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CHINA TAX ALERT

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OECD issues Action Plan on Base Erosion and Profit Shifting

Regulations discussed in this issue:

- The OECD's Action Plan on Base Erosion and Profit Shifting issued on July 19, 2013
- The OECD Report titled *Addressing Base Erosion and Profit Shifting* issued on February 12, 2013

On July 19, 2013, the Organisation for Economic Co-operation and Development (OECD) publicly released its "Action Plan for multilateral cooperation to address tax Base Erosion and Profit Shifting (BEPS). The BEPS action plan was presented to the G20 Finance Ministers at their meeting in Moscow, and inaugurates a global collaborative effort to modernise the international tax system. The plan describes 15 proposed actions, identifies expected outputs, and establishes the anticipated timeframe.

As an observer in the OECD, China is expected to closely monitor the progress of this OECD initiative, and roll out new regulations corresponding to certain BEPS action items over the coming months. This will have significant international tax and transfer pricing implications for multinational companies (MNCs) operating in China. MNCs are encouraged to immediately conduct tax health-checks to identify potential weaknesses, and take measures to rectify these areas.

Background

The debate over aggressive tax planning by MNCs has been around for many years. Since the 1960s, the public has formed the perception that MNCs routinely arrange their corporate structures aided by artificial arrangements between related parties regarding intercompany pricing, transfer of patent licensing rights, cross-charging of interest and royalties, and similar practices in order to reduce or eliminate tax liabilities in multiple jurisdictions.

The ongoing global economic recession has led to a substantial decline in government revenue relative to gross domestic product in many countries. This shortage of fiscal revenues has helped escalate BEPS issues to the highest political level in a number of countries and has become a top priority for fiscal authorities in these jurisdictions. In the G20 leaders' meeting in Los Cabos on June 18-19, 2012, the finance ministers of the participating nations commissioned the OECD to conduct a study and report on BEPS issues by February 2013.

On February 12, 2013, the OECD released its report titled *Addressing Base Erosion and Profit Shifting (BEPS report)* to summarise the conclusions of its research. This OECD project found that some multinationals use strategies that allow them to pay as little as five percent in corporate taxes when smaller businesses are paying up to 30 percent. OECD research also shows that some small jurisdictions act as conduits, receiving disproportionately large amounts of foreign direct investment compared to large industrialised countries and investing disproportionately large amounts in major developed and emerging economies. Towards the end of the BEPS report, the OECD indicated that it would develop a global action plan to provide concrete solutions to address the tax avoidance issues identified in the study. The newly issued Action Plan is the to-do item as contemplated in the BEPS report.

Action Plan on BEPS

The BEPS Action Plan sets forth an ambitious timeframe for reaching consensus on changes and modifications necessary to modernise the international tax system. The plan identifies 15 action items to address the issues highlighted in the BEPS report. Completion of the actions is planned over the next two-and-a-half years, with some of the more consensus-driven items to be finished by December 2015.

The specific actions are summarised below:

Action 1 - *Address the tax challenges of the digital economy*	Identify the main difficulties that the digital economy poses for the application of existing international tax rules and develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation.
Action 2 - *Neutralise the effects of hybrid mismatch arrangements*	Develop model treaty provisions and recommendations for the design of domestic rules to neutralise the effect (e.g., double non-taxation, double deduction, long-term deferral) of hybrid instruments/entities.
Action 3 - *Strengthen CFC rules*	Develop recommendations regarding the design of Controlled Foreign Corporation (CFC) rules.
Action 4 - *Limit base erosion via interest deductions and other financial payments*	Develop recommendations regarding best practices in the design of rules to prevent base erosion through interest expense, e.g., the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.
Action 5 - *Counter harmful tax practices more effectively, taking into account transparency and substance*	Revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring 'substantial activity for any preferential regime.
Action 6 - *Prevent treaty abuse*	Develop model treaty provisions recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate situations.
Action 7 - *Prevent the artificial avoidance of PE status*	Develop changes to the definition of permanent establishment (PE) to prevent the artificial avoidance of PE status in relation to BEPS, including via the use of commissionaire arrangements and the specific activity exemptions.

Action 8 - *Assure that transfer pricing outcomes are in line with value creation/intangibles*	Develop rules to prevent BEPS by moving intangibles among group members including: adopting a broader, clearer definition of intangibles, ensuring that profits associated with the transfer of intangibles are related to value creation, developing special rules for hard-to-value intangibles, and updating guidance on cost contribution arrangements.
Action 9 - *Assure that transfer pricing outcomes are in line with value creation/risks and capital*	Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members including adopting rules to prevent inappropriate returns from accruing to entities solely on the basis of provision of capital or contractual assumption of risks.
Action 10 - *Assure that transfer pricing outcomes are in line with value creation/other high-risk transactions*	Develop rules to prevent BEPS by engaging in transactions that would not, or would occur only very rarely between third parties including adopting re-characterisation rules, clarifying the application of transfer pricing methods in global value chains, and protecting against payments such as management fees and head office expenses.
Action 11 - *Establish methodologies to collect and analyse data on BEPS and the actions to address it*	Develop recommendations on the indicators of the scale and economic impact of BEPS and ensure tools are available to assess effectiveness and impact of measures to address BEPS.
Action 12 - *Require taxpayers to disclose their aggressive tax planning arrangements*	Develop recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules.
Action 13 - *Re-examine transfer pricing documentation*	Develop rules regarding transfer pricing documentation to enhance transparency, including a requirement that multinational entities provide all ''relevant governments' with information on global allocation of income, economic activity, and taxes paid among countries in accordance with a common template.
Action 14 - *Make dispute resolution mechanisms more effective*	Develop solutions to address obstacles that prevent countries from solving treaty-related disputes under Mutual Agreement Procedures (MAP), including the absence of arbitration provisions and denial of access to MAP in certain cases.
Action 15 - *Develop a multilateral instrument*	Analyse tax and public international law issues related to the development of a multilateral instrument to enable jurisdictions that wish to do so to implement BEPS measures and amend existing bilateral treaties.

KPMG observations

The BEPS Action Plan may have a far reaching impact on international taxation and transfer pricing in China. The State Administration of Taxation (SAT) has kept a close watch on the development of the BEPS project and is contemplating major regulatory changes to adopt key elements of the BEPS study. In addition, even before the release of new BEPS-related circulars, local Chinese tax officials may refer to the BEPS report and the Action Plan as an unofficial source of guidance when evaluating the tax and transfer pricing aspects of cross-border transactions. It is still important for MNCs to keep the BEPS issues in mind when conducting international transactions.

Based on our experience and communications with the SAT, the BEPS report and the Action Plan may impact the following tax areas in China:

1. Many MNCs have established internal lending platforms, intangible holding companies or shared service centres outside China that make charges to their Chinese affiliates. Payments such as interest, royalty and service fees reduce the Chinese corporate income tax (CIT) base through deduction and are subject to lower rates of taxation or no taxation outside China. The BEPS report will prompt Chinese tax authorities to increasingly scrutinise payments that receive 'double non-taxation' treatment, whether in audits after the fact, or prior to payments being made. This could have both tax and cash flow ramifications for MNCs with these arrangements.

2. PRC entities conducting functions that are seen as creating non-routine value (e.g., certain R&D, brand building or market penetrating activities), but which are allocated routine returns due to risks being removed by contract terms (e.g., related party contract manufacturing, distribution, contract R&D), could face further challenges with respect to their transfer pricing under the BEPS environment. Chinese tax authorities will likely focus more on the actual functions in China that are entitled to a portion of the residual profits in the entire value chain. Business activities that create potentially valuable intangibles for taxpayers in China are likely to receive heavy scrutiny.

3. Transactions with off-shore entities, which appear to be light on substance, will likely receive more attention. Backed by the BEPS report, Chinese tax authorities will likely continue the rigorous implementation of the existing anti-avoidance rules on beneficial ownership and indirect transfers, which already place heavy emphasis on commercial substance. On the transfer pricing front, the SAT will likely be increasingly intolerant of profit allocations that are dictated by contractual allocation of risks only, and will put a greater emphasis on physical substance in profits allocation. For example, if a Chinese company renders services to an offshore affiliate based on a cost-plus mark-up, while the service recipient retains the residual profit from a separate overseas contract, but has little physical substance in the residence jurisdiction, the transaction is vulnerable to Chinese tax audits from a substance standpoint. This put many existing principal structures and supply chain arrangement at risk.

4. The statement in the Action Plan regarding value creation which reads, "measures…beyond the arm's-length principle, may be required," suggests some uncertainty as to how taxpayers should determine their transfer pricing. Taxpayers with unusual related party transactions or transactions flows, or with transactions involving intangibles or unusually large scale, may be at greater risk for scrutiny or even potentially novel methods of adjustment under audit by the Chinese tax authorities. With the principle of value creation as support, Chinese tax officials may conduct even closer examination of head office expense allocations and deny tax deduction for these items equivalent to 'management fees' in nature according to the Chinese CIT law. Furthermore, PRC tax officials will continue to advocate an expansive view of 'value creation' that

includes location-specific advantages (LSAs) such as location savings and market premium to justify greater profit allocation into China.

5. The Chinese tax authorities will likely intensify the tax audit efforts on the Chinese taxable presence of non-resident companies, i.e., permanent establishment (PE) in the tax treaty context. This may include more rigorous enforcement of the various existing tax reporting and registration requirements, such as SAT Directive 19 and Guoshuifa 2009-124. In addition, Chinese tax authorities will likely use the agency PE as a weapon to target MNCs that have not established extensive manufacturing or distribution bases in China but, mainly employ local agents to facilitate the direct importation of high-margined products into China. Furthermore, China will likely place more attention on PE issues in cross-border e-commerce, and leverage from the guidance in the latest OECD model treaty commentary.

6. To increase the amount of information PRC tax officials will have when identifying audit targets and carrying out tax inquiries, Chinese tax authorities will likely roll out additional tax recordal filing and disclosure requirements to increase transparency on the tax planning arrangements of MNCs and put more pressure on taxpayers to report tax positions or face the consequence of penalty. On the international front, the SAT is likely to increase the participation in information exchanges with their overseas counterparts to uncover aggressive tax planning practices.

In summary, the release of the BEPS report provides Chinese tax authorities with a theoretical basis to launch extensive reforms within China's international tax administration. The SAT plans to issue a number of new circulars over the coming months in areas such as anti-avoidance, transfer pricing, PE determination, and CFC. These initiatives are generally consistent with the BEPS Action Plan.

In response, MNCs should immediately conduct a health check on their existing arrangement, identify potential weaknesses according to the BEPS Action Plan, and take steps to make improvements. This includes movement of functions, assets and personnel within the group, development of legal, tax and transfer pricing documentation as support, and preparation of internal control and working guideline to mitigate Chinese tax risks. With adequate preparations, MNCs will be able to adapt to the new tax landscape created by BEPS without causing unwarranted disruptions in business operation or incurring excessive amount of tax costs during the transition.

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