenecks and ambiguities with new guidance. Many complex tax issues remain, and real estate enterprises should monitor developments with these guidance and rulings to ensure full tax compliance for urban renewal projects.

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- **Bank asset management businesses** – To ringfence risks and drive specialisation, Chinese banking groups are being encouraged to spin off and centralise their asset management business as separate legal entities. This necessarily gives rise to tax considerations in relation to the selection of the incorporation location, portfolio transfer from banks to subsidiaries, people relocation, related party transactions and other restructuring implications.

- **Financial services IT innovation** – Large Chinese financial institutions have been looking to carve out their IT functions into separate legal entities, with a view to centralising and commercialising technological developments. As a new IT subsidiary defines the business relationship between itself, the rest of the financial institution, and external parties, transfer pricing issues will naturally arise. The usage of R&D incentives, whether at the level of the financial institution headquarters or IT subsidiary, also need to be assessed to maximise tax benefits.

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- **Energy and natural resources (ENR) outbound investment tax risk** – China's national oil and gas companies, oil service providers and engineering, procurement and construction (EPC) enterprises, are highly active outbound investors, particular in Belt and Road Initiative (BRI) jurisdictions. Investments in new markets and a changing global tax environment are exposing them to a range of complex tax risk management issues, notably for their holding and financing structures, transfer pricing arrangements, and foreign tax credit management.

- **VAT refund opportunities** – ENR enterprises commit significant initial capital expenditure to their projects, to which long investment recovery timeframes apply. China's VAT system, which limited the use of VAT input credits, could significantly impact on cash flow and return on investment. Recent reforms, allowing for input VAT refunds, will enable better cash management and enhanced returns on investment.

- **Consumption tax (CT) reform** – The planned reforms will shift collection obligations on oil processing from consignment processors to wholesalers and retailers. Enterprises in the oil and gas space need to follow this closely, given the potential impact on the overall tax burden of the industry.

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- **Rapid change in the digital space** – Companies operating in the digital space stand at a crossroads. Internationally, BEPS 2.0 is set to revamp the architecture of the tax rules for the digital economy. The existing Chinese tax, accounting and foreign exchange systems may, however, create practical challenges for their implementation in China. Domestically, the Chinese government is driving efforts to reduce taxes, modernise the tax collection system and support China's digital transformation. While the pace of change may be unsettling for many companies, it is also an optimal time to voice concerns and make suggestions, as policymakers are more willing to listen than ever before.

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No pain no gain: Tax challenges in the China M&A market

This past year has seen heightened inbound M&A activity in hot sectors such as life sciences and logistics, just as the Chinese tax authorities apply more sophisticated enforcement approaches to M&A. **Michael Wong**, **Chris Mak** and **Stella Zhang** explain how to best prepare.

In the inbound M&A tax space, a number of key issues stood out in the past year.

Firstly, according to Ministry of Commerce (MOFCOM) data released in October 2019, foreign direct investment (FDI) into mainland China rose 2.9% year on year. Inbound M&A and green field investment amounted to \$100.8 billion for the period from January to September 2019. Within this overall figure it is understood that inbound M&A has fallen, with more detailed data on the breakdown to become available later in the year. The fall could be a reflection of the US-China trade dispute, as well as investor concerns about the prospects for the China market going forward. However, against this, M&A in advanced sectors such as life sciences and logistics remain hot. Indeed, this is reflected in the fact that, in the data to September 2019, foreign investment in high-tech industries increased 39.8% year on year – it now accounts for close to 30% of total FDI. Consequently, tax issues arising in connection with investment in these sectors have become a matter of keen interest.

Second, due to the lack of detailed Chinese partnership tax guidance, there have long been areas of uncertainty for venture capital (VC) funds taking partnership form. To address this, on January 10 2019 the Ministry of Finance (MOF), State Tax Administration (STA), the National Development and Reform Commission (NDRC), and the China Securities and Regulatory Commission (CSRC) jointly released the notice on individual income tax (IIT) policies for natural person partners in VC partnerships (Circular 8). This constitutes a major breakthrough in IIT guidance for partnerships, clarifying that VC partnerships may be treated as ‘investment conduits’.

A third issue that has come to the fore relates to offshore disposals. It has been almost five years since the 2015 release of the revised indirect offshore disposal rules in STA Announcement 7. The local tax authorities

are getting more experienced and sophisticated in dealing with the tax issues arising under these rules for cross-border M&A transactions. In the past year, the STA has proactively organised meetings between local tax authorities and professional bodies to discuss the technical issues and practical difficulties arising. Although no further formal regulations have been released in the past year, it is hoped that more clarity for uncertain areas, such as the calculation of the tax cost base and qualification for safe harbour rules, will be provided in the future.

The most important issues to get to grips with in this changing environment will be the typical tax due diligence (TDD) issues, including the challenges and opportunities in the logistics and life sciences sectors. Also of great importance are the Circular 8 IIT preferential policy for VC partnerships and the recent developments with Announcement 7.

Logistics and life sciences

In recent years, the Chinese logistics sector has seen rapid development, driven by the development of online sales. Non-vehicle operating common carriers (NVOCs) in particular, which arrange carrier services but do not themselves carry out the delivery, have become particularly attractive for M&A, with government support stimulating the growth of such services. However, with NVOC business operating models still at a developmental stage, the appropriate sales revenue recognition approach and relevant tax treatment remain unclear, meaning investors must pay close attention to the potential tax risks.

The traditional model for express delivery services involves a number of service elements, including: pick-up, allocation, transportation, and delivery. NVOCs, in view of their business models, regard themselves as being 'agents'. They consequently treat the delivery fee, which they receive from customers, as being (minus the NVOC commission) an amount payable to the enterprise carrying out the delivery; namely, the franchisee. That is, instead of the NVOC booking the entire service fee as their own revenue, they seek to book solely their commission as income. The following non-exhaustive list of examples can, however, lead the tax authorities to take a different position:

- Where the service contract with the end customer is typically signed in the name of the NVOC, instead of using the name of the franchisees;
- Where the NVOC has the pricing latitude for the express service; and
- Where the conduct of the express service is under the overall control of the NVOC.

As NVOCs view themselves as agents, it is not uncommon for them to report VAT on their commission income at the 6% rate used for intermediary services. Two potential VAT risks thus arise. As the final customer is paying the



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NVOC a fee, covering the entire service provision (including goods pick-up, allocation, transportation, and last-mile delivery), the authorities may seek VAT to be accounted for on the entire amount, rather than on just the NVOC commission. As such, the NVOC may need to claim input VAT credit (for the payments to the franchisees) against the larger amount of output VAT. Additionally, the tax authorities may characterise the activity as a transportation service, rather than as an intermediary service, and seek to impose VAT at the 9% rate.

For investors looking at targets in the Chinese logistics industry, regard must be had to potential tax authority challenges based on disagreement over the appropriate tax characterisation of the target's business model. The potential costs of changing the business arrangement for tax compliance purposes, post-deal, may need to be examined.

When it comes to life sciences, start-ups in the Chinese life sciences sector continued to draw significant interest from funds and corporate investors. This is in particular because IPO exits are expected to increase with the launch of the Shanghai Stock Exchange's Sci-Tech Innovation



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Stella advises on inbound investment structures, business carve-outs, company restructurings and tax planning. She is also extensively engaged in tax due diligence and tax health check projects.

Board. It is also because of government moves to implement healthcare reforms.

Typical tax issues, such as the use by target companies of false tax invoices, which lack any underlying business substance, can arise for life sciences enterprises, especially for pharmaceutical and medical device companies, as occurs for traditional manufacturing companies. These may be supporting fraudulent claims for VAT input credit, corporate income tax (CIT) deductions, or IIT underpayment for employees, and other such issues.

For start-ups in the pharmaceutical and medical device sectors, formal tax invoices may be difficult to obtain for payment of clinical trial expenses to agents or hospitals, speaker fees for industry conferences, etc. This can be because of the lack of tax-compliant invoice issuances by these third parties, or regulatory restrictions obstructing such issuances.

In some cases, false invoices may have been obtained from illegal channels. In addition, certain expenses, such as sponsorship, advertising and promotion expenses and entertainment expenses, may be incorrectly classified into other expense categories in corporate accounts. These expenses

are not permitted full CIT deductions, and consequently this inappropriate classification may have resulted in deductions being claimed to which the enterprise was not entitled.

These matters are focus areas during tax audits. Therefore, reviewing service agreements signed with vendors and sample vouching of tax invoices in respect of the relevant expenses should be performed as part of TDD procedures, to assess whether the expenses deduction can be supported, whether input VAT is creditable and whether the CIT treatment of expenses is correct.

Many life sciences tech start-ups apply for a high and new technology enterprise (HNTE) certificate, allowing them to enjoy a preferential 15% tax rate as a highly innovative company. They may even make an application at an early stage of operations, when they are still in a loss-making position, as the tax losses can be carried forward and offset for the following 10 years (this follows rule changes for HNTEs in 2018).

However, a common tax risk for target companies in the life sciences industry is that their HNTE qualification may be questionable. On review, it may be found that some of the

target companies do not satisfy all the HNTE criteria. These include requirements for the HNTE to own its core intellectual property (IP), meet the requisite R&D expense/sales percentage, have sufficient qualifying revenue from high-tech products/services and have a sufficient percentage of employees engaged in R&D-related activities, among other criteria.

Finally, it is not uncommon for pharmaceutical companies to provide gift bags to doctors during industry conferences and events. The IIT should be withheld by pharmaceutical companies on these gifts, and may be overlooked by the pharmaceutical companies. Tax authority IIT enforcement efforts have focused on this area, and the authorities have used keyword searches (for ‘gifts’) on accounting journal entries, the data for which they obtained within the framework of the thousand enterprise initiative (TEI).

IIT for venture capital partnerships

The lack of detailed Chinese partnership tax rules mean that uncertainty has existed for the tax treatment of funds in the form of partnerships; a key area for consideration is the appropriate IIT treatment for individual partners where the partnership derives income from equity transfers.

The local practice in certain locations in China was to treat capital gains arising on such transfers as ‘other income’ for IIT purposes, separating it from the business income of the partnership and applying the 20% IIT rate to the partners. However, in 2018, some local tax authorities challenged this position. We saw cases across China where the natural person partners were required to treat these capital gains as part of the business income subject to progressive IIT rates from 5% to 35%. This significantly increased tax leakages for investors in the funds.

As noted above, Circular 8 was released in January 2019 to address these issues. VC partnerships can choose from two calculation methods in respect of their natural person partners’ income. The first is the individual investment fund-based method. Under this method, the income derived by VC partnerships from an equity transfer, and received by natural person partners, can be accounted separately from partnership business income and subject to the 20% IIT rate. The second is the overall annual income-based method. This allows a natural person partner’s portion of their income derived through the partnership to be designated as part of business income, and subject to progressive IIT rates from 5% to 35%.

Highlights on the policy include the following:

- Circular 8 is applicable for natural person partners of VC partnerships that comply with record filing requirements.
- For VC partnerships that select the individual investment fund-based method, income derived from equity transfer and dividend income are both required to be accounted for separately. On exit from investment positions, taxable gains on equity transfer are calculated as transfer consideration

minus investment cost and reasonable transaction expenses. Gains and losses from different investment projects can be net-off within a calendar year. However, losses are not allowed to be carried forward.

- For VC partnerships that select the overall annual income-based method, the taxable income of the whole VC partnership should be calculated on a calendar year basis. Different income categories and different investment projects are not required to be accounted separately. Losses are allowed to be carried forward for the following five years.
- Once a VC partnership selects a particular calculation method, the option is not allowed to be changed within three years.

As can be seen, Circular 8 allows VC partnerships to decide whether or not to adopt ‘transparent’ tax treatment in relation to income characterisation. It is advisable for VC partnerships to conduct a tax cost analysis of both options, based on the lifecycle of the investment projects and investment return expectations, together with overall expenses such as management fees, to choose the most tax efficient option.

Announcement 7

As noted at the beginning, local tax authorities are getting more experienced and sophisticated in dealing with cross-border M&A transactions under Announcement 7. For Announcement 7 reporting, more local tax bureaus (at least most of the tax bureaus in the Tier 1 and 2 cities) have set up standard procedures, and are willing to issue official acknowledgement receipts to confirm their acceptance of the filing documents. The Announcement 7 reporting procedure is getting more straightforward at the initial filing stage – this had raised significant challenges in the past.

In addition, during the past few years, the STA has also proactively collected questions received from local tax authorities, with a view to fine tuning policy. The STA has organised meetings between local tax authorities and tax advisory firms to discuss the tax issues and practical difficulties encountered when dealing with offshore indirect disposal cases.

One of the hot topics with respect to Announcement 7 is the calculation of the tax cost base. As noted in the discussions on M&A tax in the previous editions of *China – Looking Ahead*, if no Chinese tax has been paid on the previous transaction (on the prior acquisition of the offshore indirect investment structure by the disposer), the offshore seller may potentially suffer a higher tax cost. This is because local tax bureaus may potentially only allow the Chinese subsidiary’s paid up capital (specifically, registered capital and capital reserves) to be deducted in calculating the taxable gain.

In addition, issues could arise for investors who make investments by subscribing to newly issued shares at an

offshore level where a share premium is in point. In such cases, as earlier investors may have invested at a lower price point (with no or a lower share premium), there will be a difference between the percentage of the share capital invested by the new investors, and the shareholding percentage they hold (which will be lower). Under existing Chinese tax authority practices on cost base calculation, the base cost granted to the new investors for tax purposes will be reflective of their shareholding percentage (and consequently can be much less than their actual invested capital). This can lead to a higher tax liability for these offshore investors on exit.

The STA has sought, through the meetings arranged, to build understanding and arrive at solutions to these issues. It has also sought solutions for other matters, including access to group restructuring relief, offshore disposal price allocation between onshore and offshore entities, and tax revenue allocation between tax bureaus in different locations. Although no conclusions have yet been reached on

these topics, now that the issues have been broached and are becoming better understood at authority level, it is hoped that more clarity will be forthcoming.

Looking ahead

While there is still little sign yet that the China-US trade dispute will be resolved in the near future, with IPOs facilitated by the Shanghai Stock Exchange's new Sci-Tech Innovation Board, the further expansion of China's free trade zones, and other promising regulatory and commercial developments, inbound M&A activity into China is still expected to remain robust.

In order to boost investor confidence for investments into China, the Chinese government is understood to be working on a revision of M&A tax rules to allow for more complex deal arrangements and more tax efficient structures. Going forward, taxpayers look forward to greater clarity on Announcement 7 and rules on partnership taxation and restructuring.

Adapting to a complex world: The evolution of Hong Kong SAR tax

The Hong Kong SAR government has continued its international focus, introducing incentives to boost competitiveness while taking steps to address global tax avoidance, write **Curtis Ng** and **Ivor Morris**.

Maintaining Hong Kong SAR's position as an international business hub remains a key objective of the Hong Kong SAR government. The government has identified a number of sectors where it sees Hong Kong SAR having a significant role. In many of these areas, Hong Kong SAR has already had tax rules designed to encourage international groups to undertake activities in the jurisdiction, but the rules have not always been as business-friendly as in other parts of the world. As a result, substantial changes have been made over the past year to both the funds exemption and the research and development (R&D) incentive.

Falling short

Hong Kong SAR has long been an important centre for the asset management industry but has historically suffered in the context of private equity and real estate funds from not having an advantageous funds regime. This has led to fund managers in Hong Kong SAR sometimes adopting complex management structures and protocols in order not to create a taxable presence for the fund.

An attempt was made to improve the position a few years ago by introducing a revised offshore funds exemption, extending the scope of the tax exemption to non-resident private equity funds, and also providing an exemption for special purpose vehicles (SPV) holding companies on their gains on disposal. Unfortunately, the anti-avoidance provisions around the legislation were drawn too tightly to make it commercially practicable and the incentive remained largely unused.

The drive to amend the legislation came partly because of pressure from the OECD over harmful tax practices. The previous legislation had restricted the incentive to funds based outside Hong Kong SAR making investments outside Hong Kong SAR. Following discussions with the

OECD, this was amended to allow for Hong Kong SAR resident funds and investments in Hong Kong SAR businesses (although Hong Kong SAR real estate was still excluded).

The government also took the opportunity to take on board some of the feedback from the industry. A particular concern with the earlier legislation was that a single bad investment could taint the treatment of the entire fund. This has now been amended so that only income from the bad investment in question is excluded from the exemption. It is a welcome development.

However, it is still hard to avoid the conclusion that the government has interpreted the phrase ‘private equity’ too literally for the industry to be able fully to embrace it. The restriction of the exemption from tax for SPVs to transactions on shares in private companies will restrict those looking to undertake a private or listing transaction. Similarly, the focus on equity means that many common debt or trust arrangements may fall outside the scope of the exemption. In addition, the restriction on activities that may be undertaken by a SPV remains so tight that it is questionable whether the directors could comply both with their duties under company law and the restrictions imposed by the Inland Revenue Department (IRD).

A pattern repeated

The tale with the R&D incentive is not dissimilar. Hong Kong SAR has for several years had a specific provision in its tax legislation specifying that a deduction may be taken for R&D expenditure. Since a deduction may in any case, under general principles, be taken for most revenue expenditure incurred, its application had been limited to qualifying capital expenditure. In line with many other jurisdictions around the world, and as part of wider measures to encourage R&D activity in Hong Kong SAR, the incentive has now been expanded to allow qualifying R&D expenditure to benefit from enhanced deductions of 200% to 300% of the amount incurred.

R&D has been widely defined, meaning that a wide range of businesses and activities potentially qualify. It includes activities in the fields of natural or applied sciences to expand knowledge, original and planned investigations undertaken with the prospect of getting new scientific or technical knowledge or understanding, and the application of research or knowledge to a plan or design for producing new or substantially improved materials, devices, products, processes, systems or services.

The IRD has made it clear that any sector of the economy, including financial services, may qualify for enhanced R&D expenditure if it meets the criteria. Expenditure will not qualify if it merely seeks to implement knowledge which is public or readily deductible by a competent professional. This means that simple adaptation of open-source data or adapting existing tools to localised systems are unlikely to



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qualify. Expenditure on feasibility or market studies or on non-scientific aspects of bringing a product to market will also not qualify.

Unfortunately, there are a few restrictions that make the incentive less flexible than in a number of overseas jurisdictions. In order to qualify, expenditure must be incurred in Hong Kong SAR and incurred in generating taxable profits. More problematically, the right to the intellectual property created must vest with the person incurring the expenditure and claims are limited to expenditure on employment costs, consumables used in the R&D process and payments to designated research institutions. This is considerably more restrictive than in many other jurisdictions and fails to address the commercial nature of how groups arrange their



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businesses. For example, a group may have a bankruptcy remote company taking on development risk while using employees of another company to undertake the work. It may decide to outsource some work to specialist consultants. It may want to set up a joint-venture with another enterprise, each bringing separate expertise to the project. Each of these arrangements poses potential challenges in terms of being able to claim expenditure that ought otherwise to be eligible.

Appropriate documentation will clearly be an important aspect of substantiating any claim. Companies will need to consider how to record staff time spent on projects, how to document the process and risks involved and how to demonstrate the innovative nature of the research.

Global demands

Sadly, Hong Kong SAR's international endeavours over the past year have not been entirely focused on developing incentives, and on the opposite side of the scales, Hong Kong SAR

has had to move into line with international standards by introducing a transfer pricing (TP) law. The new law places Hong Kong SAR within the framework of country-by-country reporting, master files and local files, and for the first time, mandates companies to deal with related parties at arm's length. There are exemptions for some domestic transactions (where these do not result in a tax advantage) and some pre-existing arrangements have also been grandfathered.

The new rules also bring in important changes to the taxation of permanent establishments in Hong Kong SAR. While the concept of a permanent establishment has for many years been hidden away in the apocrypha of the IRD's rulebook, the central principle of Hong Kong SAR tax has historically been that entities are taxable when they carry on business in Hong Kong SAR and derive Hong Kong SAR sourced income from that business. Under the new rules, entities with a permanent establishment in Hong Kong SAR are required to compute the income of that permanent establishment as though it were a separate entity from the main company. This potentially results in a significant change to the tax base of branches and permanent establishments operating in Hong Kong SAR.

The IRD has recently issued three particularly lengthy practice notes giving guidance on the new TP rules and setting out their expectations in terms of documentation. It is clear that even those companies that do not meet the thresholds for mandatory reporting will still need to maintain documentation that their transactions are computed at arm's length if they are to avoid penalties. The guidance notes are also reflective of the increasing complexity of Hong Kong SAR's tax system as it evolves to meet an international environment in which the old system of simple and low taxation is becoming harder to sustain. They are also perhaps indicative of the fact that too much is being left to the whims of the tax authority rather than being unambiguously set out in legislation.

The IRD's guidance reinforces the position that the source principle still needs to be considered on top of the TP position. Groups of companies should therefore consider not only the arm's-length pricing but also whether the resulting income can rightfully be said to have arisen in Hong Kong SAR. It will be interesting to see how this evolves in practice as returns are submitted.

Ancillary changes

As part of the legislation affecting transfer pricing, a number of less prominent changes that impact international taxation were also enacted.

One of these was a provision for taxing income from the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles. Where DEMPE functions take place in Hong Kong SAR and the intangible is subsequently transferred to a related offshore company, any income arising in respect of that DEMPE

function will remain taxable in Hong Kong SAR. The widely drawn nature of the legislation means that commercial arrangements with high tax jurisdictions are potentially in the scope of the tax, and that certain transactions may effectively be subject to double taxation. The legislation also applies to transfers undertaken before the legislation came into force, meaning that historical arrangements may need to be addressed.

While the offshore transfer of intangible assets has clearly been one of the concerns focused on by the BEPS project, the legislation drafted seems a little indiscriminate and risks undermining the efforts to develop the innovation sector in Hong Kong SAR, which are spearheaded by the R&D incentive.

Another change affected the legislation that governs the credit or deduction of foreign taxes by setting out in greater detail the approach to double tax agreements (DTAs). The new legislation imposes separate tests for transactions with DTA partners, where the treaty should apply, and non-DTA partners, where domestic law tests will apply.

Using these changes, the IRD has published guidance seeking to amend long-standing practice in respect of foreign withholding taxes. Case law in Hong Kong SAR has stated that where an overseas tax is imposed on gross income that is also taxed in Hong Kong SAR, then the withholding tax is deductible as an expense incurred in generating that income. Nothing in the legislation has overturned

the case law or updated the general principle on which the Board of Review reached its decision.

Clearly, where a treaty is in place, a credit should be available for the overseas tax and is in many cases likely to give a preferable outcome. In other cases, taxpayers will need to decide whether to adopt the IRD guidance or apply the law as it stands. It is unfortunate that they are being put in this position; if the IRD wishes to amend the law it should either legislate or take a case to a higher court for judgment. In any case, taxpayers will need to look at the potential impact of the changes on their tax positions.


Looking ahead

The years to come are likely to be dominated by similar patterns to those recently seen, on the one hand making Hong Kong SAR an attractive hub both internationally and within the Greater Bay Area and, on the other, ensuring that its tax profile remains compatible with increasingly restrictive global standards.

Particular areas of focus may include developing a Hong Kong SAR funds vehicle and addressing how Hong Kong SAR's low-tax, source-based approach is affected by the roll-out of BEPS 2.0. The coming 12 months will also be a chance to see how the IRD approaches the new legislation in practice. Indeed, the ability to use the new legislation in a commercial context will be key to enabling Hong Kong SAR to cement its place as an international business centre.

R&D tax incentives: Continuous encouragement and enhanced supervision

China has continued to improve access to tax incentives and provide new regulatory support for innovation. At the same time, renewed rigour is being applied to ensure that tax incentives are claimed appropriately. **Bin Yang** and **Nicole Cao** detail the landscape.



As technological advancement becomes more crucial to economic growth and competitiveness, countries around the world are focusing their policy efforts, including their tax incentive policies, to ensure that they are at the forefront of next-era advances. Attention is focused on building leading positions in innovative technologies such as genetic editing, quantum and artificial intelligence, information technology, new energy and advanced manufacturing.

Table 1 shows data from RDmag, a leading authoritative journal of science and technology in the US, setting out R&D investment levels in 2018 in major jurisdictions; amounts are expressed in purchasing power parity (PPP) terms. As can be seen, the US and China lead the table, although China's research and development (R&D) investment is growing at a faster rate.

This increased investment in technological innovation is yielding a greater number of recorded patents worldwide. World Intellectual Property Organisation (WIPO) data from 2018 showed that total new patent application numbers, as recognised under the Patent Cooperation Treaty (PCT), increased by 3% year-on-year. As shown in Table 2, the US has the largest number of patent applications, with Japan second. China is narrowing the gap, however, with its rapid growth rate.

China's advances in this space are driven by its continually refined innovation tax policies. Its two major innovation tax incentives, the high and new technology enterprise (HNTE) incentive and the R&D expense super deduction have, in 2019, entered their 11th year of operation. Since 2018, the super deduction has been applied nationwide at 175% of the incurred R&D expense; this followed an increase from 150% to 175% for small enterprises in 2017. Many local tax authorities actively encourage applications for the R&D tax incentives, and the amount claimed continues to rise.

Table 1: The top five countries for R&D investment (PPP values)

Ranking	Countries	R&D investment (USD bn)	Annual growth	% of GDP	% of global R&D investment
1	US	553.0	2.9%	2.8%	25.3%
2	China	474.8	6.7%	2.0%	21.7%
3	Japan	186.6	0.6%	3.5%	8.5%
4	Germany	116.6	1.5%	2.8%	5.3%
5	Korea	88.2	3.3%	4.3%	4.0%

Source: RDMag

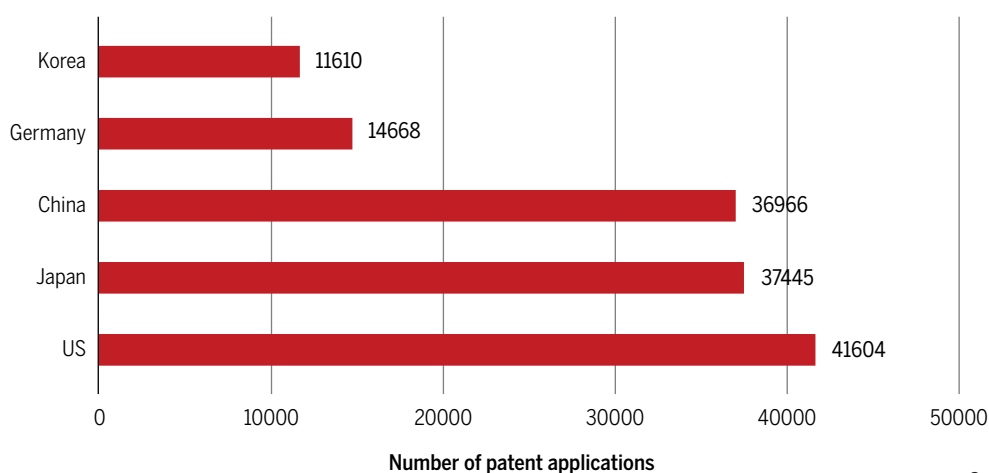
Furthermore, in May 2019, China clarified that integrated circuit design companies and software companies can continue to enjoy the so-called ‘two-year exemption and three-year 50% reduction’ corporate income tax (CIT) incentive, which has now been extended. Also in early 2019, the Shanghai Stock Exchange’s Science and Technology Innovation Board (STAR Board) for stock listing of technology enterprises was established. This provides a further valuable access point to the capital markets for China’s high-tech and strategic emerging industries.

These core incentives and new regulatory innovations are complemented by an array of other policies, such as the preferential VAT treatments (since 2016) for technology transfers and technology development services, accelerated tax

depreciation for R&D fixed assets (since 2014), and a large number of more localised policies, for example preferential individual income tax (IIT) policies for highly skilled tech staff in the free trade zones.

While the government has prioritised policies to stimulate innovative activity, at the same time, and particularly from late 2018 onwards, a more rigorous approach has been taken in policing the proper use of the HNTE incentive. In particular, local departments of science and technology in various regions are taking a more stringent approach to reviewing HNTE recognition applications. This involves carrying out inspections for existing HNTEs to see if the HNTE recognition had been improperly granted in the past, and cancelling HNTE qualifications where they were found not to be merited.

Table 2: Top five countries for PCT applications Jan-Sep 2018



Source: WIPO

Incentivising R&D and software

In September 2018, the Ministry of Finance (MOF), the State Taxation Administration (STA) and the Ministry of Science and Technology (MOST) jointly issued a notice to increase the R&D expense super deduction to 175% on a nationwide basis. It was also provided that payments made to overseas R&D contractors could qualify for the super deduction. The super deduction can only be claimed in respect of 80% of the actual amount incurred. Furthermore, foreign outsourcing expenses must not exceed two thirds of the qualifying R&D expenses incurred locally in China. However, this is still a significant improvement on the prior position whereby these expenses were completely excluded from the super deduction.

According to STA data released in May 2019, the R&D super deduction provided a total tax reduction of RMB 279.4 billion (\$39.7 billion) for 2018. RMB 87.8 billion of this is attributable to the increase in the deduction rate from 150% to 175%.

In the past, the super deduction claim process required advance project assessment by the local tax bureau, and detailed record filing by the taxpayer. From 2018 onwards, the process was changed and a self-assessment system now applies. The focus of the tax authorities is no longer on up-front assessment of the tenability of the claim. Rather, authorities will conduct post-filing inspection and follow up with the taxpayer where they have queries/concerns on the relief claim.

This new approach reduces the formalities companies need to comply with to enjoy the tax incentives but also imposes the risk on the taxpayer of tax authorities later disputing claims made earlier. Claiming companies must be sure that they fully understand the rules for the super deduction and have sound systems for the management, tracking and classification of R&D projects and expenses. Where post-inspection is failed, companies will have to pay back the tax incentives received, with late payment surcharges.

In practice, the post-inspection processes followed by local tax authorities and local science and technology authorities vary. Consequently, it is necessary for companies to remain aware of local standards and processes to control filing risks.

In the software industry, special CIT treatment has been available for software companies for many years. This provides qualified new software companies that meet the requirements with a CIT exemption for their first and second years in business, and a 50% reduction on the CIT rate for the third to fifth years (generally referred to as the 'two-year exemption and three-year 50% reduction' incentive). The existing policy was set out in the 'Notice on CIT Policies regarding Further Encouraging the Development of the Software Industry and the Integrated Circuit Industry' (Cai Shui (2012) No. 27) and was set to expire in December 2017.

Extension of this policy beyond 2017, while long discussed, was only finally announced in May 2019 in MOF/STA Announcement No. 68. While this covers companies that were already profitable in 2018, it is still uncertain whether companies that become profitable (or are established) from 2019 onwards will be able to enjoy these CIT incentives.

Increasingly stringent supervision

The HNTE incentive, now in its 11th year, continues to be a success. Its principal advantage is that it provides for a low 15% CIT rate, compared with the standard rate of 25%. In 2018, 48,000 HNTEs were newly recognised, the highest for any year to date. There were 180,000 in total by December 2018, with Guangdong, Beijing and Jiangsu ranked as the top three HNTE locations.

Table 3: Growth of HNTEs

Year	Total HNTEs	Growth rate
2014	63,000	22%
2015	76,000	31%
2016	100,000	31%
2017	131,000	39%
2018	181,000	38%

At the same time, the HNTE programme has entered an era of more stringent supervision. Local departments of science and technology in various regions are carrying out inspections for existing HNTEs to see if the HNTE recognition had been improperly granted in the past, and cancelling HNTE qualifications where they were found not to be merited.

In April and May 2019, the Guangdong HNTE cancelled the HNTE qualifications of 54 companies, including 24 businesses engaged in the electronic information industry and 14 in the manufacturing industry. This accounted for 44% and 26% of the total previously qualified enterprises, respectively.

There are six key criteria which must be satisfied to obtain HNTE status:

- Intellectual property (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: 3%, 4%, or 5% for different sales volume levels.



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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 communication with related departments and provides advice on policy planning. In addition, Bin has an MBA.



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Nicole Cao has extensive experience in providing China tax planning services to foreign multinationals and domestic enterprises, with a focus on securing tax incentives. Her clients operate in a wide range of industries, including nuclear power, chemicals, logistics, medical, aviation, machinery, IT, automobile, food, and finance, and include both MNEs and domestic enterprise groups.

As a core member of KPMG China's R&D practice, she has assisted enterprises in supply chain planning and R&D tax incentives application. She has extensive experience in high and new technology enterprise (HNTE) qualification review, application and audit defence. She also assists clients with R&D super deduction applications, establishment of R&D management systems, and with applications for government financial subsidies.

Nicole maintains strong relationships with government authorities and provides clients with advice on policy matters. She is a regular speaker at KPMG seminars.

- **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.
- **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.

In order to ensure the sustainability of HNTE claims, it is imperative that enterprises maintain robust R&D management systems, allowing them to cope with new strict application reviews and random inspections afterwards.

Support from the STAR Board

The establishment of the STAR Board in Shanghai in 2019 provides a significant boost to innovative Chinese enterprises looking to raise capital for investment. The key announcement in this regard was the issuance by the China Securities Regulatory Commission (CSRC) of the Implementation Opinions on Establishing a Science and Technology Board and Pilot Registration System on the Shanghai Stock Exchange on March 3 2019. The regulations for listing demand evidence of the innovative activities conducted by listing applicants. In this regard,

the R&D management systems used for supporting tax incentive applications can prove themselves of double usefulness.

In the Guidelines for Enterprises Listing on Shanghai Stock Exchange's Science and Technology Innovation Board, companies in six high-tech sectors are considered eligible for listing. This includes new generation information technology, biomedicine, new materials, new energy, energy conservation and high-end equipment. The guidelines clarify the criteria used to assess the technological innovation capability of applicant enterprises, for example applicant enterprises must possess exclusive IP rights over the core technologies used in their business.


Listing review involves a strict audit of R&D investment internal controls. Consequently, it is crucial to establish a comprehensive R&D management system that can both support access to tax incentives and meet the requirements for listing on the STAR Board.

The Chinese government is steadily increasing its support for R&D and innovation through R&D tax incentives, subsidies, and a more supportive regulatory framework. Accessing these increases the requirements for effective and granular management of enterprise R&D activities. This must be a focus for all enterprises seeking competitive advantage through innovation.

The authors would like to thank Jacqueline Mai, KPMG China senior manager, for her contribution to this article.

Bonded zones and free trade agreements: Optimising the trade environment

In 2019, China has pushed reforms to customs supervision and expanded the role of bonded zones, further intensified its use of TP documentation for customs purposes, and sought to refresh key trade agreements. **Eric Zhou** and **Rachel Tao** explore the challenges and opportunities.



Masures to facilitate trading activity, which include enhancing China's bonded zones, and to clarify the use of the enhanced China-ASEAN free trade agreement were released during the course of 2019. This was paralleled by more granular guidance on customs impositions on royalties, as well as evolving practices in the interaction between transfer pricing (TP) documentation and customs valuation approaches.

Bonded zones

Since 1990, China has introduced six types of special customs supervision areas with different functions. These range from the early free trade zones (FTZs), to the export processing zones, bonded logistics parks, bonded ports, cross-border industrial zones, and the comprehensive bonded zones (CBZs), which were introduced later.

In principle, CBZs are the most advanced of the special customs supervision areas and play an important role in promoting foreign trade, attracting foreign investment, leading the emergence of new industries and driving the comprehensive development of all the different types of special supervision area. Over the past decades, some of the special supervision areas were gradually converted into CBZs, and others are planned to be converted into CBZs.

In 2019, the Chinese government released a number of policies to institute a more facilitative business environment, especially from the trade and customs perspective. In particular, to advance the promotion of the CBZs, the General Administration of Customs (GAC), together with 14 ministry level departments including the State Taxation Administration (STA) and the Ministry of Commerce, published a draft version of the Opinions on Promoting High Standard Opening-up and High Quality Development of Comprehensive Bonded Zones (the Opinions).



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Rachel Tao is a director specialised in trade and customs. She is an expert on customs valuation, tariff classification, the use of special trade programmes and special customs supervision zones.

Rachel assists companies with reviewing, auditing and assessing their import and export operations. In this regard, Rachel has worked for many clients facing enquiries and investigations, and has helped them to achieve favourable outcomes. She has taken the lead on several supply chain restructuring projects, providing expert support on inter-company transfer pricing, evaluation of duty savings opportunities and resolving trade related obstacles and barriers. Rachel regularly communicates with government officials to help clients obtain guidance from the government on new customs pilot project regimes and to obtain client specific approvals.

Rachel serves clients in many industries, including importers of consumer, pharmaceutical, medical and automotive products.

The Opinions provide that the CBZs are to be developed into five types of centres. These include processing and manufacturing centres; research, development and design centres; logistics and distribution centres; inspection and maintenance centres; and sales and services centres. Guided by the Opinions, CBZs will extend their focus from traditional functions, such as export processing and logistics distribution, to other business areas, such as research, development, innovation, inspection, testing and sales services. This has the intention of cultivating new advantages for China as a business hub in the international market.

There are new measures to facilitate the movement of goods through CBZs, as well as to enable CBZ enterprises to make sales into the domestic market. For example, there is

now an exemption from automatic import licence requirements for certain types of products produced in CBZs, permission for bonded storage and display of imported automobiles in CBZs, and other measures in this vein. These measures complement efforts to reduce operating costs for businesses operated in CBZs. For instance, materials consumed during R&D activities are to be exempted from requiring import licences, and bonded repair and maintenance of foreign made goods are to be subject to a preferential supervision approach in CBZs, with much lower operating costs.

The Opinions will allow CBZ enterprises to carry out their manufacturing, trade, R&D and other activities more conveniently and efficiently. These enterprises can follow up with their in-charge customs authorities for details of specific changes planned locally. Businesses located in other

special supervision areas can also expect to enjoy the benefits of the new policies, once their special customs supervision areas are upgraded to CBZ status.

Evolving supervision methods: royalties

As noted in our previous publications, the Chinese authorities have been highly assertive in imposing customs duties on royalty payments, where the licensed intellectual property (IP) is viewed as integrated in products imported in parallel. New customs guidance in 2019 will further induce enterprises to review their exposures and self-declare accordingly.

Since March 30 2016, three ‘confirmations’ have been added to customs declaration forms: confirmation of special relationship, confirmation of price impact and confirmation of payment of royalties. Further official guidance has been issued since then, in particular with regards to the filing instructions on royalties.

In two announcements made in January and March 2019 (Announcements No. 20 and No. 58), the GAC took steps to clarify how China’s customs will enforce the collection of customs duties on royalties, with detailed guidance on the time of declaration, declaration method, and surcharges for overdue tax payment. The biggest change is the stipulation of a declaration period for dutiable royalties and the provision for late payment surcharges if an enterprise fails to declare in time.

In this regard, Announcement No. 58 states that only dutiable royalties related to imported goods should be stated as ‘yes’, while those not dutiable and not related to import goods should be stated as ‘no’. Compared with the previous regulation, the new rule has been aligned with Measures on Customs Valuation – this resolves the confusion that previously existed among importing enterprises. It has now been clarified that ‘yes’ should only be stated if royalties satisfy both criteria (that royalties are “related” to imported goods and “constitute a condition of sale”).

Announcement No. 58 also stipulates that customs will collect late payment surcharges at a daily rate of 0.05% of underpaid import taxes, if the enterprise fails to declare and make tax payment to customs within the prescribed period (within 30 days after royalties are paid).

Considering the volume of documents to be included in the package for submission, and the new requirement to report within 30 days after remittance, it is recommended that preparation should start once planning gets underway for remittance of royalties.

Affected enterprises should contact the in-charge customs authorities as soon as possible to make arrangements for switching to the new declaration mode in order to avoid surcharges arising. As surcharges can be mitigated for enterprises that make a self-disclosure, this may be of value for enterprises with dutiable royalties who fail to make the initial declaration deadline.

Pioneer for new WCO practices

At the end of 2017, the World Customs Organisation’s (WCO) technical committee on customs valuation (TCCV) published a valuation case submitted by the GAC. This was entitled ‘Use of Transfer Pricing Documentation When Examining Related Party Transactions Under Article 1.2 (a) of the Agreement’ (case study 14.2), and was discussed in last year’s customs chapter. Case Study 14.2 was the first official reference document from China’s customs which has been accepted by the WCO under the World Trade Organisation (WTO) valuation framework. Since the WCO released this Case Study 14.2 there has been a profound impact on China’s customs valuation practices, as it has played a significant role for China’s customs in valuation cases where related party (special) relationships are in point.

Transfer pricing (TP) documentation is now one of the key reference documents requested during various customs inspection processes (regular customs audits and price inquiries). However, it should be noted that there are still certain differences between TP and customs valuations, from adopted methodologies to reviewed data. Taking limited risk distributors as an example:

Table 1

Reviewed items	TP commonly recognised practice	Customs valuation recognised practice
Adoptable pricing methodologies	Transaction net margin method (TNMM) or resale price method (RPM)	Same or similar product analysis, or deductive price method
Profit indicator	Operating margin	Mainly focus on gross margin
Reference source for pricing comparison	Comparable functions and risk profile	Comparable products
Selection of comparable companies	Tend to choose Asia-Pacific region	Importing country preferred

In light of the above, where the customs authorities raise inquiries on a company’s customs valuation by making reference to TP documentation, it is recommended that the company align internally between its customs affairs department and finance department, before responding to customs on their queries.

In addition, considerations arise where special factor analysis (for example, industry analysis, financial analysis and adjustments) is set out in the TP documentation, such as where the profit is lower than a reasonable range. It is also recommended that the special circumstances be analysed from a customs valuation perspective, if the profit is higher than the inter-quartile range. Since customs authorities are open to reviewing special adjustment factors, there is also room to adopt a benchmarking study specifically for customs valuation purposes, with adjustable conditions, such as the selected comparable companies, adopted TP methodology and profit level indicator (PLI), etc.

New brick on the Belt and Road

On August 19 2019, the GAC released GAC Announcement [2019] No 136: ‘the Publication of Revised Measures of the Customs of the People’s Republic of China for the Origins of Imported and Exported Goods under the Framework Agreement on Comprehensive Economic Co-operation between the People’s Republic of China and the Association of Southeast Asian Nations (ASEAN)’ (Announcement 136). This came into effect on August 20 2019.

The ASEAN-China Free Trade Agreement (ACFTA) took effect in 2005 and has been the largest and most influential FTA signed by China. Negotiations to upgrade ACFTA began in 2014 and after several rounds of negotiations, China and the ASEAN countries completed all the necessary domestic procedures for upgrading the FTA. It was officially implemented on August 20 2019.

The upgraded ACFTA contains major adjustments to its rules of origin (RoO). For instance, previously only 500 six-digit level HS code products were covered under the list of product specific rules, but now 2,000 are covered; the PSR list provides a list of products with specified HS codes, which are governed by designated origin criteria. Many more products in the leather, textiles, apparel, footwear, and other categories will now be treated as originating goods under ACFTA. This is so long as they can fulfill the change of tariff heading (CTH) criteria, which means the first four-digit HS codes of the ‘non-originating imported materials’ category are different from those of the finished products.

Enterprises should carefully study the upgraded RoO and the influence that these changes will have on the determination of origin.

It should be noted that China’s customs has been increasingly focusing on country of origin compliance during the past years, especially with the experience gathered from recent international trade frictions, and the new FTAs (China-Korea, China-Australia, etc.) that China entered into over the past years. Enterprises should therefore pay special attention to mitigating the risks posed by country of origin verification. Import and export enterprises should fully understand and apply the correct RoO, understand the changes in the applicable RoO, follow the requirements in filling in certificates of origin, and adhere to compliance management requirements. Doing this will ensure that they correctly apply the preferential RoO and conduct origin management in a compliant manner.

The authors would like to thank Tony Chen, KPMG China manager, for his contribution to this article.

Offshore economic substance laws: Implications for Hong Kong SAR's funds sector

The implementation of economic substance laws in offshore jurisdictions will impact funds with management and advisory teams in Hong Kong SAR. **Darren Bowdern** and **Johnson Tee** explain how these changes will prompt a revisiting of fund group holding structures.

Effective from January 1 2019, entities established in recognised offshore jurisdictions will need to satisfy the new economic substance laws (ES laws). These laws have been introduced in response to efforts made by the OECD to enhance global tax transparency under Action 5 of the BEPS initiative, as well as an investigation by the EU's Code of Conduct Group into certain low- or no-corporate income tax regimes.

Offshore jurisdictions whose ES laws have come into effect include the Bahamas, Bermuda, British Virgin Islands (BVI), the Cayman Islands, Guernsey, the Isle of Man, Jersey, Mauritius, the Seychelles and the Marshall Islands.

In particular, the idea behind the ES laws is to align the location of economic substance with the jurisdictions where profits are booked. If profits are being booked in an offshore company, it should follow that the business or profit-generating activities giving rise to those profits should be situated in the same jurisdiction. Penalties will apply to entities which breach the requirements, and if they continue to infringe, the entity may be deregistered. However, where an entity is registered as a tax resident in another jurisdiction, the ES laws will not apply.

Activities falling within the ES laws include banking, distribution and service centres, finance and leasing, fund management, headquarter businesses, holding companies, insurance, intellectual property holdings and shipping. For each of these activities, minimum core income generating activities (CIGA) are required to be undertaken in the jurisdiction of incorporation, with the level of activity required being a function of the nature of the activity undertaken.

In the context of investment funds, with its tested regulatory framework and familiarity with investors generally, the Cayman Islands (and to a lesser extent the BVI) has long been seen in Asia as a preferred tax neutral jurisdiction. Structuring through these jurisdictions



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Darren heads up the M&A tax practice in Hong Kong SAR. He has been advising on transactions in the Asia Pacific region with respect to tax matters, including due diligence reviews, investment holding structures and advising on cross-border transactions. Many of these projects consist of tax effective regional planning including consideration of direct and indirect taxes, capital and stamp duties, withholding taxes and the effective use of double taxation agreements. Darren has extensive experience in working with the mainland Chinese market, including structuring acquisitions of investments in mainland China.

Darren also advises on establishing direct investment, private equity and other investment funds in Hong Kong SAR and advises clients in a wide range of industries.

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Johnson has a wide range of experience in the establishment and structuring of offshore funds, advising on operating protocols for funds, assistance with applying for treaty benefits and advising on the structuring of management fees and carried interest.

Johnson graduated with a bachelor's degree in business from Monash University (Australia) and is a member of the CPA Australia.

allows investment returns to be efficiently distributed to investors so that they may report investment returns in their respective jurisdictions of domicile.

In this regard, Cayman Islands investment funds, including their investment special purpose vehicles (SPVs), are excluded from the ES laws. This means that typical Cayman Islands limited partnership funds, the general partners (GPs) of those funds and Cayman investment SPVs established by the funds, should fall outside the scope of the new rules.

However, fund management activities remain in scope, which means that Cayman fund managers will be required to meet the CIGA requirements.

Funds beware

A fund management business is defined as “the business of managing securities as set out in paragraph 3 of Schedule 2 to the Securities Investment Business Law (2015 Revision) [SIBL] carried on by a relevant entity licensed or otherwise

authorised to conduct business under that Law for an investment fund”. ‘Managing securities’ means managing securities belonging to another person in circumstances involving the exercise of discretion.

Whilst most Cayman Island fund managers are not licensed under the SIBL, under the SIBL (2019 Revision) Act, fund managers will need to register for a licence by January 15 2020. Having said that, the impact on fund managers will vary depending on the operating model and fund type.

For hedge funds, if discretion for making investments is exercised at the level of the onshore investment advisor – for example by a licensed investment advisor based in Hong Kong SAR – instead of at the level of the Cayman Island fund manager, which would typically be the case, then technically the fund manager should not be regarded as conducting a fund management business subject to the ES laws. Conversely, for private equity, real estate and private credit funds, if the discretionary investment decision powers are exercised at the Cayman Island fund manager level, then the ES laws would apply. The upshot of this is that such funds may need to consider shifting their fund management activities to the GP, so as to fall within the investment fund exclusion.

As already mentioned, SPVs established by Cayman Island investment funds should fall outside the scope of the ES laws. Although the ES laws and guidance do not specify the level of ownership required, on a strict reading of the rules, even if the fund invests in a minority stake in a Cayman SPV, the SPV should still be regarded as being part of the investment fund.

As the definition of an investment fund only covers Cayman Island entities, the definition does not extend to BVI companies owned by the fund. While BVI ES requirements will need to be analysed separately, the substance

requirements in the BVI for a pure equity holding company should mean that such entities should continue to be able to be used in fund structures.

The upshot of all of this is that fund groups should be able to continue with their Cayman Island platforms, but modifications may need to be made in certain circumstances.

Requirements likely to expand

For companies established on or after January 1 2019 in either the Cayman Islands or BVI, compliance with the substance requirements is mandatory from the time they start conducting the relevant activities. Existing companies as at December 31 2018 had a six-month transition period (that is, until July 1 2019) to comply with the rules.


Starting in 2020, entities will have annual reporting obligations to the Cayman Island and BVI authorities in respect of their compliance with the new rules. There are heavy penalties for failing to satisfy the economic substance test, with a fine for non-compliance of approximately \$10,000 applicable to the initial year, and up to \$100,000 in subsequent years.

For continuing non-compliance, the entities may also be struck off the Registrar of Companies. This is a good opportunity to revisit the wider fund groups’ holding structure and the purpose behind it, as well as the costs and benefits of maintaining such offshore entities.

As a final point, given the development of the global tax environment towards greater transparency and the clamping down on harmful tax practices, economic substance requirements are likely to expand to even more jurisdictions, particularly those which have very low or no taxation. While existing operating structures may still be viable under current laws, management should keep a close eye on new developments and be prepared to make appropriate changes in response to such changes.

IIT reform: Paving the future of personal income tax compliance in China

In 2019, the major individual income tax (IIT) reform initiated in 2018 was reinforced with a string of clarifications. Chinese tax residents and foreigners with exposure to Chinese IIT are coming up to speed with the changes. **Michelle Zhou** explores the issues.



Following six months of public consultation and discussion between representatives of the National Peoples' Congress (China's parliament), in late 2018 China's IIT Law was amended for the seventh time since its inception. This major overhaul led to an overall reduction in the personal income tax burden for low and middle-income earners, while also instituting new safeguards on the integrity of the national tax base.

The revenue impact was immediate. According to statistics from the State Taxation Administration (STA), IIT collection between January and May 2019 was down by CNY 259.4 billion (\$36.8 billion) compared with the same period in 2018. Approximately 109 million taxpayers were treated as IIT exempt, as their salary and wages income fell under the annual personal exemption threshold of CNY 60,000.

While taxpayers and their advisors are still digesting the implications of the IIT rules, further innovations have been made. For example, IIT and Chinese corporate income tax (CIT) incentive policies are being rolled out in the Greater Bay Area (GBA – the cluster of cities in South China including Guangzhou, Shenzhen, Hong Kong SAR and others) to attract talented staff and investment into the area. Other local government authorities, such as the Lingang free trade zone in Shanghai have also followed suit with equivalent incentives.

The counterweight to reductions in the tax burden for low and middle-income taxpayers is the strengthening of enforcement efforts by the STA. Beginning in June 2019, tax authorities across the country launched enhanced IIT audit activities, with a view to applying the anti-avoidance rules contained in the new IIT regime.

Prior to 2019, solely the CIT law contained a robust and comprehensive set of anti-avoidance rules, while the IIT law lacked comprehensive provisions of this sort. Furthermore, since the inception of the IIT law in the 1980s, the Chinese tax authorities have always relied heavily on tax

withholding mechanisms; this has meant that the focus has been on collecting personal income tax revenue from wage earners for whom the employer could act as the withholding agent. By contrast, the collection of IIT on other non-wage income, lacking straightforward withholding mechanisms, was relatively weak.

The introduction of the new IIT anti-avoidance rules is expected to close some of the loopholes which existed under the old system and strengthen the administration of IIT. In view of the progressive rollout of a ‘social credit rating’ system in China, the IIT changes should prompt individual taxpayers to place paramount importance on their personal tax compliance in order to maintain their personal credit rating and minimise potential negative effects on their future business dealings.

During 2019, China activated social security totalisation agreements (SSTAs) with Luxembourg and Japan – in May and June 2019, respectively – and concluded a new SSTA with France, in September 2019. China has now extended its SSTA network to cover 11 countries including: Germany, Korea, Denmark, Finland, Canada, Switzerland, the Netherlands, Spain, Luxembourg, Japan and France. The SSTA eliminates duplicate contributions to the social security systems for international workers in both China and their home countries. It also improves the competitiveness of treaty countries with foreign operations by reducing their cost of doing business in China. The development will be largely welcomed by foreign companies as a stimulus to invest in China.

Alignment with international conventions

With the 2018 IIT reform, the STA sought to align certain Chinese rules and practices with those typical internationally, as well as bringing in new innovations, including:

- International standard ‘183-day’ test adopted for determination of tax residency;
- Taxpayer identification number formally introduced to facilitate IIT administration for individual taxpayers and enable the sharing of personal information among various government authorities; and
- Individual taxpayer’s tax compliance status, which will be a factor in the assessment of an individual’s personal credit rating.

The new IIT anti-avoidance rules encompass the arm’s-length principle for the pricing of related-party transactions, a controlled foreign companies (CFC) rule, and a general anti-avoidance rule. These rules are not new in the context of China CIT but are very relevant to IIT as observed in recent personal income tax evasion cases.

As China and its nationals continue to expand their footprint around the globe, we envisage that the following areas are likely to be scrutinised by the STA in coming years to safeguard the integrity of the national tax base.

One is the determination of tax domicile. Over the past decade, wealthy Chinese entrepreneurs have been targeted by foreign countries with favourable migration policies. For many Chinese nationals, acquiring a foreign passport means a reduction in their personal tax burden, as some of these destination countries adopt lower personal income tax rates. Even if these individuals remain in China after acquiring a foreign passport, they could still benefit from China’s preferential tax policies for foreign nationals.

However, such individuals are often unaware that acquiring a foreign passport does not automatically shield them from Chinese taxation. Article 10 of the new IIT law puts the onus on individuals to perform tax clearance procedures, prior to cancelling their China household registrations when emigrating overseas. At this juncture, it is unclear whether the tax clearance procedures under the new IIT regime will be the first step to introducing an ‘exit tax’ for individuals relinquishing Chinese citizenship. However, the introduction of the new clearance requirements has inevitably drawn the attention of those who have retained their household registration, after obtaining a foreign passport, when they seek to assess their personal tax planning options and go-forward tax compliance status.

Pending further STA guidance on the disclosure details demanded under the tax clearance procedures, individuals who have changed their citizenship, or intend to do so, should review their tax domicile and tax residence status on a regular basis (annually at the very least). This is a key step for them to assess their compliance with the tax laws in China and relevant tax jurisdictions.

A second area will be that of special purpose vehicles (SPVs) in offshore jurisdictions. Indirect transfers of equity in Chinese companies by Chinese tax resident individuals has been more closely monitored by local Chinese tax authorities in recent years. These are cases where, say, a Chinese resident holds equity in a Chinese company through two layers of companies in the British Virgin Islands (BVI). The upper tier BVI company disposes of the lower tier BVI company, thereby indirectly transferring the Chinese investment but leaving the proceeds overseas. Cases have been reported in Shenzhen, Beijing and Jiangsu where China IIT was assessed on indirect transfers prior to the introduction of the new IIT rules. With the IIT anti-avoidance rules being implemented progressively, there will be firm legal basis for Chinese tax authorities to dissect indirect transfers and assess IIT where inappropriate tax benefits are suspected to be derived.

Under the new IIT CFC rules, Chinese tax authorities can assess Chinese IIT on an offshore company share transfer where they determine that income has been pushed up into a controlled company overseas (for example, the upper tier BVI company described above), and there are no reasonable operational needs for retaining it there over repatriating it to



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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.

Michelle has a master's degree in commerce (advanced finance) from the University of New South Wales, and is an associate member of the Taxation Institute of Australia.

China. The introduction of these rules, together with the new economic substance requirements being rolled out in several offshore jurisdictions, are prompting wealthy Chinese individuals to reassess their existing investment arrangements. See *Offshore economic substance laws: Implications for Hong Kong SAR's funds sector* for more on the latter rules.

Only the beginning

The recent introduction of anti-avoidance rules into the Chinese IIT law may be viewed as the first step on a longer journey. Chinese tax policymakers are looking closely at other measures used internationally, which they may later consider for adoption into domestic law.

Mechanisms such as voluntary disclosures or amnesty programmes are important features of some countries' tax systems. These mechanisms allow for taxpayers to report and settle outstanding taxes with a reduction in, or even an exemption from, fines and interest, rather than having to carry the risk of much greater tax and penalty exposure if the tax authorities detect non-compliance.

In China, tax compliance in the entertainment sector has been a key focus in recent times, with cooperation on historic non-compliance advisable for mitigation of penalties, though more formalised systems would be a worthwhile policy innovation going forward.

Information transparency and exchange

In 2010, the US Congress passed the Foreign Account Tax Compliance Act, which stipulated that all US citizens living in the US but holding overseas assets worth more than \$50,000, or US citizens and green card holders who reside outside the US and have \$200,000 or more in overseas assets, must declare and file tax returns to the US government. Any refusal to do so is considered as intentional tax evasion and exposed to fines of up to \$50,000. All non-US financial institutions must identify and disclose the account details of their US clients to the US tax authorities and undertake withholding obligations, if any.

On the international front, automatic exchange of information (AEOI) on financial accounts is improving tax compliance. It is delivering concrete results for governments worldwide and is proven to be effective at improving transparency. By mid-June 2019, more than 90 jurisdictions participating in the OECD's common reporting standard (CRS) since 2018 have exchanged information on 47 million offshore accounts, with a total value of around €4.9 trillion (\$5.4 trillion). The AEOI initiative, implemented through 4,500 bilateral agreements to date, represents the largest exchange of tax information in history and the largest collective international effort to counter tax evasion in over more than two decades.

In order to maintain the integrity of the CRS, the OECD continuously analyses actual and perceived loopholes that have been brought to their attention and tried

to determine appropriate actions to close these loopholes. Moreover, the OECD has analysed more than 100 residence and citizenship by investment schemes, known as golden passports or visas, offered by CRS-committed jurisdictions, and identified schemes that potentially pose a high-risk to the integrity of the CRS.

As of May 2019, mainland China has activated 67 exchange relationships with respect to more than 100 jurisdictions committed to the CRS; the STA's first exchange with Hong Kong SAR occurred in 2018. As the economy becomes increasingly globalised and cross-border activities become more prevalent, relying solely on domestically collected information on taxpayers will not suffice to ensure taxpayer compliance. China's recent IIT reform, its active

participation in the CRS to date and its investment into the Golden Tax System will establish the appropriate legal, administrative and technological framework to verify taxpayer compliance, and bring national tax administration in line with the globalised economy.

Paving the way for the future

The 2018 China IIT reform is only the beginning of a long journey to a much more sophisticated Chinese tax system for individuals in future. The full effect of the recent changes will only become fully evident once full substantive and procedural guidance is rolled out and implemented.

The author would like to thank Lina Hu, KPMG China senior manager, for her contribution to this article.

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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Managing China's wealth: Rich pickings for foreign asset managers

The steady growth of China's middle class is increasing the demand for asset and wealth management services for domestic institutions and individuals. **Henry Wong** explores the commercial and tax implications of these developments.

In 1998, there were only six fund management companies in China with RMB 10 billion (\$1.4 billion) of assets under management (AUM). Since then, the Chinese asset management industry has grown to more than 120 fund management companies with more than RMB 51.4 trillion of AUM. The expansion of China's middle class will drive the industry further forward in the future; it is among the most attractive parts of the Chinese financial services industry for foreign players. Foreign assets managers can bring their years of international asset management experience and global market perspective to Chinese investors, and win business on this basis.

The loosening of the foreign ownership restrictions in the sector has created a recent opportunity for foreign asset managers to operate an asset management business directly within China, rather than being limited solely to investing in China's capital markets from overseas through the QFII/RQFII/Stock Connect channels (see *China capital markets open up: New opportunities bring fresh tax challenges*).

Establishing an asset management company in China enables foreign fund managers to raise funds directly in RMB in China, and serve wealthy Chinese individuals directly. Since the release by the Asset Management Association of China (AMAC) of 'Answers to Relevant Questions Regarding the Registration and Filing of Private Funds (No.10)' in 2016 (FAQ 10), a total of 21 foreign-invested private fund managers (PFM) have registered with the AMAC, with 46 registered products and RMB 5.4 billion of AUM as of August 2019, according to a previous AMAC statement.

Looking ahead, foreign asset managers will need to pay attention to competition from domestic players such as securities companies, bank wealth management (WM) subsidiaries and insurance companies participating in the asset management market. In addition, domestic tech giants are progressively taking advantage of their strong distribution channels

over the internet to enter the asset management scene in force. On the regulatory front, the Guiding Opinions on Regulating Asset Management Business of Financial Institutions (New AM Rules) entered effect in 2018, setting stricter requirements for asset managers. Foreign participants need to pay close attention to this.

Asset management and foreign managers

For foreign investment managers seeking to raise a securities investment fund in mainland China, there are two main options.

One of them is the joint-venture fund management company (FMC JV). Among the existing FMC JVs, most foreign investors only hold minority shares. This is because of long-standing regulatory restrictions on the percentage of shares that may be held by foreign investors in an FMC. However, in 2017 the State Council (the cabinet) announced that these restrictions would be removed within three years. Since then, the holding limit has been raised from 33% to 51%, and foreign companies have started to increase their holdings to this level. Subsequently, in October 2019, the China Securities Regulatory Commission (CSRC) made an announcement that the original deadline would be brought forward from 2021 to as early as April 2020. This means that, in principle, foreign investors will be able hold 100% of an FMC from next year.

An FMC JV facilitates the issuance of a broad range of fund products, including both publicly and privately raised funds. However, a foreign asset management firm entering the Chinese market may not necessarily want to partner with a Chinese JV partner or pay a substantial amount of premium to increase its ownership share in an existing JV. There is, therefore, another other option for entering China's asset management industry, and this is the private securities fund management company (PFM).

PFMs give foreign managers 100% control of all aspects of operations. The same sort of tax issues also present themselves for each option.

Since June 2016, foreign asset managers have been allowed to incorporate onshore wholly foreign owned enterprises (WFOE), which they can register with the AMAC as private securities fund managers. Through PFM WFOEs, fund managers can raise money from Chinese investors directly and make independent investment decisions on their behalf. AMAC-issued FAQ 10 confirms that PFM WFOEs can make investments in securities on secondary markets in mainland China. In August 2019, the AMAC further announced that foreign PFM could apply to conduct retail mutual fund businesses. Prior to this, PFM could only raise private fund products and sell to high-net-worth individuals or institutions through private offering.

The PFM WFOE registration rules require that its foreign shareholder (and ultimate foreign controller) must be a finan-

cial institution licensed by the financial regulatory authorities in its home jurisdiction. The securities regulatory authorities of that jurisdiction must have signed a memorandum of understanding on securities regulation cooperation with the CSRC, or other institutions recognised by the CSRC. Furthermore, the PFM and its foreign shareholder (ultimate controller) must have not been subject to any material penalty by a regulatory or judicial department in the past three years.

China asset management operations – tax perspective

From a tax perspective, the most relevant issue for both FMC JVs and PFM is the VAT on asset management products. The relevant guidance provides that the manager of asset management products will be treated as the VAT payer, to the extent that the latter falls within the VAT charge. The applicable VAT rate is 3%, charged under the simplified method; namely, without the ability to claim any input credit. The relevant guidance is provided in Circular Caishui [2016] No. 140, Circular Caishui [2017] No. 2 and Circular Caishui [2017] No. 56.

It is notable that China decided to impose the VAT filing and payment obligations for asset management products on the fund/asset manager, instead of imposing it on the issuance vehicle of the products itself. The main reason is that most, if not all, asset management products existing in China are structured as contractual funds and not as legal entities or partnerships. Contractual asset management funds cannot be registered as taxpayers under the existing tax administration system and therefore cannot directly pay the VAT.

As VAT rules for asset management products deem the fund/asset manager to be the taxpayer, complicated VAT filing and calculation issues arise when that manager is managing multiple products at the same time. For example, the trading of financial commodities like listed securities, foreign exchange, and derivatives is subject to VAT, with the ability to offset gains and losses within a VAT reportable year. However, what if asset management product 'A' realises net gains on trading of financial commodities, while asset management 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 – the manager must aggregate all the VATable activities together and pay the VAT on behalf of all of the products under its management.

So far, there is still no clear guidance on how to deal with the allocation of VAT cost across different products. It is therefore at the manager's discretion to decide what is the most acceptable method for the investors from a business standpoint.

Another issue is how to deal with the trading gains obtained by different types of securities funds, if the same PFM is raising both private and public securities investment funds – assuming the PFM upgrades its licence to include a

public mutual fund business. Currently, there is a VAT exemption available for public securities investment funds on gains derived from trading of shares and bonds. As this tax preference policy cannot be applied to private securities funds, PFMs will need to be careful in selecting IT systems capable of conducting sophisticated VAT calculations. This will have to be able to manage the different applications of VAT for different financial instruments, different income types, and different types of fund registration (for instance, public vs private products).

According to Circular 140, gains from redemption, where assets are held to maturity, are not within the scope of VAT. However, according to Circular 36, any transfer of the ownership of financial commodities will be subject to VAT. This leaves a question over whether a fund unit redemption should be subject to VAT or not. In particular, it is quite common for a public fund product to be issued without any fixed maturity date, so there is never a concept of 'held to maturity'. On the other hand, one would argue that the fund unit will not exist after the redemption directly with the fund manager, meaning that there is no transfer per se. This differentiates the situation from trading, which involves buying and selling of a fund unit with another third party in the market. It remains uncertain whether fund redemption is subject to VAT or not.

Another issue for PFMs is that China now implements the common reporting standard (CRS) on tax information exchange with other jurisdictions. The key guidance here was set out in May 2017 in Administrative Measures on Due Diligence Checks on Tax-related Information of Non-residents' Financial Accounts. Foreign investors operating PFMs in China must fulfil the obligations set out in this guidance, including:

- a) Due diligence on financial account: designing and implementing a due diligence process to identify reportable accounts (for example, non-resident account).
- b) Information collection and reporting: collecting reportable information, such as the tax residency country of the account holder, completing the CRS filing in a timely manner and submitting a written annual report.
- c) Continuous compliance: establishing an ongoing monitoring mechanism, following up with the implementation of the CRS compliance obligations and replying to the examinations of regulatory authorities.

Failure to fulfil CRS compliance obligations may lead to punishment by the regulatory authorities, including impaired assessment of taxpayer creditworthiness, operations suspension, revocation of business permits, and cancellation of the accountable senior management personnel's appointment qualifications.

Given the opening up of the retail mutual-fund business to foreign PFM WFOEs, a series of issues need to be carefully considered. These include, the capability of the IT systems to monitor the valuation, bookkeeping, VAT determination on



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the increased numbers of fund products being raised by the PFM, and meet compliance requirements cyber-security and data privacy rules, operational risk and regulatory rules, and human resource arrangements.

China's new asset management rules

Regulatory efforts have recently been made to unify the oversight of the asset and wealth management sectors in China and ensure that they do not stray too far from their core social purpose.

These new measures are intended to remove the perception among Chinese investors that asset management products issued by banks provide 'implicit guarantees' on their returns and principal amounts. Chinese financial regulators have expressed increasing concern that many fund products raised in the market are investing in non-standard assets (such as credit and lending) that lack transparency and could have liquidity problems, or involve arbitrage that further promotes shadow banking activities. In this regard, since April 2018, the China Banking and Insurance Regulatory Commission (CBIRC) and People's Bank of China (PBOC) have issued several regulations.

These include the New AM Rules, Measures on Supervision and Administration of Wealth Management Business of Commercial Banks (WMB Measures) and Administrative Measures on Wealth Management Subsidiaries of Commercial Banks (Subsidiaries Measures).

These rules will impact all asset management institutions in China, including domestic, foreign-invested and JV institutions. The New AM Rules emphasise that asset management business activities should stick to "managing the assets entrusted by others". Asset managers should not branch out from this to raise asset management products that could be seen as involving cash pooling, provision of guaranteed payments or redemptions, or use multi-level structures that disguise underlying lending activities (for instance, products that compound shadow lending imbalances in the financial system).

Requirements are set out in the New AM Rules to limit the promotion of products that provide principal or redemption guarantees. Investor education by financial institutions must draw their attention to investment risks, and wean investors away from the belief that investment products will always provide principal or redemption guarantees.

From the tax perspective, VAT rules stipulate that returns on investments that provide "fixed, guaranteed or principal-

protected" 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. It is not clear whether a substance-over-form approach needs to be applied, or whether the 'form' set out in the explicit terms of contracts or contract equivalent documents should be followed. As the New AM Rules no longer allow asset managers to provide guaranteed redemption on its products, theoretically speaking, all asset management products governed by the New AM Rules would not provide "fixed, guaranteed or principal-protected" returns. However, if the Chinese tax authorities eventually take a substance-over-form approach to determine whether a financial or investment product is principal-protected or not, investors will need to pay close attention to the specific nature of the investment. In particular, they will need to pay attention to any special arrangements in new product contracts based on the existence of credit or income enhancement arrangements. These could be seen, in substance, as providing guaranteed or principal-protected returns, such that VAT is due on the income received.

Regarding valuation approaches for asset management products, the New AM Rules encourage application of the fair market value recognition method by asset managers. This may result in changes to the existing valuation methods used for asset management products. In order to reflect the asset value fairly, potential VAT and related surcharges on unrealised investments will also need to be considered for accrual. This will add further complexity to VAT calculation work, raising requirements for IT system upgrades.

Foreign asset managers that are planning to establish their first PFM WFOE, or to update their existing one to tap into the public mutual fund market, should pay close attention to all these regulatory developments.

What's next?

As can be seen, there are increasing opportunities for foreign institutions to participate in asset management business in China. At the same time, the issuance of a series of new asset management rules have set higher requirements for asset managers. Many uncertainties and ambiguities persist in the tax space, with further clarity hoped for in the coming years as the market matures.

The author would like to thank Aileen Zhou, KPMG China senior manager, and Wendy Ding and Hans Hu, KPMG managers, for their contributions to this article.

Understanding risks and maintaining agility in the asset management space

As the industry landscape and regulatory requirements continue to evolve, with a steady increase in tax complexity and investor reporting requirements, it is becoming increasingly important for asset management organizations and leaders to remain agile. They need to continuously find innovative ways to navigate the opportunities and challenges presented by new technologies, evolving distribution channels, and potential new modes of collaboration.

KPMG China can assist you in better understanding the embedded risks of the ever-changing tax policy landscape to make more informed decisions on day-to-day operations, allowing you to proactively create real value for investors.

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China capital markets open up: New opportunities bring fresh tax challenges

China's capital markets continue to expand and open up, offering a range of innovative new investment channels. **Henry Wong** explores the tax challenges arising under each of these channels.



China's capital markets have grown exponentially in recent decades and are now steadily opening up to foreign investors.

Notable recent developments include the China A-shares market, which has been progressively added to many leading international stock indexes such as MSCI, S&P Dow Jones and FTSE Russell. Its weight in these stock indexes is continuously increased.

The domestic Chinese bonds market was also added to the Bloomberg Barclays Index Aggregate in April 2019. Meanwhile, in June 2019, the Shanghai-London Stock Connect was officially launched, covering both the primary and secondary markets. This complements the earlier Stock Connect schemes between Hong Kong SAR and Shanghai/Shenzhen. The Shanghai-London Stock Connect allows Chinese companies to list on the London Stock Exchange (LSE) – an arrangement not facilitated by the Shanghai-Hong Kong Stock Connect scheme.

The Shanghai Stock Exchange Science and Technology Innovation Board (STAR Market) was opened in July 2019. It mainly attracts tech start-ups and is an attempt to replicate the successes of the US NASDAQ stock market. Then more recently in September 2019, the Chinese government announced that the quota limitation on the qualified foreign institutional investor (QFII) and RMB qualified foreign institutional investor (RQFII) programmes is now completely abolished. As such, qualified foreign asset managers are free to choose between the QFII/RQFII or Stock Connect channels to invest in China's capital markets directly without quota limitation.

Finally, in parallel with these developments, the steady growth of China's economy and increase in the middle-class population has meant that the demand for asset and wealth management services for domestic institutions and individuals is also growing significantly. The commercial and tax implications of these developments are explored

Table 1

Investment channels	Eligible investors	Regulatory bodies	Eligible investments	Investment currency
Stock Connect (Shanghai-Hong Kong, Shenzhen-Hong Kong)	All foreign investors including individuals (but only institutional professional investors for SZSE ChiNext shares)	People's Bank of China (PBOC), China Securities Regulatory Commission (CSRC), Hong Kong Securities and Futures Commission (HKSF)	<ul style="list-style-type: none"> – Approximately 1,260 stocks as of September 6 2019: – 578 Shanghai Stock Exchange (SSE) shares: Constituents of SSE 180 Index and 380 Index and dual SSE-Hong Kong Exchanges and Clearing (HKEX) listed shares – 680 Shenzhen Stock Exchange (SZSE) shares: Constituents of SZSE Component Index and SZSE Small/Mid Cap Innovation Index and dual SZSE-HKEX listed shares 	Offshore RMB, HKD and USD
Bond Connect	Foreign financial institutions (commercial banks, insurance companies, securities companies, FMCs and other asset management institutions) and investment products issued by them, other medium- and long-term institutional investors (like pension funds, charitable foundations etc.) as approved by PBOC	PBOC, Hong Kong Monetary Authority (HKMA), China Government Securities Depository Trust & Clearing Co, China Securities Depository and Clearing Company.	All bonds traded in the CIBM	Onshore RMB, offshore RMB
China Interbank Bond Market (CIBM) Direct		PBOC, Ministry of Finance (MOF), State Administration of Foreign Exchange (SAFE)	<p>All cash bonds and other products permitted by the PBOC.</p> <p>Foreign institutions can also invest in repos, bond borrowing and lending, bond forwards, IRS, FRA, etc.</p>	Onshore RMB, offshore RMB

Table 1 (continued)

Investment channels	Eligible investors	Regulatory bodies	Eligible investments	Investment currency
QFII	Foreign institutions meeting the following requirements: <ul style="list-style-type: none"> – Commercial banks: ≥ 10 years operation, ≥ \$5 billion AUM, ≥ \$300 million Tier 1 capital – Securities companies: ≥ 5 years operation, ≥ \$5 billion AUM, ≥ \$500 million capital – Asset management institutions, insurance companies and others: ≥ 2 years' experience, ≥ \$500 million AUM 	CSRC, PBOC, SAFE	<ul style="list-style-type: none"> – All securities listed on SSE/SZSE – Cash bonds in inter-bank market – Securities investment funds, including close-ended, open-ended and ETFs – Index futures – FX derivatives (for hedging purposes only) – Other products approved by CSRC 	USD or other FX (convert to RMB onshore)
RQFII	Foreign institutions in (including asset management institutions, securities companies, commercial banks, insurance companies and overseas subsidiaries of China FMCs)	CSRC, PBOC, SAFE		Offshore RMB

further in *Managing China's wealth: Rich pickings for foreign asset managers*.

On the tax front, China has progressively rolled out a series of tax exemption policies to encourage the development of the capital markets. However, the Chinese financial service sector's unique tax environment still presents significant challenges and tax uncertainties for investors and industry players. In this article, we consider the major business and tax challenges presented for the leading types of investment channels into China, to enable foreign asset managers to be better prepared when investing into China.

Investing into China's capital markets

Without any establishment in mainland China, foreign asset management institutions can still directly participate in China's capital markets via different channels, mainly the QFII/RQFII (just announced to be fully opened up to all qualified investors), CIBM Direct (China Interbank Bond

Market), Stock Connect and Bond Connect, among others. Set out in Table 1 and below is a snapshot of the eligible investors, regulatory institutions, eligible investments and investment currencies of different channels.

Stock Connect

The Stock Connect programme was first launched in 2014 between the Shanghai and Hong Kong SAR exchanges, and was extended in 2016 to encompass a link between the Hong Kong SAR and the Shenzhen market. It allows mainland Chinese investors to purchase Hong Kong SAR and Chinese companies listed in Hong Kong SAR. At the same time, it allows foreign investors to buy listed China A shares, without having to apply for a licence to invest through QFII/RQFII channels.

Stock Connect covers both individual and institutional investors and is the easiest way for foreign investors to invest in the China A share market, with no need to open a bank account in mainland China. Instead, investments can be

made via Hong Kong SAR stock brokers. This being said, foreign investors are limited on their selection of investable securities. As of September 2019, only 578 securities listed on the SSE and 680 securities listed on the SZSE are eligible for trading under Stock Connect.

In the most recent development, Shanghai-London Stock Connect was officially launched in June 2019, and it covers both primary and secondary markets. Investors can trade depositary receipts in the secondary market. For ‘west-bound’ listings, Shanghai Stock Exchange-listed companies can use newly issued shares to issue global depositary receipts (GDRs) and to achieve primary market security issuance on the LSE. This differs from the existing Shanghai-Hong Kong Stock Connect, which is only a secondary market trading mechanism.

Preferential Chinese tax treatments have been provided to attract foreign investment through Stock Connect. Foreign investors are temporarily exempt from corporate income tax (CIT) and VAT on trading gains arising on transfer of A-shares. However, dividends from A-shares, paid to foreign investors, are subject to 10% withholding tax (WHT). While treaty relief can be available to certain investors such as sovereign wealth funds (SWFs), the tax treaty relief application and tax reclaim processes remain inefficient, and industry groups continue to lobby for a streamlined approach.

While investors can technically apply for WHT refunds to the in-charge tax bureau of the listed company which paid the dividend, in practice the application procedure is cumbersome and time-consuming. There is inconsistency between the WHT refund documentation requirements of different local tax authorities; foreign investors consequently need to liaise closely with each listed company and their specific in-charge tax authorities to secure refunds.

We also observe that most tax authorities require the official seal of the listed company on the application documents and that listed companies may take different approaches to providing their official seal to investors. For example, listed banks generally require that the share certificate, usually held by the offshore custodian bank of the foreign investor, be notarised by an authorised public notary and certified by the Chinese embassy in the country of incorporation. This is very onerous and takes a lot of time; investments in multiple listed companies result in a heavy workload for WHT refund applications.

Bond Connect

Similar to Stock Connect, Bond Connect is a mutual market access scheme that allows eligible investors from mainland China and overseas (through Hong Kong SAR) to trade in each other's bond markets. Through Bond Connect, launched in 2017, foreign investors can trade in the secondary market and subscribe for CIBM bonds in the primary market through Bond Connect, meaning they can trade all

CIBM bonds. At the end of 2018, the China Foreign Exchange Trade System (CFETS) and Bloomberg together launched access channels to China's interbank bond market. This allows foreign investors to obtain bids and quotes data, as well as trade onshore Chinese bonds via the Bloomberg terminals, making investment activity more efficient. Similar to Stock Connect, Bond Connect may now be the most convenient channel for foreign investors who are otherwise not qualified to use CIBM Direct access (discussed further below), to participate in China's bond market.

As regards to the Chinese tax treatment, Caishui [2018] No. 108 (Circular 108) provides for a three-year exemption from CIT and VAT for interest income derived by foreign institutional investors investing in Chinese bonds; this runs from November 7 2018 to November 6 2021. However, there still remains a number of tax ambiguities. Three in particular stand out:

- Do asset backed securities (ABS) qualify as ‘bonds’? There are various types of tradable debt instruments available to foreign investors in the Chinese bond market, including ABS, asset-backed notes (ABN) and interbank certificates of deposit (CD). However, Circular 108 does not provide a clear definition of ‘bonds’. There is some uncertainty as to whether the VAT and CIT exemptions for bond interest can be applied to income from special debt instruments, for example ABS, ABN and CD, or whether it is limited to plain-vanilla bonds, such as government bonds, government-supported institution bonds or corporate bonds. While ABS and ABN can be traded in the interbank bond market and are considered ‘bonds’ by many financial institutions, they differ in terms of issuance and trading mechanisms. The originator will first transfer the underlying assets to a special-purpose vehicle (SPV) set up for issuance of a specific asset management product. The manager of the SPV will oversee the ABS and issue securities to investors.
- Do ABS returns qualify as ‘interest’? Circular 108 provides a CIT exemption for ‘interest income’ with the definition cross-referencing the CIT Law. The CIT Law defines ‘interest income’ as being derived by an enterprise from the provision of funds for use by others, where this does not constitute equity investment – it specifically lists (non-exclusively) deposit interest, loan interest, bond interest, and arrears interest. It is unclear whether the income derived from holding ABS should be treated as interest income and therefore qualify for the Circular 108 exemption. A tax administrative point to note is that, at present, an asset management product cannot be registered by the manager or the sponsor with the tax bureau. Consequently, the manager or the sponsor cannot act as the withholding agent for foreign investors, in the same way as corporate bond issuing companies would. Therefore, ‘interest’ arising on ABS investments, while

not yet subject to Chinese withholding tax as an administrative matter, may not necessarily be entirely free of liability to Chinese tax as a legal matter. As such, this creates an additional tax exposure for foreign investors who wish to invest in these investment products.

- Is there VAT on returns from asset management products? An asset management product is regarded as a 'financial product' from a Chinese VAT perspective. Income from a financial product may be subject to VAT if it is regarded as a principal-protected product. However, VAT regulations are unclear on the meaning of principal-protected product and different tax bureaus take varied and inconsistent positions on the matter.

CIBM Direct Access

Before the launch of the Bond Connect scheme in 2017, certain foreign institutional investors were able to invest in China's interbank bond market through an application to be eligible investors with CIBM.

Tracing the history of this investment channel, in 2010 the PBOC launched a pilot scheme allowing foreign central banks or monetary authorities, RMB settlement banks in Hong Kong SAR and Macau SAR, and cross-border RMB settlement participating banks in Hong Kong SAR and Macau SAR, to trade and settle bonds in the CIBM. In December 2011, QFIIs and RQFIIs were allowed to apply for approval and quota to invest in the CIBM via a bond settlement agent. The PBOC from July 2015 allowed foreign central banks, monetary authorities, international financial organisations and SWFs to invest in the CIBM without approval requirements and quota limits. From 2016 onwards, more types of foreign institutional investors were allowed to invest in the CIBM, including commercial banks, insurance companies, securities firms, fund management companies and other asset management institutions, as well as their investment product vehicles. This was in addition to pension funds, charity funds, endowment funds and other mid-term or long-term institution investors recognised by the PBOC.

CIBM Direct has higher qualification requirements than Bond Connect for investors to be eligible, but it also provides a wider scope of investment opportunities. This includes repos, bond borrowing and lending, bond forwards, interest rate swaps (IRS), and forward rate agreements (FRA), among others, for hedging purposes, which brings certain advantages in terms of risk management.

In respect of the bond investment, the tax issues that foreign investors face under CIBM Direct Access are similar to those faced for investments via Bond Connect. However, given the wider range of investment types accessible, there are even more tax uncertainties that arise. For example, take the tax treatment of derivative transactions. Technically speaking, according to relevant VAT regulations, gains derived from derivative transactions are

subject to VAT. However, in practice, the Chinese transaction counterparty will generally not withhold VAT arising in relation to foreign investors because of the lack of a relevant withholding mechanism.

QFII/RQFII programmes

A QFII is a foreign institutional investor that meets certain qualification criteria and is approved by the CSRC. It can invest in a range of securities products, and was in the past subject to an investment quota approved by the State Administration of Foreign Exchange (SAFE). As of August 2019, the total quota of 292 foreign institutions stood at \$111.38 billion.

The RQFII programme is a modified version of QFII that facilitates foreign investment in mainland China via offshore RMB accounts. It was also similarly subject, in the past, to an investment quota approved by the SAFE. As of 2018 year-end, the total RQFII quota amounted to RMB 1.940 trillion.

With the opening up of China's capital markets and financial services sector underway, it was recognised that the existing rules of the QFII and RQFII schemes would no longer meet the demands of the new market environment. In response, in early 2019 the CSRC issued the 'Notice on Public Consultation for the Measures for the Administration of Domestic Securities and Futures Investment by QFII and RQFII and the Provisions on Issues Concerning the Implementation of the Measures for the Administration of Domestic Securities and Futures Investment by QFII and RQFII' (the CSRC consultation papers).

The QFII/RQFII programmes already have a more comprehensive investment scope than Stock Connect or Bond Connect. The scope will now be further expanded by the CSRC consultation papers to cover private fund investments, and will also be permitted to invest in stocks listed on the New Third Board (the National Equities Exchange and Quotations System Co), financial and commodity futures, and bond repos.

In parallel with the release of the CSRC's consultation papers, the SAFE firstly abolished investment quota restrictions for QFII/RQFII in September 2019 and secondly, simplified FX settlement rules. The latter changes provide that: 1) the 20% annual limit on the repatriation of principal and profit by the QFII is now removed; 2) the three-month lock up period on repatriation of principal for QFII/RQFII is now removed; and 3) QFII/RQFII is now allowed to hedge exchange rate risk through entering into FX derivative transactions.

While these changes facilitate remittances for QFII/RQFIIs, a requirement for tax clearance remains. QFII/RQFIIs needs to perform a record filing with the local tax bureau and submit tax record filing forms, with the local tax bureau's stamp, to the remitting bank before net income

and net trading gain proceeds can be repatriated from China. This makes profit repatriation less convenient compared with other channels. The tax record filing takes time and effort, and uncertainties exist in relation to the application procedure requirements (in the absence of any relevant nationwide guidance), and local tax authority practices. In particular, many tax authorities only accept an application on a yearly basis. This means that profits realised by a QFII/RQFII at the beginning of the year can be repatriated no earlier than the middle of the following year subsequent to the submission of application documents.

Furthermore, where there are sub-accounts set up under QFII/RQFII master accounts, there can be challenges in separately repatriating profits from these sub-accounts. In practice, the tax authority may only accept a repatriation application at the whole QFII/RQFII account level. This means that a foreign asset manager that uses a sub-account structure should plan in advance on profit repatriation.

Preferential tax policies for QFII/RQFII provide temporary CIT and VAT exemptions for gains on trading of equity investment assets, including shares. However, tax uncertainties exist, and will increase with the scope expansion of the QFII/RQFII programme:

- VAT treatment of corporate bond interest: Bond interest is subject to VAT since the May 2016 implementation of VAT reform, meaning that QFII/RQFII licence holders must conduct VAT filing and settlement for profit repatriation. While Circular 108 provided a tax exemption for bond interest, it is not clear how to treat interest arising before the circular became effective on November 7 2018. Uncertainty exists in particular for corporate bonds in the absence of an effective VAT withholding mechanism. There is also uncertainty on the treatment of bond interest arising before the May 2016 VAT reform rules entered into effect (namely, the application of previously existing business tax). The practice adopted by local tax authorities is also inconsistent.
- Tax treatment of fund distributions. According to Caishui [2008] No. 1, distributions from security investment funds are exempt from CIT. However, it is not clear if this applies to non-resident taxpayers such as QFII/RQFII, and the practices adopted by local tax authorities are inconsistent. On the other hand, 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 be subject to VAT. However, in practice, there are still many ambiguities on the meaning of fixed, guaranteed or principal-protected investment returns. Distributions from funds that invest in bonds are treated, in practice, as bond interest by some local tax authorities and subject to VAT.
- VAT treatment of FX gain/loss of QFII principal. According to the relevant FX regulations, a QFII must



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provide principal for investment in foreign currency and then convert it into RMB for investment. If a QFII wants to remit funds out of China (including both profit and principal), it has to convert its RMB into foreign currency. It is unclear whether the FX gains derived from these conversions of the principal should be subject to VAT. Technically speaking, realised gains from FX trading are subject to VAT. However, the QFII is not ‘actively’ engaging in FX trading and the conversions are made pursuant to a regulatory requirement. FX gain/loss is only realised during the currency conversion at the time of repatriation. In practice, some local tax authorities may impose VAT on the above-mentioned realised FX gain of the principal.

Making the most of the opportunities

With all these exciting new developments opening up China’s capital markets, tremendous opportunities are now available to foreign investors, and these are expected to proliferate in

the near future. However, as with other industries and sectors in China, as regulatory rules are relaxed and new opportunities present themselves, tax rules necessarily have to do some catch-up. This is crucial so that the new policies are, in practice, effective at encouraging fresh foreign investment into China, and are not stymied by tax uncertainties.

We certainly hope that the Chinese tax authorities will continue to clarify rules on the taxation of foreign investment into the Chinese capital markets. In the meantime, investors are recommended to seek appropriate advice from tax professionals, keep a close watch on tax rules development, and fully understand market practices and local tax authority interpretations. In addition, active participation in asset management industry associations is crucial for raising suggestions for improvement to the relevant China regulatory bodies.

The author would like to thank Aileen Zhou, KPMG China senior manager, and Wendy Ding and Hans Hu, KPMG managers, for their contributions to this article.

Going out: China outbound investment faces new tax challenges

While global FDI levels sag and China ODI falls, Chinese investment in BRI jurisdictions continues to grow. However, a range of tax challenges face Chinese MNEs in BRI countries and other locations, write **Michael Wong** and **Joseph Tam**.



Recent years have seen a reduction in foreign direct investment (FDI) flows across the world. China's inbound FDI has held up reasonably well, but outbound direct investment (ODI) has reduced.

In 2016, Chinese ODI reached its peak to-date (\$196.1 billion), with a drop in 2017 (\$158.3 billion) and 2018 (\$129.8 billion); in 2019 \$78.5 billion of non-financial ODI was recorded from January to September. As noted in the Financial Times (*The story of China's great corporate sell-off, September 20 2019*), Chinese companies in 2019 became net sellers of global assets for the first time since they became major players in global M&A. The record sell-off has totalled approximately \$40 billion for the year-to-date, according to data from Dealogic. This being said, there are a number of fields in which Chinese ODI continues to grow.

In 2018, the China Ministry of Commerce (MOFCOM) statistics indicated that Chinese enterprises invested \$15.6 billion in jurisdictions covered by the Belt and Road Initiative (BRI), meaning an increase of 8.9% on the prior year. Key investment destinations include Singapore, Laos, Vietnam, Indonesia, Pakistan, Malaysia, Russia, Cambodia, Thailand and the United Arab Emirates.

While MOFCOM figures show BRI accounting for 13% of total mainland China ODI, this does not capture the very significant amount of mainland China-BRI investment that goes via Hong Kong SAR and several Caribbean jurisdictions. Certain economic research institutes estimate the figure could now be as high as 21.6%. Growth has appeared to continue, both in terms of ODI in the BRI countries and in terms of the number of new engineering, procurement and construction (EPC) projects; there were 3,642 new BRI EPC contracts new signed in 2019 to-date, according to MOFCOM.

Of significant concern is that there are some key uncertainties that are looming over Chinese outbound tax planning. Tax certainty means that

enterprises have the capacity to make an accurate assessment of the tax and compliance costs associated with an investment in a country over its lifecycle. High levels of tax uncertainty are seen to raise risk premiums and hurdle rates for investments – to the extent that Chinese outbound investing enterprises face deeper tax uncertainty, this means that potentially worthwhile investments may not be undertaken.

The past year has seen a number of developments in both the tax and non-tax arenas that may raise uncertainty and impact the investment plans and operating structures of China multinational enterprises (MNEs), among others. The most significant in this regard include:

- The new economic substance requirements in various offshore jurisdictions, which have been used extensively by Chinese MNEs for their overseas investments;
- The EU Mandatory Disclosure Regime, which impacts planning arrangements by Chinese MNEs in relation to their extensive investments in the EU;
- Brexit and its implications for significant Chinese investments in the UK; and
- The BRI Tax Administration Cooperation Mechanism (BRITACOM), as a basis for addressing tax uncertainty in China's most promising investment locations for the future.

Other key issues impacting on Chinese outbound investment, including developments with the China mutual agreement procedure (MAP), advance pricing agreements (APA), and the emerging new global tax framework, are explored in the transfer pricing (TP) and international tax articles in this edition.

Offshore uncertainties

The first uncertainty comes in the form of the new economic substance requirements in offshore jurisdictions.

Chinese MNEs investing overseas, frequently set up entities in low-tax offshore jurisdictions as vehicles for investment in target markets. This is done for a variety of commercial and legal reasons. For example, a holding company could be set up in the Cayman Islands with the aim of facilitating a future initial public offering (IPO) in either the US or Hong Kong SAR. Holding companies may be set up in United Arab Emirates (UAE) to facilitate the regional management of the business and/or investments in the Middle East. For certain sectors (technology, media and telecoms (TMT), energy, etc.), entities in the Cayman Islands are used to hold intellectual property, or as a firewall to separate the potential legal risk of the underlying operations/assets from the Chinese companies or their immediate holding entities.

In recent times, however, the traditional low-tax jurisdictions have been compelled to introduce economic substance requirements. This is due to both the establishment of the EU blacklist of non-cooperative

jurisdictions, and the expansion of OECD/Forum on Harmful Tax Practice peer review under BEPS Action 5 to cover low substance arrangements in offshore jurisdictions. The details of the new rules are explored in further detail in *Offshore economic substance laws: Implications for Hong Kong SAR's funds sector*.

Jurisdictions where new and stringent substance compliance requirements must be met include Bermuda, the British Virgin Islands (BVI), Cayman Islands, UAE, Guernsey and Jersey. Entities in these jurisdictions may need to increase their local physical presence, in terms of activities, local expenditure, and recruitment of local employees, in order to comply with the new requirements.

While there are local variations in the requirements, they are broadly equivalent across each of the offshore jurisdictions. Substance requirements took effect from January 1 2019, with a six-month grace period given to existing entities to meet the requirements. Chinese investors that have intermediary holding companies in those jurisdictions (especially BVI or Cayman Islands), should evaluate, on an ongoing basis, the use of such jurisdictions in their investment/operating structures and apply cost-benefit analysis to assess possible needs for adaptation.

The EU is still reviewing the legislation enacted by the various offshore jurisdictions to test whether their new substance measures meet the EU's 'fair taxation' principles. As such, additional guidance notices may be issued in relation to the implementation of these rules. Furthermore, international efforts to establish a new global tax framework are examining the potential to deploy a global minimum tax across all countries (pillar two of the Inclusive Framework global consensus solution to the tax challenges of digitalisation). If these rules are instituted, it would have an even more profound effect on the use of offshore jurisdictions than the substance requirements noted above. Chinese enterprises would need to give refreshed consideration to their structures at that point; for more detail, read *BEPS 2.0: What will it mean for China?*.

Tax reporting and Brexit

The EU Mandatory Disclosure Regime (MDR) brings a new dynamic for Chinese enterprises which have operations/investments in Europe. The MDR aims to combat aggressive tax planning/structures mainly driven by tax considerations, and Chinese businesses will need to consider the potential impact on their existing structures.

The EU directive establishing MDR (Directive 2011/16/EU, referred to as DAC6) entered into force in June 2018, and requires EU member states to have national regulations in place by December 2019, with information exchanges to commence from October 2020. The MDR requires intermediaries, such as tax advisors, accountants and lawyers, to disclose potentially aggressive tax planning



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arrangements. It also establishes the means for tax administrations to exchange information on these structures.

However, not every cross-border arrangement would be reportable; the obligation is limited to arrangements that fall within a set of so-called ‘hallmarks’ and a ‘main benefits’ test, which are set out in DAC6. In certain cases, if there are no intermediaries that are responsible for the required reporting, the reporting obligation would shift to the taxpayers themselves.

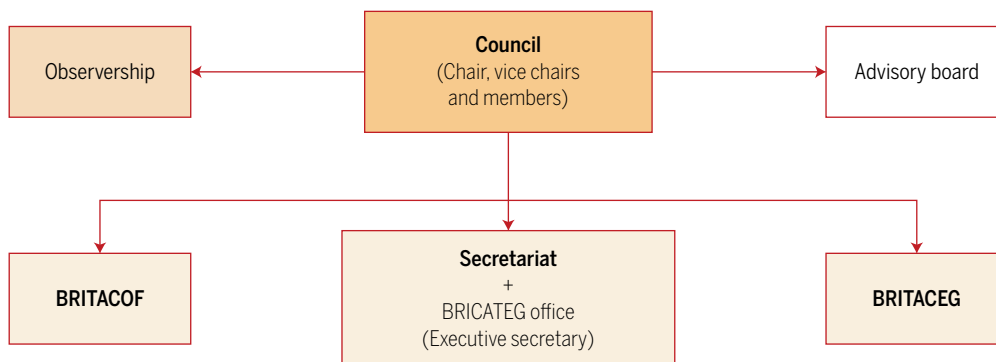
Nevertheless, it is worth noting that the disclosure requirements have retroactive effect: reportable cross-border arrangements (where the first steps are implemented between the date when DAC6 enters into force – during the period June 25 2018 to July 1 2020) must also be reported during July 1 2020 and August 31 2020. In this connection, it is imperative for intermediaries and taxpayers (including Chinese enterprises) to start reviewing and assessing the requirements of DAC6, even in the absence of a specific transposition law.

Any reportable or potentially reportable arrangements/transactions should be documented as a precautionary measure to comply with the retroactive reporting obligations. Alternatively, Chinese enterprises should also consider whether any changes to their structures (which fall within the above reporting requirements) should be made or not.

In relation to Brexit, the UK has long been viewed as a highly attractive destination for Chinese investment. In 2018, the UK was reportedly the largest recipient of Chinese ODI worth \$4.9 billion, followed by \$4.8 billion in the US and \$4 billion in Sweden. The tax implications of Brexit are being followed closely by Chinese investors keen to mitigate the impact on their European operations run out of the UK and the value of their investments. Potential tax implications being focused on by Chinese investors:

- Where EU directives, including the Parent-Subsidiary and Interest and Royalties Directives, no longer apply to

Figure 1 – The governance structure of BRITACOM



UK enterprises, the latter may need to rely on double tax agreements (DTAs) to reduce WHT exposures.

- Possible limitations on the free circulation of goods between the UK and other EU member states, and new technical and administrative complications for VAT and customs, are being followed closely by Chinese enterprises, along with transitional arrangements negotiated.

Chinese MNEs are reviewing the exposures of UK entities they have established or acquired to see if structure adaptations are required.

BRITACOM

In last year's article *Tax opportunities and challenges for China in the BRI era*, we detailed initial efforts to drive tax administrative collaboration between BRI countries. These efforts were motivated by a number of particular challenges for investors from China and other BRI countries.

These included uncertain tax policy design and tax administrative practices. For example, tax uncertainties arising from poorly drafted, unclear or complex tax rules, unpredictable or inconsistent treatments by tax authorities, and high levels of bureaucracy for tax compliance, etc.

We also noted an inconsistent approach to applying international tax standards. For example, in the application, by local tax authorities, of cross-border tax rules in a manner inconsistent with international tax standards, including permanent establishment (PE) assertions and profit attributions, or TP adjustments, etc. In addition, we highlighted issues with dispute prevention and dispute resolution mechanisms, such as a lack of access to rulings, APA and MAPs, and lack of resources to administer, etc.

In April 2019, the BRI governments sought to take these efforts further with the first BRI Tax Administration Cooperation Forum Conference (BRITACOF), held in Wuzhen, China. This was attended by heads of tax administrations and representatives of international organisations, academia and the business community, and saw the launch of BRITACOM as a structured institutional solution to establish a sound and friendly BRI tax environment.

BRITACOM has set out five dimensions for tax cooperation, being: (i) following the rule of law in taxation; (ii) expediting tax dispute settlement; (iii) improving tax certainty; (iv) streamlining tax compliance and digitalising tax administration; and (v) enhancing administration.

The governance structure of BRITACOM consists of the Council, Secretariat, BRI Tax Administration Cooperation Forum (BRITACOF), BRI Tax Administration Capacity Enhancement Group (BRITACEG) and the Advisory Board (see Figure 1):

- The Council is the decision-making body and in charge of personnel arrangements, strategic decisions, and coordination of BRITACOF and BRITACEG;
- The Secretariat supports the routine operations of the Council, BRITACOF and BRITACEG (e.g. regulation drafting, internal administration issues);
- BRITACOF is the annual meeting of BRITACOM, and a permanent platform of dialogue on tax matters;
- BRITACEG is a network consisting of BRITACOM member competent tax authorities and certain observers. It is intended to drive collective tax policy research, mutual technical assistance and tax training; and

- The Advisory Board includes representatives of the business community, international organisations and academics. It provides strategic advice drawing on international expertise and experience.

At present, Chinese investment in the BRI countries is mainly focused in the infrastructure sector. With the steady improvement of BRI infrastructure and interconnectivity over time, it is anticipated that BRI countries will attract further investment in other traditional and emerging sectors, for example consumer markets, innovative financing, and TMT. Early moves through

BRITACOM, including the policy research and coordination efforts of BRITACEG, to resolve intra-BRI tax frictions and uncertainties should lay the groundwork for this coming stage of investment. This may include efforts to encourage and support the adoption of international tax standards across BRI countries, updating of BRI tax treaties, streamlining tax administration, and enhanced mechanisms to deal with tax dispute prevention and resolution.

The authors would like to thank Yi Zhang, senior tax manager in the Beijing office, for her contribution to this article.

China transfer pricing enforcement: Modernised approach matures

China has seen the continued evolution of its transfer pricing (TP) enforcement towards a data-based administrative approach, and away from the more aggressive audit approach of earlier years. **Xiaoyue Wang** and **Choon Beng Teoh** explore the latest trends.

In last year's eighth edition of *China – Looking Ahead*, the article *Now that we got data, what are we gonna do with it? – TP challenges and opportunities* discussed the following three broad issues.

The first was TP compliance. The Chinese tax authorities, to further drive TP compliance, had introduced a multi-criteria profit monitoring mechanism for large multinational enterprises (MNEs), as well as for taxpayers with complex related-party transactions. In 2018, the Jiangsu Provincial Tax Bureau rolled-out the profit monitoring mechanism for 150 large MNE taxpayers. This risk-based profit monitoring mechanism leverages big data analysis tools and provides the tax authorities with multiple sources of obtaining information on taxpayers. The mechanism was later introduced in other cities and provinces by the State Taxation Administration (STA).

The second was 'non-trade' transactions. The Chinese tax authorities continued to centre their enquiries and investigations on non-trade transactions, such as outbound royalty and service fee payments. In particular, greater scrutiny was applied to taxpayers paying large sums of fees overseas despite having a mainly domestic supply chain.

The third was international disputes. The STA increased its resources and efforts to resolve international disputes through prioritising mutual agreement procedure (MAP) cases in line with China's commitment to the BEPS Action 14 minimum standards recommendations. As a result, the STA and competent authorities resolved a substantial number of MAP cases in 2018. There was significant progress in the advance pricing agreement (APA) negotiations with competent authorities as well.

In the absence of significant new TP policy or regulatory changes in China in 2019, these three trends have remained the priorities of the STA. At the same time, the STA and the local tax authorities have exhibited a

pragmatic approach to TP monitoring and enforcement, in view of the challenging economic environment.

There are still some important enforcement trends in 2019, which we examine here. The sister chapter *Outbound investment and TP: A more robust framework emerges* also looks at advances with the MAP and APA programmes, particularly in the context of assisting outbound investment. A further chapter, *Hong Kong SAR's new TP rules: Convergence with global norms*, looks at the 2018 introduction of the TP rules, and the comprehensive guidance set out in 2019.

China's TP enforcement environment

In last year's edition of *China – Looking Ahead*, the article *Seeing the tax trees from the data forest – managing tax administration in the digital age* explained the steps taken by the STA to transform the Chinese tax authorities and make them more tax service oriented. From a TP perspective, the STA has been redirecting its effort from an investigative approach to a preventative approach, referred to as the 'administration/management' approach.

At present, the administration/management divisions of the tax authorities are primarily responsible for inspecting contemporaneous documentation and related-party transaction filing forms, while the investigation divisions conduct TP audits. The planned transition aims to reduce the relative role of TP formal audits. Going forward, these are not seen as key tax revenue collection tools for the Chinese tax authorities and instead a more significant role pivots to administration/management division reviews and follow-up queries.

At the same time, the STA and local tax authorities have moved away from focusing on the amount of tax collected as a key performance indicator (KPI) for tax officers. We observe that tax inspectors in Tier 1 cities are becoming more commercially aware in their understanding of TP issues, and are more understanding and reasonable when conducting TP assessments and audits. The tax authorities in smaller cities, nonetheless, remain aggressive towards TP audit targets, especially where local circumstances put them under pressure to raise tax revenues.

In some audit cases, complications arise in practice over which tax authority division (the tax inspection division or the international tax/TP division) should manage TP audits. TP cases are usually dealt with by the international tax/TP division, but in some local authorities this can sometimes overlap with other divisions. Where a tax inspection division asserts its authority, the arguments may not be fully focused on TP technical matters, which complicates life for taxpayers.

A further difference is that tax adjustments imposed by the international tax/TP division would typically carry less severe penalties than tax adjustments made by the tax

inspection division. The adjustments made by the international tax/TP division are usually subject to payment interest, whereas the adjustments made by the tax inspection division can carry late tax payment fines, a much heavier penalty. Having said that, cases initiated by the tax inspection division, in many instances, would be passed over to the international tax/TP division if sufficient explanation is provided to the tax inspection division during the process to demonstrate that the disputed matters are, in fact, solely TP related.

Taking a high-level view, the overall picture is that the amount of additional taxes collected from formal TP audits dropped in recent years. It is understood that in 2018 this was approximately RMB 3.5 billion (\$494 million), a reduction of 30% compared to 2017. The administration/management approach, conversely, brought in additional taxes of approximately RMB 54.4 billion in 2018, and is about 8% higher than in 2017.

Under the administration/management approach, the Chinese tax authorities' focus is on strengthening the administration of related-party transaction filings and TP documentation reports to encourage compliance and to nudge taxpayers to proactively adjust their profits (and tax paid) to meet the arm's-length standard. This 'cooperation model' is viewed as a key development area by the STA, and they are focused on fostering frequent communication between tax authorities and taxpayers to strengthen tax administration in China.

The emphasis on TP compliance is evident in the profit monitoring mechanism, launched in 2018 for large MNEs and enterprises with complex related-party transactions. This was discussed at length in the TP chapter of the eighth edition of *China – Looking Ahead*. In the Jiangsu province, where the mechanism was first introduced, the tax authorities have selected a further 70 taxpayers in 2019 to be subject to the mechanism, bringing the number of taxpayers under monitoring to a total of 220. The selected taxpayers have been requested to complete multiple forms, some quite onerous, so that the tax authorities will be able to provide specific feedback to taxpayers on improvements/modifications to their tax risk management systems and TP policies. The process is not yet complete but, once completed, the results will be communicated to the relevant taxpayers.

The Guangdong and Sichuan provinces are adopting the same approach with support from the Jiangsu province authorities and the STA.

Spotlight on service and royalty fees

The long-standing focus of the Chinese tax authorities on non-trade related-party transactions continued into 2019.

The Chinese tax authorities traditionally hold the view that inter-company cross-border service fee and royalty payments are high-risk transactions from a TP perspective. The



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authorities still make a point of reviewing transactions of this type, conducted by Chinese subsidiaries of MNEs, even where the profit margin left in China remains high following deductions for the payments. Of particular interest to the tax authorities are taxpayers with largely domestic supply chains, such as automotive parts manufacturers and

distributors, that source most of their components/materials within China and sell to Chinese customers. The Chinese tax authorities question the rationale for (and value of) the support/technology received by the Chinese entity from overseas related parties, irrespective of which service fees/royalties arise.

To give a sample of recent instances where the Chinese tax authorities reviewed outbound non-trade payments made in 2017 and 2018, we might point to the following:

- 1) The Shenzhen tax authority's anti-avoidance branch, established after the merger of the local and state tax bureaus in 2018, initiated a preliminary information and data collection on more than 300 enterprises with large outbound non-trade payments. It required these enterprises to perform self-assessment and make adjustments, as appropriate;
- 2) The Beijing tax authorities, in 2019, have also similarly increased their efforts on conducting reviews on outbound payments; and
- 3) The Tianjin Port free trade zone tax bureau also issued review notices to 14 companies that have significant outbound payments.

While self-assessments have become a more common tool used by the Chinese tax authorities, there are various audit cases we have become aware of through business engagement or reports in the public domain.

In an example of a formal audit case, the Anhui tax authorities reported in December 2018 on their conclusion of a TP audit on a large outbound payment of service fees (approximately RMB 120 million), made from a local Chinese entity to its overseas headquartered company. The Chinese entity has been making above-average operating profits for its sector, even after paying these fees.

In the past, many companies would have thought that leaving above-average margins in China would give them some measure of protection. The Anhui tax authorities, nevertheless, initiated an investigation and focused on the substance of the intragroup service arrangement. After a comprehensive fact-finding exercise, the Anhui tax authorities concluded that the Chinese entity had its own well-resourced management system and operated its business relatively independently. Consequently, payment for the services from the headquarters could not be reasonably justified on substance grounds. The Anhui tax authorities further revealed that the Chinese entity actually paid the service fee amount based on a general cost allocation from the headquartered company, and argued that part of the service charges failed to pass the 'benefits test'. The Anhui tax authorities disallowed the deduction for a portion of the service fees, resulting in a tax adjustment of RMB 8.2 million.

The Ningxia Yinchuan economic and technical development zone's (ETDZ) tax authorities reported, in September 2018, of a case where a Chinese-based taxpayer, as a service recipient, entered into service agreements with two service providers (one with a Hong Kong SAR related party and another with a second related-party entity) for similar consulting services. During the investigation, the Yinchuan ETDZ authorities concluded that the Hong Kong SAR entity did

not have sufficient technical capability and business substance to be able to provide the consulting services noted in the service agreement. The authorities disallowed the deduction for the fees paid to the Hong Kong SAR entity, resulting in a tax adjustment of approximately RMB 1.4 million.

With respect to licensing transactions, MNEs should ensure that royalty fee recipients have the necessary substance to control and perform development, enhancement, maintenance, protection and exploitation (DEMPE) functions related to intangibles. This is crucial to sustaining the position that the recipients are entitled to the royalty fee as intangible asset legal/economic owner. The DEMPE analysis framework was introduced into the OECD TP Guidelines for Multinational Enterprises and Tax Administrations issued in July 2017 (OECD TP Guidelines) following the BEPS project and adopted by China in Announcement 6, also in 2017.

From the point of view of sustaining the taxpayer TP position *vis-a-vis* the Chinese tax authorities, it is generally preferable to align legal ownership with the control and performance of DEMPE functions and substance. However, it can be acceptable to the authorities that the legal owner of the intangible and the entity performing DEMPE functions are different entities. In this regard, the Chinese tax authorities can accept that MNEs may prefer to centralise legal ownership of the intangibles in one entity for ease of tracking, for example in the headquarter entity, but that the substance and the actual performance and control of DEMPE functions are in the operating entities. However, for such cases, the Chinese tax authorities take the position that the entity with such centralised legal ownership should be located in the same jurisdiction as those conducting substantive activities, so that there is no tax advantage to be gained from separating legal ownership from performance of DEMPE.

Substance requirements are now being further raised across the world, with offshore jurisdictions such as the Cayman Islands having enacted economic substance laws in response to peer review demands by the forum on harmful tax practices, which continues to pursue action on harmful tax practices pursuant to BEPS Action 5. The EU code of conduct group is making even greater demands. Commonly seen holding, finance and IP management structures located in the Cayman Islands and elsewhere will have adapt to these economic substance laws or otherwise be 'structured out'. MNEs – and especially Chinese 'going-out' enterprises – are consequently having to revisit their structures, not only merely in response to economic substance laws but also for overall TP risk management purposes. As noted above, structures that lack substance are already under pressure from a TP perspective. Details of these economic substance laws are discussed in the chapter, *Offshore economic substance laws: Implications for Hong Kong SAR's funds sector*.

Equity transfers

In the TP chapter of *China – Looking Ahead*'s eighth edition, we noted that more equity transfer TP audit cases are being reported. This trend has continued in 2019, with several reported cases detailed below.

A recently concluded equity transfer case was reported by the TP team of Changchun tax authority in March 2019, published on the website of the China TP News. A joint-venture (JV) set up in Changchun had incurred consecutive losses for a number of years, and its foreign investor decided to divest and sell all of its JV equity to the domestic investor. Both parties held the position that no gain should be recognised on the equity transfer, noting the sustained business losses.

However, the Changchun tax authority's TP team found that the value of the land use rights controlled by the JV had increased enormously over the 10 years they had been held (they had originally been purchased at a relatively low price). The land value was reported in the books of the JV using the cost method. The authorities rejected this as a valid measure of arm's-length value for determining the equity transfer price, and demanded market valuations be obtained. A valuation was later performed by professional firms, and a tax adjustment of approximately RMB 50 million was made.

An enforcement case was also reported in relation to an equity transfer in Kunshan, Jiangsu province (reported in Jiangsu Economic News in July 2018). In this case, the tax authorities initiated an investigation regarding the equity transfer of a Chinese entity with a multi-level overseas ownership structure, headquartered in the British Virgin Islands (BVI). The subsidiaries were all registered in tax haven jurisdictions. As required by the TP regulations, the transfer of equity was disclosed in the TP local files and this attracted

the attention of the tax authorities. Accordingly, the authorities prepared a comprehensive analysis and concluded that this intra-group equity transfer was not priced at arm's length. After several rounds of discussions and negotiations, the Chinese entity and the authorities mutually agreed with a tax adjustment of more than RMB 20 million.

As with all the equity transfer cases, a tax valuation report is often important evidence to demonstrate that there have been adequate studies undertaken by taxpayers on the transfer, and the values have been appraised using the most appropriate valuation methods. The local tax authorities now routinely expect such tax valuations to be performed.

Looking ahead

In China, the increasing sophistication of the STA and the local tax authorities, in terms of their TP knowledge and the enhanced tools at their disposal, means that taxpayers are constantly on the surveillance radar. As noted in this chapter, non-trade payments and equity transfers are key transactions that will constantly be reviewed by the Chinese tax authorities. However, at the same time taxpayers expect better tax services from the STA and local tax authorities, and the latter are seeking to respond to this demand.

It is imperative for MNE taxpayers, outbound and inbound alike, to be able to defend their TP models and have strong documentation in place. The cooperation model advocated by the STA encourages frequent communication between the taxpayers and the STA, as well as the local tax authorities. This will hopefully smooth the relationships between the parties and may make future investigations and interactions less confrontational.

The authors would like to thank Alfred Wang, KPMG China senior manager, and Lino Lv, KPMG China manager, for their contributions to this article.

Outbound investment and TP: A more robust framework emerges

China outbound investment is now taking place against the backdrop of an increasingly robust and supportive TP framework. **Xiaoyue Wang**, and **Choon Beng Teoh** examine issues for enterprises, the MAP and APA programmes and their relevance to BRI investments.

In recent times, there has been an increasing focus by the Chinese tax authorities on outbound investment and business activity by MNE groups with their headquarters in China. One of their first priorities is to examine whether the headquarter entities charge any service fees to group subsidiaries outside China. If services have in fact been rendered, and the service recipients benefit from these services, the transfer pricing (TP) regulations require that such costs be charged out by the service providers.

Based on our experience, Chinese outbound companies do not usually charge out the costs they incur for supporting the wider group (for example finance, human resources, legal, IT and other corporate head office costs). If they do charge out it is sometimes done haphazardly. For these groups to get up to speed with proper TP compliance, intragroup charging arrangements need to be appropriately designed and implemented. This includes identifying the appropriate cost base, determining the manner in which corporate support is provided to each overseas subsidiary, calculating the service charges either via direct charges or indirect charges, and applying arm's-length mark-up rates for each of the services. Both the Chinese and overseas tax authorities responsible for the group subsidiaries are equally interested that service charges are set appropriately among group companies.

As a further point, many 'going-out' enterprises have large-scale operations that meet the threshold for the preparation and submission of country-by-country (CbC) reports. China made mandatory the annual submission of CbC reports when it adopted the OECD BEPS Action 13 three-tier documentation, with State Taxation Administration (STA) Announcement 42 issued in 2016.

The CbC report contains information on large MNE groups' operational footprint, breaking down a group's revenue, profits, tax and other attributes by tax jurisdiction. The Chinese requirements are in

line with the OECD requirements. Groups with consolidated annual revenue of at least RMB 5.5 billion (\$778 million), with their ultimate parent company in China (or a Chinese entity appointed by its group to file the CbC report), must file the CbC report in China by May 31: five months after the close of the financial year end of the group. This, in effect, means that enterprises filing the CbC reports in China have a rather small window of time between the closing of the financial books and the preparation and submission of the CbC reports.

The Chinese tax authorities have indicated that the quality of the CbC reports they have received is less than satisfactory. Given the importance of the submission, and the potential for them to be exchanged with other tax authorities around the world (who may query inconsistencies or anomalies), it is imperative for taxpayers to ensure that the CbC reports meet the necessary standards. The preparation of the CbC reports should follow the guidance provided by the Chinese tax authorities and that issued by the OECD. Furthermore, taxpayers should ensure that their reporting systems are able to extract the relevant financial information and data required by the CbC report. This should ensure minimal human intervention to reduce risk of errors.

To date, the Chinese tax authorities have activated the multilateral exchange of CbC reports with 44 tax jurisdictions, largely through the CbC Multilateral Competent Authority Agreement (MCAA). Such a large exchange network increases the potential tax exposures of Chinese outbound MNEs in foreign jurisdictions.

The Chinese tax authorities, having received the information contained in the CbC report, proceed to conduct various analyses to identify the TP risks of the MNE group. The analyses are generally conducted at the level of the local tax authorities and the results are shared with the STA. The STA is the conduit for cross-border exchange in the event that any of the information needs to be exchanged with overseas tax authorities.

The OECD has published a handbook, *The Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment*, and it explains how this can be done. This takes into account the different approaches to tax risk assessment applied in different countries, the types of tax risk indicator that can best use the information contained in CbC reports, and the challenges that may be faced by tax authorities in interpreting and applying the risk assessment results. It shows that CbC reports can be a very important tool for the detection and identification of TP risk and other BEPS-related risks, used alongside other information that a tax administration typically holds, and gives the authorities leads for further enquiries. However, it also cautions on the risk that simplistic and misleading conclusions may be drawn if CbC reports are used in isolation. The guidance is generally used as a reference by the Chinese tax authorities in practice.

The OECD handbook identifies 19 risk indicators that could be derived from the information contained in the CbC report. The OECD emphasises that none of these potential indicators should be taken by themselves to suggest that a group poses an increased tax risk in a jurisdiction. Rather, they may be combined in different ways to build an overall picture of the level of tax risk posed by a group. The 19 risk indicators are:

- 1) The footprint of a group in a particular jurisdiction;
- 2) A group's activities in a jurisdiction are limited to those that pose less risk;
- 3) There is a high value or high proportion of related party revenues in a particular jurisdiction;
- 4) The results in a jurisdiction deviate from potential comparables;
- 5) The results in a jurisdiction do not reflect market trends;
- 6) There are jurisdictions with significant profits but little substantial activity;
- 7) There are jurisdictions with significant profits but low levels of tax accrued;
- 8) There are jurisdictions with significant activities but low levels of profit (or losses);
- 9) A group has activities in jurisdictions which pose a BEPS risk;
- 10) A group has mobile activities located in jurisdictions where the group pays a lower rate or level of tax;
- 11) There have been changes in a group's structure, including the location of assets;
- 12) Intellectual property (IP) is separated from related activities within a group;
- 13) A group has marketing entities located in jurisdictions outside its key markets;
- 14) A group has procurement entities located in jurisdictions outside its key manufacturing locations;
- 15) Income tax paid is consistently lower than income tax accrued;
- 16) A group includes dual resident entities;
- 17) A group includes entities with no tax residence;
- 18) A group discloses stateless revenues in Table 1 of the CbC report; and
- 19) Information in a group's CbC report does not correspond with information previously provided by a constituent entity.

Chinese outbound enterprises are, therefore, reminded to extract data as accurately as possible in completing the CbC reports and assess the risks that may arise to minimise risk of any potential future tax challenges by the authorities. For example, as noted in the sister TP chapter, *China transfer pricing enforcement: Modernised approach matures*, the CbC report is one of the data sources leveraged for conducting risk assessment under tax authority profit monitoring mechanisms. Consequently, it is important that the output of the risk assessment is not influenced by the inconsistent data from the CbC report.



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Further, in light of various factors such as global trade tensions, the rise of costs operating in China, the impact of economic substance rules on group structures, and the impending changes to the international tax rules through BEPS 2.0, it is important to reflect the arrangements of the MNE group in the CbC report accurately and to tell a consistent story to all tax authorities, including in China.

Mutual agreement procedures

China is acutely aware that a swift response to international tax disputes, along with the provision of tax certainty to taxpayers, are vital to maintaining the flourishing international trade promoted by the country's leadership.

In a global climate that has seen some major economies taking a backward step by erecting protectionist measures,

China has been unrelenting in advocating enhanced global trade, not least through its Belt and Road Initiative (BRI). In this regard, China is committed to ensuring efficient resolution of international tax disputes through judicious use of mutual agreement procedures (MAPs), and aims to meet the MAP minimum standards set out in the BEPS Action 14 paper. It also seeks to provide tax certainty through an enhanced advance pricing agreements (APA) programme. These programmes are intended to support certainty for outbound and inbound investment. In 2018, the STA facilitated cross-border tax settlements and conducted bilateral consultation with 11 treaty partners across 167 cases. A total of RMB 3.6 billion of double taxation was eliminated for taxpayers.

MAP caseloads have been increasing dramatically worldwide. According to OECD statistics, the opening inventory of TP-related MAP cases in 2018 was 1,132 cases, excluding backlog cases that started before January 1 2016. A total of 930 cases were newly started in 2018, while 394 cases were closed. The end-2018 inventory of TP-related MAP cases was 1,668.

In China, the 2018 statistics (excluding backlog cases that started before January 1 2016) show that there were 44 TP-related MAP cases at the start of 2018. Throughout 2018, the STA started 13 TP cases and concluded 20 TP cases, bring the TP-related case closing inventory at the end of 2018 to 37. For cases started before January 1 2016, the average time to close TP cases was 46.89 months, whereas for cases started from January 1 2016, the average time to close TP cases was 17.76 months.

The tax authorities in China and elsewhere have accelerated their negotiation and conclusion of MAP cases, adding more resources to MAP teams. A critical aspect of BEPS Action 14, spurring on tax authority MAP efforts, is the peer review process, whereby the effectiveness and efficiency of a jurisdiction's MAP processes are assessed by peer jurisdictions.

The seventh batch of dispute resolution stage one peer reviews was launched at the end of 2018, which included mainland China and Hong Kong SAR, and was performed in the first half of 2019 – the results are still pending. Stage one peer review assesses countries against the terms of reference of the BEPS Action 14 minimum standard, according to an agreed schedule of review. The subsequent stage two peer review focuses on monitoring tax authority follow-up on any recommendations set out in the stage one peer review report.

A MAP case completed by Chinese and Indian tax authorities last year provides a good example on the willingness of the competent authorities to swiftly resolve tax disputes. The taxpayer in question was a large-scale outbound-investing Chinese MNE, which had been operating in India for more than 10 years. The Indian local tax authorities asserted that the Chinese MNE had an Indian

permanent establishment (PE) and sought to impose a significant tax liability on the basis of large attributed profits. Through successful MAP negotiations, the final adjustment agreed by both competent authorities was significantly reduced. The MAP case resolution only took one round of negotiations and four months from application to open the MAP to the conclusion of the case. The successful conclusion of the MAP had a crucial impact on the client, by effectively giving it tax certainty in relation to its existing Indian operations, as well as setting a solid basis for the future development of its Indian market activities.

In addition to speeding up the conclusion of MAP cases with competent authorities, China is also considering other mechanisms to supplement MAP that can dispose of cases efficiently. The MAP article of the double tax treaties entered into by China does not include a mandatory arbitration mechanism. China's long-standing view has been that permitting a third party to resolve taxation matters would weaken its sovereignty over tax collection. However, at present various ideas for improving dispute resolution are being floated and discussed by the STA and wider tax community.

Ideas of interest were raised at a China-France tax authority-sponsored seminar on BRI tax dispute resolution mechanisms, held in summer 2019 at the Taxation Research Institute of the STA. France is an observer country within the BRI Tax Collection and Cooperation Mechanism (BRITACOM), and so was keen to support this. Experts at the seminar agreed that innovative BRI dispute mechanisms are needed to ensure that budding BRI economic partnerships are not hampered by tax disputes, which can be exacerbated by unclear or complex tax rules, excessive documentation requirements, and unpredictable tax treatments. In particular, TP rules and administrative practices in many BRI emerging economies are still at a developing stage, and aggressive TP adjustments can frequently be observed. As BRI tax authorities can be resource-strapped, resolution of TP adjustment-related double taxation can take a long time.

Panellists from China at the seminar, which included representatives from the Chinese tax authorities and university professors, suggested that the MAP clause in BRI double tax treaties could be strengthened by inserting a clear timeline for the resolution of disputes. One of the panellists suggested including arbitration as a supplemental method, to be initiated when the MAP fails to resolve a particular tax dispute. However, they suggested that clear parameters for initiating an arbitration proceeding would need to be established. The panellists also explored the idea of including mediation as part of the resolution process.

The openness of the panellists signals China's commitment to facilitating trade and investment among the BRI economies. So far, to our knowledge, there has not been

Table 1

Type	From application to conclusion (with respect to APAs signed by China in 2018)				
	1 year (including 1 year)	1 – 2 years (including 2 years)	2 – 3 years (including 3 years)	More than 3 years	Total
Unilateral	2	0	0	0	2
Bilateral	1	0	1	5	7

any further indication directly from the STA regarding its position on arbitration or other measures to speed up the resolution of MAP cases. However, as can be seen from the above, all possibilities are up for debate.

Advance pricing agreements

Similarly, the STA has maintained its focus on steadily promoting the work of bilateral APA negotiation with competent authorities. The progress made in the past few years on the APA programme is in line with the STA's commitment to prevent double taxation and providing certainty to taxpayers. As noted in last year's TP chapter, there was a significant increase in STA resources for APA and MAP work in the previous two to three years, which means that more Chinese and foreign MNE taxpayer APA/MAP arrangements can be expected to be facilitated, going forward.

The latest statistics in the 2018 Annual Report published by the STA, show that the total cumulative number of APAs signed by the STA with the taxpayers between January 1 2005 and December 31 2019 reached 156, consisting of 89 unilateral and 67 bilateral APAs.

In 2018 alone, two unilateral APAs and seven bilateral APAs were concluded and signed. Of the seven bilateral APAs, five were concluded with Asian countries, one was with a European country and another was with a North American country. In contrast, 2017 saw a total of eight APAs signed with the STA, consisting of three unilateral APAs and five bilateral APAs. Most of the APAs signed in 2018 involve the manufacturing industry, a similar trend seen in the past years.

The 2018 Annual Report also described the number of APAs concluded between 2005 and 2018 by transaction type and agreed TP method. The largest portion of transactions involved the transfer of the right to use or ownership of tangible assets, which appeared in 136 concluded APAs. For the most part, taxpayers requesting APAs were manufacturing entities. The second largest grouping involved the transfer of the right to use or ownership of intangibles, which appeared in 31 concluded cases, followed by the provision of services, which was covered in 42 concluded APAs. The 2018 Annual Report states that the STA expects the share of tangible-asset transactions to

decrease relative to other transaction types, with an increasing number of service companies deciding to apply for APAs in light of China's tertiary industry development.

APAs are known to take a relatively long time to conclude, depending on the complexity of a particular case and how collaborative the competent authorities are at the negotiation table. However, APAs can also be concluded relatively quickly, even for bilateral APAs, as evidenced in Table 1. The table was extracted from the 2018 Annual Report and shows the time taken from application to conclusion for the nine APAs signed in 2018.

Taxpayers can choose to apply for a unilateral APA which, in theory, can be resolved quicker. However, it does not fully resolve double taxation in all cases. Therefore, in deciding whether to file for a unilateral or bilateral APA, taxpayers should take into account the following:

- If the related-party transaction amount is not large and the types of transactions are not extensive, a unilateral APA may be sufficient to obtain tax certainty.
- If the transaction amount is large, and the nature of the transaction or the business model is complex (for instance if the transactions involve intangible assets and group services), applying for bilateral APAs can greatly reduce TP risks for enterprises and avoid double taxation.

The STA has indicated that it will prioritise certain APA requests taking into account the following factors:

- First come, first served. Therefore, taxpayers should make early preparations to get a head start if they are interested in an APA.
- The quality of the submission package. The submission package should include answers to the following questions: Have all the required documents been submitted? Has sufficient documentation clearly evidencing the transactions throughout the entire value chain been provided? Is the proposed TP policy and methodology reasonable and justifiable? Are the calculations correct?
- The STA may consider whether the applicant is in a specific industry or located in a specific region that merits prioritised attention.
- For a bilateral APA request, whether the bilateral APA partner country (or region) has the intention to accept

the case and pursue the bilateral APA will also be an important factor for consideration.

Among the four factors above, tax authorities value the quality of the submission package the most. Additionally, the tax authorities have been exploring other appropriate TP methods apart from the traditional and widely adopted transactional net margin method (TNMM). The TNMM was the most common approach applied in both unilateral and bilateral APAs concluded between 2005 and 2018. Therefore, a submission that proposes an innovative application of TP methods (for example, the residual profit split method) is likely to merit the STA's prioritised attention.

Similarly, high quality quantitative analyses for intangibles (particularly local market intangibles), cost savings or market premium, issues that are close to the heart of the STA and often used as arguments for allocating more MNE profits to China, are very much welcomed by the STA.

Apart from clarifying the requirements that taxpayers should meet in pursuing an APA application, the STA and local tax authorities, in their bid to provide more streamlined taxpayer services, are also developing a simplified APA application approach.

The Shenzhen tax bureau is already piloting such an approach, and there are indications that the Beijing tax bureau may also introduce the simplified APA application approach. The simplified APA application approach under the pilot programme is made available to taxpayers with simple and clear related-party transactions and functional profile, and to taxpayers whose profile is familiar to the Shenzhen tax bureau. Under the trial, the Shenzhen tax bureau will select a small number of cases to establish some

precedent cases. The feedback received is expected to be used to further enhance the process and the STA may replicate the process across all regions in China.

Looking ahead

For cross-border disputes that need to be resolved through the MAP and APA processes, the increased resources at STA level and its pro-activeness will certainly facilitate more cases to be resolved for past disputes and secure future tax certainty. The STA has been open to matters concerning international cooperation. Consequently, the results of the OECD stage one peer review on China's MAP process will be much anticipated.


On managing future TP risks through the APA programme, the STA welcomes quality submission APA packages with analyses that include local market intangibles and location specific advantages. With the STA also piloting a simplified application process, the STA is making the APA more accessible to taxpayers, particularly those with relatively simpler transactions.

As discussed in the chapter, *BEPS 2.0: What will it mean for China?*, efforts to update the global international tax framework may result in fundamentally new approaches to international profit allocation (at least for large in-scope enterprises) and increased demands on China's dispute prevention and resolution capacities. As details emerge of this new framework (assuming global agreement can be achieved), renewed assessment will need to be given by the STA and by the tax community as to how tax certainty can be achieved in future.

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Hong Kong SAR's new TP rules: Convergence with global norms

In 2018, Hong Kong SAR enacted TP legislation, a significant step in aligning its tax rules with international standards. **Karmen Yeung, Irene Lee and Tanya Trantallis** set out the key features of the rules and their compliance requirements.



Hong Kong SAR has seen considerable changes in its taxation landscape in recent years. One of the most notable and significant changes was the enactment of its TP legislation on July 13 2018. This came in the form of Inland Revenue (Amendment) (No. 6) Ordinance 2018, which was subsequently added as part of the Inland Revenue Ordinance (the IRO).

This enactment affirms the Hong Kong SAR's Inland Revenue Department's (IRD) commitment to align the territory with the international tax landscape and to implement the measures under the OECD BEPS Action plan. It codifies the arm's-length principle into the IRO.

Following the enactment, the IRD also published three departmental interpretation and practice notes (DIPNs) on July 19 2019, which are DIPN 58: TP Documentation and Country-by-Country Reports, DIPN 59: TP Between Associated Persons, and DIPN 60: Attribution of Profits to Permanent Establishment in Hong Kong. These provide further guidance to taxpayers on the interpretation of the TP rules within the IRO.

IRO's key mandates

The IRO mandates implementation of the arm's-length principle as the fundamental TP rule in Hong Kong SAR. The IRO empowers the IRD to adjust profits or losses where a transaction between two related parties departs from the transaction that would have been entered into between independent persons, in cases in which this has created a tax advantage (TP Rule 1). DIPN 59 further explains the application of the arm's-length principle and reiterates that the IRD generally follows the OECD TP Guidelines.

Domestic related-party transactions that meet certain criteria and transactions that were entered into or were effected before the commencement date of the relevant TP provisions within the IRO (July 13 2018) are exempt from the application of TP Rule 1.

The IRO mandates taxpayers to prepare three-tiered TP documentation, which consists of a country-by-country (CbC) report, master file and local file. The requirements and information to be included in this TP documentation are in line with the OECD TP Guidelines, without any significant deviations or peculiarities as such.

Hong Kong SAR entities are required to prepare master files and local files for accounting periods beginning on or after April 1 2018, unless they meet the exemption thresholds specified within the IRO. There are two exemption criteria under the IRO, focusing on both the business size of the entity and the quantum of related-party transactions.

Master and local files exemption criteria

Taxpayers will **NOT** be required to prepare master file (MF) and local file (LF) if they meet either one of the following two exemption types:

- a) Based on size of business (any two of three criteria)
- Total annual revenue ≤ HK\$400 million (\$51 million)
 - Total assets ≤ HK\$300million (\$39 million)
 - Average number of employees ≤100

OR

- b) Based on related party transactions (for that particular category of transactions)*
- Properties (excludes financial assets/intangibles) ≤ HK\$220million (\$28million)
 - Financial assets ≤ HK\$110million (\$14million)
 - Intangibles ≤ HK\$110million (\$14million)
 - Any other transactions (e.g. service income/royalty income) ≤ HK\$44million (6million)

** Specified domestic transactions between associated persons will not be taken into account when determining whether the exemption thresholds in respect of the four categories of related party transactions are met.*

The Hong Kong SAR exemption threshold has referenced certain elements of mainland China's TP requirements, but is comparatively one of the more lenient requirements within the Asia-Pacific region.

Hong Kong SAR taxpayers that are not subject to TP documentation rules are nevertheless encouraged to keep on file documentation to illustrate that reasonable effort has been made in determining the arm's-length price for related-party transactions.

It is the IRD's view, that having robust TP documentation that is in full compliance with the Amendment Ordinance will place taxpayers in good stead when it comes

to tax or TP audits. The documentation will serve as the first line of defence in any tax or TP examination and allow the taxpayer to demonstrate that it has made reasonable efforts to ensure that the related-party transactions entered into are in compliance with the arm's-length principle. In this respect, having a comprehensive and robust TP documentation can serve as basis for penalty waiver to some extent.

CbC, IP and PE

Groups with an annual consolidated revenue exceeding HK\$6.8 billion will be required to file CbC reports for accounting periods beginning on or after January 1 2018. Hong Kong SAR is a signatory to the Multilateral Competent Authority Agreement (MCAA) and has activated exchange relationships of CbC reports with various tax jurisdictions worldwide (57 jurisdictions). These exchange relationships are expected to expand over time, thereby increasing the TP risks for operations in Hong Kong SAR.

The IRO has also introduced a new specific deeming provision (section 15F) to align TP outcomes with value creation in the context of IP. This has significant implications for taxpayers that carry out value-creating DEMPE functions in Hong Kong SAR which contribute to any IP held by an overseas related party. The effective date of section 15F has been deferred for 12 months: for the year of assessment beginning on or after April 1 2019. Taxpayers should ensure compliance with the arm's-length principle and properly document the TP position supporting their IP strategy in case of any challenges from the IRD.

Provisions covering permanent establishment (PE) were also set forth in the TP legislation. TP rules are applicable to any non-resident which has a PE carrying out a trade, profession or business in Hong Kong SAR. DIPN 60 provides guidance as to how profits should be attributed to a PE – the income or loss is to be determined through use of the authorised OECD approach (AOA). The AOA is a two-step profit attribution approach that firstly hypothesizes the PE as a separate enterprise by way of functional analysis, and secondly identifies the key entrepreneurial risk taking (KERT) functions (for financial institutions (FI))/significant people functions (for non-FI). DIPN 60 states that the master file and local file are equally applicable to a PE.

Looking ahead

The enactment of Hong Kong SAR's TP rules affirms the IRD's commitment to enhancing the Hong Kong tax system's compatibility with international tax standards. The IRD has indicated that it is likely to carry out site visits during TP examinations, which is very different from the past desktop-style investigations. This means that proper and accurate documentation (in particular functional analysis) will be very important.

While the IRD has not indicated any particular industries as audit targets, certain industries (for example, asset management) have in the past generated interest and attention from the tax authorities. Companies with related-party transactions, such as service transactions, financing transactions, intangibles, and other, will also generate attention from the IRD. Taxpayers should ensure reasonable effort has been exercised in determining and defending their TP policies.

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In the transfer pricing area, Karmen has assisted many companies in devising TP policies for corporate service, use of intangibles, intragroup manufacturing, and sales support and treasury function. She has also supported companies in TP audits, correspondence adjustments and advance pricing arrangements. She completed the first domestic APA in HK SAR involving IP.

With her rich experience working in mainland China and Hong Kong SAR, Karmen was been appointed to lead our tax practice to serve our clients in the Greater Bay Area (GBA) and help companies to capitalise on the special policies and opportunities available in the GBA.

Among many of her public service roles, Karmen is an honorary council member of the China Certified Tax Agents Association, and council member of the Asia-Oceania Tax Consultants' Association and Hong Kong Productivity Council. She is the past president of the Taxation Institute of Hong Kong (2015-2017) and ex-chairperson of the Taxation Committee of The Federation of Hong Kong Industries.



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Tax administration and compliance management: Steady progress follows reforms

China merged its previously separate state and local tax authority systems in 2018. This has provided a basis for improvements in tax administration and services, and required taxpayers to adapt. **Michael Li, Tracey Zhang and Fang Wei** explore the changes.

In last year's eighth edition of *China – Looking Ahead* the article *Adding wings to a tiger: Data in tax enforcement in China* looked at a number of significant changes in the structure and organisation of Chinese tax administration. Of particular importance was 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. Another important development was the abolition of tax 'pre-approval' and 'recordal' requirements, as part of China's transition to a more self-assessment-based tax system; this was coupled with the issuance of detailed guidance on the on-file documentation taxpayers would need to keep in order to support their tax positions on audit.

This year we detail how the latest tax administration improvements have sought to build on the 2018 changes, and how enterprise in-house tax management practices have sought to keep pace.

The government's new priorities

Building on the STB-LTB merger in 2018, the national government has identified a number of new focus areas for further enhancing tax administration efficiency and taxpayer services. These interlink with the government's broader multi-year programme of reducing red tape and regulatory burdens and improving the overall Chinese business environment; for example, by reducing the time it takes to establish/liquidate companies, etc. This has already resulted in China's ranking in the World Bank's 2019 Doing Business report rising from 78th to 46th, out of 190 countries.

In the latest announcement, Premier Li Keqiang outlined a series of priorities in June 2019 that were subsequently set out in the official notice Guo Ban Fa [2019] No. 39 (Circular 39). On the tax side, these interlink the *Fang-Guan-Fu* programme, translated as 'one service standard, one administrative procedure, and one rule for law enforcement'.



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Michael is the tax technology leader of KPMG China. His team offers technology-enabled tax solutions to drive the tax performance of enterprises, including compliance automation, process optimisation, and data analytics. In addition, during 2012-2013, he was seconded to the KPMG US Los Angeles office with a global china practice role covering China-US investment.

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It requires the State Taxation Administration (STA) and other government agencies to draft and implement detailed regulations to achieve the following, in many cases by the end of 2019:

- Implementation a 'one-stop shop' process for new enterprise set-up. This is to cover the plethora of various licences and registrations needed for a new company, which previously required applications to multiple separate authorities. These include the business licence, company stamp, official tax invoice arrangements, tax control equipment, social security registration, housing funds registration, and others. The processes have already been consolidated to a certain degree, as noted in last year's chapter. The goal now is to complete the consolidation process. Pursuant to Circular 39, in September 2019 it

was announced (in Guo Ban Fa [2019] No. 89) that pilot reforms in this space in Beijing and Shanghai would be rolled out nationally.

- Implementation of 'one-website' processing of enterprise de-registration, so that the process can be completed simultaneously with all the relevant agencies (tax, social security, commerce, customs, etc.).
- Establishment of a national unified digital tax invoice platform to provide free e-invoice issuance service to taxpayers. E-invoicing is to be expanded from general tax invoices (for example, for CIT deductions) to special tax invoices (for VAT input credits) within a short timeframe. Building on Circular 39, in August improvements to the invoice management system were outlined in Shuizonghan [2019] No. 223 and No. 243, with more to follow.

The launch of a national unified digital tax invoice platform is of particular importance. It helps to further reduce risk of invoice fraud (for example, fraudulent VAT input credits, CIT deductions and more), by allowing more effective cross-checking by the tax authorities. It also provides useful statistical data on economic performance to the government policymakers.

The platform also facilitates further integration of enterprise in-house tax management systems with tax authority invoicing systems. This could drive automation of output VAT special invoice issuance to customers, the verification of the input VAT special invoices received from vendors, and the integration of accounting systems/e-filing systems.

Post STB-LTB merger

We have observed developments in tax administration practices following last year's STB-LTB merger. In many cases, these constitute a continuation of new trends which had emerged in recent years.

In last year's chapter, a trend was noted whereby Tier 1 city (Beijing, Shanghai, Guangzhou, etc.) tax authorities had in many cases become more 'reasonable'. For taxpayer cases where complex commercial arrangements were in point (for instance, cross-border restructurings) the authorities appeared to be showing more commercial sophistication and sensitivity in deciding on the tax treatment. At the same time, it was noted that in lower tier cities the tax authorities were becoming more aggressive. This was driven by the greater pressure these cities were under to raise tax revenues and, in some cases, the grounds on which tax was imposed could be quite unreasonable.

Increasing 'reasonableness' amongst Tier 1 city tax authorities has been observed in a number of contexts:

- Tier 1 tax authorities are becoming more open to listening to taxpayer and tax advisor interpretations of tax rules in complex cases – for instance, restructuring cases falling under the Announcement 7 indirect disposal rules. Tier 1

city authorities have been seen to adopt a certain degree of flexibility, such as where it is difficult to say whether the very strict literal terms of the Announcement 7 restructuring safe harbour have been met.

- Some Tier 1 tax authorities have been seen to adopt reasonable approaches in seeking to understand and accommodate companies facing economic difficulties. This has particularly been seen to be the case in the context of the China-US trade frictions. An example is where companies restructure to deal with the economic challenges, and make taxable intragroup transfers of assets and entities for which valuations are required. In some cases, tax authorities in Tier 1 cities have been seen to accept valuations, put forward by taxpayers, which show future profit projections lower than current and historic levels. The economic stresses of the current era are being acknowledged by the authorities in a commercially sensitive way, and in a way that was less often seen in the past.
- For treaty relief cases, there is a mixture of increased rigour of enforcement, coupled with an increasing degree of commercial sensitivity for treaty relief evaluations. In some Tier 1 cities, the authorities have taken a more open-minded view that was the case in the past. Rather than simply dismissing treaty relief applications out of hand where the overseas treaty claimant has limited personnel, the authorities have been seen to encourage taxpayers to set out their position why they thought relief was justified, in the context of the commercial arrangements supporting their specific business model.

Of course, there are still plenty of instances in which tax authorities in Tier 1 cities take harsh and unbending positions, but the overall trend is seen as positive. At the same time, a less favourable position is often seen in Tier 2 and 3 cities, whether in terms of services, coordination or administrative approach. For example, some Tier 2 and 3 city local tax authorities still heavily review the application for treaty relief, instead of implementing the current lighter record filing procedures. This is despite the changes made under STA Announcement 60 already being several years old.

Turning specifically to the effects of the STB-LTB merger, this is seen to have produced some positive results. We have noted efforts made by the merged tax authorities to cut red tape and improve services. In many cases they have achieved significant time improvements, and lessened documentation and procedural requirements, for new company setup, inter-district relocation of companies, record filings for tax relief, and liquidation/deregistration. We have also noted that tax bureaus are eager to burnish their credentials in the area of providing taxpayer services. For example, the Shenzhen tax authority is piloting a simplified APA application approach, and they are also working closely with local customs authorities to coordinate pricing for royalties paid in connection with goods imported.



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The STB-LTB merger has also given rise to some drawbacks. We have noted that in some cases, there was a greater divergence of tax official opinions, on the tax treatment of similar issues, due to the differing backgrounds and understandings of former STB and LTB officials.

A further noted outcome of the STB-LTB merger process is that while the merger was underway last year, it had led to some disruption of normal activities, such as in relation to the review and audit of indirect transfers and cross-border service fee and royalty payments. Now that the new post-merger arrangements are more firmly in place, cross-border tax matters are being actively picked up on once more. There was also a backlog of transfer pricing (TP) audit cases left outstanding following the disruption of the LTB-STB merger period; some authorities are now rushing to wrap these up with reasonable adjustments, in line with the timelines for conclusion set under their key performance indicators (KPIs).

STA's tax technology strategy

The STA is setting its tax technology strategy for the next three to five years. According to the tax technology planning

tender document, released by the STA in November 2018, strategic planning is focused on the following areas:

- Integration and enhancement of tax app systems (both for desktop and mobile interfaces);
- Data governance and use;
- IT infrastructure and security;
- Government information sharing and collaboration; and
- New technology use and innovation.

As shown in the last bullet point, in addition to enhancing the national tax administration system, the Golden Tax III system, the STA is also eager to explore the use of new technologies. These include blockchain, cloud computing, big data, mobile internet, face/voice recognition and artificial intelligence. For many of these technologies, the STA is drawing on experience with pilot programmes by provincial tax authorities, such as the blockchain pilot in Shenzhen (see *We need to talk about platforms: Ongoing tax challenges in China*). In general, the STA takes an open approach to understanding potential applications for new technologies, and is engaging extensively with industry in refining its technology strategy.

Corporate tax management best practice

On the corporate side, large enterprise taxpayers are making significant efforts to upgrade their corporate tax management to match changes at tax authority level.

Many large enterprises in China are planning to institute more systematic corporate tax management frameworks. These give top management a clearer sense of priority areas for improvement, allowing them to set roadmaps and action plans and allocate sufficient resources for improvement over time. The frameworks encompass the enterprise tax management strategy, preferred and applicable corporate tax governance models, tax team structure, and tax management tools (for example, tax management measures, manuals and templates).

For large Chinese enterprises with overseas investments or operations, the China-based headquarters are increasingly keen to have tax management frameworks in place to govern their overseas businesses. Concerns have mounted in recent years over the lack of overseas tax expertise, insufficient focus on potential overseas tax exposures, and deficiencies in the timely collection of overseas tax information. Headquarters consequently see a need to fix guidance on the segregation of duties between headquarters and overseas entities, and on the prioritisation of tax matters or tax information for close headquarters attention. We have seen



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several large enterprises make this a research focus for 2019, and they have reached out to advisors for input on designing optimal overseas tax management frameworks.

On tax technology, ever more taxpayers have chosen to perform a tax IT planning and tax data governance review. They are increasingly aware of the challenges involved in tax management system integration with ERP and financial systems, and in the coordination of different tax management modules. They are determined that their tax technology investments should facilitate alignment with the STA's systems. They are also concerned that, in many cases, data inputs from upstream systems into the tax management system may not be ready in terms of quality and granularity. As these issues could significantly impair the degree of system automation that can be achieved, reviews and analyses are being prioritised before kicking off any system construction.

Looking ahead, we expect that these best practices in corporate tax governance and tax technology will be followed by ever more Chinese companies.

China double tax arrangements: New paths emerge

The past year has seen a further evolution in China's tax treaties, in particular in integrating impactful BEPS permanent establishment (PE) changes. The maturity of work on global tax reforms hints at more profound changes ahead, write **Chris Xing** and **Conrad Turley**.

Over recent years there had been something of a lull in the signing of significant tax treaties by China. This situation shifted in 2018 and 2019, with China signing new treaties, and entering protocols to existing treaties, with a number of jurisdictions. These included India, New Zealand, Italy, Spain, Angola, Argentina, Congo and Gabon, as well as a substantial new fifth protocol to the Hong Kong SAR double tax agreement (DTA).

A number of key developments are in evidence, and these are best understood in tandem with the accompanying article: *The age of reason(ability): Economic shifts impact China's cross-border tax enforcement*.

BEPS PE updates

As noted in last year's publication, while China did sign the BEPS multilateral instrument (MLI) in 2017, it opted to make the minimum updates possible: namely, the principal purpose test (PPT) and associated new DTA preamble. Notably, China did not opt for the BEPS PE updates. However, in the new treaties and protocols entered into recently, many of the BEPS PE changes have been adopted, though in a fairly hotchpotch manner.

Examples of this mixed approach are much in evidence:

- Take the BEPS PE provision requiring case-by-case substantive evaluation of whether activities conducted are truly preparatory and auxiliary in nature. This analysis overrides the 'specific exclusions' in Article 5(4). It has been adopted in the new China treaties with Congo, Gabon, Spain, Argentina, and New Zealand, but not for the other new agreements.
- The treaties with India and New Zealand adopted the contract-splitting rule for construction PE, while the preparatory and auxiliary

activity anti-fragmentation rule was adopted solely in the treaty with Spain.

- Meanwhile, the BEPS dependent agent PE (DAPE) rule appeared in treaties with Spain, Argentina, India and New Zealand, and the arrangement with Hong Kong SAR. However, the updated independent agent concept, associated with the new DAPE rule, has only been adopted in the arrangements with Italy and Hong Kong SAR.

The PE provisions in Chinese treaties are already quite diverse, and these changes add yet another layer of complexity. It further raises the question of how Chinese treaty policy on PE will develop going forward, both in terms of inclusion of BEPS PE changes in future bilateral treaty changes and in terms of China's position, going forward, on its reservations on the MLI PE provisions.

Of the PE provisions above, by far the most interesting is the new DAPE wording, particularly as adopted in the arrangement with Hong Kong SAR. As is well known, Hong Kong SAR is the portal through which much of mainland China's overseas direct investment (ODI) flows, and through which much of the country's foreign direct investment (FDI) enters. Ministry of Commerce of the People's Republic of China (MOFCOM) data to the end of 2018 indicates that 54% of mainland China's FDI stock, \$1.1 trillion, comes through Hong Kong SAR. At the same time, the stock volume of mainland China's non-financial ODI in Hong Kong SAR reached \$622 billion, making it the principal channel for outbound investment.

The BEPS DAPE rule is explained in the updated OECD model tax commentary as focusing on whether a local representative of a foreign enterprise "convinced" local market customers to enter into contracts with the enterprise. This is clearly a lower threshold than the existing rule, which focuses on whether the foreign enterprise "authorised" the local representative to enter into contracts binding on it. In light of this, existing Hong Kong SAR-based arrangements for marketing support and distribution into mainland China may need to be re-examined.

The new definition of "independent agent" also requires refreshed consideration on whether local China marketing support subsidiaries may be excluded from its scope. It should be noted that China typically applies deemed profit approaches for the calculation of PE profits, which in the case of selling agents may be calculated as a percentage of sales. As such it cannot be assumed that, if a local marketing support subsidiary receives an arm's-length consideration, that there will be no further profit to tax. The STA is yet to provide guidance on the application of the new PE rules in the Hong Kong SAR arrangement and the other treaties mentioned above, and this will be highly anticipated.

By the same token, Chinese enterprises operating in/through Hong Kong SAR will also need to consider any additional exposures under the new PE threshold. New

Hong Kong SAR tax guidance on PE profit allocation principles was set out in Departmental Interpretation Practice Notes (DIPN) 60, issued in July 2019, which will be relevant in this regard.

A final notable trend in the PE space, emerging in the new treaties, is the inclusion of special PE profit allocation clarifications. The protocols to the Italy, Gabon, Congo and Argentina treaties provide that where a construction/installation PE arises, only profits attributable to the activities conducted by the PE will be attributed to it, not the total value of the construction/installation contract. The Argentina protocol further elaborates, for the specific case of EPC contracts, that revenue from cross-border sales of equipment, which occur parallel to but separate from the services rendered via the construction/installation PE, will not automatically be attributed to the PE.

The increased use of such clauses reflects the challenges that Chinese EPC projects were facing in many countries; with the planned refresh of many treaties with Belt and Road Initiative (BRI) countries, it is to be expected that these clauses will be drawn into further treaties.

Transparency and SWF treaty provisions

A key feature of the new/updated treaties is that most of them include provisions dealing with transparent entities. This is the case for the agreements with India, New Zealand, Italy, Spain, Argentina, and Congo. These provide that to the extent that the country of establishment of the relevant entity (for example, the partnership) allows for transparent treatment (attributes income of the partnership through to the underlying partners), then the country of source, including China, will adopt the same treatment. These treaties join the China-France treaty of 2015, which up to now was the only China treaty to provide for such transparency.

These provisions start to address an issue that was heightened last year by STA Announcement [2018] 11 (Announcement 11). The latter provided that unless there are specific provisions in a given treaty dealing with partnership transparency, then foreign partnerships themselves must qualify for the treaty benefits in their own right. However, most foreign partnerships will not be registered overseas as tax residents, and will not be in a position to claim relief. As Announcement 11 otherwise blocks any look-through to the underlying partners to allow them to claim treaty benefits in their own right, this has become a major issue.

However, welcome as these changes are, the lack of inclusion of such provisions in the new protocol with Hong Kong SAR, as the major channel for investment in mainland China, is unfortunate. It might also be noted that much investment in China comes via the Cayman Islands and British Virgin Islands (BVI) partnerships. As these jurisdictions have no tax treaties with China, there is no foreseeable resolution to this issue for partnerships in these jurisdictions.



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Another notable area relates is sovereign-related treaty benefits. Earlier in the 2010s a number of treaties (for example with France, the Netherlands, Switzerland and the UK) were updated to include various tax rate reductions and exclusions for sovereign-controlled entities. These joined earlier treaties (with Saudi Arabia, UAE and Kuwait) with similar exclusions. This trend continues with the latest treaties, reflecting the importance of Chinese sovereign wealth funds (SWFs) and state-owned entities (SOEs), and the emergence of new bodies linked to the BRI, such as the Silk Road Fund.

In addition to an exemption from withholding tax (WHT) in most of the treaties for interest paid to state-owned banks, including the national pension fund (NSSF), China Investment Corporation (CIC) and the Silk Road Fund, many of the treaties offer lower/zero WHT for dividends paid to state controlled entities (Argentina, New Zealand, Congo). In the case of Argentina, this goes further to also cover capital gains. Given how important Chinese state-controlled entities are to BRI investment, the BRI treaty refresh is likely to work in many more such provisions.

Beyond the matters outlined above, the new and updated treaties include various BEPS provisions, including: the PPT; the new BEPS treaty preamble; the residence tie-breaker on the basis of mutual agreement; and the modernised exchange of information and MAP articles. These are in line with the changes that are set to be made across Chinese treaties via the MLI. The latter is set to update 63 Chinese tax treaties and rising, with the adherence of further China treaty parties to the MLI. However, it is still not clear when China will have completed domestic procedures to ratify the MLI.

The treaties also tweak WHT rates for various types of income and the timeframes for construction PEs. Interestingly, the Argentina treaty incorporates a ‘most-favoured nation’ (MFN) clause, which will ‘automatically’ alter WHT rates in the treaty where Argentina signs a more favourable treaty with another country. This is the second Chinese treaty that includes such a clause, after the China-Chile DTA of 2015.

Treaty relief administration updated

In October 2019, new treaty relief administration guidance was set out in STA Announcement [2019] No. 35 (Announcement 35). This will take effect from January 2020 and replaces the existing guidance in Announcement [2015] No. 60 (Announcement 60). The guidance is in line with a broader government programme to reduce regulatory burdens and red tape for businesses, and moves China further in the direction of a full self-assessment-based tax system. There are two main changes:

- Announcement 60 required treaty relief claimants or WHT agents, when notifying the tax authorities of a relief claim, to submit upfront extensive supporting documents. This could be highly burdensome. Announcement 35 now simply requires that supporting documents are kept by the relief claimants on their files for review. Solely a short notification form is sent to the authorities, either directly from the relief claimant or via the WHT agent.
- A further change alters WHT agent tax exposures. The Announcement 60 system obliged the WHT agent to ensure that the materials (relief form and supporting documents) are complete. The WHT agent also had to ensure that the assertions made by the relief claimant in the form (as supported by the documents) corresponded to the qualifying conditions for treaty relief. This could lead to liabilities for WHT agents for underpaid tax or penalties, where it was later determined by the authorities that relief was not merited. This naturally made many WHT agents quite cautious when it came to applying reduced treaty WHT rates upfront, and pushed relief claimants into making cumbersome refund applications instead. Announcement 35 makes clear that the WHT

agent’s responsibility is just to check that the claimant has fully filled out the form, and should facilitate upfront grant of relief.

While these clarifications are welcome, many deficiencies and uncertainties remain for China treaty relief administration. For example, WHT refund processes should in principle take 30 days, but local tax authorities can spin these out for a long period by making repeated requests for additional supporting documentation and explanations; there is no hard ‘stop the clock’ rule. There is a lack of clarity on the extent of WHT agent obligations to the tax authorities in relation to obtaining supporting documents from the relief claimant.

Relief claimants continue to face a lack of clarity on the precise documentation needed to support their DTA positions, and this is compounded by the continued absence of a tax rulings system in China. It remains to be seen in 2020 how effective this new guidance will be in practice, and whether the STA can make any positive moves to address these other issues.

The calm before the storm?

As covered in greater detail in *BEPS 2.0: What will it mean for China?*, China has been heavily engaged in the G20/OECD project on overhauling international tax rules through the Inclusive Framework (IF) on BEPS. As a steering group (SG) member, and as home to many of the world’s largest companies in the digital space, China has a key role in the process. The IF is striving to agree on a new architecture for international tax rules by January 2020, with work on detailed rule design to follow.

The work is based on two pillars. Pillar 1 aims to change the fundamental building blocks of international tax by introducing a non-physical remote taxable presence threshold (alongside traditional physical presence PE) and formulary rules for profit allocation, which would operate at an MNE group level in conjunction with traditional entity-to-entity transactional arm’s-length principle-based TP rules.

At present it is understood that a wide range of large MNEs could fall under this scope, especially those which rely heavily on marketing intangibles for their business operations. This could capture highly-digitalised businesses as well as leading branded goods firms. MNEs, inbound and outbound from China, could face new tax exposures across their market jurisdictions, and would require significantly overhauled tax accounting and compliance systems to calculate and allocate profits.

Pillar 2 aims to introduce a global minimum tax, relying on an income inclusion rule and an undertaxed payments rule. This would call into question the use of low-taxed intermediaries in distribution, finance and IP structures, as well as impact the value of tax incentives obtained in countries of operation.

The expectation is that, if the IF project succeeds in achieving consensus, the Pillar 1 rules could become a global minimum standard (adopted widely across countries), while the Pillar 2 rules might become best practice (perhaps adopted by a smaller number of countries).

At a policy level, China has seen few new CIT rules of significance this year, just minor measures such as the exemption for China depositary receipts and clarified tax treatment for perpetual debt. However, in view of the

magnitude of the changes that could come with Pillar 1 and 2, this could be taken as a temporary lull before significant changes set in. Chinese tax policymakers and businesses operating in China are conscious that the new international tax rules would be coming into effect in parallel with a rapidly changing global trade environment, meaning that tax and tariff changes would need to be considered in parallel for structuring of global supply and value chains.

The age of reason(ability): Economic shifts impact China's cross-border tax enforcement

In the context of a changing global trade and investment environment, and China's economic slowdown, tax enforcement approaches are evolving and maturing. **Chris Xing** and **Conrad Turley** trace the latest trends.

There are a number of key dimensions to the current changes in the economy and trade and investment climate that are impacting China's tax and regulatory policies and enforcement approaches.

In the domestic dimension, the Chinese economy grew by 6.6% in 2018 and is on course for growth of 6.2% in 2019, the lowest rate in 30 years. This has given further impetus to structural reforms, including an accelerated liberalisation of restrictions on inbound investment, as well as efforts to cut red tape and improve the business environment.

In terms of inbound investment, a 'negative list' system governs investment limitations. The government reduced nationally restricted sectors from 63 to 48 in late 2018, and then further to 40, effective from July 2019. They reduced restricted sectors in the free trade zones (FTZs) even further, to 37. The changes open up sectors that were previously off-limits to foreign investors. It also removes, for certain sectors already partially open to foreigners, the requirements for them to have Chinese joint-venture (JV) partners.

There is a strong focus on drawing investment into services and high-tech manufacturing, and the liberalisation covers transport, logistics and wholesale, ship and aircraft building and services, professional services, energy and transport infrastructure, telecoms, auto manufacturing and financial services. July 2019 saw announcements that the liberalisation of the latter would be accelerated from 2021 to 2020, with ownership limits on foreign investors to be scrapped by next year. These changes have the effect of both encouraging further greenfield foreign direct investment (FDI) and opening up potential M&A opportunities.

Commensurate with these changes, FDI has been further increasing. Indeed, FDI hit a historic high of \$139 billion in 2018, meaning that FDI once again overtook outbound direct investment (ODI) for the first time since 2015. It has grown further in 2019, with growth of 2.9% for the first

three quarters of the year. Official statistics also show FDI in the FTZs to be rising even faster than the national level. China's tax policies in 2019 have aimed to support this liberalisation, such as with a 15% corporate income tax (CIT) rate announced in August 2019 for certain activities in the Shanghai and Shenzhen (Qianhai) FTZs.

Even against the backdrop of existing challenges in the China-US economic relationship, US FDI in China increased (to \$6.8 billion) in the first half of 2019, according to data from Rhodium Group. Investment now increasingly takes the form, in the words of Amcham China, of 'in China, for China', as opposed to manufacturing investment in China as an export hub, as in the past. In this context, the reduction in investment restrictions is clearly playing a role – witness in this regard Tesla's new Shanghai factory, which will be the first wholly foreign-owned auto plant in China.

The second focus is cutting red tape. China has been making concerted efforts to cut red tape and reduce regulatory burdens, for example for establishing/liquidating companies, etc. This resulted in China's ranking in the World Bank's Doing Business report rising from 78th in 2017, to 46th in 2018, to 31st in 2019, out of 190 countries. This means that China has now surpassed France, the Netherlands and Switzerland as a place to do business. These efforts continue to be intensified, with central government monitoring of a large number of Chinese cities that have been set key performance indicators (KPIs) for further improvement; for example, a targeted three-day period for new enterprise establishment.

A major element of these efforts is lessening the administrative hassles associated with tax compliance. By way of example, this includes the elimination of requirements for taxpayers to file large amounts of documentation with the authorities up front when claiming reliefs/incentives (documentation may be kept on file for future audit). It also includes improved procedures for issuance of tax residence certificates, and facilitation of most interactions with the authorities online. Furthermore, for complex international transactions, the tax authorities in Tier 1 cities are showing themselves increasingly commercially-sensitive and facilitative in obtaining reasonable tax outcomes (for instance, in treaty or restructuring reliefs).

The global dimension

In 2019, it became more apparent that greater global uncertainty on tariff levels (US-EU, US-China, etc.), as well as increased national restrictions on exports and corporate acquisitions based on sensitivities around technology, may become lasting features of the international economic landscape. This could have several impacts in the international tax space.

The first consideration is customs. In past decades, multinational enterprise (MNE) corporate tax planning could take a generally stable global trade environment, with a tendency towards progressive reduction of tariff levels. It might be said that the relatively low profile of tariffs raised the sig-

nificance of international tax rules in driving the structure of MNEs. If higher tariff levels and greater volatility in the setting of tariffs become entrenched, then MNEs may need to reconsider, and in some cases restructure, their supply and value chains, and perhaps retain a flexibility to do so with greater frequency.

The emergence and deepening of regional trade pacts, such as the regional comprehensive economic partnership (RCEP) in Asia-Pacific, may impact the shape of new arrangements. It is understood that the Chinese tax authorities are looking at possible improvements to existing guidance on restructuring relief and indirect offshore indirect disposal rules, which could be highly relevant for the emerging world of tomorrow.

It is also worth considering the outbound investment environment. In 2016, Chinese ODI reached its peak to-date (\$196.1 billion). It dropped from this level in 2017 (\$158.3 billion), 2018 (\$129.8 billion) and in 2019. Key factors behind the reduction were China's tightened regulations on ODI, which restricted investment in foreign real estate, sports clubs and other areas, and efforts to rein in highly leveraged acquisitions. Another factor was the stricter review by several governments, in particular the US, of foreign inbound acquisitions.

In consequence, Chinese ODI into the US, including M&A and greenfield, fell by 95% between 2016 and 2018. Since 2016, China ODI has swung further towards the 65 Belt and Road Initiative (BRI) countries. It is estimated by some research institutions that BRI-directed ODI increased from 16.8% in 2016 to 21.6% in 2018; 60% of mainland China's ODI goes through Hong Kong SAR and several Caribbean jurisdictions, so a tracing exercise needs to be conducted. Further increases to BRI investment are anticipated in 2019.

China's policy efforts in the international tax space have mapped this change, with the BRI Tax Administration Cooperation Mechanism (BRITACOM) established at the first conference of the BRI Tax Administration Cooperation Forum (BRITACOF) in April 2019. The tax authorities of 34 countries and regions signed up as BRITACOM council members (with more expected to join subsequently). They have done so with a view to working collectively to resolve tax administrative deficiencies and tax rule frictions, which could frustrate planned investment projects and limit the ability of the BRI to achieve its full potential. Initial collaboration plans have been set for the next two years, including sharing best practices on rule design and administration, providing capacity building support (for example in tax compliance system automation), setting up mechanisms for dispute resolution and achieving greater consistency in treaty application.

In the context of the broader trends mapped out above, 2019 has also seen a number of significant Chinese treaty and policy developments, covered in the article *China double tax*

arrangements: New paths emerge. However, more significant change awaits the emergence of a new international tax consensus at G20/OECD level, expected early in 2020. This is dealt with in the article *BEPS 2.0: What will it mean for China?*

Enforcement

The question of enforcement is also unavoidable in this context. The past few years have seen an evolution in China's approach to tax enforcement and an associated change in the tone and content of public communications to taxpayers. This was observed already in last year's chapter, where we noted that WeChat and website updates by the State Taxation Administration (STA) and provincial tax authorities focus on providing service and assistance to taxpayers, for example by facilitating access to incentives.

This is a change from the prior approach, where many enforcement cases were highlighted with a view to raising taxpayer awareness of tax audit effectiveness and penalty strictness, in order to encourage compliant behaviour.

The last year has further seen a fall-off in the number enforcement cases reported in the Chinese tax-specialist media, principally by China Taxation News (CTN). There were also, in contrast to earlier years, no notable court decisions on cross-border tax matters.

Our round up of enforcement developments this year draws to a greater extent on the KPMG China client team's experience in the field. Assisting this is KPMG's internal insight sharing system, whereby client teams pool notable cases and their manner of resolution.

Treaty relief

As we noted last year, in 2018 the STA issued revised guidance on the interpretation of beneficial ownership for treaty relief cases. In STA Announcement [2018] 9 (Announcement 9), the STA decided to retain the commercial substance-driven concept of beneficial ownership, which has been used for the past decade since the issuance of STA Circular [2009] 601 (Circular 601). This interpretation treats the beneficial ownership test as a type of anti-abuse concept. This brings it beyond solely looking at whether the income recipient has real control over the disposal of that income and related assets – the aspects central to its interpretation in a number of developed countries (for example, in the *Indofoods* and *Prevost Car* cases). However, it is notable that in the 2019 European Court of Justice (ECJ) decision in the Danish beneficial ownership cases, the ECJ linked beneficial ownership with anti-abuse objectives. This decision, and developments in the application of beneficial ownership in other countries, have (arguably) brought the rest of the world more in line with China on this matter.

What is noteworthy then, against this backdrop, is how the Chinese tax authorities have been becoming, at least in

Tier 1 cities, more commercially sensitive and reasonable on treaty relief in many instances.

Announcement 9 introduced a form of 'derivative benefits' test, whereby a treaty relief applicant could reference the commercial substance at the level of 100% direct and indirect parents to access treaty relief for dividends. Specifically, relief would be granted if the parent company would have passed the beneficial ownership test and was tax resident in a jurisdiction whose treaty with China gave equivalent tax relief. While helpful for MNEs, this was not considered to be of much use to fund structures. Furthermore, the STA guidance that accompanied Announcement 9 set out illustrative examples of activities that would be considered 'substantive' for investment management activities; for instance, management of investments in 50 companies in 10 countries and significant staff at the level of the treaty relief claimant. This was considered as setting the bar rather high.

However, in practice, some authorities have been willing to take a more pragmatic stance. For real estate investment trusts (REITs) and aircraft leasing structures, in cases seen in practice, certain authorities have been willing to have regard to the commercial substance at the level of REIT managers/leasing companies in the same jurisdiction. This is despite the fact that the latter would not necessarily be the parent of the treaty relief claiming SPVs, or indeed have any equity holding relationship with the SPVs. In these instances, the authorities appear to acknowledge that this is the commercial nature of such business arrangements, and apply the guidance flexibly. However, such treatment may be denied by other local authorities and for other types of structure; for instance, PE funds would generally be thought to have a harder time making such a case.

Tax authorities in some cases have been seen to take more holistic views of taxpayer arrangements when considering whether treaty relief should apply. For example, for dividend treaty relief, Announcement 9 provides a safe harbour under which a subsidiary of a listed company, tax resident in the same jurisdiction, would automatically qualify for relief. While this does not extend to interest *per se*, in practice, cases have been seen where the authorities were willing to consider the fact that a group finance company had a listed parent in the same jurisdiction, together with the existence of a modicum of decision-making substance at entity level, as a basis for agreeing that treaty relief should apply.

A more reasonable stance by the authorities can be combined with increasing comprehensiveness in case review. For example, the Shanghai tax authorities subject outbound dividend payments, involving treaty relief worth RMB 5 million (\$706,000) and above, to follow up review. However, whereas in the past (and still in many places in the country) treaty relief applications might be rejected out of hand where the overseas treaty claimant has limited personnel, the authorities have more recently been seen to give due consideration to taxpayer explanations of the commercial rationale for certain arrangements.



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It should be noted though that there are still plenty of enforcement cases going the other direction. Certain local tax authorities can still demand to see levels of staffing, assets and business operations at the level of treaty relief claimants that are out of sync with commercial reality. Indeed, some cases have been observed where the authorities appeared to be drawing selectively (and arguably out of context) from the Announcement 9 interpretative guidance. Quite a number of Tier 2 and 3 city local tax authorities have still not shifted to the treaty relief administrative procedures mandated under STA Announcement [2015] 60, which moved the system from pre-approvals to record filing with follow up review.

However, on the whole, the trend is considered positive. In common with broader Chinese government efforts at cutting regulatory burdens, record filings were recently simplified in STA Announcement [2019] No. 35, cutting out the need to deposit extensive documentation with the authorities upfront, and reducing tax exposures for WHT agents; see the article *China double tax arrangements: New paths emerge*. Furthermore, there is greater data sharing/pooling across different branches of government; for example, between the tax authorities and the State Administrations for Market Regulation (SAMR) and the State Administration of Foreign Exchange (SAFE). These developments, together with advances in tax authority big data analytics, should make case review progressively more targeted and less bothersome for most taxpayers making routine payments and associated treaty relief claims.

Equity transfer

This section is best read alongside our inbound M&A piece: *No pain no gain: Tax challenges in the China M&A market*. The Chinese tax authorities continue to focus considerable enforcement efforts on equity transfer cases, including both direct cross-border transfers – foreign company directly sells China equity – and indirect offshore disposals, where one foreign company disposes of another foreign company that holds China equity). The latter cases are governed by STA Announcement [2015] 7 (Announcement 7).

Greater data sharing/pooling across different branches of government, use of ‘web crawler’ software to find disposal-relevant information from public sources, and big data analysis have all increased tax authority effectiveness in detecting and following up on equity disposals. As a further factor, the merger of state tax bureaus (STBs) and local tax bureaus (LTBs) (STB-LTB merger) last year had led to some disruption of normal activities; with new organisational arrangement now in place, enforcement against cross-border equity transfers could once again take centre stage.

This being said, and in line with the observations above in relation to treaty relief cases, the past two years have seen an increasing commercial sensitivity and reasonableness among Tier 1 city tax authorities.

It has been found in practice that tax authorities are becoming more open to listening to taxpayer and tax advisor interpretations of equity transfer tax rules in complex cases. This may be attributed to tax authorities gaining, both through their work and through training provided by tax advisors, greater experience of and exposure to a diversity of complex cases (for example, MNE group restructurings falling within the scope of Announcement 7). This has helped in resolving cases where there has been ambiguity over whether restructuring relief should be available, or cases for which calculation of transfer consideration or equity cost base has proven problematic.

For cases involving restructuring relief, Tier 1 city tax authorities have been willing, in instances, to adopt a degree of flexibility, such as where the strict terms of the safe harbours have not been met. Thus far, this has mainly been observed for Announcement 7 indirect transfer restructuring cases, while a stricter and more inflexible line appears to be taken, for the moment, in relation to direct transfer restructuring cases falling under STA Circular [2009] 59 (Announcement 59). In the Announcement 7, cases some authorities have been pro-active in consulting with provincial level authorities and the STA to see if they can be permitted to grant relief reflective of the commercial circumstances. Higher level tax authorities have also shown a greater willingness of providing high-level guidance to taxpayers on restructuring cases.

An example of this is cases where an offshore parent company receives the equity of a Chinese sub-subsidiary as a distribution from its (overseas) subsidiary. This is not explicitly relieved under Announcement 7, which requires share consideration to pass between the entities. However, in several cases, local authorities have been willing to accept that, as the transaction is entirely intra-group and does not involve cash consideration, the transaction should also qualify.

For such cases, it can help to give the authorities a full and clear explanation of the context. Where it can be shown that the companies are facing economic difficulties, particularly in the context of the ongoing China-US trade friction, and need to restructure to continue their business operations in China, then this can be factored in. What is more, in cases where restructuring relief can simply not be qualified for, the authorities have shown reasonableness in accepting transfer valuations for China entities that reflected diminished potential future profitability as a result of changed global economic circumstances.

Beyond the above, the cutting of red tape has also facilitated equity transactions. Foreign transferors of Chinese equity, which expected transaction procedures to take months based on past experience, were struck by how procedures could now be handled within a few weeks. At the same time, as with the treaty cases, taxpayers continue to encounter circumstances in which the authorities take a harsh approach. Typical circumstances are where the local authorities:

- Insist on an equity cost base calculation which only allows the taxpayer to deduct a fraction of the amount that they paid for the disposed of equity;
- Are unwilling to accept taxpayer arguments around the reasonable business purposes for an offshore indirect transfer, and insist on imposing Announcement 7 tax;
- Adopt highly restrictive and conservative interpretations of when the restructuring relief terms are satisfied; and



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- Seek to apply (in observed cases) TP rules to adjust equity disposal consideration in third party sales.

As ever, Chinese tax administration in the equity transfer space remains a work-in-progress. Going forward, there are indications that the STA may look again at possible improvements to the existing Circular 59 and Announcement 7 guidance, with a view to making this more facilitative for business restructurings required in the evolving economic climate.

BEPS 2.0: What will it mean for China?

Intensive work at international level to erect a new architecture for international tax rules by 2020 will have deep implications for businesses. **Conrad Turley** and **Sunny Leung** explore what this might mean for China's burgeoning digital economy.



In last year's eighth edition of *China – Looking Ahead, A Sisyphean task? – Tax playing catch up with the fastest moving digital economy in the world* tackled trends in the digital economy (DE) and provided an overview of the various proposals to update international tax rules. These proposals had emerged from debates at the Inclusive Framework on BEPS (IF) during the course of 2018.

In 2019, the IF's work crystallised into an IF programme of work. The IF is working intensively towards global consensus on a new architecture for international tax rules by early 2020, with the detail of the rules to be ironed out in the course of the year. While it is still not certain that consensus will be reached on this timescale, we can already start to consider the impact such rules would have on multinational enterprises (MNEs) operating cross-border into and out of China. In doing so, it must be noted that while much of the initial focus of the global efforts was on so-called highly-digitalised enterprises, the proposals being taken forward have a much wider sweep of application, capturing a wide variety of industries and sectors.

Whatever rules do emerge will have to be reconciled with an increasingly complex international picture. Numerous countries have announced or adopted unilateral measures to tax digitalised businesses, with impacts on China's increasingly globalised DE players, and it remains to be seen if these rules will be suspended and rolled back following agreement on a global solution. The parallel long-running challenges, presented by Chinese domestic tax rules to structuring and operating new forms of digital business models, are dealt with in the separate article, *We need to talk about platforms: Ongoing tax challenges in China*.

Emerging global tax framework

Last year we explained how the UK, US and India had all advocated in 2018 for different approaches to modifying existing international tax



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conventions on nexus and profit attribution to address the challenges of digitalisation; so-called pillar one of the strived-for global consensus solution. These different approaches were subject to public consultation in March 2019.

The UK emphasised the importance of user participation and contributions, such as for transport, accommodation, and e-commerce platforms and for online advertising business models built around free services (for instance search and social media).

The US advocated for a broader scope for new rules, recognising that digitalisation is an aspect of a larger process of 'intangible-isation', whereby intangible assets are more predominant in the value creation processes of MNEs. In line with this, new rules should capture all large businesses whose business models have marketing intangibles at their core, including luxury goods, autos and consumer branded products alongside highly digitalised businesses.

India sought a still broader solution. While the UK and US proposals suggested that user contributions/intangible assets drove super-normal profits, and that therefore just this element of MNE profits should be allocated to user/market countries, India argued that market countries should have a share of all MNE profits. They argued that digitalisation enabled foreign enterprises to have a sustained, ongoing relationship with their customer/user base in a country without the need for physical presence. Consequently, both physical and remote distribution arrangements would need be subject to the same level of tax in the market country to preserve a level playing field. They suggested that MNE profits, both from routine activities as well as the 'residual' profits, be allocated to markets using fractional apportionment methods.

While there was no consensus on any one of these different approaches, by themselves, the commonalities of the approaches allowed for a programme of work to be drawn up (issued in May 2019), and for working parties (WPs) under the IF to commence detailed work from June 2019. More recently, in October, the Secretariat set out a proposed 'unified approach' for public consultation drawing on these commonalities. In particular, all approaches provided that:

- The traditional threshold for a market country to assert taxing rights over foreign business, the physical presence permanent establishment (PE) threshold, would have to be supplemented by a new nexus rule, a 'remote taxable presence' threshold. Under this, a company could have a taxable presence in a market on the basis of its revenue from the market, perhaps supplemented by other factors showing engagement with the local customer/user base (for example, data collected, advertising spend, etc.);
- The allocation of profits to the market/users jurisdiction would be made out of MNE group consolidated profits. This would be a step away from the historic reliance on the transactional arm's-length approach to transfer pricing (TP), which focuses on entity-to-entity transactions within the MNE group. Indeed, the nexus assessment would also occur at the MNE group level, having regard to all the interactions between various MNE entities and the market/user country. This compromises the separate entity principle at the heart of the existing international tax system.
- The new rules would be simplified to the highest degree possible, to facilitate adoption across all of the 135 IF jurisdictions. Many of these have limited tax

administrative capacity and would already struggle with highly complex new rules; as do many more developed countries and MNEs at present with the existing TP framework. This indicates that simplified ratios and metrics are likely to be used for calculating MNE residual profits, and for calculating the proportion of this to allocate to market/user countries.

Drawing on these commonalities, and in parallel to the work of the WPs, the IF steering group (SG) has worked with the OECD Secretariat on developing a unified approach. The SG includes the most significant global economies – China, the US, Germany, France, UK, Japan and India – as well as representatives of a number of smaller developed open economies and developing countries. It is tasked with finding the political compromises to guide the technical work of the WPs.

The chair's statement from the G7 finance ministers' meeting in July gave some indications of the possible shape of this compromise, involving trade-offs between the Europeans and the US. It was indicated that broader scope rules, capturing businesses heavily reliant on marketing intangibles, would be pursued – in line with the US approach – but that ways would be explored to adjust the allocation of taxing rights to markets to reflect the high degree of digital engagement that some highly-digitalised business models have with their customers/users; namely, the use of ratios/metrics that recognise the European position that users/data play a key value creation role. The Secretariat unified approach proposal sought to concretise this compromise by setting out an approach involving three 'amounts' of profit which may be allocated to a market country. Amount A is the allocation of residual profits using formulaic metrics. Amount B is a floor on the return attributed to 'baseline' physical marketing and distribution activities. Amount C uses standard TP rules to allocate further amounts to the market for functions beyond the Amount B 'baseline'.

Amounts A, B, and C are all noted to need strong dispute mechanisms, such as arbitration, International Compliance Assurance Programme (ICAP) or multilateral advance pricing agreements (APAs). Business line/regional segmentation are to be further explored. These new profit allocation rules would co-exist with traditional TP rules. It remains to be seen whether compromise can be built around these proposals over the coming months.

In parallel with this, under pillar two, rules to establish a global minimum tax are being developed. These would subject low-taxed controlled foreign companies (CFCs) in an MNE group to a 'top up' tax, so that the effective tax rate (ETR) on overseas income of the MNE rises to a globally fixed minimum rate.

To achieve this, residence countries would apply income inclusion rules, along the lines of the US global intangible low tax income (GILTI) rules, and market/source countries would apply base erosion rules. The latter could take the form



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of withholding taxes or a denial of deductions for outbound payments, and would need to be coordinated with the income inclusion rules of residence countries to avoid double tax (income inclusion rules would likely take priority).

France and Germany were the original advocates of this proposal, and the US appeared open to it from an early stage given they already apply GILTI. While other developed countries had earlier expressed scepticism, in July the G7 finance ministers agreed in principle to the minimum tax. It remains to be seen whether other IF countries can be brought on board; many observers consider it likely that while pillar one may become a minimum standard, with adoption across IF jurisdictions, pillar two may simply be set as a best practices recommendation, open to adoption by countries who wish to do so.

China – external pressures

China is a SG member and a key player in the IF process. Given that China will in 2019 have the world's largest retail

market, and given the rapid expansion of Chinese DE enterprises overseas, the impact of any new rules on China are being closely scrutinised by Chinese tax policymakers. A number of considerations come to the fore.

First off, an increasing number of countries, particularly in Europe and across Asia-Pacific (ASPAC), but increasingly also in Latin America and Africa, are adopting unilateral measures to tax products and services delivered through digital channels. In Europe, France, Italy, Hungary and Slovakia have all instituted different measures, while Austria, Spain, UK, Czech Republic, Poland, Belgium and Slovenia are at different stages of progress with proposed rules. Many of these take the form of digital service taxes (DSTs), levied on online advertisers and intermediaries as gross basis turnover taxes; these generally follow a design developed by the EU Commission in 2017.

Not being covered by tax treaties, these would necessarily lead to double taxation, and impose a high effective tax burden for low margin or loss-making businesses. In ASPAC, India, Taiwan (China), Australia, Vietnam, Malaysia and Pakistan have adopted measures, while Indonesia, Thailand, Korea and New Zealand are all developing proposals. Many of these jurisdictions have deferred implementation/enactment of their unilateral measures pending the outcome of the IF process. If the latter fails to obtain a consensus solution in line with the ambitious time plan set out, these jurisdictions have indicated their intention to proceed with their unilateral rules.

These measures have the potential to have a very disruptive effect on Chinese DE players' overseas expansion plans. They come at a time when these companies are also grappling with the new VAT/GST rules, being adopted by many countries, which make platform intermediaries jointly or wholly liable for the VAT/GST obligations of third-party merchants transacting through the platforms. They also emerge as Chinese DE players are just coming to terms with strict new data privacy and handling requirements in many jurisdictions (for example, the EU's General Data Protection Regulation (GDPR)).

As such, from a policy perspective, reaching a global consensus solution, which sees the suspension and rollback of unilateral measures, would appear to be in the interests of China Inc. Even though this will involve additional tax registration requirements for these enterprises in their markets, and a requirement to allocate part of their residual profits – where a new treaty framework is in place and the rules are universally adopted, tax would apply solely to net income and double taxation should be limited.

It is also noted that the aim of the US and other leading countries is that the new rules should provide for a 'modest' additional allocation of taxing rights to market countries, so limiting disruption.

A second point is that given that the pillar one rules may even go wider, to cover branded consumer and luxury

goods, the impact on Chinese exporters requires evaluation. In a listing of the world's top 100 brands compiled by Forbes, only one Chinese company was included (Huawei). Indeed, the inclusion of branded consumer and luxury goods enterprises within the scope of the pillar one rules does appear more likely to affect US and European firms than Chinese businesses. At the same time, Chinese companies are leading global exporters of various consumer goods including apparel, personal computers, household appliances and tools, and furniture. To the extent these are caught within the scope of the rules they would need to register taxable presences in their market countries and calculate and allocate a proportion of their global residual profit.

It will therefore be crucial, at the detailed rule development stage, to see how the scoping rules are defined. The exclusion of companies exporting generic goods, and of contract manufacturers producing for brand owners and other such B2B sales, would remove a large number of Chinese enterprises. Excluding companies on the basis of metrics showing limited reliance on intangible assets could exclude many low margin companies which would otherwise find the compliance costs very burdensome. Furthermore, scoping out smaller scale businesses, such as those with global revenue under the €750 million (\$826 million) country-by-country reporting (CbCR) threshold, could also limit China enterprise exposures further.

From a China inbound perspective

A third important consideration is that from the Chinese inbound perspective the rules will interact with China's status as the world's biggest retail market. It is, after all, a huge cross-border e-commerce market with B2C imports expected to make up 12% of Chinese online retail by 2020. China is also the world's largest market for a number of product categories, including automobiles, spirits, luxury goods, and mobile phones, where it accounts for in excess of 30% of global consumption. The new rules could result in further foreign branded and luxury goods MNEs having taxable presences in China, and needing to allocate part of their global residual profits to China.

Beyond consumer and luxury goods, many of the global DE giants have more limited engagement with China on regulatory grounds, meaning that the outcomes of the new rules would be mixed. For example, in consequence of firewall restrictions, Facebook and Google have minimal users in China (although they do earn substantial revenues from Chinese advertisers to overseas customers). As such, the new rules would likely not treat them as having a remote nexus to China. For other DE players such as Amazon, which is heavily engaged in China, the rules would likely apply.

However, whether the new rules would result in additional tax revenues being allocated to China is an open question. In Chinese TP enforcement practice, concepts of local

market intangibles and market premium (as a location specific advantage) have long been used to make adjustments to the profits allocated by foreign MNEs to China. These adjustments have been particularly relevant for luxury goods, such as handbags, jewellery and cosmetics, and high-end automobiles. Foreign MNEs in these sectors have in many cases been able to command prices well in excess of those prevalent in other markets and, as noted above, China now accounts for the largest element of global demand for many such goods. The BEPS TP amendments did not change this, but rather were leveraged by the Chinese tax authorities in support of their local market intangibles arguments.

It seems quite possible that, insofar as the new rules would allocate a proportion of MNE residual profits to market countries, the quid pro quo would be that countries using TP concepts of market premium and local market intangibles (such as China and India) would be expected to moderate their usage. At the same time, the impact of the shift to the new model may differ for China and for India, given the different product mixes being sold into the two countries and different consumer profiles.

Such matters would be expected to be part of the global negotiations, alongside the proportion of residual profits allocated to market jurisdictions, the role of dispute prevention and resolution mechanisms, and the setting of a floor on returns to physical marketing and distribution activity.

Looking ahead

At the implementation level, both Chinese MNEs going out and foreign MNEs active in China will have significantly increased tax compliance and risk management obligations, such as:

- New types of accounting records may be needed to segment MNE group profits into separate business lines. These will then be assessed for whether they exceed nexus thresholds, and will be used as the starting point for residual profit calculations. Allocation of central costs could be extremely challenging.
- New types of data will need to be collected to apply the scope, nexus and profit attribution rules. These may include statistics on data collection and user activity in different markets, advertising spend directed at various countries, and data tracing product sales through intermediaries to final consumer markets; another very challenging task.
- New types of filing may be needed, such as enhanced CbCR, remote taxable presence filings, third-party distributor/intermediary returns.
- Given how tax authorities will need to become more 'joined up' on information exchange, multilateral tax risk

assessment, joint audit, and dispute prevention and resolution, MNE tax departments will similarly need to adopt more joined-up firm-wide tax risk management, and work closely with business line and IT teams to generate the data for new records and filings. Advisors will need to move in lockstep with this.

- One particularly challenging area may arise in ensuring that treaty relief is available. While the new rules determine nexus and profit allocation at the MNE group (or business line level), relief from double tax will still need to be applied at entity level. Clearly, any new rules for attributing new market tax liabilities to particular MNE entities as the 'taxpayers' will require multilateral frameworks under which tax authorities can agree profit allocations.
- Another challenging area is reconciling the market profit allocations under the new rules to existing TP rules. The new rules will 'pull profits out of the system' and adjustments will therefore be needed to the 'system profits' allocated to various MNEs entities on an initial arm's-length basis.
- MNEs may consider undertaking business restructurings, whether to eliminate redundant principal/IP holding structures, align entity structures with the business line segmentation used for profit attribution, and pro-actively manage challenges with scoping or nexus thresholds. Economic and tax modelling is likely to be a crucial part of such exercises.

The impact of pillar one will need to be assessed alongside the impact of pillar two, if this is part of the final global consensus solution and is anticipated to be widely adopted. The impact on effective tax rates (ETRs) for Chinese MNE overseas profits could lead to restructuring to eliminate intermediate holding company entities, though the interaction with pillar one would be key. For pillar two, the impact of the rules turns to a great degree on the minimum rate set, the existence or absence of scope and substance exclusions, and the use of worldwide or jurisdictional blending under the rules.

Clearly, whatever the shape of the rules, there will be high complexity for MNEs in terms of new accounting records, ETR calculations, the operation of the coordinating mechanism between income inclusion rules and base erosion rules, and managing dispute prevention and resolution mechanisms.

Specific challenges may also arise in a China context, given that China does not provide for group consolidated filing for CIT purposes, and the complex interaction of China's foreign exchange control rules with tax administration. As the global proposals become more granular, Chinese policymakers will have to turn their attention to the resolution of these matters.

We need to talk about platforms: Ongoing tax challenges in China

As policymakers in China and elsewhere inch towards a new global tax framework to deal with the challenges of digitalisation, many domestic tax law and administration issues are yet to be resolved for China's digital economy. **Sunny Leung** and **Conrad Turley** take a look.

Understanding domestic tax law and administration issues for China's digital economy (DE) requires an understanding of its rapidly evolving landscape, and in particular the importance of the platform economy in China. Last year's DE chapter, *A Sisyphean task? – Tax playing catch up with the fastest moving digital economy in the world*, provided a thorough overview. Here is the up-to-date version.

China's booming e-commerce has driven the expansion of China's overall retail economy to such an extent that in 2019 China is to overtake the US as the world's largest retail market for the first time, with \$5.6 trillion in sales for China against \$5.5 trillion for the US. According to analysis from eMarketer, e-commerce makes up 35.3% of Chinese retail sales against 10.9% in the US. Such is the scale of Chinese e-commerce that it is set to account for 56% of the global total in 2019 and as much as 63% in 2022.

Beyond e-commerce, the broader China digital economy, defined to encompass the sharing economy, the ICT sector, mobile payments and other facets, is also booming and projected to reach 35% of Chinese GDP by 2020. Of particular importance in driving this trend are the digital ecosystems being built through the 'superapps' developed by several leading Chinese DE companies. Alibaba and Tencent (through WeChat) have built the most prominent superapps, providing services relating to payments and finance, shopping, transport, social media and messaging, health, entertainment, dining, education, and much more. It is often remarked that this is the equivalent (in a Western context) of bundling WhatsApp, Apple Pay, Uber, Facebook, Expedia and a host of others.

These superapps are seen as tantamount to 'critical infrastructure' and a 'public utility'. Consumers can spend most of their time within a given ecosystem, which caters to all their needs, while the superapps provide a crucial gateway for third-party suppliers (for example through WeChat

mini-programs and public accounts). Other players are now building substantial ecosystems, including Meituan Dianping, which evolved from group buying and restaurant review and ordering businesses, and Bytedance's Douyin (branded Tiktok in the West), which developed from a video streaming service.

The strength of this digital ecosystem model is such that the major Chinese players have been rapidly expanding overseas. This is particularly notable in South Asia and South East Asia, where Alibaba, Tencent and others have made significant investments in regional e-commerce platforms, as well as rolling out many of the services refined in the Chinese market. In particular, Chinese mobile payment services have embedded themselves in overseas markets by first catering to Chinese tourists, who made 150 million trips abroad in 2018, and then expanding to serve the wider population (as in Malaysia).

Going further, some Chinese DE players are having outstanding successes in Western markets, such as Tiktok's 200 million overseas monthly active users, of which 40 million are in the US.

China's perennial domestic tax and digitalisation issues

Last year's DE article provided a thorough overview of the long-running tax issues existing for digital business models in China. These issues remain largely the same and we recap them here in brief. (This article should also be read in tandem with its sister chapter, *BEPS 2.0: What will it mean for China?* which picks up the evolving DE tax story at global level.)

Regulatory lag

China's regulatory and tax framework finds it difficult to keep up with the breakneck evolution of China's digital economy, with the growth of superapps and the sharing economy. For example, regulatory classification of ride-sharing platforms as information technology or transport services complicates their classification for tax purposes, and the application of the 6% or 9% VAT rates.

Platforms as principals

Platform intermediation is remaking huge swathes of the Chinese economy, from transport to retail to finance to health services. Questions arise over whether the platforms should be designated as brokers or as principals, with the obligations and liability of platforms for service quality in a state of evolution, and with challenges for platforms in obtaining use of so-called 'double clearing accounts'. If the platforms are to be treated as principals, then China's documentation-heavy tax system creates potentially severe headaches, as tax invoices (*fapiao*) are needed to be issued by vendors (taxi drivers, restaurants, etc.) in order for VAT input credits or corporate income tax (CIT) deductions to be claimed. With tax compliance

levels low among many small vendors, this can prove very challenging. Many are hoping for new policies and reliefs on general tax invoice control and tax computation mechanism to bring the actual cost of being tax compliant to a more reasonable level.

Platforms and tax collection

As superapps ecosystems and platform models occupy a greater part of the economy, some local tax authorities have actively pursued platform operators to withhold tax from platform participants; for example, individual income tax (ITT) withholding on taxi driver fares. At a national policy level, it is still not clear what direction the government will go in for drawing platforms further into tax collection efforts.

Some initiatives, such as Tencent's collaboration with the Shenzhen tax bureau on a pilot blockchain tax invoicing system, might point in the direction of more effectively taxing the vendors themselves. This system, already in operation for a year and deemed a success, involves the automatic generation of digital *fapiao*, simultaneous with vendor sale and customer mobile payment. The tax authority has real-time information on this data and the customer expense reimbursement claims with employers (who will make corresponding deductions). At the same time, the Tax Collection and Administration Law, due to be finalised in late 2019, contained provisions requiring platforms and financial intermediaries to report to the tax authorities all transactions above a threshold, involving them in the tax administration process. Future evolution in this space remains to be seen.

Cross-border issues

A large range of issues remain to be resolved. Considerable ambiguity exists around the classification of various digital service for CIT withholding tax purposes, such as imported cloud services. Furthermore, it is also unclear when imported digital services can be said to be fully consumed outside China and so outside the charge to VAT (for example, outbound payments for online adverts shown on Facebook to overseas users).

Chinese foreign exchange rules, and their limited categories of outbound payments, also compel companies to characterise/bundle digital product sales in a tax inefficient manner (for example, as licence fees, as shrink-wrapped software) to facilitate the making of the remittance.

Chinese PE guidance remains ambiguous on many matters. While tightened data transfer and protection rules under the Cybersecurity Law may compel foreign enterprises to store and process data onshore, the treatment of servers, mirror servers, UIs etc. as PEs is still unclear. China's adoption of the BEPS PE changes, and in particular the agency PE changes, in recently updated tax treaties (see the international tax chapter) raises questions about the PE exposure of



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warehousing, purchasing, and representation activities in China. This is particularly pertinent for the mushrooming number of special e-commerce zones (35 and rising) and free trade zones (FTZs) (18 and rising) which are being promoted as hubs for e-commerce platform activity.

Finally, China runs a digital services export surplus and the government is increasing the scope of VAT refunds for excess input credits for various encouraged sectors. However, the rules are still piecemeal and evolving.

Looking ahead

It might be noted that, if there is a major global agreement of the revision of international tax rules, then resolution of many of the matters above, for withholding tax, foreign exchange, and PE, will become increasingly pressing. With the Chinese economy slowing, and with the government conscious that the DE holds the key to sustained growth into the future, it remains to be seen if further efforts will be made to address at least some of these issues in the coming year.

Five years of rapid VAT evolution: How have predictions held up?

Recent years have seen striking changes in the VAT landscape, both in China and overseas, in relation to the scope of the tax, its mode of operation and the technology underpinning it.

Lachlan Wolfers reviews a series of predictions made in 2014.

At a KPMG global conference in Hampshire, UK, held on February 24-25 2014, a small group of KPMG's indirect tax leadership team formulated the following propositions around the future of indirect taxes to 2020. These propositions were hotly debated at the time, with an almost incredulous response from many of those attending. Now, just over five years later, it is timely to look back and see if these predictions have proved to be correct or not.

In so doing, we are not embarrassed by the fact that a small number of these predictions proved to be spectacularly wrong, primarily because this adds balance, reality and credibility to those predictions we clearly got right. In an overall sense, we are stunned by the accuracy of the correct predictions, though the precise timing of their coming to fruition has differed slightly from our original estimates – some earlier than expected, some later.

This has meant that for tax practitioners, the past five years have been a time of immense transformation and change, and it is reassuring to realise that we not only predicted these changes, but in many cases we embraced them. Building on this track record, we have set out a series of further predictions in the sister articles: *Future of VAT: Continued evolution and increasing significance* and *VAT and technology: The first fully automated tax?*

Here, in this article, for ease of reference the term VAT (value-added tax) is used to apply equally to a GST (goods and services tax).

Proposition (2014)	Assessment	Comments
Indirect tax will be charged at the place of consumption	Highly accurate	At the time, this was not a terribly bold prediction given that several countries had implemented measures designed to align the collection of VAT with the place at which consumption takes place. However, aspects of the rules in the EU had still not evolved. For example, rules seeking to tax electronically supplied services within the EU were still based on the location of the supplier until 2015.
There will be a customs duty regime for services	Right idea, wrong tax	<p>At the time, many of us foretold the demise of customs duties, but as of 2019-20 and in the midst of an era of heightened trade tensions and Brexit, customs duties are clearly on the ascendancy.</p> <p>However, what prompted this prediction at the time was the beginning of the digitisation of service delivery – for example, consumers no longer purchasing CDs, DVDs, software, newspapers and the like in tangible form; 3D digital printing was also in its infancy. Interestingly, while this prediction is clearly not accurate as regards customs duties, we have still seen a considerable expansion of the customs duty base to capture the value of services or intangibles which are related to goods – for example, product warranties and guarantees, and the value of trademarks and other IP rights.</p> <p>The broader point we were seeking to make with this proposition was the rise of taxes on cross-border digitised services, and with the advent of both VAT measures for electronically supplied services, as well as digital services taxes, it is a case of saying that the trend was observed correctly, but the tax through which it would be implemented was not.</p>
Every country has a VAT regime	Highly accurate	VAT now applies in more than 160 countries throughout the world. Aside from the US, there are only a handful of relatively small economies without a VAT system either already implemented, or scheduled for implementation.
Proliferation of new and old indirect taxes that you will own	Accurate, and beginning to really emerge	The introduction of digital services taxes, new environmental taxes, and other 'miscellaneous' forms of indirect taxes (often industry specific, such as proposals for financial transaction taxes) continue to grow. What many of these taxes have in common is that they are consumption based, and therefore typically 'owned' by the indirect tax function within the organisation.
Indirect tax rates accelerate dramatically	Accurate, but stabilising	For a short period after this prediction was made, VAT rates ended their significant run of increases in many countries in the wake of financial and economic crises. However, VAT rates have since largely plateaued from 2015-18, with the unweighted average standard VAT rate of OECD countries remaining stable (OECD's Consumption Tax Trends 2018, p. 45). Notwithstanding, an average increase could still be observed in certain regions, for example, Africa (KPMG indirect tax rates table, 2019). It now appears that VAT rates in many European countries are already at a natural high, and governments are seeking to increase VAT revenues by other means, while rates in the Asia-Pacific region may still have room for further increases.
'We know where you are': use and enjoyment provisions are here to stay	Highly accurate	Use and enjoyment provisions essentially allow for the imposition of VAT if the relevant consumer 'uses and enjoys' the relevant service in that jurisdiction. This principle underpins much of the OECD guidelines for determining the place of consumption.
'From paper to data'	Highly accurate	This statement was intended to capture the shift from paper-based invoicing, to a more data-driven approach. It also encapsulates the shift from document-based analysis carried out by tax auditors, to the use of data and analytics techniques.

Proposition (2014)	Assessment	Comments
No more periodic returns – tax will be settled in real time	Highly accurate, but way ahead of its time	Even in 2019-20, only a handful of countries pre-fill VAT returns, or otherwise require point of sale tax collection. This prediction clearly has another five years or more to really come to fruition, but remains as accurate a prediction now as when it was made in 2014.
Big data will close the VAT gap	Accurate, but not as successful as it could be	According to a September 2019 press release issued by the European Commission, the VAT gap across the EU fell by €8 billion (\$8.8 billion) to €137.5 billion in 2017, and as a percentage it fell from 12.2% to 11.2%. In simplistic terms, it means that around 11.2% of all VAT revenue theoretically collectible is not being collected. While the reduction in this percentage which has been achieved is certainly a positive step forward, this is one of those predictions that will likely take some time before even more significant inroads can be made. Clearly, the broader shift away from cash-based economies to a cashless society will provide the means for tax authorities to plug the VAT gap. Right now, tax authorities around the world typically fit into three categories: (1) those that do not have the data but wish they had it; (2) those with the data but without the skills (yet) to fully interrogate it; and (3) those with the data and the ability to interrogate it. Expect more and more tax authorities to move up the curve over the next few years.
The tax transparency debate will shift to indirect taxes	Not really accurate	At the time of this prediction, the tax transparency debate for corporate taxes was in its infancy. That debate is now in full swing, but is yet to really shift to indirect taxes. Perhaps that is because the role of business in indirect taxes is as a tax collector, with the true imposition of the tax falling on end consumers. Interestingly, in some ways the tax transparency debate in corporate taxes has suffered from a lack of understanding of the balance between direct and indirect taxes. For example, some news chapters have criticised certain companies in the energy and natural resource industry for their perceived lack of corporate tax contributions, in circumstances which ignores their very substantial contribution of indirect taxes, especially excise-based taxes.
Data quality and analysis will be the new audit battleground	Accurate, and beginning to really fully emerge	Similar to the prediction on big data closing the VAT gap, tax authorities are yet to have optimised their data and analytics capabilities, though this will change. However, as of now, with the rise of e-invoicing through government systems as well as real-time (or near) reporting, this is increasingly putting pressure on tax functions to get the data right the first time.
You won't control all your own data anymore	Highly accurate	Whether it be the tax authorities obtaining access to your data (increasingly on a real-time basis), or third parties, data control continues to be a major issue with broader impacts than tax.
Your data will become very interesting to others	Highly accurate	Similar to the above comment.
Indirect tax legislation will become written with data analytics in mind	Highly accurate, but still only just emerging	We already see this with rules written to deal with B2C supplies of digital services. For example, in the European Union (Council Regulation 1042/2013, Chapters 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. The adoption of similar 'data points' in other areas of VAT will surely also occur.
You will be redundant by 2020!	Well, are you?	This statement was intentionally provocative and not really intended to be taken too literally at the time. However, the broader point being made was that technology and data, and analytics capabilities, would render many tax professionals redundant.



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What do these past predictions tell us?

Many of these past predictions fit into two broader categories: (1) predictions as to the growth of indirect taxes – either by way of new countries adopting VAT; the expansion of scope of indirect taxes; or increases in indirect tax rates; and (2) the impact of big data, data and analytics, and technology – in terms of the impact on the preparation, filing, auditing or verification of transaction-level data that forms the basis of a taxpayer's VAT obligations.

While our correct prediction of these two broad trends underlies the relatively high success rate of our more specific predictions, what is perhaps also interesting to observe is the increased influence of both the BIC countries (Brazil, India and China) on global indirect tax developments, and of countries with relatively new VAT systems. When tax experts typically think of VAT, they generally regard the 'home' of the tax as being in the EU, which is of course true because VAT initially grew out of France in 1954, and then developed throughout the European Union (then the European Economic Community) during the late 1960s and 1970s, before being truly globalised in the 1990s and 2000s. The EU is also the region with the highest VAT rates in the world, and therefore remains at the epicentre of how indirect taxes are managed within most large multinationals.

However, because of the requirement for consensus amongst EU member states (28 at the time of writing, likely to be 27 shortly after publication), the ability to institute change in the operation of VAT throughout the EU can be more challenging. Furthermore, many countries that have only recently introduced a VAT, have learned lessons from those that have gone before them.

What we now see, and this may be a little confronting to those based in the EU, is that the source of change and innovation in the operation of VAT systems throughout the world may no longer be the EU. Instead, many of those countries that have adopted modern VAT systems, such as New Zealand, Canada, Australia and Singapore, may be regarded as among the leaders in this area. We also have countries like India, with its adoption of software to enable the pre-filing of returns and invoice matching; China, which applies VAT to financial services as its default model, as well as taxes on certain C2C transactions (in real estate); and Brazil, China and India, with their highly-regulated government invoicing systems that demonstrate remarkable ingenuity in the development of their VAT systems.

In short, the future of indirect taxes from a policy development, administration and technology and systems perspectives, may lie outside the EU. It is quite conceivable that measures adopted in, say, the BIC countries or in smaller jurisdictions without legacy systems, may be a more reliable signpost to the future.

Having said that, the EU has remained steadfast to the fundamental principles of a VAT as compared with the BIC countries – enshrining concepts of fiscal neutrality (driven by the key principles of an internal market and free competition) and VAT, as a consumption tax, into the first VAT directive and its substitutes and in the case law of the European Court of Justice.

Future of VAT: Continued evolution and increasing significance

It is evident that the world will see VAT further increase in importance as a revenue raiser for countries, and that there will be ongoing change to its scope and mode of operation. **Lachlan Wolfers** makes predictions for the coming years.

In *Five years of rapid VAT evolution: How have predictions held up?* we cast an eye back over the changes, foreseen and unforeseen, of recent times. Here, we are looking at the coming years and setting out bold predictions for changes in VAT as it increases its dominance as a national revenue raiser and continues to morph in response to a changing economic environment.

Specifically, we predict that:

- Consumption taxes will be the dominant form of taxation around the world;
- VAT (or equivalent) will be applied to financial services as the default model;
- VAT refunds will largely end (except for a few small categories); and
- VAT returns (as we know them) will die.

Undoubtedly, China is at the forefront of many of these trends, though they affect a wide range of jurisdictions. These predictions are paralleled by a series of related predictions for VAT and technology in another accompanying article, *VAT and technology: The first fully automated tax?*

Consumption taxes and world domination

Over the course of the past 30+ years, the weighted average corporate tax rate by GDP among 208 separate tax jurisdictions has virtually halved from 46.6% in 1980, down to 26.5% in 2018 (as published by the Tax Foundation, *Corporate Tax Rates around the World*, November 27 2018). Although, it must be acknowledged that the OECD average corporate tax revenue has remained relatively stable as a percentage of total tax revenue throughout (being 8.8% of total tax revenue in 1965 and 9% in 2016).

More staggeringly, is the adoption of VAT by countries, which has increased virtually sevenfold in a period of just over 40 years (from 25 countries in 1977 to around 168 countries in 2019).

Consumption-based taxes, which include VAT, goods and services taxes (GST), sales taxes, excise taxes, and other forms of taxes on goods and services, account for 33% of total taxation across the OECD (according to the OECD's 2018 Consumption Tax Trends, p42, the OECD un-weighted average). They are now only marginally behind taxes on income, profits and capital gains (essentially, personal income tax and corporate income tax combined, which is at 34%) in terms of total revenue collected.

These statistics tell us that consumption taxes are clearly an important source of revenue and that, with the introduction of VAT systems, they are taking on an ever-greater share of that consumption tax revenue. However, the role of consumption taxes as the dominant form of taxation is yet to come to fruition. This will happen over the coming years.

The modern problem with corporate taxation is in the battle for determining 'where' the value is created, which generates the profit of the business, and therefore 'who' has the right to tax that profit. By contrast, in indirect taxes, there is near unanimity in the view that tax should be collected in the place where consumption occurs. The challenge in indirect taxes is how best to collect it.

Corporate taxation, in its current form, is ill-equipped to deal with a situation in which a highly digitalised business can be physically located in country A, but sell products or services on a global basis, without people or significant capital outside their home base. The work being carried out by the OECD as part of its BEPS project (Addressing the Tax Challenges of the Digitalisation of the Economy) to achieve consensus around a new paradigm for taxing the digitalisation of the economy is worthy, and may well be successful in the short-to-medium term. Ultimately however, one wonders if the outcome of this process will be that corporate taxation becomes less of a priority for certain countries, especially where they are at least able to collect a minimum tax liability under pillar two of the OECD's proposals. We explore this more in *BEPS 2.0: What will it mean for China?*.

This is not to suggest that governments will give up on corporate taxes. As the past few years of tax transparency has shown, the 'fair' imposition of corporate taxes has become not just a legal imperative, but a moral imperative too. An imperative that is increasingly being demanded of highly digitalised businesses.

Faced with such a highly politicised taxation environment affecting highly digitalised businesses; the likelihood of any new measures triggering a boon for transfer pricing professionals; the need to introduce considerable simplifications to ensure the measures are workable in practice; and extensive arbitration measures – governments will likely follow the path of least resistance and diversify their risks and costs by relying on a range of different forms of consumption taxes, noting that consumption taxes (as compared with indirect taxes) are not always, by their nature, borne by end-consumers.

This is not to ignore the other big elephant in the room, which is that the base for corporate taxation is profits, and with many of the large digital economy participants in the world being unprofitable (at least, as yet), this may be 'much ado about nothing'.

Putting all this together, surely legislation which imposes taxes based on turnover from sales, collected in the markets in which these businesses sell, brings with it a far greater alignment between the motives and interests of businesses and those of the countries in which sales are taking place. In short, if, as French politician Jean-Baptiste Colbert colourfully noted, "[t]he art of taxation consists in so plucking the goose as to procure the largest quantity of feathers with the least possible amount of hissing", then surely consumption taxes represent the better goose for plucking.

It is these facts which have spurred the introduction of digital services taxes, or their equivalents, in places like France. There are also similar proposals in the UK and elsewhere. These facts have also spurred the introduction of a foreign e-services tax in Taiwan (China), as well as India's equalisation levy and significant economic presence concepts (to name a few).

To be clear, the proposition that consumption taxes will be the dominant form of taxation is not intended to traverse the legal debate as to the nature of digital services taxes as either a direct or indirect form of taxation. For this, it is worth looking at the EU's proposal for a Council Directive on the common system of a digital services tax (COM(2018)148, March 21 2018) and the request for a preliminary ruling to the ECJ in case C-75/18 involving Hungary's telecommunications tax, and the Advocate-General's opinion in this case issued on June 13 2019. Rather, it is intended to apply the concept of consumption taxes both broadly and practically. These are situations in which the tax is collected by an intermediary but intended economically to be borne by the end consumer (which describes indirect taxes); and where the tax is either calculated or determined by reference to the place in which consumption occurs (for example, gross business receipts taxes).

A further rationale for the view that consumption-based taxation will be the dominant form of taxation around the world is the environment. Be they carbon taxes, environmental levies, the myriad of taxes, fees and charges relating to air travel, traffic congestion charges or even 'shopping bag taxes' – all of these are forms of environmentally-oriented consumption-based taxes.

Recent proposals in France and the Netherlands to potentially end the zero rating of international air travel in a bid to tax CO₂ emissions, further highlight encroachments on the previously sacrosanct concept that international air travel should not attract VAT.

In short, consumption taxes are not far behind corporate and personal taxes (combined) in being the dominant form of tax revenue collected amongst OECD countries. The

trend sees consumption taxes increasing and corporate and personal taxes (combined) falling. It, therefore, does not take much imagination to envisage a day when consumption taxes overtake.

VAT on financial services: The new default

This is a topic that has added impetus with the advent of the latest European Commission review (announced in April 2019) into the exemption from VAT for the financial services industry. There is a perceived greater urgency to act in this space. Put simply, the view that financial services broadly should be exempt from a VAT is unsustainable in the long-term, for two main reasons.

First, the policy rationale for exempting most financial services from VAT arguably no longer exists. Historically, one of the main reasons for the exemption was the inability to measure the value added on a transaction-by-transaction basis, for example on forex transactions. However, with the growth of fee-based services relative to margin-based services, this measurement problem is no longer as prevalent. Similarly, some countries have demonstrated the ability to devise simplifications to tax margin-based loan services (China, Argentina and Israel); to tax the value added in general insurance (New Zealand, China, Singapore, Australia and South Africa); and even life insurance (India, though excluding the savings component).

Second, the nature of financial services is fundamentally changing. No longer is it possible to draw a clear line between the products or services of traditional banks, insurers and asset managers and contend that they need to be exempted from VAT for their services; while component or outsourced providers, especially many ‘new economy’ participants in peer-to-peer (P2P) lending, fintech, payment processors, and even digital currency providers, may be taxed.

Let’s take a very simple example. It is commonplace for consumers to be charged a fee for withdrawing money from an ATM, for instance when using a card from a different bank. In Australia, such fees are exempt from GST in accordance with Regulation 40-5.09(4A) of the GST regulations and this is confirmed in GST Ruling 2014/2. However, what is the inherent policy problem which limits the ability to apply GST to these transactions? How does this really differ from a situation in which a customer uses their credit card and a surcharge is imposed, for which GST will apply (if the underlying supply is taxable – see GST Ruling 2014/2)? Likewise, how does this differ from a situation in which the fee is imposed by a third-party payment processor, which is similarly taxed for GST purposes in Australia?

From a broader policy perspective, is this an example where the GST treatment differs because of ‘who’ is making the supply, rather than by reference to ‘what’ is being supplied? To be clear, it is not suggested that the analysis of the current legisla-

tion is incorrect, rather that the policy does not produce economic equivalence between substantially similar transactions.

Interestingly, when Facebook launched its new cryptocurrency Libra in June 2019, it symbolised the growing encroachment of digital economy participants into the financial services sector, and signalled the death knell for the ability to ringfence exempt financial services from a VAT. This trend is even more obvious in countries such as China, where companies including Alipay and Tencent dominate the digital payments market.

There are three major exceptions where the taxation of financial services under a VAT is unlikely to be fully realised. The first is in certain personal loan products, such as home loans, where for political expediency, governments may well choose to continue with exemptions from VAT. The second is in the trading of derivatives and other financial instruments, where the imposition of VAT would operate more like a wealth or capital gains tax (such as in China). Derivatives or financial instruments are also arguably not really ‘consumed’ in any traditional sense. The third and final exception is in jurisdictions which apply substitutes for VAT in certain areas of financial services; for example, the EU’s insurance premium taxes, Korea’s education tax, and Thailand’s specific business tax.

The challenges in maintaining financial services’ exemption from VAT are all too obvious when one considers recent international case law and legislative developments. Take for example the treatment of payment processing services. The question of whether exemption applies or not differs significantly from jurisdiction to jurisdiction, and can even vary depending on whether the service fee is collected from the end-consumer, or through the merchant. For example, the UK has historically adopted a wide application of financial services VAT exemptions, including for payment services, as opposed to other EU countries which have adopted a narrower interpretation of VAT exemptions. Where payment services are provided to merchants, VAT exemptions have a highly distortive effect and create VAT leakage in the supply chain. Many payment service providers and processors therefore seek to apply VAT on their services, allowing them to claim input tax credits.

The other notable example is in the classification of cryptocurrency. For example:

- In European Union Case C-264/14 (*Hedqvist*), the European Court of Justice held that bitcoin is a currency and therefore exempt from VAT when used to pay for goods or services;
- In Australia, as of July 1 2017, the supply of cryptocurrency is not subject to GST but through a legislative amendment that creates a new category of digital currency, which is neither money nor currency; and
- In Canada, recent legislative proposals have been introduced to define cryptocurrencies at ‘virtual payment instruments’, which are not money but which are nonetheless exempt from GST as a ‘financial instrument’.

While these examples highlight the growing trend to exempt a cryptocurrency from VAT when it is effectively used as a medium of exchange, operations surrounding the use of cryptocurrencies, such as mining, may still be subject to VAT.

This highlights the difficulties in ringfencing financial services from VAT. As both the Australian and Canadian examples show, if ringfencing is to occur, then the concept of 'financial services' needs to be regularly updated. In the EU, the problem is even more acute given that the EU Directive dates back to 1977, and even the proposals back in 2011 to update the rules would already be outdated. Put simply, regularly updating a concept which, from both a commercial and regulatory perspective, is increasingly blurred, is exceptionally difficult.

For all of these reasons, we predict that VAT will be applied to financial services as the default method, though a limited range of exemptions will still need to apply.

VAT refund disappearing act

The proposition that VAT refunds will end is one of the most controversial. In particular, the idea that VAT, which is a tax not intended to be imposed economically on business, would cease to be refundable in circumstances where inputs exceed outputs in a given period, is near heresy. It directly contradicts the OECD's guidelines. Furthermore, critics of this proposition may point to the potentially detrimental impact on exporters and start-up businesses.

However, let's consider the evidence on the state of VAT refunds, some of which is based on the KPMG International VAT/GST Refunds Survey 2014 carried out on the efficiency VAT/GST refunds in 65 countries, and on more recent developments since that time:

- 1) Securing VAT refunds is a commonly deployed device used by fraudsters, and therefore scrutiny is required so as not to leave tax authorities exposed. They require tax authorities to deploy significant resources to combat such fraud, often with the impact of delaying refunds for legitimate businesses;
- 2) Tax authorities are increasingly taking an inordinate amount of time to process refunds – for instance, some EU countries are known to scrutinise and delay VAT refunds, especially for non-resident companies and even for those with taxable activities in the country of refund;
- 3) Tax authorities are increasingly imposing tax audits as a precondition for the payment of a refund (for example, in Indonesia);
- 4) Refunds of VAT are often being offset against other tax obligations before being paid (for example, in Australia);
- 5) We are seeing a growing trend of countries only allowing VAT refunds to foreign businesses if the principle of reciprocity is followed with respect to businesses from that first country operating overseas. For example, many EU countries do not allow VAT refund claims for businesses located outside the EU unless there is a reciprocity agreement or similar arrangement with that country for VAT recovery.



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Indeed, in a global context, refunds to non-resident non-VAT registered businesses is becoming the exception rather than the rule;

- 6) Anecdotaly, the availability of tourist VAT refund schemes seem to be diminishing, either through the imposition of higher *de minimis* amounts, or through administrative burdens which practically discourage their use (for example, long queues, offices not being open, enhanced paperwork requirements etc.).

Due to the factors above, businesses are also increasingly becoming reluctant to claim VAT refunds for certain expenses on a cost-benefit basis.

One wonders if this trend of diminishing, discouraging and disentitling otherwise legitimate refund claims will lead to a situation in which they largely end. We say 'largely' end because we would expect them to continue for exporters and for other suppliers making zero-rated suppliers habitually. The abolition of VAT refunds for these specific situations would be counter-productive for those countries, either in terms of harming their international competitiveness or in effectively undermining the policy of zero-rating certain supplies. Indeed, a number of countries are expanding the scope of exported services concessions (exemptions or zero-rating), such as Russia, Indonesia, Cambodia and China. This has the corresponding effect of limiting the need for refunds by foreign businesses receiving those services. Furthermore, sales of goods to large exporters (in countries like France and Italy) and of certain services to exporters (Costa Rica) also operate so as to minimise the need for refunds by those exporters.

The shift away from VAT refunds is interrelated with our view that the future will see the use of blockchain technology and mechanisms to collect VAT through the payment system (for example, in the UK). This will result in VAT systems more closely resembling retail sales taxes. (We have gone into this in further detail in *VAT and technology: The first fully automated tax?*)

A further example where we see the risk of refunds being denied is in situations where a business' VAT payable is overstated, either by reason of overstated output tax or more commonly, by understating input tax credits in that tax period. This can arise because of a myriad of innocent commercial reasons, including not processing accounts payable invoices on a timely basis, or because purchase invoice amounts were missed off initially. The ability to later identify understated input tax credits and seek a refund of them, is potentially at risk. Australia is an example of a country which has taken considerable steps to impose limitations on such refunds, including by reference to time periods and by measures which are designed to ensure the end-consumer benefits if such a refund is paid out.

If VAT refunds end, they will likely be replaced by a system allowing the carry forward of VAT credit balances, much like the carry forward of losses in a corporate tax context.

Death of the VAT return (as we know it)

This proposition is not dissimilar to one made by KPMG back in 2014 (have a look at *Five years of rapid VAT evolution: How have predictions held up?* and the prediction that there will be no more periodic returns). The only difference is that this is starting to become a reality, for example in India, with the introduction of an electronic invoicing system which will be used for the pre-filing of GST returns, proposed from January 1 2020; and in Brazil, with perhaps the most advanced e-invoicing system in the world, requiring a digital stamp from the tax authority and real-time reporting of transactions.

The death of the VAT return is an inevitable consequence of several factors. First, electronic invoicing through government regulated invoicing systems, which means that the government already has the sales data to enable pre-filing of returns. Second, the need to carry out data matching or verification of purchase invoices through such government regulated invoicing systems (see *VAT and technology: The first fully automated tax?* for more). And third, the need for real-time reporting of transaction level data (for example in Spain and Hungary) such that the government is provided with ERP data on a regular or real-time basis.

Similarly, European countries including Portugal, Poland, Austria, Norway are increasingly adopting a standard audit file for tax (SAF-T) and similar requirements, that ask taxpayers to provide transactional data in a pre-defined auditable format to tax authorities, either periodically or on the tax authority's request. Poland is planning to replace the VAT return entirely with the SAF-T filing from 2020.

It is highly likely, in our view, that over the next five years, VAT returns will be pre-filled for taxpayers. The objective then turns into one of carrying out a reconciliation exercise to check the accuracy of the returns and make any adjustments required.

While pre-filing may be the direction of travel in the short-to-medium term, in the longer-term the actual filing of VAT returns may be rendered completely redundant. We explore this further in *VAT and technology: The first fully automated tax?* Because the data that forms the basis of VAT returns will be fed automatically from business' own enterprise resource planning (ERP) systems, simplifications will render the compliance process largely untouched by subjective judgment and B2B transactions will no longer be taxable and creditable, given VAT systems will closely resemble retail sales taxes. Furthermore, in accordance with the proposition we make in *VAT and technology: The first fully automated tax?*, in many countries the data will in fact be held directly through government regulated invoicing systems.

In conclusion, VAT returns will die a natural death, and it will likely occur in two stages – first, through pre-filing, and second, through a combination of enhanced data transmission tools and the removal of much of the subjective judgment which currently takes place in VAT compliance.

VAT and technology: The first fully automated tax?

Looking ahead, technological changes will impact VAT administration and compliance, with significant implications for the role of the VAT professional. **Lachlan Wolfers** sets out a series of predictions for the years ahead.

In *Future of VAT: Continued evolution and increasing significance*, we outline a series of predictions on the increasing importance of VAT as a national revenue raiser, as well as anticipated changes to its scope and mode of operation. Here, we are taking this one step further and looking at how technological change will impact VAT administration and compliance, and its implications for the role of VAT professionals.

Specifically, we anticipate that:

- Government-regulated invoicing systems will grow significantly – as well as their importance becoming ever more significant – and that they will wreak havoc on compliance costs for multinationals;
- VAT compliance will be met by technology and will be outsourced by most large businesses. Simplifications which reduce the risk of fraud, or which are necessary to prevent errors or eliminate disputes will grow;
- In-house tax departments, and tax advisors, will be disintermediated by tax authorities;
- VAT will more closely resemble sales tax (through the use of blockchain technology); and
- Unless tax professionals and the organisations they serve transform urgently, they risk falling down the value chain.

In many respects, the technological changes envisaged here are a continuation of the rapid changes seen in recent years. We predicted this some years ago and as set this out *Five years of rapid VAT evolution: How have predictions held up?* China will continue to be, as it has been, in the vanguard of these technological developments.

Government-regulated invoicing systems will wreak havoc

If you ask practitioners in most countries whether tax invoices are regulated, the answer is invariably yes. However, here, reference is not being made to examples of tax invoices being issued by businesses, either in

paper or electronic form, from the business' own enterprise resource planning (ERP) system.

Typically, tax invoices in most countries contain certain standardised content in relation to a transaction. These include: the inclusion of the supplier's name and the tax authority-issued registration number; the recipient's name; the transaction date; a description of the relevant good or service being supplied; the transaction amount; and the amount of VAT charged.

Rather, we are talking about countries in which the ability to issue such a tax invoice, or to generate a transaction record, is regulated by the government. That is, where a tax invoice must be issued through the use of government software or hardware, and not through a business' own ERP system. We are already seeing this in jurisdictions such as mainland China, Brazil, Taiwan (China), Indonesia, Korea and India, and similarly in Portugal, which is also requiring taxpayers to issue invoices through government-certified software.

The theory or intention behind the use of government-regulated invoicing systems is that they arguably seek to improve the integrity of transactions and their recording; help to reduce the VAT gap; and they aim to eradicate VAT fraud by only allowing a recipient an input tax credit if the corresponding output tax of the supplier has been accounted for.

While these are worthy pursuits, in many respects they can impose significantly higher compliance costs on businesses. It is a classic example of rule-making which seeks to mitigate the fraud of a small minority, at the expense of the vast majority who are ordinarily compliant. Based on experience, a significant number of challenges can be posed for businesses by the introduction of such government-regulated invoicing systems. For example:

- Duplication, because tax invoices are issued in addition to normal commercial invoices;
- The need to build an interface, or application program interface (API) or other linkage between a business' own ERP system and the government regulated invoicing system;
- The fact that from an IT security perspective, businesses are often compelled to ringfence these systems from their own secure IT environment;
- Reconciling ERP data (commercial invoices) to the regulated tax invoices;
- Losing input tax credits where suppliers omit to issue tax invoices;
- The impact of service outages and maintenance which can detrimentally impact business; and
- The need to adopt processes which may not match the ordinary processes or systems used in the business.

Interestingly, many countries, especially in the EU, have chosen to adopt the less interventionist approach of

real-time reporting. That is, to obtain the transaction level data on a real-time basis. As mentioned, this is a step short of government-regulated invoicing where the government effectively seeks to interpose itself into the transaction/invoicing chain. One wonders, and perhaps even speculates, that some countries applying real-time reporting may well transition to government regulated invoicing in the near future.

The main reason for calling out this very recent trend in government-regulated invoicing systems is the exponential increase in compliance costs which would be caused if all countries did this, and if they did so in their own way. That is, if each country chose to adopt their own regulated invoicing system, each taking a slightly different form, and with unique software or hardware requirements. This is the risk that creates most concern.

If this trend continued, it would effectively mean that multinational companies seeking to centralise their global compliance efforts, would need to maintain and operate literally over 100 different country-specific hardware or software systems and interface-type solutions. In short, the benefits of centralisation would be lost.

The answer to this problem is not to naively suggest that there could be a single global regulated invoicing system. Rather, it is to suggest that a body like the OECD could and should seek to define common standards in a way that seeks to reduce compliance costs (for businesses and governments alike) through that commonality. For example, by defining the optimal core functionality of the software or hardware being developed; by prescribing how that software or hardware should interface with common ERP systems; as well as minimally acceptable IT security standards. In fact, it could be similar to the guidance published by the OECD on the standard audit file for tax (SAF-T), which is now increasingly being introduced by countries mainly in Europe.

An interesting by-product of the advent of government-regulated invoicing systems is the increased importance of tax invoices in VAT systems. For example, longstanding practice in Australia was that while the law required the issuance of tax invoices to consumers within 28 days of a request and law prescribed the minimally acceptable content of such tax invoices, in the event of an audit tax, invoices serve merely as one form of evidence as to when, who and how much was involved in a given transaction. It is never determinative of the transaction itself. In common parlance of form versus substance, the tax invoice may describe the form, but the substance is the whole circumstances of the transaction itself.

By contrast, China, with its highly regulated invoicing system (known as the Golden Tax System), put a high level of importance on tax invoices, which were treated as being the best evidence of a transaction. This is not to say that the form of the tax invoice will always supplant the substance of

a transaction, but exceptions are relatively limited in practice (for example, fraud). Examples abound of taxpayers being denied input tax credits which they would otherwise have been entitled to, merely by reason of the (wrong) type of tax invoice, the content of the tax invoice, the failure to retain the tax invoice, or the failure to verify the tax invoice.

We predict that along with the rise of government-regulated invoicing systems and the increased importance of data and analytics by tax authorities in auditing or verifying VAT compliance, practically the data inputted into tax invoices will assume elevated importance – in the fullness of time it will be virtually determinative evidence as to how, when and for how much a transaction takes place. This is not to suggest that the law will explicitly state this, rather it will be the practical reality of a system which relies on those same data fields used in tax invoices to feed the ERP systems and in turn the analytics used in the detection of errors or anomalies.

Already, we are seeing developments in optical character recognition technology, together with artificial intelligence, that are enabling human-less invoicing – system logic is driving the invoice issuance process by a supplier through to the receipt, validation and processing of invoice payments by the recipient.

In short, we are beginning an era in which there is limited, or even no, human interaction in the tax invoice issuance process. As such, if ‘the system’ does not flag it as anomalous, erroneous or extraordinary, the content of the tax invoice becomes the reality.

VAT compliance will become a technology proposition and will largely be outsourced

It almost seems contradictory to argue that large businesses will outsource their VAT compliance and related technology needs, given the impending death of the VAT return discussed in *Future of VAT: Continued evolution and increasing significance*. However, let’s consider what remains when VAT returns die.

As noted above, the longer-term perspective is that VAT compliance will effectively be managed through the data which is fed from business’ own ERP systems directly to the tax authorities, or via government-regulated invoicing systems.

As we all know, the single biggest operational challenge facing in-house tax departments right now is in managing data. Data management problems stem from a number of factors, such as:

- The use of multiple systems within most organisations, including the need to maintain legacy systems;
- The problem in extracting data from those multiple systems; having them ‘talk’ to each other, or in bringing together (coherently) data from those multiple systems;
- The challenges of reconciling the data, or in making manual adjustments to the data; and



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Before joining KPMG China, Lachlan was the leader of KPMG Australia’s indirect taxes practice and the leader of KPMG Australia’s tax controversy practice.

Lachlan led KPMG’s efforts in relation to the VAT reform pilot programme in China. During the course of this work, he provided advice to the Ministry of Finance (MOF), the State Taxation Administration (STA) 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 and business transfers, as well as other reforms relating to the introduction of advance rulings in China.

Lachlan was 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.

Before joining KPMG, Lachlan was a partner in a major law firm. He has extensive experience in a broad range of taxation and legal matters. He has appeared before the High Court of Australia, the Federal Court of Australia and the Administrative Appeals Tribunal, including in the first substantive GST case in Australia.

Lachlan is a noted speaker on VAT issues and has presented numerous seminars for various professional associations, industry groups and clients on the VAT reforms in China.

- The continuation of historical practices where ERP systems were configured for the benefit of the business and finance departments, but not necessarily the in-house tax department.

In fact, among the most common complaints made by in-house tax departments is that they are unable to fully comply with tax laws because of system limitations. This usually necessitates practical workarounds or manual processes to manage compliance.

Moore's law, adapted to a data context, would suggest that data will double every two years, with businesses accruing more systems rather than fewer. Given this, logic would suggest that data management challenges will increase exponentially. And herein lies the role of the VAT compliance professional. Their role will be to design processes (including through robotic process automation) and deploy technology tools (in many cases using artificial intelligence) to manage the data which, in turn, manages VAT compliance. In short, VAT compliance will be (nearly) entirely a technology proposition.

The second part of our proposition, which is that most large businesses will outsource this work, is not stated as a matter of self-interest, but instead comes down to simple economics. The reliance on technology solutions to manage VAT compliance often requires significant up-front investment cost, if built by the organisation for their own needs. Yet that same cost may be split among hundreds or even thousands of taxpayers if developed by third-party providers such as the Big 4 accounting firms or specialist software providers. The economic equation is entirely comparable with that of cloud computing, which is effective because large up-front investment costs can be shared among a large group and obtained more affordably on a subscription basis. Added to this is the fact that the maintenance and updating of VAT compliance technology can also be costly.

Two other factors also bear consideration. The first is that with the rise of government-regulated invoicing systems, the cost of technology investment increases too. The second is that as businesses digitalise their models, they increasingly need to comply on a global basis. These two factors combined will lead to an exponential increase in VAT compliance costs unless outsourcing occurs.

For these reasons, the more that VAT compliance becomes a technology play, the greater the likelihood that it will be outsourced.

Simplifications which reduce fraud, errors and disputes will proliferate

In 10 years' time, we will look back quaintly on the era in which businesses were able to claim input tax credits (in many jurisdictions) for business costs such as motor vehicle usage (fuel) for employees on work-related trips; mobile phones for employees for business use; meals for employees

on business trips; and even entertainment (to the extent that is still available).

Put simply, many of these types of costs are susceptible to exaggeration and error. In an era of digitalisation, where many types of processes are highly systematised and where verification of the correctness of these credit claims would consume a disproportionately large amount of resources, it would not be a surprise for these types of claims to either be denied credits outright, or be subject to a simplification which provides an automatically determined credit amount or percentage. An example of this could be the adoption of an arbitrary 50% for all employee meal costs. Potentially, this type of simplification may even be extended to other types of costs incurred on business trips, such as accommodation and domestic air travel.

An interesting question remains as to whether simplifications will also be applied to areas such as in the financial services sector, which are currently subject to partial exemption methods (as in the EU). Singapore is a country with simplifications in this area, as it effectively mandates the percentage entitlement to input tax credits depending on the classification of the financial services institution. Many Asian jurisdictions also only provide limited flexibility in partial exemption methods, through the use of only 'revenue based' apportionment methods.

While in *Future of VAT: Continued evolution and increasing significance* we argued that financial services would be subject to VAT as the default method, there will likely still be certain areas for which exemption remains, thereby giving rise to the need for an apportionment of credits. Similarly, other sectors that commonly make a mix of both taxable and exempt supplies, such as the real estate sector, could also be subject to simplifications to ease compliance in calculating input tax credits.

In short, in an era of binary coding, where everything is reduced to either a '0' or a '1', it is not a stretch to envisage the end of approaches or methodologies for calculating input tax credits which are subjective, or highly prone to over-exaggeration, error, or require disproportionate tax authority resources to verify and audit.

In-house tax departments and tax advisors will be disintermediated

Among the propositions made, this is perhaps the most controversial and also the gloomiest from the perspective of a tax advisor. It is the idea that we, as tax professionals, whether working in-house or as external advisors, will likely be disintermediated by tax authorities.

Let's consider the case for this. First, it is already happening to an extent. Consider the fact that the tax authorities now deal electronically with business; in most countries they publish extensive information to help businesses comply, whether in the form of legislation, rulings, interpretations,

guidance material, etc. Many tax authorities have developed chatbots and similar, such that now most routine queries are handled without the need for a tax professional. In short, understanding a businesses' obligations has already been made considerably more efficient (and require less labour or input from tax professionals) than they did in the pre-internet era of 20 years ago.

Second, as noted above, tax authorities are now building their own government-regulated invoicing systems to obtain transaction level data automatically, or they are requesting it on more of a real-time basis than ever before. With this data, they can carry out data and analytics testing to then determine whether the business is complying and, if not, by how much. They do not need tax advisors for this, certainly not as much as before.

Third, and this is the major point, in the technology race, the tax authorities will always win. They will win because the tax authorities can build technology tools which they can mandate to serve an entire population, whereas any third-party technology is always subject to competitive pressures, and the need for pricing and sales. Tax authorities are also not subject to normal returns of investment. In theory, provided the government stands to gain \$1 of extra tax revenue over and above the cost of deployment of a new tool, they can proceed.

Our recent project experience, while unrelated to VAT, may nonetheless be very relevant in demonstrating the potential to be disintermediated. In 2019, the Chinese government authorities introduced new rules for the withholding of tax on employee salaries and wages. Unusually, these new rules required tax to be withheld by employers on the basis of net income concepts, not gross income. Several large professional service and payroll firms invested considerably in developing technology to facilitate employers aiming to obtain the necessary data from their employees efficiently, which would in turn allow them to determine the net income amounts from which to calculate the tax withholding in respect of each employee. Just prior to its commencement, the government decided to launch its own technology tool, which would allow employees to upload the data and transmit it to employers each month, in a type of pre-filling exercise. In the blink of an eye, the government had effectively assumed responsibility for a business opportunity which would, historically at least, have been carried out by the private sector.

In all likelihood, we will end up with a mix of government-owned technology to manage the compliance or risk processes, with government-approved technology: tools developed by the private sector which meet certain government specifications. Australia's single touch payroll system used for employment tax reporting is an example of this latter approach.

Make no mistake though, tax authorities stand the very real prospect of disintermediating a significant proportion of the tax profession!

VAT will increasingly resemble sales tax (thanks to blockchain)

The 2017 edition of *China – Looking Ahead*, included an article entitled *Lighting a pathway to 2025*, which argued that VAT will more closely resemble a sales tax. The response to the article was highly divisive, with some practitioners considering the proposition to be ludicrous, while others agreed. To be fair, at face value, the proposition is ludicrous when one considers that VAT has now been expanded to more than 160 countries around the world; a sevenfold increase in the past 40 or so years.

However, the validity of the proposition is simply illustrated by considering how VAT works through a typical supply chain of a manufacturer supplying a pair of sneakers to a wholesaler, and through to a retailer before being sold to an end consumer. It is only when one recognises that the supply of the sneakers involves three separate output tax obligations and two separate input tax credit entitlements, which effectively cancel out the corresponding output tax amounts on those transactions, all so that when the retailer sells to the end consumer, the output tax will be accounted for. In short, five separate recordings on a VAT return which must be accurate, where only one of which actually matters.

One of the key policy rationales for imposing this multiplicity of obligations, at least historically, was to ensure that VAT would be accounted for, in part, even if there was fraud in some other part of the supply chain. However, the reality is that by imposing so many obligations, albeit on different parties, the potential for fraud remains and some argue it is exacerbated. Leaving that issue aside, surely even an eight year old child can recognise the potential for a technology solution to radically overcome the inefficiency inherent in this system.

Now if we wind forward two years since that article was published, the same prediction could be ventured now, but perhaps with even stronger force. In particular, four main developments have, in our view, opened the doors to VAT more closely resembling a retail sales tax.

First, the use of blockchain or distributed ledger technology (DLT) seems to have progressed from a largely theoretical concept (except in the case of cryptocurrencies), to becoming more widely used. In particular, there have been increasing request for proposals (RFPs) from large multinationals seeking assistance in deploying blockchain technology to manage their invoicing processes.

It is increasingly clear that blockchain can be deployed as a means to solve VAT fraud; for example in the EU, where VAT fraud with missing traders happens in certain jurisdictions on an unacceptable scale. Given that VAT is collected by businesses in multiple stages of a supply chain, where money flows directly between suppliers and recipients and invoices are being used to collect the VAT from customers and by intermediaries to claim input tax credits, with no or

limited control and visibility on the VAT collection by government, further measures are clearly required. Where a trader goes missing without paying the VAT (collected from its customers) to the tax authorities, tax authorities are often too late in detecting the fraud and unable to trace fraudsters, while the recipient of that supply still claims the credit for the input tax it incurred and paid to that supplier.

Blockchain has the ability to fundamentally transform the VAT collection process with greater transparency and security for both tax authorities and taxpayers. A distributed ledger can connect taxpayers, tax authorities, intermediaries and even banks.

Indeed, blockchain as a concept can readily be applied to VAT through a supply chain – that is, rather than requiring each party throughout the supply chain to account for VAT, B2B parties can be matched through a form of digital certificate, with only the last stage of the supply chain accounting for the VAT.

There is a powerful analogy in terms of the potential transformation of VAT under blockchain, with the transformation in the early 20th century in the system of land titles used in Australia and several other Commonwealth countries. Under old system land titles, it was necessary to trace the history of any land titles back to inception, in order to ensure that the current land title being transferred was validly owned by the vendor and therefore could be sold to the purchaser, and not later be voided or challenged. By contrast, under the Torrens Title system, the purchaser of any parcel of land can rely upon the indefeasibility of the current title to the land shown on the register.

Likewise, in a VAT context, instead of the necessary accounting for output tax and input tax through the early stages of any supply chain, blockchain would allow for digital matching of B2B supplies and related invoices, such that ultimately only the final stage involving B2C transactions would require a real tax outlay.

Second, in the recent elections for the new Prime Minister of the UK, carried out by the Conservative Party, one of the candidates, Michael Gove, proposed replacing the UK's VAT system with a simpler sales tax system. Interestingly, the hysteria this created was significant, with one commentator writing in the influential weekly magazine, *The Spectator*, asking whether Gove was “on drugs”. Other tax professionals on LinkedIn wrote furiously in defence of VAT, fearing somehow that their professional expertise and very livelihood would be at risk.

With respect, many of these comments completely missed the point. They singularly failed to take into account the impact of technological developments which could create greater security and validity in the transaction lifecycle, without the need for the supplier to account for output tax and the recipient claim input tax on B2B transactions. It similarly ignores the fact that much of the highly publicised

examples of fraud within VAT systems occurs at the B2B level – for example, with missing trader and carousel fraud; with the EU scheme on trading carbon permits; and in Australia, with precious metals trading.

Third, and perhaps most fundamentally, it ignores the fact that VAT systems are themselves having to create special rules or exceptions to combat fraud. Take for example the imposition of a reverse charge in Australia in the precious metals industry; the requirement for purchasers to withhold VAT on taxable sales of residential real estate in Australia; the numerous examples of reverse charge rules being applied throughout the EU, for instance a domestic reverse charge mechanism for mobile phones, chips, laptops, tablets, etc; and in New Zealand, with the zero rating of B2B land sales. These are all examples of the VAT system failing to properly combat fraud. In effect, the substitutions in certain cases resemble forms of retail sales taxes.

Fourth, the recent phenomenon and growth of e-commerce platforms in facilitating the cross-border sale of goods and services between business and consumers (or between consumers) has necessitated yet more stop gap measures to overcome fundamental limitations in traditional collection methods under a VAT. In particular, we have seen the use of intermediaries who assume a liability or role as principal in accounting for VAT on transactions; with Australia's low value goods regime being among the most extreme examples. Other examples include split payment methods, joint and several liability provisions (for example, in Germany), and collection from other intermediaries such as banks (for example, in Vietnam), which are either being implemented or debated.

In the US, special collection methods on platforms are being introduced in response to the *Wayfair* decision. Each of these collection methods serve to support or centralise the enforcement of collection from a few large participants, in preference to the real suppliers of the goods and services. While the attractiveness of these methods from a tax authority perspective is obvious, it plainly represents a further admission that the fundamentals of VAT systems are no longer fit for purpose, at least in a highly digitalised world.

In short, blockchain technology could be used to provide an immutable, time-stamped, distributed and distributable, public record of all transactions occurring on the chain, with real-time tax collection. This provides the means by which, in substance, VAT more closely resembles a retail sales tax.

Tax professionals and their client organisations must transform or risk falling down the value chain

The final proposition is more of an early warning for all tax practitioners, whether working in-house or as external tax advisors. The call to action stems from a concern, briefly discussed above, that the most pressing problem facing the tax profession right now is a data problem. Take for example the

following statements, which seem to reflect the reality of most businesses right now:

- 1) “We can’t get the data”;
- 2) “The quality of our data is poor”;
- 3) “We spend an inordinate amount of time scrubbing, reconciling and adjusting our data”;
- 4) “Even when we have the data, we need to perform significant manual adjustments”;
- 5) “Our data is spread across multiple systems, which do not speak to each other”; and
- 6) “The tax authorities believe we have the data at the ready, in the form in which they want it”.

With the increase in the volume of data, the growing importance of real-time reporting, and the heightened expectations around robust processes and systems, how can the average tax professional carry out their work effectively if they have no control over the data and no confidence about its accuracy?

In too many cases, there is a ‘head in the sand’ approach, in which everyone else is blamed for this problem: ‘finance won’t give us the data’, ‘we have too many systems so it won’t work’, etc. And while this may be true to a significant extent, unless and until the tax function takes some ownership over the data or seeks to influence those who do, the role of the tax professional will be diminished within the organisation. Transformation is becoming ever more urgent and important.

In a concept KPMG calls ‘tax reimagined’, we take a holistic view of how to transform the tax function. This covers questions on how to deploy people with the right skills, develop the right processes and harness technology to do

this in a way which is consistent with the business’ overall strategy. Simply relying on technology to solve the problem will not work. People, processes and systems need to be transformed in harmony.

These transformation projects are invariably pushing tax professionals to up-skill as data scientists and likewise, IT professionals to cross-skill as ‘tax technologists’.

Testing the predictions

The authors welcome the opportunity to be tested on the correctness of these propositions in a further five years from now. However, whether they withstand the test of time or not, two of these propositions should start to raise alarm bells with tax professionals. These are propositions that the in-house tax department, and tax advisors, will be disintermediated by tax authorities and the proposition that unless tax professionals and the organisations they serve transform urgently, they risk falling down the value chain. These should be seen as a call to action to tax professionals to take back control of the data and the processes, and to embark on a transformational journey using technology. Either that, or risk falling down the value curve or being disintermediated by the tax authorities.

In conclusion, technology is impacting every aspect of indirect taxes – from why it is attractive for governments as a source of revenue, through to the scope of the tax, how it is collected, administered, and the skills required to carry out the role of a tax professional. When described in this way, there is nothing particularly remarkable or provocative about these propositions since this are merely symptomatic of what we are seeing in terms of the digitalisation of the broader economy.

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