KPMG

cutting through complexity

TAX

Global International Corporate Tax

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Over the past 30 years, China has received over USD 1.3 trillion of foreign direct investment, with 60 percent of inflow in the last 10 years. The increasing presence of foreign capital in the PRC leads to promulgation and enforcement of sophisticated tax rules that have significant ramifications on multinational companies' operations in China.

Introduction

As the world's second largest economy, China offers multinational companies (MNCs) rich business opportunities, abundant and productive workforce, increasingly mature infrastructure, and lucrative consumer markets. However, complex Chinese tax laws, heightened scrutiny by the Chinese tax authorities, and a sombre economic environment, have created a PRC tax landscape that has never been more challenging for MNCs.

The Chinese tax system is intricate and Chinese tax practices vary from location to location. It is critical that you properly manage the Chinese tax burden, fulfil compliance obligations, and take advantage of the tax benefits that you are entitled to. Other than the tax rules, various government branches routinely issue new regulations that often have a deep impact on cross-border tax planning. Failure to understand the latest regulatory development can create undue tax and business risks and affect the ultimate success of your China operations.

KPMG China's Global International Corporate Tax (GICT) practice is here to help. We are dedicated to assist you in finding answers to critical questions such as:

- What kind of corporate structure is appropriate
- Where intellectual property should be located
- How should local supply chains be configured to help mitigate overall effective tax burden.

We will help you navigate through vague tax rules and shifting tax practices at the national and local levels, face challenges from the tax authorities, and maximise the possibilities.

International tax challenges in China

MNCs face a daunting array of tax challenges in China. The Chinese laws and regulations in the cross-border context are intricate and in constant flux. Foreign companies must grapple with a multitude of tax issues in various phases of the investment cycle, and sometimes struggle for the answers. The complex nature of these issues requires specialised expertise to handle them effectively. Below are some of the Chinese tax challenges that MNCs commonly face.

- **Beneficial ownership**

China has income tax treaties with close to 100 foreign countries and jurisdictions, providing substantial benefits by reducing the 10 percent withholding tax on China sourced passive income. To combat potential abuse of the treaty system, Chinese tax authorities have limited the extension of treaty benefits related to certain passive types of income to residents of a treaty jurisdiction that meet the beneficial ownership test. To access lower withholding rates under a treaty, a foreign recipient needs to demonstrate that it conducts substantive business activities in the residence treaty jurisdiction and possesses dominion control over the China-sourced passive incomes. In reality, the criteria for beneficial ownership are vague. The answers on treaty qualification are often painfully elusive.

- **Permanent establishment**

A foreign person's business profits can only be taxed in China to the extent that its activities in China rise to the level of a permanent establishment (PE) in the treaty context. The Chinese criteria of PE are expansive. Some examples of how a PE can arise in China include a fixed place of business, a construction site, a continuous presence of foreign personnel, or a dependent agent with contract execution authority on behalf of a non-resident. In recent years, Chinese tax authorities have

intensified efforts to monitor activities of non-residents in China that may lead to PE creation, and have followed a substance-over-form doctrine in the examination. MNCs doing business in China need to be vigilant to avoid unintentionally creating taxable presence in China and subjecting offshore profits to PRC taxation.

- **Indirect transfer**

China has a fairly singular indirect transfer rule. When a MNC disposes of a Chinese subsidiary by indirectly transferring the shares of a non-resident special purpose vehicle (SPV) that holds the ownership interest in the Chinese subsidiary, the MNC generally needs to report the indirect transfer to the local PRC in-charge tax bureau. If the local tax bureau decides that the interposition of the SPV lacks a legitimate business purpose, it could re-characterise the indirect transfer as a direct transfer of the Chinese subsidiary, and impose a 10 percent Chinese withholding tax on gains from the transaction. The Chinese tax authorities have regularly invoked the indirect transfer rules in cross-border tax enforcement. How to convince the Chinese tax bureaus that a certain offshore holding structure should be respected for tax purposes represents a major challenge for many MNCs.

- **Re-organisation**

The Chinese tax re-organisation rule prescribes complete or partial tax deferral on gains realised in a tax re-organisation transaction that meets prescribed conditions. Tax re-organisations by MNCs usually face more stringent restrictions. Only three types of cross-border transactions are eligible for tax deferral treatment. In addition, the Chinese tax re-organisation rules just spell out the general taxation principle while leaving a number of operating details unaddressed. In most cases, government authorities other than tax bureaus need to be engaged to complete a restructuring transaction. MNCs often find little official guidance to facilitate the cooperation of the various government branches in different locations. As a result, significant hurdles exist for MNCs to carry out re-organisation and secure the desired tax deferral treatment in China.

- **Anti-avoidance**

China has a general anti-avoidance rule (GAAR) that emphasises business purpose in recognising tax outcomes. A commercial arrangement must not have the elimination, reduction, or deferral of Chinese corporate income tax (CIT) as its main objective. Otherwise, the arrangement may be re-characterised for Chinese CIT purposes, and the intended tax result may be denied. The Chinese GAAR is loosely defined, and offers little explanation as to what a business purpose is. Due to its flexibility of interpretation, the GAAR has become a weapon of choice for Chinese tax authorities in tackling perceived tax abuses, especially in the international tax arena. This wide reach of the GAAR has generated a great deal of uncertainties on MNCs' cross-border tax planning in China.

"The Chinese tax authorities have adopted an increasingly assertive approach in cross-border tax administration and will continuously develop new rules to stop aggressive tax planning from eroding China's tax base. This will make international taxation become one of the most technically challenging areas of China's tax

Khoonming Ho
Partner in Charge, Tax
China & Hong Kong SAR

How GICT China can assist you

With our deep knowledge and experience, we can provide you with value-added assistance throughout the investment cycle, and help you withstand the PRC tax challenges and maximise tax opportunities. Depending on your areas of interest, below is a summary of the critical tax issues that you should consider and how we can make a difference.

Investment phase	Critical issues	How GICT China can help
Entry	• Where should you invest in China? • What type of presence you should have in China, e.g., representative office, branch, subsidiary, or partnership? • What direct and indirect taxes will you need to pay in China? • What tax incentives are available to you and how do you qualify? • What tax planning is available to reduce your PRC tax burden and withholding taxes? • How do you structure and finance your investment in China? • Do you need an onshore or an offshore investment holding company, and if so, where? • How should you set up a tax efficient supply chain?	• Assist with location analysis and help you identify the appropriate investment sites in China. • Negotiate on tax incentives and financial subsidies and conclude collaboration agreements with the local governments on your behalf. • Advise on the appropriate mode of presence based on your contemplated business operation in China. • Advise on the formation procedures and process to establish the local presence. • Advise on the structure of the investment, including holding structure, financing structure, and supply chain arrangement, from both tax and regulatory standpoints.
Financing	• What is the tax cost in using different funding methods such as equity, related-party loan or third-party loan financing? • How can you better achieve day-to-day cash management within and outside China? • Should you establish a treasury vehicle in China and in the Asia Pacific region?	• Advise on potential cash pooling mechanism to better utilise excess cash within the group. • Advise how to comply with the thin capitalisation rules in the tax and business regulations, as well as various foreign exchange requirements. • Advise on potential hybrid financing arrangement and negotiate with the local foreign exchange and tax authorities on your behalf.
Operation	• Are you kept aware of Chinese tax developments and procedural changes that impact your PRC tax reporting responsibilities? • How do you manage your PRC tax compliance? • How do you control the PE exposure of overseas affiliates in China? • How do you account for deferred taxes and uncertain PRC tax positions, and calculate the proper tax provisions in China based on the FASB ASC 740 and the IFRS principles?	• Inform you on the latest rules and requirements that may impact your PRC tax compliance status. • Assist your China tax team to review, co-source or outsource the preparation of tax returns in accordance with the PRC tax regulations and local practices. • Help you develop protocols and working guidelines to control specific tax risks such as PE exposure. • Assist your China team to identify deferred tax issues and tax risks, advise on proper tax provision calculations, and provide periodic in-house training in tax accounting.

Investment phase	Critical issues	How GICT China can help
Internal re-organisation	• How should you structure the internal restructuring – transfer of assets or equity interests? • What are the PRC tax outcomes for the parties to the re-organisation? Can the restructuring receive tax deferral/exemption treatment? • How do you know if the restructuring satisfies the business purpose requirement? • Are tax incentives and tax attributes (e.g., net operating losses) still valid or available after the restructuring?	• Advise on the appropriate types of reorganisation that may be pursued, and the corresponding preconditions. • Advise on the direct and indirect tax implications of the restructuring and seek assurance from the Chinese tax authorities in advance on the tax treatment of the reorganisation. • Advise on the regulatory procedures for completing the restructuring. • Advise on post-restructuring integration issues and identify planning opportunities.
Profit repatriation	• How do you redeploy profits effectively and efficiently within China and the Asia Pacific region? • How should you repatriate your profit? • Should you consider other repatriation methods besides dividends, such as cross-charging of service and royalty fees? • How do you reduce the PRC tax costs incurred during repatriation?	• Advise on tax efficient repatriation of profits through the proper structuring of supply chain and allocation of business functions, assets and risks. • Advise how to build up commercial substance in an offshore holding company to satisfy the beneficial ownership requirements for treaty qualification. • Advise on the procedures for seeking treaty benefits and assist on preparing treaty application packages. • Assist with seeking clearance from the Chinese tax and foreign exchange authorities on outbound remittances.
Exit	• If needed, how should you exit the Chinese investment? Should you sell assets and liquidate or transfer equity? • In the case of liquidation, what are your defence strategies if you are audited during exit? • In the case of equity transfer, shall you engage in direct transfer or indirect transfer of equity interest? • In the case of direct transfer, are you eligible to any treaty relief? • In the case of indirect transfer, are you subject to the mandatory reporting requirement? How likely will the indirect transfer be recast into a direct transfer?	• Advise on exit strategy planning and the tax implications. • Advise on the Chinese tax and regulatory issues upon liquidation of the local entity. • Assist with PRC tax filings and any exit tax audit defence. • In the case of direct transfer, assess the applicability of an income tax treaty and assist with seeking treaty relief. • In the case of indirect transfer, advise how to build up substance in an intermediate holding company outside China, assist with preparing the required reporting package, and conduct subsequent negotiations with the tax authorities.

Why KPMG?

Over the past 30 years, KPMG has built a reputation in China for professionalism and sound business and tax advice. We achieve quality through an in-depth understanding of your industry and operations, our expertise in PRC tax laws and business regulations, our strong working relationships with Chinese tax authorities across all levels, and our familiarity with local practices. From day-to-day issues to long-term projects, our GICT team in China can help you meet the challenges posed by the current economy.

Our service approach

Our approach focuses on understanding your business issues and strategic and operational tax risks. With our extensive experience of working with MNCs in China, we are in the position to offer you a systematic approach in solving tax problems. We will:

- Work closely with your management team to understand your investment goals and plans
- Develop an effective international investment tax strategy that reduces your PRC tax burden while supporting your global business objectives
- Leverage our understanding of your business, industry and issues to deliver a high quality, smooth and efficient process that will help you overcome tax and regulatory obstacles
- Be your business advisor for your PRC investments and share with you the many opportunities developed from our experiences in China.

Our GICT China team

Our GICT China team is well-balanced and multi-skilled with strong knowledge and practical experience in China. It is led by senior tax professionals that have extensive cross-border tax advisory experience within and outside China. Our team members are fluent in Mandarin and English, which ensures clear communication with your teams in China and overseas.

Our global network

International tax is not isolated to one country. Cross-border transactions usually have implications across multiple tax jurisdictions and therefore require an integrated approach to handle, not only from China's perspective, but also from the angles of other countries.

Our GICT China team is supported by our highly integrated global network of international tax professionals in over 150 countries, to provide seamless cross-border tax services. Our colleagues in the global GICT network will collaborate with your teams in China and the home office jurisdictions to form a strong service team.

We look forward to offering you support all the way, and helping you realise the great opportunities that China presents.

"Hong Kong continues to be very active in building a double taxation agreement network. This factor together with its traditional tax advantages make Hong Kong a very attractive conduit for inbound investments into China as well as for outbound investments out of China."

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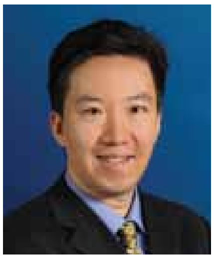

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