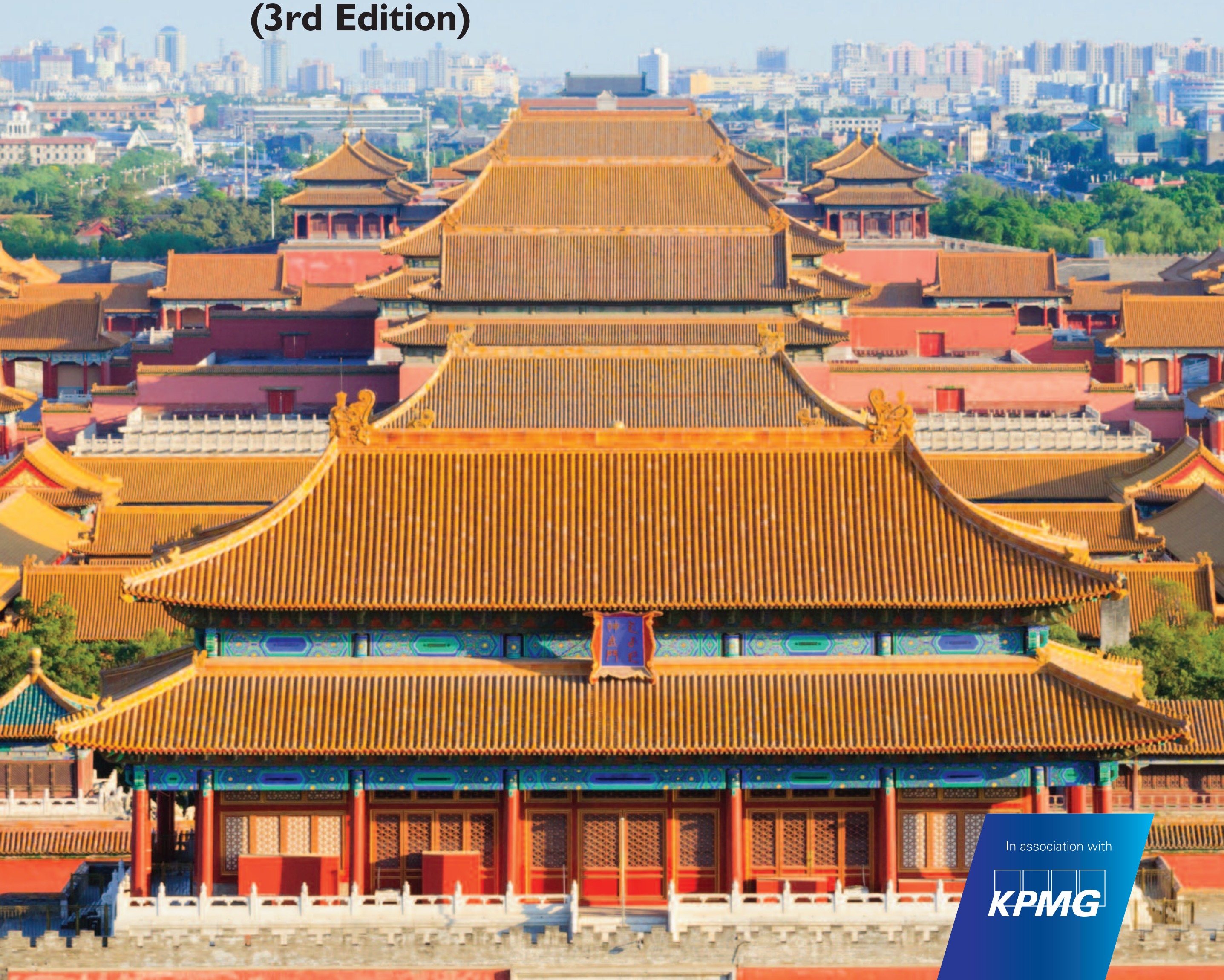
INTERNATIONAL TAX REVIEW™

Tax Reference Library
No 85

China

Looking Ahead

(3rd Edition)



In association with KPMG

Your trusted advisor in China
China: fast-paced, complex, thriving. Substantial growth awaits, but does your business have the foundation to support it?
KPMG China's trusted Tax professionals understand the unique challenges, regulatory shifts, and growth opportunities, which have resulted in China's emergence as one of the largest and fastest growing economies.
For more information, please contact:
Khoonming Ho
Partner in Charge, Tax
China and Hong Kong SAR
khoonming.ho@kpmg.com
Northern China
David Ling
Partner
Tel: +86 (10) 8508 7083
david.ling@kpmg.com
Central China
Lewis Lu
Partner
Tel: +86 (21) 2212 3421
lewis.lu@kpmg.com
Southern China
Eileen Sun
Partner
Tel: +86 (755) 2547 1188
eileen.gh.sun@kpmg.com
Hong Kong
Ayesha M. Lau
Partner in Charge, Tax
Hong Kong SAR
Tel: +852 2826 8028
ayesha.lau@kpmg.com
kpmg.com/cn
KPMG
cutting through complexity
© 2013 KPMG International Cooperative ("KPMG International"), a Swiss entity. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved. The KPMG name, logo and "cutting through complexity" are registered trademarks of KPMG International.

INTERNATIONAL TAX REVIEW™

Contents

Foreword 4
Khoonming Ho, Tax Partner in Charge, China and Hong Kong SAR

BEPS – what will it mean for China? 6
The OECD's action plan for multilateral cooperation to address tax base erosion and profit shifting (BEPS), published on July 19 2013, 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. **Abe Zhao**, **Leonard Zhang** and **David Chamberlain** of KPMG China comment on the implications of BEPS for China.

CIT – cross-border transactions under scrutiny 12
While China is seeking to enhance its position as a favourable jurisdiction for international trade and investment, it needs to safeguard its tax base in the context of cross-border transactions. **Chris Xing**, **Curtis Ng** and **Vincent Pang** of KPMG China assess how the country is working to improve the efficiency of tax collection and combat tax evasion arising from cross-border transactions.

Transfer pricing – Chinese authorities scaling new heights 17
The OECD released its BEPS Action Plan in July 2013 in an environment that continues to challenge global economic recovery. **Cheng Chi**, **Irene Yan**, **Brett Norwood** and **Michelle Sun** of KPMG China provide their insights on how China is raising its effort to combat aggressive tax planning and evasion and play a more critical role in transfer pricing enforcement and thought leadership globally.

VAT reforms to accelerate in 2014, with challenges lying ahead 24
On August 1 2013, the Chinese government announced the nationwide rollout of the first phase of the VAT pilot programme, a significant advance towards replacing business tax (BT) throughout mainland China with a value added tax (VAT) for the services sector. **Lachlan Wolfers**, **John Wang** and **Shirley Shen** of KPMG China look ahead at further VAT changes to come in 2014.

Customs – from enforcer to enabler 30
The conventional perception of the Chinese Customs authorities has always been that of a trade restrictive border guard that imposes financial and administrative barriers for importers and exporters. However, **Lilly Li**, **Anthony Chau** and **Eric Zhou** of KPMG China observe there are signs that the Chinese Customs authorities are slowly adopting global practices that are geared more towards trade facilitation than trade restriction.

M&A relief – flickering lights at end of tunnel 35
John Gu, **Lily Kang** and **Eileen Sun** of KPMG China analyse the tax challenges for M&A activities in China and share their insights on how tax regulations may evolve to deal with these challenges.

Private equity – exit challenges 40
In tandem with the rapid increase in private equity (PE) activities in China over recent years, Chinese tax authorities have taken seemingly aggressive steps to protect its tax base. **John Gu**, **Paul Ma** and **Henry Wong** of KPMG China consider the tax challenges that will or will continue to be faced by PE investors especially and advise on measures to mitigate those exposures.

Contents, continued

From Qianhai to Shanghai – resurgence of regional incentives? 46

Preferential tax incentives specific to certain areas were supposed to be things of the past after the 2008 corporate income tax (CIT) reform. However, the recent launch of the Qianhai Cooperation Zone and the Shanghai Pilot Free Trade Zone (PFTZ), suggests otherwise. **Karmen Yeung** and **Chris Mak** of KPMG China examine the implications for foreign investors.

Hong Kong – new tax initiatives in the pipeline 53

Hong Kong's status as an international finance centre has been enhanced by recent developments relating to double taxation agreements, Islamic finance and tax information exchange agreements. **Ayesha Lau**, **Darren Bowdern** and **Garry Laird** of KPMG China examine these developments and consider how the OECD's BEPS project may have an impact on Hong Kong.

Real estate – the tax landscape in China and Hong Kong 58

Chris Abbiss, **Lewis Lu** and **Jean Jin Li** of KPMG China foresee significant changes to the tax and regulatory environment in both Hong Kong and Mainland China over the next 12 months.

Transportation and logistics – challenges of VAT reform 62

China's unification plan for indirect taxes will see the dual business tax (BT) and value added tax (VAT) regime gradually replaced by a single VAT system. Many businesses in the transportation and logistics industry are still wrestling with the uncertainties and local variations created by the reform, so far introduced on a pilot basis. **Jennifer Weng**, **Tracy Zhang** and **Bin Yang** of KPMG China provide advice on how these issues may be resolved.

Healthcare industry – under closer scrutiny than ever 66

China will be a crucial player in the healthcare & life sciences industry soon, including being a global leader in drug discovery and innovation. It is unsurprising then that the pharmaceutical industry has come under the scrutiny of Chinese authorities, including those in tax. **Grace Xie**, **Henry Ngai** and **Ho-Yin Leung** of KPMG China discuss the challenges facing the healthcare industry in China in 2014.

Auto industry – bumpy rides ahead 72

With the auto industry in China growing at a breakneck pace, the Chinese authorities are placing it under close scrutiny on issues ranging from Customs duties, indirect tax and transfer pricing. **William Zhang**, **David Ling** and **Sam Fan** of KPMG China examine the tax challenges lying ahead for car manufacturers and producers of auto parts and components in China, and ways to deal with those challenges.

Green tax policy – slow but steady 77

China has made some progress recently regarding resource tax, consumption tax and an emission trading scheme. It may be only time before this more holistic approach culminates in an environment tax or green tax. **Jean Ngan Li**, **Sunny Leung** and **Jessica Xie** of KPMG China consider what progress may be made in China's tax policies on environmental protection.

Editorial

Welcome to the third edition of China – Looking Ahead, a series of articles published in association with KPMG.

This year's publication continues the previous years' theme of addressing how China is modernising its tax system, even introducing some ideas first seen overseas, while retaining the right to shape it according to its own needs.

The articles start with a look at what the OECD's work on base erosion and profit shifting will mean for China and continue with studies of, for example, transfer pricing, the move to a single VAT system, exit challenges for private-equity investors and the re-emergence of tax incentives through the establishment of the Qianhai Cooperation Zone and the Shanghai Pilot Free Trade Zone. Including the foreword, there are 14 articles. Watch out, in particular, for the focuses on the real estate, transportation and logistics, healthcare & pharmaceuticals and the auto industries.

The more and more you look at China's tax system, you see a regime that is developing quickly, but also one where, like in other places, investors have to stay razor-sharp to be aware of local differences, particularly in how the rules are enforced. This probably applies nowhere else in the same way as it does in China.

We hope these articles will help you when dealing with your tax affairs in China.

Ralph Cunningham
Managing editor
International Tax Review

Editorial

INTERNATIONAL TAX REVIEW

Nestor House, Playhouse Yard, London EC4V 5EX UK
Tel: +44 20 7779 8308
Fax: +44 20 7779 8500

Managing editor: Ralph Cunningham
Email: rcunningham@euromoneyplc.com

Magazine editor: Salman Shaheen
Email: sshaheen@euromoneyplc.com

Online editor: Sophie Ashley
Email: sashley@euromoneyplc.com

Corporate tax editor: Matthew Gilleard
Email: mgilleard@euromoneyplc.com

Production editor: João Fernandes

Publisher: Oliver Watkins
Email: owatkins@euromoneyplc.com

Associate publisher: Andrew Tappin
Email: atappin@euromoneyplc.com

Business manager: Megan Poundall
Email: mpoundall@euromoneyplc.com

Marketing manager: Kendred Dove
Email: kdove@euromoneyplc.com

Divisional director: Greg Kilminster

SUBSCRIPTIONS AND CUSTOMER SERVICES
Customer services: +44 20 7779 8610
UK subscription hotline: +44 20 7779 8999
US subscription hotline: +1 800 437 9997

International Tax Review is published 10 times a year by Euromoney Trading Limited, London.

ISSN 0958-7594

Foreword

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

The Year of the Snake in 2013 ushered in a new government in China, headed by President Xi Jinping and Premier Li Keqiang. The new government has put political, economic and financial reforms at the top of its agenda over the next decade. After the Third Plenum of the 18th Chinese Communist Party (CCP) Congress that was held in Beijing from November 9 to November 12 2013, a Communiqué and Decision by Central Committee of CCP on Deepening of Key Reforms (Decision) were issued. According to the Decision, China will gradually increase the proportion of revenue from direct tax and accelerate VAT reform. China will also reform consumption tax with a view to capturing high energy-consuming and/or polluting products and selected luxury products. Other tax reform areas include consolidated individual income tax filings, real estate tax, resource tax and environment protection tax. Against that background, in this edition of China – Looking Ahead, KPMG China's tax experts explore what the Year of the Horse may have in store for foreign investors in 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.

As stated in the foreword of the first edition of China – Looking Ahead (May 2011), with China having become the second largest economy in the world, a readiness for engagement with foreign tax administrations will inform the fiscal thinking and action of China. As can be seen from the chapter, BEPS – WHAT WILL IT MEAN FOR CHINA?, that readiness has manifested itself in the active participation of China in this important OECD initiative. The self-confidence and assertiveness of the Chinese tax administration that goes with the country's new world status have also come through in its dealing with international tax issues such as enforcement and administration of tax treaties, which are addressed in the chapter, CIT – CROSS-BORDER TRANSACTIONS UNDER SCRUTINY. Going in hand in hand with these issues is China's approach to related-party transactions. In the chapter, TRANSFER PRICING – CHINESE AUTHORITIES SCALING NEW HEIGHTS, we foresee that Chinese tax administrations will venture into new territories in terms of different TP methodologies and types of transactions, industries and sectors to focus on.

With the nationwide expansion of the pilot programme on August 1 2013, VAT reform will continue to be in the spotlight. In the chapter, VAT REFORMS TO ACCELERATE IN 2014, WITH CHALLENGES LYING AHEAD, we examine how Chinese tax authorities and indeed businesses will wrestle with the proverbial devil in the detail and how VAT reform will step up when its focus shifts from the general economy to special industries. Conversely, with more free trade agreements being entered into, Chinese Customs is making relatively quiet, but equally far-reaching progress; this is given deserved coverage in the chapter, CUSTOMS – FROM ENFORCER TO ENABLER.

More enablers indeed are what many foreign investors are hoping for in the area of tax reliefs for M&A. Will the uncertainties and inflexibilities surrounding M&A tax regulations, such as Circular 698 and Circular 59, be reduced or removed any time soon? In the chapter, M&A RELIEF – FLICKERING LIGHTS AT END OF TUNNEL, we hope to share some insights on this question, and in the chapter, PRIVATE EQUITY – EXIT CHALLENGES, we cover the particular difficulties encountered by private equity funds when exiting from investment projects in China.

For both existing and new investors, new free trade zones are becoming more prevalent. These developments might come as a surprise to many investors, who can be forgiven for thinking they have seen the last of the regional incentives after the 2008 tax reform, which aimed to level the playing field for investors. So in the chapter, FROM QIANHAI TO SHANGHAI – RESURGENCE OF REGIONAL INCENTIVES?, we examine the potential implications of these new zones for foreign investors. In contrast, with even closer economic integration between China and Hong Kong SAR, we assess, in the chapter, HONG KONG – NEW TAX INITIATIVES IN THE PIPELINE, how the tax policies of the Hong Kong SAR will evolve to safeguard its status as an international tax centre.

As China's tax regime becomes more mature and sophisticated, we foresee the rapid development of tax rules that cater for specific industries and sectors and the building up of specialised resources within the Chinese tax administration to implement and administer these rules. For that reason, we explore the future developments in tax policies and practices across a number of key sectors: (1) REAL ESTATE – THE TAX LANDSCAPE IN CHINA AND HONG KONG; (2) TRANSPORTATION AND LOGISTICS – CHALLENGES OF VAT REFORM; (3) HEALTHCARE INDUSTRY – UNDER CLOSER SCRUTINY THAN EVER; and (4) AUTO INDUSTRY – BUMPY RIDES AHEAD. Last but not least, the all-encompassing issue of environmental tax policy, which will be important for the sustainable growth of the Chinese economy, is addressed in the chapter, GREEN TAX POLICY – SLOW BUT STEADY.

In conclusion, VAT reform will proceed at full throttle in 2014 and should bring both opportunities and challenges to businesses. There can be no better advice on this than: "Be prepared!" Progress in the clarification of corporate income tax rules such as offshore indirect disposals and rollover reliefs for group restructuring can still seem frustratingly slow and uncertain to many foreign investors. Businesses should look out for a stepping up in transfer pricing audits.

Special zones such as the Qianhai Cooperation Zone and the Shanghai Pilot Free Trade Zone will raise hope on various fronts ranging from:

- renminbi internationalisation;
- the elimination of foreign exchange restrictions;
- the simplification of regulatory processes; and
- local tax incentives and subsidies

which should prompt investors to rethink the way they do business in China. However, more time should be allowed for the development of the implementation rules for these zones and the possibility that more new zones will appear cannot be ruled out. Overall, tax-wise, 2014 should be a positive year for foreign investors.

Biography

Khoonming Ho
Tax Partner in Charge of China and Hong Kong SAR

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: + 86 10 8508 7082
Fax: + 86 10 8518 5111
Email: khoonming.ho@kpmg.com

Khoonming Ho is the tax partner in charge of China and Hong Kong SAR. Since 1993, Khoonming has been actively involved in advising foreign investors about their investments and operations in China. He has experience in advising issues on investment and funding structures, repatriation and exit strategies, M&A and restructuring.

Khoonming has worked throughout China, including in Beijing, Shanghai and southern China, and has built strong relationships with tax officials at both local and state levels. He has also advised the Budgetary Affairs Committee under the National People's Congress of China on post-WTO tax reform. Khoonming is also actively participating in the government consultation project about the forthcoming VAT Law.

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

BEPS – what will it mean for China?

The OECD's action plan for multilateral cooperation to address tax base erosion and profit shifting (BEPS), published on July 19 2013, 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. Abe Zhao, Leonard Zhang and David Chamberlain of KPMG China comment on the implications of BEPS for China.

As a key partner of the OECD, China is expected to monitor the progress of this OECD initiative closely and roll out new regulations corresponding to certain BEPS action items over the coming months. These new rules and tax enforcement practices will have significant international tax and transfer pricing implications for multinational companies (MNCs) operating in China.

Multinational companies are encouraged to conduct tax health-checks immediately to identify potential weaknesses, and take measures to rectify these areas.

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 of aggressive tax planning by some MNCs. 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 15 actions are summarised below:

1) Address the tax challenges of the digital economy

This action includes identifying the main difficulties that the digital economy poses for the application of existing international tax rules and developing detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation.

2) Neutralise the effects of hybrid mismatch arrangements

This includes developing model treaty provisions and recommendations for the design of domestic rules to neutralise the effect (for example, double non-taxation, double deductions and long-term deferral) of hybrid instruments/entities.

3) Strengthen CFC rules

This includes developing recommendations regarding the design of controlled foreign corporation (CFC) rules.

4) Limit base erosion through interest deductions and other financial payments

This includes developing recommendations for best practices in the design of rules to prevent base erosion through interest expenses, for example, the use of related-party and third-party debts 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.

5) Counter harmful tax practices more effectively, taking into account transparency and substance

This includes revamping 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.

6) Prevent treaty abuse

This includes developing model treaty provisions and recommendations for the design of domestic rules to prevent the granting of treaty benefits in inappropriate situations.

7) Prevent the artificial avoidance of PE status

This includes developing changes to the definition of permanent establishment (PE) to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and the specific activity exemptions.

8) Assure that transfer pricing outcomes are in line with value creation – intangibles

This consists of developing 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.

9) Assure that transfer pricing outcomes are in line with value creation – risks and capital

This includes developing 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.

10) Assure that transfer pricing outcomes are in line with value creation – other high-risk transactions

This includes developing rules to prevent BEPS by engaging in transactions that would not, or would occur only 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.

11) Establish methodologies to collect and analyse data on BEPS and the actions to address it

This includes developing recommendations on the indicators of the scale and economic impact of BEPS and ensuring that tools are available to assess effectiveness and impact of measures to address BEPS.

Biography

Abe Zhao
Tax Partner

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: + 86 10 8508 7096
Fax: + 86 10 8518 5111
Email: abe.zhao@kpmg.com

Abe Zhao serves as KPMG China's international tax leader and has considerable experience of cross-border tax consulting. His specialty area is in advising on international tax structures. He has assisted a number of US, European and Australian multinational clients in the agricultural, construction and engineering, real estate, pharmaceutical, telecommunications, and entertainment sectors in tax planning engagements.

Serving both China inbound and outbound clients, Abe has extensive experience in international M&A and post-M&A integration; financing and intangible licensing/transfer arrangements; repatriation and exit planning; the design and development of international tax efficient supply chains; tax structuring for inbound and outbound private equity investment; foreign tax credit computation and analysis; transfer pricing controversy and documentation; and cost sharing arrangements.

He is a frequent speaker at seminars and forums and regularly contributes to academic journals on tax subjects.

Abe received his bachelor of business degree from the People's University of China, a masters in economics from the University of Virginia, and a masters in accountancy from the University of Georgia. He is a licensed US certified public accountant (CPA), and has received certified management accountant (CMA) and certified financial manager (CFM) certifications from the Institute of Management Accountants.

12) Require taxpayers to disclose their aggressive tax planning arrangements

This includes developing recommendations for 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.

13) Re-examine transfer pricing documentation

This includes developing 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

Biography

Leonard Zhang
Tax Partner

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: +86 10 8508 7511
Fax: + 86 10 8518 5111
Email: leonard.zhang@kpmg.com

Leonard Zhang joined KPMG China's Beijing office from the economic and valuation services (EVS) practice in KPMG's Silicon Valley office in the US where he has worked on both transfer pricing and valuation projects for a variety of clients in different industries. He has significant experience in financial modelling, financial statement analysis, and performing quantitative and statistical analyses.

Leonard's past transfer pricing experience includes preparing global documentation and planning studies for the intercompany transfer of tangible goods, intangible properties, and services. He participated in a number of unilateral and bi-lateral advance pricing agreement (APA) projects, including some US-Japan APA projects. He assisted many technology companies in shifting their technology intellectual property (IP) as well as their advertising and marketing intangibles offshore. His previous engagements involved using a variety of innovative valuation techniques and profit split models to support the IP migration structure and the result.

Since joining KPMG China in December 2008, Leonard has led a number of transfer pricing planning, transfer pricing audit defence, APA, and tax-efficient supply chain management projects. He helped his clients defend their transfer pricing positions successfully; he also assisted his clients in reviewing the effectiveness of their supply chain management from a transfer pricing perspective and implementing the supply chain restructuring models he proposed.

activity and taxes paid among countries in accordance with a common template.

14) Make dispute resolution mechanisms more effective

This includes developing 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.

15) Develop a multilateral instrument

This includes analysing 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.

Chinese tax implications

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 project and is contemplating major regulatory changes to adopt key elements of it. And even before the release of new BEPS-related circulars, local Chinese tax officials may refer to the action plan as an unofficial source of guidance when evaluating the tax and transfer pricing aspects of cross-border transactions. It is important for MNCs to keep the BEPS issues in mind when structuring international transactions.

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

Deductible outbound payments

Many MNCs have established internal lending platforms, intangible property holding companies or shared service centres outside China that make charges to their Chinese affiliates. Payments such as interest, royalties 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 through the participation in special foreign tax regimes. The BEPS Action Plan will prompt Chinese tax authorities to increasingly scrutinise payments that receive double non-taxation treatment. This could have both tax and cash flow ramifications for MNCs with these arrangements.

Historically, hybrid loans have not been used extensively in financing Chinese operations, partly due to the restrictions on registering non-conventional debt instruments with the Chinese foreign exchange authorities. Recently, the SAT has informally indicated that a cross-border payment from China that is not taxed in a foreign jurisdiction because of a mismatch in characterisation should not receive a deduction in China. If such a tax position is taken in practice, the regulatory authority is likely to be China's General Anti-Avoidance Principle (GAAR).

Contractual allocation of risks

Chinese entities performing functions that are seen as creating non-routine value (for example, certain R&D, brand building or market-penetrating activities), but which are allocated routine returns due to risks being removed by contract terms (for example, related-party contract manufacturing, distribution or contract R&D), could face further challenges to their transfer pricing under the BEPS environment. Chinese tax authorities will 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.

For example, if the Chinese subsidiaries of a MNC participate materially in marketing campaigns in China and incur significant marketing expenses, Chinese tax authorities in some situations may argue that these marketing activities generate valuable intangible assets and at least part of the intangible assets belongs to the Chinese entities that physically carry out the marketing functions. This result is not changed by the fact that the Chinese entities may have been fully compensated by an overseas affiliate for the provision of marketing services, because the Chinese tax authorities' argument is that the amount of the compensation is not commensurate with the value of such marketing services.

In such a case, Chinese tax authorities may ignore the purported characterisation of the Chinese subsidiaries that entitles them to routine profits only and adjust the profits of the Chinese entities upwards based on the presumption that they own non-routine intangibles. This situation is more likely to happen when the MNC operates in highly profitable industries in China (for example, automobile and pharmaceutical) and a significant amount of the profits relating to Chinese sales has been allocated to overseas affiliates based on a contractual allocation of risks.

Commercial substance

Transactions between Chinese subsidiaries and offshore entities, which appear to be light on substance, are likely to receive more attention. Backed by the BEPS Action Plan, Chinese tax authorities are likely to continue the rigorous implementation of the existing anti-avoidance rules on beneficial ownership and indirect transfers, which already place heavy emphasis on commercial substance. Specifically, a foreign company seeking benefits under the dividend, interest, royalty and capital gains articles of an income tax treaty that China is a party to will need to possess enough commercial substance in the residence jurisdiction. Such physical substance is embodied in the form of personnel presence, asset utilisation, risk taking and independent decision making. Similarly, when a foreign company that owns an equity interest in a Chinese company is transferred, the foreign company usually needs to own sufficient commercial substance in the residence jurisdiction for its corporate existence to be respected by Chinese tax authorities.

On the transfer pricing front, the SAT will be increasingly intolerant of profit allocations without physical substance. 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 challenges from a substance standpoint. This may put many existing principal structures and supply chain arrangements at risk.

Biography

David Chamberlain
Tax Director

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: +86 10 8508 7056
Fax: + 86 10 8518 5111
Email: david.chamberlain@kpmg.com

David Chamberlain is a director in KPMG China's tax transfer pricing practice. Based in Beijing, David brings about 20 years of transfer pricing experience from both the government and the private sector in the US. David joined KPMG China in July 2012. Previously, David specialised in dispute resolution services from the Silicon Valley office of KPMG US.

Before joining KPMG, David was a team leader with the Advance Pricing Agreement (APA) Program within the US Internal Revenue Service (IRS). At the IRS, David negotiated APAs with taxpayers ranging from small businesses to billion-dollar multinationals in a wide variety of industries, dealing with numerous countries throughout Asia and Europe.

Before joining the IRS, David spent many years as a transfer pricing and international tax adviser with a primary focus on structuring tax-efficient global transfer pricing arrangements for high technology companies.

David has negotiated many APAs and led numerous transfer pricing projects, including leading cross-functional efforts to structure and implement tax-efficient supply chain management strategies for many high-tech and e-business companies; leading the KPMG US effort in bilateral APAs with Japan, Australia and Canada; and acting as IRS APA team leader for a number of APAs dealing with the valuation of intangible property transferred in connection with cost sharing arrangements.

Value creation

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 of scrutiny or even potentially novel methods of adjustment under audit by the Chinese tax authorities. Senior officials from the SAT have suggested informally that China may consider a formulary allocation method in special situations to allocate profits in intercompany transactions if a traditional OCED transfer pricing methodology does not yield a result that reflects value creation by the Chinese entities properly relative to their foreign counterparts.

With the principle of value creation as support, Chinese tax officials may conduct even closer examinations of head-office expense allocations and deny tax deductions for these items equivalent to management fees in nature according to the implementation rule of the Chinese CIT law. When Chinese companies pay service fees or royalties to overseas affiliates, it is more important than ever before to have documentation ready supporting that the payment is not stewardship in nature; instead, these payments generate direct and tangible value to the Chinese payors.

Chinese tax officials will also 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. Chinese tax authorities indicated many times before that many MNCs have been able to reap greater profits in China than their home countries because of unique characteristics of the Chinese market. On the one hand, business operation costs in China are generally lower than in developed countries and therefore many MNCs in China derive location savings. On the other hand, due to a lack of competition that often exists in more mature markets as well as the immense purchasing power that originates from a rising middle class, many MNCs have been able to sell products at higher prices in China than in their home countries; this excess pricing represents market premium. Both location savings and market premium translate to super profits for MNCs. It is the view of the SAT that the Chinese market creates value for the MNCs that leads to these super profits, and that at least a portion of such excess profits should be subject to Chinese taxation. The BEPS Action Plan lends further theoretical support to this position of the Chinese tax authorities.

Permanent establishment

Chinese tax authorities are likely to intensify tax audit efforts on the Chinese taxable presence of non-resident companies, that is, PE in the tax treaty context. Regulation in recent years, such as SAT Directive 19 and *Guoshuifa* 2009-124, require foreign companies to register onshore projects or service activities with the Chinese tax authorities and submit recordal filings with the in-charge Chinese state tax bureaus if these companies wish to take a tax position of no-PE in China based on the relevant income tax treaties. We expect that these tax reporting and registration requirements will be enforced more rigorously going forward.

China will also pay more attention to PE issues in cross-border e-commerce transactions, and leverage from the guidance in the latest OECD model treaty commentary. For instance, when conducting e-commerce in China, many foreign companies have to place servers in China to maintain fast and stable data transmission across the Chinese border. The servers may be owned by the foreign companies or may be leased from third parties. If the server plays an instrumental role in facilitating and executing e-commerce transactions, Chinese tax authorities may argue that the server represents a fixed place of business for the foreign company and constitutes a taxable presence in China. If so, profits attributable to the server would be subject to Chinese CIT.

Finally, Chinese tax authorities are likely to use the concept of 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 complete the direct importation of high-margin products into China. The initial targets of tax investigation are likely to be companies selling luxury consumer-goods brands in China. If a foreign company engages a dependent agent to perform significant portions of commercial negotiation in China, regardless of whether the agent signs the contracts on behalf of the foreign companies or whether the contracts are signed within China, the tax authorities could argue that the foreign companies have an agency PE in China. If that is the case, the tax authorities may use a formulary method to allocate a portion of the foreign company's profits to this PE for Chinese CIT purposes, as traditional transfer pricing methods may be ineffective in achieving the intended tax outcome.

Information collection

To increase the amount of information Chinese tax officials will have to identify audit targets and carry out tax examinations, the tax authorities will roll out additional tax recordal filing and disclosure requirements to increase transparency of the tax planning arrangements of MNCs and put more pressure on taxpayers to report tax positions or face a penalty. The SAT is designing new tax reporting forms as a part of the annual tax return package for companies and is referring to other tax compliance forms in the world to design its own reporting system.

On the international front, the SAT will increase its participation in information exchange with their overseas counterparts to uncover aggressive tax planning practices. China has signed income tax treaties with more than 100 jurisdictions and tax information exchange agreements with at least 10 others. All of these treaties or agreements allow the Chinese tax authorities to obtain information from their counterparties concerning foreign taxpayers. Recently, China became the 56th signatory to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. The convention allows China to exchange information automatically or spontaneously with other signatories and conduct simultaneous tax examinations on a MNC both within and outside China. This easy access to a MNC's tax-related information from another foreign jurisdiction creates a new deterrent for any tax arrangement whose feasibility depends on its lack of full visibility to Chinese tax authorities.

BEPS and tax administration reform

The release of the BEPS Action Plan 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, place of effective management (POEM) and CFCs. These initiatives are generally consistent with the BEPS Action Plan.

In response, MNCs should immediately conduct a health check on their existing arrangements, 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 controls and working guidelines 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 amounts of tax costs during the transition.

CIT – cross-border transactions under scrutiny

While China is seeking to enhance its position as a favourable jurisdiction for international trade and investment, it needs to safeguard its tax base in the context of cross-border transactions. Chris Xing, Curtis Ng and Vincent Pang of KPMG China assess how the country is working to improve the efficiency of tax collection and combat tax evasion arising from cross-border transactions.

Over the last year, positive developments have included circulars issued by the Chinese tax authorities clarifying uncertainties over issues relating to cross-border secondment arrangements and the determination of the beneficial ownership of dividend income. At the same time, China is also imposing a more restrictive tax treaty interpretation to combat arrangements that are perceived to be an abuse of double tax treaties.

These themes and some of the recent developments in China's expansion of its double tax treaty network as well as outcomes of renegotiated tax treaties with some of its most prominent trading partners are discussed here and illustrations highlight the Chinese and Hong Kong SAR tax authorities' recent interpretive approaches applied in tax issues relating to cross-border transactions and likely future trends.

China's efforts to unify Chinese double tax agreements and the emphasis on general anti-avoidance rules

As of June 2013, China has entered into 101 double tax agreements (DTAs) with other jurisdictions and regions, including Hong Kong and Macau SAR. Information from the State Administration of Taxation of China (SAT) shows that Botswana, Ecuador and Uganda were among the latest countries to sign a DTA with China in 2012 and 2013.

In addition to the expansion of its treaty network, Chinese tax authorities have also renegotiated a number of existing DTAs. Most notably, the older agreements with Belgium, Denmark, Netherlands and the UK have been modified to encompass anti-avoidance measures so they are in closer alignment with standards set out in the OECD's Model Tax Convention on Income and on Capital (OECD Model). As of the publication date, the DTAs with Belgium, Netherlands and the UK have yet to be enforced. For instance, under the modified DTAs for each of the articles pertaining to passive income such as dividends, interest and royalties, an additional limitation of benefits (LOB) paragraph has been added to deny preferential treaty rates if the main or one of the main purposes of the claimant is to take advantage of the treaty benefits.

An additional article has been added to these new Chinese DTAs to give China or the DTA country rights to apply its domestic general anti-avoidance rules (GAAR) when needed. This is in line with the international practice that such a LOB paragraph/article is commonly seen in other countries' DTAs (for example, Singapore, UK and Japan).

In other aspects, the revised DTAs have also seen some relaxation. In some cases, the permanent establishment (PE) clauses under certain DTAs have been loosened in two aspects:

- The period for a construction PE (that is, an enterprise which carries on a business through "a building site, a construction, assembly or installation project, or supervisory activities" in the other country) has been extended from six months to 12 months. This is a more relaxed clause compared to the same PE clause under older treaties; and

- The time threshold for furnishing services to create a PE (service PE) has been amended from six months to 183 days, which unifies it with the service PE threshold under other more recently concluded Chinese DTAs. As such, the unified treaty articles interpretation under *Guoshuifa* [2010] No 75 (Circular 75) issued by the SAT will be also applicable to these revised Chinese DTAs.

The dividends and royalties articles for the above DTAs have also been revised. The withholding tax (WHT) rates for dividends and royalties have been cut from 10% to 5% and 6%/7% respectively, subject to specific conditions being met. The specific conditions are drafted in line with similar articles under other more recent DTAs concluded by China.

Another focal point is the revisions to the article on capital gains – the renegotiated Chinese DTAs have adopted the standard capital gains clauses in DTAs which China has recently concluded. The revisions limit China's taxing rights on capital gains from the disposal of shares of a Chinese company, under which China only has taxing rights on (i) gains from a disposal of shares of a land-rich company and/or (ii) gains from a disposal of shares of a company in which the recipient directly or indirectly owns at least 25% of the shares of that company. A land-rich company refers to a company deriving 50% of its value, directly or indirectly from the value of immovable property situated in China. Given this trend, the older DTAs (for example, those with Ireland and Switzerland) with the relaxed capital gains tax clause that does not impose a 25% threshold may eventually be revised to be consistent with the above.

The new Chinese DTAs with Belgium and Netherlands also include a new article to exempt capital gains tax from the disposal of quoted shares where specific conditions are satisfied. Such added treaty protection is welcome news for foreign investors.

Common cross-border transactions and related tax law development

Secondment arrangements and safe harbour from PE assessment

In April 2013, the SAT issued Announcement [2013] No 19 (Announcement 19) to provide further guidance on when the cross-border secondment arrangements of expatriates (secondee) by a foreign enterprise (home entity) to an enterprise in China (host entity) may give rise to a taxable presence under Chinese domestic law or a PE under a Chinese DTA where the home entity does not directly or indirectly own the host entity.

Announcement 19 states that the "fundamental criterion" is whether the home entity bears all or part of the responsibilities and risks in relation to the work products of the secondees, and whether it is the home entity that normally reviews and appraises the job performance of the secondees. Announcement 19 also prescribes five "reference factors" in deciding whether the secondees are in substance the employees of the home entity.

The five reference factors prescribed in Announcement 19 to decide whether the Secondees are in substance employees of the home entity are:

- The host entity pays the home entity management fees or makes payments in the nature of service fees;
- The payment to the home entity from the host entity is more than the secondees' wages, salaries, social security contributions and other expenses borne by the home entity;
- The home entity does not pass on all the related payments made by the host entity to the secondees; instead, the home entity retains a certain amount of such payments;
- PRC individual income tax (IIT) is not paid on the full amount of the secondees' wages and salaries borne by the home entity;

Biography

Chris Xing
Tax Partner

KPMG China
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
Tel: +852 2978 8965
Fax: +852 2845 2588
Email: christopher.xing@kpmg.com

Chris Xing has assisted numerous international and domestic Chinese private equity funds and corporations on tax due diligence, and a wide range of tax issues concerning cross-border transactions, corporate establishment, M&A and other corporate transactions in the People's Republic of China (PRC) and Hong Kong.

Chris has also assisted multinational corporations with undertaking investments in the PRC, restructuring of business operations and devising tax efficient strategies for implementing PRC business operations and profit repatriation strategies.

Chris is a member of the Mainland Taxation sub-committee of the Hong Kong Institute of Certified Public Accountants and is an editor of the Asia-Pacific Journal of Taxation. He is also a regular speaker and writer on tax matters, and has published numerous articles on Chinese taxation in various journals. He has also been interviewed and quoted in the *New York Times*, *Wall Street Journal* and BBC World News.

Biography

Curtis Ng
Tax Partner

KPMG China
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
Tel: + 852 2143 8709
Fax: +852 2845 2588
Email: curtis.ng@kpmg.com

Curtis Ng is well versed in the complexities of delivering compliance and advisory services to multinational clients in various sectors. His experience includes a depth of experience in cross-border business activities and coordination and liaison with specialists to provide the most efficient and effective services.

Curtis received his BSSc degree in Economics. He is an associate member of the Hong Kong Institute of Certified Public Accountants, an associate member of the Taxation Institute of Hong Kong and a certified tax adviser in Hong Kong.

- The home entity decides the number, the qualification, the remuneration and the working locations of the secondees in China.

If the fundamental criterion is met and at least one of the reference factors is satisfied, the secondees will generally be considered employees of the home entity rendering services in China and thus the home entity may be regarded as having a taxable establishment or place of business in China. In the DTA context, if the secondees who are viewed as employees of the home entity render services in China for longer than six months, a service PE is normally created.

Announcement 19 also requires the tax authority in charge to focus on reviewing the execution documentations/information (for example, secondment contracts, protocols set for the secondees and information on the secondment arrangement payments) and related economic substance in assessing whether the home entity has any corporate income tax (CIT liability) for the secondment arrangement.

In a DTA context, if the establishment or place of business through which the services are provided by a foreign tax resident – applying the Announcement 19 criteria – is of a relatively fixed and permanent nature, it will be regarded as a PE of the home entity in China. However, Announcement 19 also contains a "stewardship exception" that the home entity would not have a taxable establishment or PE in China merely because its employees perform stewardship functions (for example, exercises the home entity's shareholder rights and safeguards its shareholder interest) at the host entity's place of business.

Announcement 19 represents a measure by Chinese tax authorities to tighten tax enforcement against non-residents on their taxable presence in China (whether in the domestic law or the DTA context), but where the assessment of which is now guided by clear principles that should be respected by the local tax administration authorities. As such, this provides more certainty to foreign companies deploying staff to China and is another welcome development.

Further clarifications on beneficial ownership requirements for granting tax treaty benefits for dividends under Circular 165

The assessment of beneficial ownership over passive income derived by foreign residents from China through *Guoshuihan* [2009] No 601 (Circular 601) remains a real challenge for foreign enterprises when they apply for tax treaty relief on passive income derived from China. Though the SAT has issued SAT Announcement [2012] No 30 (Announcement 30) to clarify a few important matters of application of Circular 601, significant interpretational issues with the circular remain unclear. A positive development is that the Chinese tax authorities issued Circular 165 in April 2013 to provide clarifications about the assessment of the beneficial ownership of dividends under the PRC-Hong Kong DTA for the purposes of WHT on dividends received by Hong Kong dividend recipients. Circular 165 reduces interpretational uncertainties where the holding company is in Hong Kong and concrete action by foreign enterprises to secure their beneficial ownership positions can consequently be taken.

Circular 601 provides various factors that are considered to be unfavourable to treaty applicants to be regarded as a beneficial owner. Circular 601 has not further elaborated on how the adverse factors are to be considered and weighed (that is, collectively or individually) when determining the beneficial ownership.

In this regard, Announcement 30 clarified that, when determining beneficial ownership, these factors should be collectively considered and weighted against the substance of the overall commercial arrangement based on the substance-over-form principle. This "totality of factors" approach in assessing who is the beneficial owner of a non-resident enterprise in relation to dividends derived from China is further confirmed under Circular 165.

Another favourable aspect of Circular 165 is that it also makes clear that 'investment activities' will be considered to be a type of 'business activities'. Thus, the tax authorities may not deny DTA relief solely on the basis that the claimant only holds one investment and that the holding of multiple investments would in principle be a favourable factor to establish the existence of 'substantive business operations'. Similarly, Circular 165 also prescribes that the tax authorities should go beyond considering only the number of staff and the magnitude of staff costs of the claimant when assessing whether the claimant's staffing level is commensurate with its income; they also need to take into account the responsibilities and nature of the work of the staff, considering the fact that, for instance, a small number of experienced and competent staff may be sufficient for the needs of the business.

Circular 165 also clarifies that the tax authorities should not draw a negative conclusion based on the fact that the claimant is 'lowly' capitalised. This effectively removes the negative implications of having the claimant being thinly capitalised so long as it is commercially justifiable and the interest payments on the claimant's debt do not result in a failure of the income retention test under the first adverse factor under Circular 601.

Circular 165 pinpoints the importance of examining the applicant's legal capacity and rights to control and dispose of investments, as supplemented by information on the actual exercise of those rights, in determining whether the claimant is the beneficial owner of the income. It specifically directs the tax authorities' attention to the claimant company's articles of association, as well as other documents demonstrating the degree of the claimant's freedom of action in relation to its deposition and use of its investments.

Such changes will obviously place stronger emphasis on the claimant's adherence to corporate governance formalities such as board meetings' minutes as the key in finding evidence of the beneficial ownership of the income derived.

Under the safe habour provision under Announcement 30, if any of the subsidiaries which are directly/indirectly held by the listed parent that is not a tax resident of the same DTA partner state of the listed parent, this safe harbour provision will not be available.

Although Circular 165 provides further interpretation of the safe harbour rules contained in Announcement 30 such that the safe harbour provision should still be available in situations where the applicant is held by a non-listed HK resident company and where there is a third jurisdiction entity between the applicant and the ultimate HK holding company, it does not explicitly lessen the above-mentioned requirement where all intermediate holding companies (between HK Listed Parent and the applicant) should be HK tax residents to enjoy the safe harbour provision.

The upshot of Circular 165 for Hong Kong holding companies is quite positive. Where commercially feasible, foreign investors should consider leveraging the potential benefits of using a Hong Kong holding company as a gateway to investing in China.

New developments on Hong Kong tax residency certificates application

On the administrative side, in seeking treaty protection, *Guoshuifa* [2009] No 124 (Circular 124) set out administrative procedures which need to be followed. In this regard, one of the specified documents to be submitted to the PRC tax authorities is a tax residency certificate issued by the tax authority from the foreign investor's country of residence.

The issuance of Circular 165 for Hong Kong holding companies should be positive news. However, it is worth noting that Hong Kong tax authorities have tightened up the issuance of HK tax residency certificates to applicants incorporated/constituted outside Hong Kong. In particular, with effect from April 1 2013, different application forms have to be completed and filed by applicants incorporated/constituted in and outside Hong Kong (HK and non-HK applicants). While it is relatively simple for Hong Kong applicants to obtain HK Tax Residency Certificates, non-HK applicants are required to provide information regarding their business activities and establishments, staffing, nationality, residency and responsibilities of each director in and outside Hong Kong. This information was only required to be submitted upon request in the past.

Typical examples of non-HK applicants are overseas incorporated intermediate holding companies. Companies (either incorporated in or outside Hong Kong) listed on the Hong Kong Stock Exchange, normally hold their equity investments in China through overseas incorporated intermediate holding

Biography

Vincent Pang
Tax Partner

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: +86 10 8508 7516
Fax: + 86 10 8518 5111
Email: vincent.pang@kpmg.com

Vincent Pang is a specialist in the industrial and consumer market sectors and has extensive experience in serving many companies in these sectors.

Vincent started his career with professional accounting firms in Canada in 1991 and has experience in various disciplines including tax, auditing and consulting. He arrived in Beijing in 1998 and started to focus on providing PRC tax services to foreign investors in the areas of tax structuring, tax planning, general tax advice as well as tax compliance services.

Vincent has also been active in assisting many foreign companies in designing their corporate and operational structures in China to meet their business objectives. He has been focused on providing M&A tax services to both foreign and domestic companies and assisting in tax due diligence, transaction structuring, post-acquisition structuring and contract negotiation from a Chinese tax perspective as well as setting up various forms of legal entities for acquisition or operational purposes.

companies. To claim treaty benefits under the PRC-HK DTA, Hong Kong listed companies as well as the intermediate holding companies have to be Hong Kong tax residents and present their HK tax residency certificates to the PRC tax authorities under the safe harbour provision under Announcement 30. However, in reality, management and control of a listed group are normally exercised at the level of the listed company. As special purpose vehicles, it may not be common for the intermediate holding companies to prepare and maintain their own documentation (for example, board minutes) to substantiate that their management and control are exercised in Hong Kong. Even though in practice the HK tax authorities may still consider their applications favourably upon submission of documentary evidence on a group basis, the processing time for these applications will be significantly longer.

International tax law developments on cross-border transactions

Increasing globalisation and the growth of e-commerce means it has become easier for MNCs to locate business functions away from where their customers are. Consequently, it is easier for such companies to shift functions, risks and the ensuing profits across borders to jurisdictions that provide greater efficiencies, and sometimes, greater tax advantages.

In response to safeguarding each country's own tax base, the OECD was tasked by the G20 at its meeting in 2012 to develop a policy framework to address the erosion of domestic tax bases due to the shifting of corporate profits to other jurisdictions.

On July 19 2013, the OECD released its action plan for multilateral cooperation to address tax base erosion and profit shifting (BEPS). What the BEPS action plan sets forth is an ambitious to-do list, consisting of 15 action items to be completed by 2015. The action plan demonstrates a fierce determination against international tax avoidance and has ramifications for the modernisation of international tax system.

As a result of the BEPS action plan, there will be significant revisions and additions to the OECD Transfer Pricing Guidelines and other OECD transfer pricing-related documents. As China has been an observer at the OECD and a strong advocate of anti-avoidance, the PRC tax authorities will definitely monitor the execution of the action plan and propose corresponding changes under the domestic law to align with it.

Proposed changes will likely focus on clarifying, strengthening and developing guidance in areas such as the digital economy, hybrid instruments, treaty abuse, dependence on specific PE exceptions and commissionaire, significant interest deductions, intangibles, and transfer pricing policies.

Clear strategies must be set forth and articulated across departments for MNCs which want to stay on top of the tremendous changes occurring in the international tax system. Multinational companies should perform immediate tax health checks to identify potential weaknesses in their tax positions. This will involve several rounds of review of existing operational structures to see if they derive disproportionate income from underlying economic activities. Additional attention should be placed on the use and exploitation of intangibles, which has already been hinted at in the BEPS report and the action plan.

An internal transfer pricing policy review should also be carried out simultaneously. In light of the increasing uncertainty, advance pricing arrangements (APA) and other forms of early engagement with the tax authorities could again be sought to avoid operational disruptions for the company due to TP disputes with tax authorities.

At the group level, MNCs should review their existing international financing and organisational structure. It is imperative that MNCs should be ready to make proper disclosure of their international profit allocation, with sufficient and concrete documentation, for possible challenges raised by the tax authority.

Last but not least, businesses should take into account the potential impacts of any changes on planning arrangements being contemplated now or the planning arrangements may be at risk.

Prepare for the future

The closer alignment of Chinese DTAs with the OECD Model demonstrates PRC tax authorities' increasing efforts to make China a more favourable jurisdiction for foreign investment and to achieve more uniformity in tax treaty interpretation in China. Nonetheless, given there is more emphasis on GAAR under these newly renegotiated DTAs, existing equity holdings, profit repatriation and exit strategies should be revisited and assessed as to whether the intended treaty benefits could be secured in the long run.

With the globalisation and cross-border cooperation between tax authorities becoming more extensive, China's treaty network and its enforcement of tax collection in relation to cross-border transactions will probably continue to evolve over time to reflect international tax developments and economic realities. Offshore investors that have cross-border transactions with China enterprises would be advised to stay ahead of these changes and undertake appropriate s to retain their competitive advantage in the future.

Transfer pricing – Chinese authorities scaling new heights

The OECD released its BEPS Action Plan in July 2013 in an environment that continues to challenge global economic recovery. Cheng Chi, Irene Yan, Brett Norwood and Michelle Sun of KPMG China provide their insights on how China is raising its effort to combat aggressive tax planning and evasion and play a more critical role in transfer pricing enforcement and thought leadership globally.

On the international stage, the Chinese central tax authority, the State Administration of Taxation (SAT), issued a report, "China Country Practices", in 2012, published in the UN's Practical Transfer Pricing Manual for Developing Countries (the UN manual). The SAT's contribution to this manual is intended to illustrate the views of the SAT on the challenges facing China's transfer pricing management. These include limitations of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD guidelines) when discussing certain issues of developing countries, and the impact of location advantages on the profits of multinational enterprises operating in China, affecting the application of the arm's-length principle. More specifically, the limitations of applying the transactional net margin method (TNMM) in developing countries, location-specific advantages (LSAs) as well as local contributions to intangibles were also highlighted.

The SAT's contribution to the UN manual reflects China's increasing efforts to contribute to and define aspects of the international TP framework. In particular, it is a call-out to the OECD regarding the need to consider additional factors affecting companies' profits in China (and potentially other developing countries) which, to date, have not been taken into account by the OECD guidelines, which were overwhelmingly written by developed countries.

China maintains its appetite for pursuing advanced pricing agreements (APAs), though one needs to be judicious when considering the strength of a particular APA application. As of December 31 2012, China was involved in about 180 APAs at various stages. This illustrates that APAs are continuing to gain in popularity, taxpayers are increasingly interested in APAs as a feasible TP risk mitigation strategy and that tax authorities are willing to consider these applications. It is worth noting, however, that a substantial number of APAs – especially bilateral APAs of which there are more than 100 – are still in the pipeline.

Recently, we have also seen certain breakthrough transfer pricing cases in China including the signing of the first cross-regional unilateral APA on intra-group services. The APA covers multiple legal entities, provinces and (district) tax authorities. Another audit case has brought the application of LSAs by the tax authorities resulting in additional tax assessment.

Looking ahead to potential changes to the Chinese transfer pricing regulatory framework, the SAT has been collecting feedback from local tax officials, who have, in addition to their usual responsibilities, also been asked to collect, review and provide feedback as to the quality of transfer pricing documentation reports for the past few years, on the existing TP regulations set out in Implementation Measures of Special Tax Adjustment (Provisional) Circular 2 (Circular 2). Discussions have been conducted about the administration of transfer pricing investigations, cost sharing

Biography

Cheng Chi
National Transfer Pricing Leader

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3433
Fax: +86 21 6288 1889
Email: cheng.chi@kpmg.com

Based in Shanghai, Cheng Chi is the partner in charge of KPMG's global transfer pricing services for China and Hong Kong SAR [Special Administrative Region]. He has led many transfer pricing and tax efficient value chain projects in Asia and Europe, involving advance pricing arrangement negotiations, cost contribution arrangements, pan-Asia documentation, controversy resolution, global procurement restructuring and headquarters services recharges. His clients include those in the industrial markets such as the automobile, chemical, and machinery sectors, as well as the consumer market, logistic, communication, electronics and financial services industries.

A native Chinese, Chi started his transfer pricing career in Europe with another leading accounting firm, covering many of Europe's major jurisdictions while based in Amsterdam, before returning to China in 2004.

A frequent speaker on transfer pricing and other matters, his analyses are regularly featured in tax and transfer pricing publications globally. Chi has been recommended as a leading transfer pricing adviser in China by the Legal Media Group since 2009.

arrangements, the efficiency of administration of equity transfers, and the adequacy of transfer pricing documentation requirements. It is likely that the SAT will issue a new comprehensive circular to replace Circular 2.

Application of the arm's-length principle in China

Similar to the OECD Guidelines, China also follows the arm's-length principle in its transfer pricing regulations and administration. However, there are differences in the detailed application of the principle due in part to data constraints, particularly under the TNMM. According to China's laws and regulations:

- Tax authorities may adjust to the median of a set of comparable data for any given year in which the Chinese entity's taxable profit level is below the median profit level indicated by the comparable companies.
  If all countries had similar requirements, then each year taxpayers would be subject to adjustment in one jurisdiction or another: it is impossible to predict, and then achieve during a fiscal year, what will be the median result of a set of comparable companies after year-end. The OECD guidelines address this problem by specifying that results falling within a range based upon comparable data should be considered to be at arm's-length. While the SAT has given oral guidance publicly that generally speaking being within the interquartile range, and only sometimes below, sometimes above, should not typically lead to an adjustment, the written regulations to date offer no such protection for taxpayers.
- "Single-function" entities should maintain reasonable (and positive) profit levels and not bear market risk or other risks related to decisions they cannot control; this message was later reiterated in Circular *Guoshuihan* [2009] No. 363 (Circular 363), which stipulates that entities with limited functions and risks should maintain an appropriate (positive and stable) level of profits.
- In practice, Chinese tax authorities rarely accept any loss-making comparables when assessing an arm's-length profit range using the TNMM regardless of the change/trend of the market.

Consistent with these principles, the SAT has been taking an industry-specific approach by targeting low-profit industries, multinational enterprise (MNE) groups and market leaders, and studying operating models that industries adopt to minimise tax costs. Though there is no formal safe harbour rule in China, in practice, minimal expectations for profitability also exist for some industries, such as processing of electronic components, and manufacturing of home appliances.

With the publication of the UN manual, the SAT formally expressed its views on the transfer pricing implications related to unique market characteristics in developing countries, such as LSAs and local marketing intangibles, which are expected to serve as arguments for retaining additional "non-routine" profit within China and will have a further impact on the application of the arm's-length profit range locally. With a lack of reliable local comparables, Chinese tax authorities are making adjustments for LSAs to comparables from other jurisdictions.

Location specific advantages

As outlined in the UN manual, LSAs refer to the net cost savings derived by MNEs through the establishment of operations in low-cost jurisdictions. Location savings are commonly realised from the cost advantages in raw materials, labour, rent, transportation and infrastructure, as well as government industry policies and tax incentives.

China has been asserting LSAs exist for many years and requiring additional remuneration for local cost advantages in audit and APA negotiations. In the past, it has demanded the application of higher mark-ups to low-margin or contract service providers using location savings arguments. Recently, it has been testing a more systematic mechanism in assessing the advantage attributed to local cost savings. The main challenges comprise demonstrating empirical evidence regarding the existence and measurability of such savings, and determining how to attribute accurately and effectively the savings to the respective parties involved in the context of the arm's-length principle.

In a recent transfer pricing audit case, Chinese tax authorities applied a factor analysis approach to assess location savings related to a local R&D facility of a large electrical MNE group. In that case, officials maintained that:

- The main reason for the MNE group to relocate its R&D facility from the home country to China was to take advantage of low operating costs in China, i.e., an LSA exists.
- Under the contract R&D service arrangement, the MNE group's overseas related parties had been enjoying the benefits of lower R&D costs, as the LSA generates additional profit.
- The local R&D facility was therefore under-remunerated based on the cost plus method.

Reviewing the R&D service costs breakdown in detail, Chinese tax authorities selected a number of cost items such as labour, rental, utilities and maintenance for a cost comparison analysis. The degree of location savings was then calculated based on the cost differentials sourced from open market data as well as company-specific information. Relevant dissaving factors, such as differences in working efficiency, additional relocation expenses incurred due to the start-up of local R&D facilities and training provided to the locally hired R&D team were also considered, and quantified, to arrive at the net location savings. However, a potentially contentious issue in this case was the allocation of savings between the home and host countries, which were all allocated to, and taxed in (presumably for a second time), China.

Another local advantage is related to the concept of market premium. The term usually refers to the surplus profit obtained by sales of product at a higher price and/or volume due to differences in market conditions. Due to the fast-growing China market demand and preference of Chinese customers for foreign brands, China has asserted that MNE distributors in China are likely to earn a profit in excess of comparable distributors in developed countries. To account for this, a market premium may be allocated reflecting the success of local marketing efforts. Large investments in local advertising, marketing and promotion (AMP) aimed at Chinese customers may also result in higher profitability for Chinese affiliates. In cases regarding royalty arrangements, this argument has also been relied upon by authorities to discount the contributions of foreign intangibles and question royalty rates charged to Chinese affiliates.

It should be noted that tax authorities in other jurisdictions may not concede that LSAs exist in a particular instance; or that LSAs lead to substantially greater profits for a group, even if they exist. For example, for competitive reasons and the structure of the market or that an arm's-length arrangement is to leave all of those profits in China, as the UN manual seems to suggest the SAT feels is appropriate, even when LSAs exist and lead to increased profits. As the concepts related to LSAs may be controversial and potentially result in local transfer pricing adjustments significantly deviating from the traditional application of the arm's-length principle under the OECD framework, disputes may arise between competent authorities and negotiations on bilateral and multilateral APAs under a mutual agreement procedure (MAP).

As China's status as a low-cost country is slowly diminishing, some MNEs for which labour costs are a substantial portion of total manufacturing costs (for example, textiles companies) are now seeking to transfer their manufacturing activities to lower cost jurisdictions. Already a number of examples of manufacturing operations are being relocated within China which have led to transfer pricing adjustments, and given the emphasis on LSAs and local intangibles, it is

Biography

Irene Yan
Tax Partner

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: + 86 10 8508 7508
Fax: + 86 10 8518 5111
Email: irene.yan@kpmg.com

Irene Yan is a partner in KPMG China's global transfer pricing services group and is responsible for the Northern China region. She joined KPMG in Beijing in 1993. With more than 19 years experience with the firm, she has a broad knowledge of PRC taxation, particularly corporate income tax, indirect tax and individual income tax.

Irene has conducted research and has been actively involved in the PRC inter-company transfer pricing practice since the late 1990s. She has extensive experience in operational transfer pricing, business model tax optimisation, contemporaneous transfer pricing documentation, transfer pricing due diligence and risk assessment, controversy resolution, unilateral advance pricing arrangements (APA) and bilateral APAs.

Her rich experience covers industrial markets, the information, communication and entertainment markets, consumer markets, property and infrastructure, energy and resources, and financial institutions. Her clients include a number of multinational enterprises with investments in China as well as large domestic enterprises with overseas investments covering diverse industries.

Biography

Brett Norwood
Tax Partner

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3505
Fax: +86 21 6288 1889
Email: brett.norwood@kpmg.com

Brett Norwood is a tax partner and PhD economist with KPMG's global transfer pricing tax practice. Before joining KPMG in Shanghai, he held transfer pricing positions first in New York, and more recently in Beijing for nearly six years.

Brett has led the documentation efforts for companies with several dozens of entities across China, advised a variety of taxpayers regarding their transfer-pricing audits in China, and also advised multiple state and privately owned China-based companies expanding their operations overseas. In the US and China, he has served clients in a variety of industries including financial services, consumer goods, manufacturing, automotive, advertising and marketing services, and others, analysing cross-border transactions in Asia, Europe, and North and South America.

He frequently speaks at industry events, tax forums and in webinars; gives presentations in Chinese to the tax authorities on topics such as cost sharing agreements, valuation of intangibles, valuation of equity and international aspects of transfer pricing including tax efficient supply chain management, using written materials in Chinese; and regularly leads regional and China national training programmes.

possible that China may also pursue on a widespread basis substantial exit charges, just as certain developed countries already do.

Emerging transfer pricing issues for MNEs in China

Inference of related-party transactions (RPTs) based on substance and control

Following the logic of India's recent court case *LG Electronics India Pvt Ltd v ACIT*, China is also seeking to impose adjustments in several cases by inferring or deeming related-party transactions between affiliates. The features that lead to deemed RPTs typically involve:

- Fast-moving consumer goods (FMCG) companies with a domestic supply chain
- Limited overseas related-party transactions undertaken by the domestic entities (that is, minimal buy-sell transactions since most if not all raw materials are locally sourced and finished goods are substantially sold within China)
- The entire Chinese supply chain has been operating at a loss over the long-term (sometimes as long as 10 or 20 years)
- The distributor that sells to third-party Chinese customers may pay a brand royalty to the overseas brand owner
- The distributor also incurs a significant amount of AMP expenses annually.

In the past, it would have been rare for an in-charge tax authority to pursue a transfer pricing investigation due to the lack of material cross-border transactions. However, similar to the LG case, we see instances where it is argued that a third party would not conduct its overall operations earning long-term losses as observed by subsidiaries in China, and that it is the decision-making of the overseas related party that is leading to the losses of the China entity(ies). It may be further argued that the losses in China are due to the creation of brand intangible licensees (for an overseas headquartered company) through excessive AMP expenses of the distributor licensee, and as such, it should be compensated by the brand owner for this service.

In terms of investigating, as a first step, the in-charge tax authority may request and scrutinise documentation relating to the marketing activities undertaken in China, including meeting minutes, organisation charts and contracts. This documentation may provide some evidence to suggest that the decision-making and final sign-off of key decisions are made by the overseas company, even if in fact the final sign-offs may only be rubber-stamping, which can form the basis to question the reasonableness of the local entity bearing associated risks.

As a result, tax authorities may challenge the losses incurred in China and claim that the overseas brand owner should bear the AMP costs associated with building up and maintaining the brand in China since the owner is performing the majority, if not all, of the strategic decision-making associated with the marketing and advertising activities in China. We would like to note that these loss-making entities may be considered too complex to qualify for treatment as entities assuming limited functions and risks under Circular 363, described above.

This challenge by the tax authorities regarding AMP expenses of FMCG companies in China may lead them to mimic the approach taken in the LG case and benchmark the level of routine AMP expenses. As discussed, excess spending on AMP is an incremental, measurable increase in expenses of the loss-making licensee; whereas the potential benefits of such spending are much harder to quantify. Presuming the comparable companies selected are from the greater Asia Pacific region, the results of this type of analysis may include companies operating in markets where lower AMP expense intensity could be attributable to market factors (for example, a number of brand rivals) and/or differences in the cost of media production relative to China. If so, the benchmark range of the appropriate level of AMP expenses may be lower than their Chinese counterparts. In such a case, taking into account the disadvantages faced by the tested party in China, an adjustment would need to be made to the comparable data, one which would lead to a higher level of routine AMP expenses. Detailed analyses would be needed to understand and quantity differences in AMP expense intensity; and taxpayers need to keep in mind that while such an analysis is theoretically consistent with the SAT's treatment of LSAs in general, the result would lead to a smaller tax adjustment in China in the example above, and local tax authorities might be reluctant to easily accept this reasoning.

The use of deemed RPTs, when combined with Circular 363, suggests an environment in which loss-making entities are likely to be challenged aggressively. Circular 363 already states that certain, simple entities should not incur losses under almost any circumstances. However, China has been encouraging the expansion of more advanced, value generating activities such as R&D, which bear the risk of potential losses or revenue shortfalls due to increasing investment spending, R&D risk of failure or inefficiency and market risks for newly developed products. The adjustments imposed in these cases, nonetheless, illustrate the commitment of the Chinese tax authorities to pursue loss-making companies: while the China footprint of group companies may clearly be more than that of single function low risk entities, these more complex operations – sometimes spread across multiple entities – may still be challenged with the assertion that they have limited decision-making ability in some sense, and on that basis, argue they should be insulated from losses by related parties (even when there is not an obvious related-party transaction between them to adjust for this purpose).

China is also expanding its audit scope to include local marketing intangibles, arguing that local marketing activities create excess profit, which should also be taxed in China. However, there is a question of how to treat such marketing intangibles: if deemed transactions on AMP are concluded to have occurred in China, the local subsidiaries would presumably not be entitled to any further profit related to marketing intangibles, since they have already been compensated for their development. The question of how this may play out is yet unanswered. We believe that this trend will likely continue and that Chinese tax authorities will expand their audit scope to other industries where they believe LSAs may exist, especially related to marketing, such as luxury retail brands. It will be important for taxpayers in these industries to follow progress in this and other industries as well, as it will likely also affect the concurrent dialogue regarding the assessment of LSAs presented by the SAT in the UN manual.

Intercompany charges

China recently released administrative procedures for the remittance of cross-border payments. However, it is not relaxing its attention on service fees charged from overseas related parties from a transfer pricing perspective. Arguments that may arise from the assessment of service fees include:

The substance of the service, including demonstration both of its existence as well as benefits for the China entity(ies):

China's focus on intra-group service arrangements begins with substantiating the existence of the service. Taxpayers have to prove that services between related parties were actually provided and that if so, the party receiving the services benefited and that the charges were reasonable. If a taxpayer fails to show a service was conducted due to the lack of clear guidance or criteria, then no deduction will be considered. Local officials often request substantial supporting documents from service agreements, and even as deliverables. Even if the service activity exists, it is still necessary to show how the services benefit the China entity, that is, that profit increases as a result of this service.

Biography

Michelle Sun
Tax Director

KPMG China
38th Floor, Teem Tower
208 Tianhe Road
Guangzhou 510620, China
Tel: +86 20 3813 8615
Fax: +86 20 3813 7000
Email: michelle.sun@kpmg.com

Michelle Sun is a director in KPMG's global transfer pricing services (GTPS) group in Guangzhou. She has been working in the transfer pricing practice since 2003. Before joining KPMG, she worked for another Big Four accounting firm where she started her career in transfer pricing and acquired extensive experience in this area.

Michelle is actively involved in various transfer pricing projects, including risk reviews, documentation, transfer pricing planning, supply chain management/planning. She also has experience in solving transfer pricing disputes with the PRC tax authorities as well as bilateral advance pricing agreement applications.

Michelle's clients include a number of multinational and domestic enterprises in a wide range of industries, including consumer markets, electronics, petrochemicals and real estate. Further to the analysis on tangible goods transactions, Michelle also has experience in the assessment of the value of intangible goods, such as the provision of services and planning for royalty charges. Michelle also has experience in establishing group shared service allocation mechanisms.

Calculation of a reasonable service fee

If a taxpayer can show the service took place and that China entity(ies) benefited from it, the next question is the reasonableness of the service fee. Cost and fee computation schedules may be requested. If the service is not one to one, for example, it is an allocation made by an offshore shared service centre, then the allocation method may be a point of considerable contention. Effectively, the burden of proof is with the taxpayers and the failure to provide relevant supporting documents can result in corporate income tax being non-deductible. As for fees remitted outside of China, there is also a risk of it being deemed a royalty fee (most common for certain IT-related services) or dividend payments, in which case other taxes, such as withholding taxes, may be levied.

Cost sharing agreements

As Circular 2 has formally introduced the concept of a cost sharing agreement (CSA) into the China TP regime, in assessing the overseas services charges, it is conceivable that a tax official may ask whether it is allocated into China as part of an offshore CSA. In particular, any sales and marketing, procurement, R&D and technical support related services may be inherently linked with CSA which shall be reported and registered up to the SAT level.

Though it is clear that the difference between a CSA related cost and a shared service agreement relies upon the creation and sharing of intangibles, in practice, the boundary is vague partly because of the lack of a clear definition of intangible assets under China's tax and transfer pricing framework. Tax authorities have, in some cases, argued that sales, technical and development related activities create intangible assets, for which China should be due additional compensation in the future. In such cases, the deductibility of the allocated cost may also be questioned since the tax authority may take the view that the (deductible) cost should be apportioned according to the expected future benefits associated with the arrangement. Many tax authorities do not have extensive practical experience with this type of analysis, so such discussions can be resource intensive. However, CSAs are themselves a topic of increasing interest in China, they are likely to play an increasingly relevant role for taxation in China and taxpayers should expect such issues to arise more frequently.

China has also seen a breakthrough in transfer pricing related to intra-group service arrangements in early 2013 with the signing of the first unilateral APA on services. In the future, APAs on services may be a worthwhile approach for taxpayers with complex service arrangements or service arrangements spanning multiple companies and districts to consider due to the potential efficiencies across tax and non-tax aspects of remittance procedures in China. Additionally, APAs typically involve more senior, experienced officials who may be able to provide extra insight into issues of substance, benefits, reasonable calculation mechanisms, and others about these types of fee arrangements.

Looking ahead

As an active player on the international stage, China is making itself heard and establishing a proactive approach to protecting domestic tax revenue, and is even driving the dialogue on the treatment of complex tax issues for developing countries on an international scale.

We also note an increasing trend for companies headquartered in China to be facing challenges in overseas jurisdictions regarding their transfer pricing arrangements on outbound investments. These companies often try to adopt policies and internal control mechanisms consistent with the OECD guidelines, similar to companies headquartered in the US and Europe which have considerable experience in navigating these issues. Implementation of arm's-length arrangements is likely to be an increasing area of focus for these China headquartered companies as their overseas (non-China) operations continue to grow. We predict that the future landscape of China transfer pricing will likely involve clarifying the SAT's position on situations in which Chinese entities face issues, reversing the fact pattern of those being contended, such as when China headquartered companies seek to compensate overseas subsidiary losses or receive compensation from their foreign subsidiaries for services rendered.

More broadly, taxpayers and their service providers will need to remain cognisant of the constantly evolving transfer pricing landscape in China. We expect that new approaches with little precedent outside of China, such as the application of formulary apportionment that was mentioned in the UN manual as an alternative to the more traditional transactional or profits-based methods for companies, will be applied in audits and APA applications.

VAT reforms to accelerate in 2014, with challenges lying ahead

On August 1 2013, the Chinese government announced the nationwide rollout of the first phase of the VAT pilot programme, a significant advance towards replacing business tax (BT) throughout mainland China with a value added tax (VAT) for the services sector. Lachlan Wolfers, John Wang and Shirley Shen of KPMG China look ahead at further VAT changes to come in 2014.

In the first phase of the VAT pilot programme, which commenced in Shanghai on January 1 2012 before being progressively expanded nationwide, VAT has replaced BT for the transportation and "modern services sector". The modern services sector comprises consulting services, R&D and technical services, leasing of tangible movable property, cultural and creative services, IT services, radio, film and television services, and logistics and ancillary services.

The first phase of the VAT pilot programme has made considerable inroads in alleviating the tax burden on businesses in China:

- Manufacturers, wholesalers and retailers are now eligible to claim input VAT credits for the services they purchase;
- Businesses in the services sector are now eligible to claim input VAT credits for the fixed assets, goods and services they use in their business; and
- Exporters are eligible to zero rate or exempt the services they provide across borders.

While the first phase of the VAT pilot programme has been implemented relatively smoothly, international experience will show that the next phase, due to commence in 2014, will be far more challenging. In 2014, it is expected that VAT will replace BT in several critical sectors, including telecommunications, real estate and construction, financial services and insurance, and hospitality services. In this edition of China – Looking Ahead, we will take a look at how these forthcoming reforms are likely to affect these sectors. We will also examine some recent developments and what they portend for the future of indirect taxes in China.

Telecommunications and e-commerce

In recent consultations conducted by KPMG with China's Ministry of Finance (MoF) and the State Administration of Taxation (SAT), we understand that the telecommunications sector, dominated by the three State Owned Enterprises – China Mobile, China Telecom and China Unicom – will be subject to 11% VAT, in lieu of 3% BT, in the very near future. There is speculation that so-called value added telecommunications providers, such as data storage and processing operators, information services, internet access services and call centre operators, may be subject to 6% VAT.

These industries are likely to confront a range of issues including the potential for a range of mixed or composite supplies to contend with, including where handsets are bundled with usage agreements, or when digital content is bundled with telecommunications services. Both Chinese and international telecommunications providers will be closely following the VAT treatment of roaming charges, due to the growth of Chinese consumers travelling abroad and international visitors roaming while in China.

The centralisation by large telecommunications providers of their purchasing functions to obtain cost savings also pose challenges for regulators, with significant input

VAT credit balances likely to accrue to those centralised procurement functions, while output VAT will typically be accounted for at the individual branch level.

In the e-commerce sector, recent technological developments have highlighted the need for the modernisation of the VAT system. The ability for ordinary consumers to purchase electronically supplied services from offshore providers through the internet has led to indirect tax revenue leakages around the world, and global reforms being led by the OECD.

In China, the gap between the VAT system and modern commerce is perhaps even more pronounced. Foreign companies cannot, as a general rule, even register for VAT purposes. The use of a VAT withholding system on imported services, rather than a reverse charge, coupled with China's currency controls, has resulted in real leakages of VAT revenue collection on both business-to-business (B2B) and business-to-consumer (B2C) transactions. The VAT reforms provide a strong platform to review these issues thoroughly and modernise the VAT collection system. With an increasingly tech-savvy population, hungry to experience the best the world has to offer, the time is ripe for reforms in this area. Put simply, the system needs to facilitate foreign businesses being able to both discharge their VAT liabilities in China efficiently, and access input credit relief on their inputs.

Real estate and construction

In recent consultations with the MoF, government officials have signalled an intention to apply 11% VAT to both real estate and construction services, in lieu of 5% BT and 3% BT, respectively.

While much of the focus is on the applicable VAT rate, a further question is the breadth of the tax base for real estate transactions. The BT system applies not only to commercial, retail and industrial property, but also to residential real estate transactions at all stages of the supply chain. That is, the sale and lease of both new and second-hand real estate, residential or commercial, by developers and the general public, attract BT.

Any new VAT system which narrows the scope of the tax when compared with the existing BT system would create a revenue gap. Furthermore, with the residential property market in China's biggest cities experiencing significant and sustained growth over the past decade, the temptation for the government to introduce VAT to rein in demand cannot be discounted. Potentially, China may be among the first countries in the world to apply VAT to all forms of real estate transactions, not only at the business level, but also by private individuals. The scale and complexity of doing so for a population of more than 1.3 billion cannot be underestimated.

A further challenge for policymakers is in managing the transition from BT to VAT. Whether to tax construction or real estate transactions under existing contracts, with the potential for effective retrospective pricing or profitability impacts on existing projects, and whether to tax property sales on a gross revenue or margin basis, remains of considerable interest. Additionally, many Chinese consumers have made substantial property gains in recent years and the question of whether the VAT will tax only active development profits and speculative investment, as opposed to merely passive gains, remains to be seen.

The impact of these reforms on existing business models used by developers and real estate funds is likely to be significant as well. For example, where property is developed for the purpose of leasing on a long-term basis, significant input VAT credits are likely to precede output VAT for a long period of time. These timing differences create a real long-term carrying cost. By contrast, pre-sales of properties by developers create the reverse problem – output VAT being generated before input VAT credits, which can create a permanent excess VAT credit balance on a project-by-project basis. The key point here is that the general policy of not allowing businesses to access refunds of excess VAT credits can transform transactions which would be relatively straightforward in other countries, into substantial VAT burdens in China.

Finally, the existing tax system in China already imposes a raft of different taxes on real estate transactions, including corporate income tax, land appreciation tax, stamp duty, deed tax and city level taxes, and raises the question of the need for wholesale reform of property taxes. One doubts whether that will be forthcoming any time soon. The prospect of having a VAT and a land appreciation tax, both of which tax the value added is very real. The question of whether the liability to one form of tax is deductible under another will be watched with considerable interest.

In 2011, the combined real estate and construction sectors raised 51% of all BT revenue, highlighting the fact that this single sector of the economy poses the most significant risks and opportunities in implementation of the VAT reforms. As a recent OECD report highlighted:

> Levying VAT on newly constructed immovable property instead of BT may also have an effect on house prices. This type of tax reform would therefore have to be planned and evaluated carefully and should be part of a broader property tax reform. The timing of such a type of reform seems crucial.

Financial services and insurance

It is expected that the financial services and insurance sectors will be among the last industries to move to VAT, possibly in the second half of 2014. Those sectors are subject to 5% BT, though with some transactions subject to BT on a gross revenue basis, some on a net basis and others exempt.

The most critical issue will be the approach to taxing interest income under a VAT given that it is clearly the largest revenue source for Chinese banks. While practically all countries exempt interest from a VAT, China may be among the first to tax it. The reason lies in the fact that interest income, except

Biography

Lachlan Wolfers
Seconded Tax Partner
Leader, Centre of Excellence, Indirect Taxes

KPMG China
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
Tel: +852 2685 7791
Fax: +852 2845 2588
Email: lachlan.wolfers@kpmg.com

Lachlan Wolfers is the leader of KPMG's centre of excellence for indirect taxes in China. Before that, he was the leader of KPMG's indirect taxes and tax controversy practices in Australia. He is a member of the network's global leadership team for indirect taxes, and its regional leader for indirect taxes.

Lachlan is regularly invited to advise the Ministry of Finance and the State Administration of Taxation in relation to the VAT reform programme, as well as other tax reform initiatives such as the introduction of a system of advance rulings.

He holds a masters of taxation with first class honours, as well as combined economics and law degrees, also with honours, all from the University of Sydney.

Lachlan has also co-written the leading textbook on capital gains tax in Australia, as well as writing chapters for textbooks on income tax and GST. He is a regular presenter and media commentator on tax issues, both in China and previously in Australia.

for inter-bank lending between approved providers, is subject to BT. Given that historically at least, interest margins have been heavily regulated in China, the theory is that the margin incorporates an allowance for indirect taxes. However, with interest margins gradually being deregulated, it is not clear that this implicit assumption will hold true into the future.

It is expected the VAT reforms will result in interest income being subject to VAT. That is, the banks will have an obligation to remit VAT at a rate which is yet to be determined, in relation to their interest income. Both the banks and business borrowers will be eligible to claim input VAT credits for their expenses in relation to these transactions. The tax base for the banks may be the margin they derive, which may be achieved by exempting from VAT and granting a deemed input VAT credit for interbank lending. The systems changes required to achieve this outcome will pose massive challenges to the banking sector.

While this approach may be appropriate in an environment of regulated interest rates, and necessary to protect government revenues, it may not be internationally competitive. If Shanghai is to become a global financial centre, it will be competing with markets in New York, London and Hong Kong, none of which tax interest income under a VAT (or equivalent indirect tax). So the question remains as to whether this approach, which may be necessary to apply domestically, would also apply to cross-border loans, which could hamper the efforts of the Chinese banks competing on a global stage.

This example highlights one of the challenges for the policy makers in implementing the VAT reforms in China – it is such a vast economy, undergoing one of the most substantial changes in modern history. Reforms implemented today can very quickly become redundant, or at least ill-directed tomorrow.

The Chinese insurance sector is a further example of this. At present, the insurance market is, by the standards of fully developed economies, relatively unsophisticated. Insurance penetration of the market in China is 3.8% (being premium income as a percentage of GDP), which remains low compared to the global average, which is more than 7%.

In recent consultations with KPMG, the MoF and the China Insurance Regulatory Commission (CIRC) have indicated an intention to apply VAT to the general insurance sector, based on the VAT models used in countries such as New Zealand and South Africa, and for life insurance to be exempt from VAT, which is consistent with international norms.

If implemented in this way, the introduction of a VAT model for general insurance which taxes the difference between premium income and claims paid, would radically alter the compliance obligations of insurers in China. Both Chinese and foreign insurers will need to implement changes to their systems, claims management processes, contracting and pricing. With most policies of 12 months or more duration, the effective timeframe for implementation is likely to be very short.

Hospitality services

One sector which has received comparatively little attention to date in the VAT reform process is hospitality. Taxpayers in this industry pay BT at the rate of 5% in the category of "other services".

The introduction of VAT for hospitality services, in particular, hotels, is likely to have a significant impact. Again, questions of mixed and composite supplies will arise given the proliferation of multiple VAT rates in China. For example, hotel accommodation may be taxed at one rate, while conference or event facilities may be taxed at a different one. Takeaway food and beverages may be subject to VAT at a 17% rate, while the same food and beverages sold in restaurants where services are provided may be subject to VAT at a different rate. When combined, a single conference may attract VAT at different rates for the accommodation component, the event facilities and the food and beverages served to guests. Price shifting and complexity for hotels will undoubtedly arise.

For businesses, a critical question will be the extent to which they can claim input VAT credits for the use of conference and event facilities, and for employee business travel accommodation. The idea of a full VAT credit being available should not be regarded as automatically assured given that domestic air travel costs are already not creditable for VAT purposes.

Finally, reward schemes commonly used in the hospitality sector may be subject to new indirect tax imposts. At present, the BT system does not have a deemed sales rule which applies market values to gifts and similar giveaways. However, the existing VAT rules do apply such market value concepts, potentially resulting in real VAT liabilities for the operators of these reward schemes. Experiences in the EU with reward schemes highlights the potential for challenging VAT issues to arise.

Early warning signs

Theoretically, the introduction of a VAT in place of BT should alleviate the tax burden on business. That is because BT is a tax on business and is reflected in the profit and loss of the business. By contrast, VAT is a tax which is collected by business but is ultimately imposed in an economic sense on the end-consumer. It is a balance sheet item.

Logically therefore, the replacement of BT with a VAT should have facilitated the passing on of the VAT impost to consumers in the form of price changes. However, that outcome has, by and large, not eventuated in China. Several factors have contributed to the introduction of VAT being viewed through a somewhat different lens by businesses there:

- Unlike many other countries, the VAT system in China uses multiple VAT rates – 3% for small scale taxpayers, 6% for the modern services industry, 11% for the transportation sector, 13% for certain food items, and 17% as the general VAT rate applicable to the sale and importation of goods, and leasing of tangible movable property. The use of multiple VAT rates leads to competitive neutrality issues under which economically equivalent services may be taxed at different VAT rates. The consumption of goods and services by businesses likewise leads to different levels of input VAT credits which impact on the overall net VAT burden of businesses.
- In China, VAT registration occurs at the branch level rather than at the legal entity level. Furthermore, the inability to secure refunds of excess input VAT credits (except in relation to certain exports), means that timing and mismatching issues can create real and permanent liabilities.
- The staged rollout of the VAT reforms has, until recently, led to VAT being imposed on services provided in some cities, and BT in others. Correspondingly, it has led to some inputs being subject to VAT and others remaining subject to BT. The overall VAT liability of a business may be impacted by the mix of its inputs, and the location of its suppliers.

Biography

John Wang
Tax Partner

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3438
Fax: +86 21 6288 1889
Email: john.wang@kpmg.com

John Wang was previously a tax official in the Chongqing Municipality State Tax Bureau, with more than seven years of tax audit and administration experience.

John joined KPMG China after completing his MBA courses in the UK in 2004.

In his career as a tax consultant at KPMG, John has deployed the knowledge and skills acquired from both his work at the tax authority and his MBA studies in providing advisory services to multinational clients and domestic clients in a wide variety of industries. He has been actively involved in helping companies prepare for the continuing PRC VAT reform.

One hopes that once VAT applies to all industries and in all cities throughout mainland China, the VAT system will start to reflect more of its economic foundations as a consumption tax collected by, but not economically imposed on, businesses.

An early warning sign came about in August 2013 with the replacement and consolidation of a series of VAT pilot programme rules into a single circular, *Caishui* [2013] 37. In that circular, the previous net basis approach to accounting for VAT was abolished, causing unintended and detrimental consequences to parts of the transport and logistics sector; and the abolition of various concessions for the asset leasing sector, resulting in an increased tax burden, which has caused many to rethink their business models. This has raised the prospect that the light touch regulatory approach to the implementation of the VAT reforms may soon be at an end.

Due to the relatively short timeframes for implementation, many businesses made hasty decisions at the time of the introduction of the VAT pilot programme. Those decisions should now be revisited as the programme matures and a more thorough and risk managed review of compliance is undertaken by the tax authorities.

A ray of light

Just as there may be early warning signs on the horizon, there is an equal measure of hope and opportunity. For example, in

2013 the government introduced VAT consolidation rules which broadly allow input VAT credit balances of certain branches to be offset against output VAT liabilities of other branches. While those rules are limited to consolidation of VAT returns at the branch level only (that is, they do not allow consolidation between parent and subsidiary), it is a step in the right direction. At this stage, the implementation rules which give practical effect to consolidation are limited to airlines, but the framework for their application across all industries is now in place. It is hoped that they will be implemented more broadly in 2014 and beyond.

A further significant development was the release in 2013 of SAT Announcements 47 and 52, which contain the implementation rules for zero rating and exempting exported services respectively. The release of these implementation rules pave the way for many cross-border services benefiting from concessional VAT treatment which was not previously available under the previous BT regime.

Wish list

One of the relatively unique, and at times challenging, aspects of the indirect tax system in China is the so-called Golden Tax System. This is the regulated invoicing system under which businesses must use hardware approved by the government to issue special and general VAT invoices. The hardware contains IC cards which ensure that every invoice issued through the system transmits data to the tax authorities used to reconcile with the VAT return submitted by the business. Those special VAT invoices, when issued, must then be validated by the recipient business if it is to be used for the purposes of claiming input VAT credits.

The strict controls over invoicing in China are intended as a key measure to reduce fraud. Concepts of carousel or missing trader fraud which have posed threats to the VAT systems used in many other places around the world, especially in the EU, are notably absent in China.

The flipside of the Chinese system is that the rigidity of the Golden Tax System can create challenges for businesses, especially multinational companies. Software to link transactions through the Golden Tax System with a business' own enterprise resource planning (ERP) systems are needed; centralisation of tax and finance functions among the different branches of a business throughout mainland China can be difficult; and electronic invoicing remains in an embryonic state. The extent to which multinational companies seeking to centralise their indirect tax functions either globally, or regionally, are often tempered by the need for specific solutions for China. The Golden Tax System is the oft cited reason for those differences.

The key question which remains is whether proposed future enhancements to the Golden Tax System will respond to the growing modernisation and centralisation of efficient indirect tax functions occurring on a global scale. The increased use of tax engines or tax determination software, centralised compliance solutions and data analytics are all recent trends adopted internationally to manage the sheer volume and complexity of indirect taxes. Each of these solutions is designed to maximise compliance and mitigate the risk of errors, yet their implementation and widespread usage in China remain some distance away. These solutions are not a threat to the Golden Tax System, rather, they apply different techniques and approaches, all striving to achieve enhanced compliance. As future refinements to the Golden Tax System are made, e-invoicing becomes more widespread and software developers refine their solutions for China, greater alignment or a co-existence between these systems and the Golden Tax System must surely be on the horizon. The time is near when different indirect tax technology and compliance solutions for China will no longer be necessary.

If 2013 may be regarded as a year of change as the first phase of the VAT reforms were implemented nationwide, 2014 has the potential to significantly surpass it in terms of the sheer magnitude of the reform process being implemented.

Biography

Shirley Shen
Tax Senior Manager

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: +86 10 8508 7586
Fax: + 86 10 8518 5111
Email: yinghua.shen@kpmg.com

Shirley Shen started her career with professional accounting firms in Australia in 2004 and has experience working across various disciplines including tax and accounting. Before joining KPMG China in 2007, she worked in the tax department of another big-four firm for two years. Shirley has strong experience in the energy and natural resources industry. She provides tax health check, tax provision review, tax due diligence, structuring and planning advice to major multinational and domestic clients.

She is actively involved in the VAT reform in China by assisting the Legislative Affairs Office of Budgetary Affairs Commission of the National People's Congress and the Ministry of Finance since 2008.

Shirley is a key member of KPMG's indirect tax centre of excellence and has been involved in many VAT reform projects for multinational companies and state-owned enterprises. She 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.

Customs – from enforcer to enabler

The conventional perception of the Chinese Customs authorities has always been that of a trade restrictive border guard that imposes financial and administrative barriers for importers and exporters. However, Lilly Li, Anthony Chau and Eric Zhou of KPMG China observe there are signs that the Chinese Customs authorities are slowly adopting global practices that are geared more towards trade facilitation than trade restriction.

The General Administration of Customs (GAC) in China is making a strong effort to build Customs' image as more business friendly, technology savvy, and adherent to international standards. It has made and will make more important strides in pursuit of this objective including:

- the recent slew of mutual recognition agreements that China Customs has entered or is planning to enter into;
- the signing of the China-Switzerland free trade agreement (FTA), which has been the subject of growing interest among multinational companies recently; and
- the new rules that clarify how FTA-qualifying goods that are first stored in China bonded zones can still enjoy FTA treatment when sold for domestic consumption.

More specific initiatives being undertaken at the local level particularly include:

- the ongoing transition to paperless customs declarations to be carried out until 2015;
- the expected changes to Customs valuation rules involving bonded goods; and
- the new methodology that Customs may soon employ in determining the consumption and scrap rates for processing trade companies which appear to mirror the World Trade Organisation (WTO) rules on Customs valuation.

More mutual recognition agreements being pursued

China Customs has been bolstering its bilateral ties with other Customs authorities in the region through increased initiatives to sign mutual recognition agreements for trade facilitation under Advanced Economic Operator (AEO) schemes. After entering into such an agreement with Singapore Customs last year, China Customs has now signed another one with Korea, which is a bigger trading partner. With many large Korean companies investing in China, many are optimistic significant economic benefits may be realised through this agreement.

Although already signed, the agreement is not expected to take effect until next year as both parties need time to make internal assessments, prepare their systems and allocate adequate resources for its implementation. Once online, qualified importers and exporters in China and Korea will be able to access a green channel where less administrative burdens and checks would be performed at the border, resulting in smoother and faster clearance times.

While preparations are underway for the China-Korea AEO scheme, China is also leading negotiations with the EU and the US to gain recognition under the EU AEO and US Customs Trade Partnership against Terrorism (C-TPAT) programmes. The overall economic benefit and risks between China and the US/EU are still being assessed. Negotiations with the EU appear to be more advanced as talks are expected to be completed this year. However, no definite timeframe has yet been set for the conclusion of negotiations with the US.

Driven by manpower and resource constraints, more AEO initiatives are expected in the next five to 10 years. In fact, negotiations are also underway for AEO recognition with Japan, Taiwan, and Hong Kong. It is interesting to note that while trade volumes have increased significantly in China, the number of China Customs officers has remained nearly constant at 50,000 nationwide, which makes it impossible to screen each and every shipment that enters the country. Having more AEO agreements in place would therefore enable Customs to deploy and dedicate its resources more in scrutinising lower tier importers.

At any rate, China's Customs systems may already be geared for AEO implementation. Its electronic Customs systems are practically ready to accommodate AEO requirements based on several years of implementing its enterprise classification system, whereby top tier companies (that is, with an AA status), are selected and granted privileges similar to AEO. In fact, under the mutual recognition agreement between China and Singapore, an AA rating is already synonymous with having AEO status. Once the China – Korea AEO comes into effect, qualified companies will be able to apply for a special code with China Customs. This code will be indicated in the declaration form and can readily identify AEO-qualified companies to which the necessary privileges should be extended.

Use of free trade agreements

At least two significant developments relating to FTAs took place in China this year. First was the signing of a landmark FTA between China and Switzerland, and another was the issuance of rules clarifying the FTA qualification of goods that are imported through bonded zones in China.

China-Switzerland FTA and direct transportation challenges

The Switzerland-China FTA was signed last July and is expected to take effect in the middle of 2014. From the date of enforcement, 99.7% of Chinese exports to Switzerland will be immediately exempt from duties and a relatively slower tariff elimination process will commence for Switzerland exports to China (with a zero duty target on 84.2% of Swiss exports in China within 15 years).

In addition to Switzerland, China has already signed FTAs with more than 20 countries and regions including ASEAN countries, and New Zealand. Furthermore, it now provides preferential duty rates to 37 least developed countries as a form of aid akin to the Generalised System of Preferences (GSP) accorded by the US and EU.

Nevertheless, it is a common observation that many importers in China have not benefited fully from FTAs or preferential duty programmes due to a lack of understanding of relevant regulations. For example, some importers may believe that a transshipment, storage or sale through another country would disqualify automatically the goods from enjoying the preferential duty rates, even if the goods originated from a beneficiary country. In fact, for as long as exporters are able to obtain certificates of origin under relevant agreements, importers can still benefit from preferential duty rates as long as the transportation and storage of these goods would meet the 'direct transportation' rule.

Direct transportation generally requires the goods to be transported directly from a beneficiary country or region to China, without any transshipment via any other countries. However, regulations in China also indicate that goods transported via other countries could still be recognised as directly transported if the goods do not undergo operations other than those necessary to preserve them in good condition and are under customs supervision in those countries. If importers can make sure about the two conditions, that is, obtain the preferential certificate of origin and direct transportation, they would still be able to enjoy the preferential duty rates after providing adequate documents to the customs.

FTA qualification retained in bonded zones

Many multinational companies use China's customs areas (such as free trade zones and bonded logistics parks) to store high duty rate goods under bonded status. In the past, if these bonded goods were qualified for FTA treatment (that is, are covered by a certificate of origin) these would be denied the FTA rate when released in to the domestic market due to the absence of clear regulations. However, in June 2013, the GAC issued Circular No 36, which clarified the procedure required for a company to use preferential duty rates for goods imported via these customs areas and the documents required for the application.

With Circular No 36, we may foresee some customs areas in China becoming preferred international distribution centres in the future where FTA qualification is retained not just for goods to be locally sold, but for those to be transshipped to other FTA destinations as well. If the Chinese government could issue certificates of non-manipulation for goods warehoused in China bonded zones areas, as Singapore does, more companies would be able to benefit from preferential rates under FTA after first being stored in bonded warehouses in China.

China paperless Customs reforms

Among the most important reforms implemented by China Customs over the past three years is the establishment of a paperless customs clearance facility. This measure is expected to improve the balance between strengthening customs supervision while enabling smoother clearance processes. Reforms commenced in 2012, but the process will only be completed in 2015, by which time it is hoped that China's customs systems will be comparable to those of other developing countries where importers and agents can lodge customs declarations from the comfort of their own desks.

The overall impact of these reforms will be significant across various industries. Most importantly, it may transform the manner in which Customs agents and freight forwarding companies conduct business as they may be obliged to redefine their roles, innovate and provide more value added services to their clients rather than simply lodge declarations. Secondly, manufacturing and trading companies (especially multinational corporations) that have outsourced their Customs functions would have to consider these implications that paperless filing may bring:

- The company may need to rethink the customs clearance and logistics management function to determine which types of arrangements and which customs brokers/agents would have the best value for the company.
- Human resources staff could be deployed more efficiently and re-equipped with the necessary skills. For example, field logistics personnel may be relocated to the main offices and provide additional skills training to in-house logistics staff on how to conduct paperless declarations, as well as its corresponding advantages and risks.
- It would be necessary for information systems to be upgraded to match the requirements set for paperless filing. Along with this, information technology (IT) security protocols should be enhanced to protect the integrity of company data since paperless filing may require the sharing of information across different departments.
- Last and certainly not least, new internal controls and checks on accountability would have to be developed since the critical function of making customs declarations will be moved even closer to company premises which could imply possible Customs visits and questions in the future on the accuracy and quality of the declarations made.

The implementation of the paperless customs clearance programme will be linked to the enterprise classification management system. Companies with a rating of C or D will not be allowed to apply for paperless declarations, but are encouraged to make the effort to improve their systems and performance to qualify for an upgrade and paperless filing. On the other hand, those under AA, A, and B status are likewise enjoined to maintain their levels of performance to avoid the risk of being downgraded.

Since the reforms are still in process, we would recommend companies, regardless of their enterprise rating, to pay close attention to any developments or pronouncements by China Customs regarding various areas of customs management and determine how they can prepare from the standpoint of system efficiencies, internal controls, internal procedures/manuals and resource allocation. Adapting to these reforms should be a high priority for companies at least in the next two years.

New developments in customs valuation

The GAC is expected to issue a regulation in the future that will govern the customs valuation of bonded and processing trade goods. Different rules are applied on how to assess the customs value of a good that is released from a bonded zone to the domestic market (for example, depending on the type of bonded zone the goods are stored in). The proposed regulation will set a consistent national standard on how bonded and processing trade goods should be valued for customs purposes when these are entered for domestic consumption. The draft of these new rules has already been submitted to the legislation department of the GAC for discussion.

We understand that WTO valuation principles will still be followed for determining the customs value of goods imported or exported under general trade, while the cost plus method could be adopted as to determine the customs value of bonded goods in the future.

The last major change in China's Customs valuation policy was the Measures of the PRC Customs on Determination of Dutiable Value for Imports and Exports (No 148 GAC Order), enacted in 2006. Since then, there have not been any notable changes in China's Customs valuation policy for nearly eight years, with the exception of two regulations:

- Provisions for Examination of Customs Valuation using Formula Pricing (No 11 GAC Circular issued in 2006)

Biography

Lilly Li
Tax Partner

KPMG China
38th Floor, Teem Tower
208 Tianhe Road
Guangzhou 510620, China
Tel: +86 20 3813 8999
Fax: +86 20 3813 7000
Email: lilly.li@kpmg.com

Lilly Li became a partner at KPMG China in 2005. Before joining the firm, she worked at the China Tax Bureau and the Australian Taxation Office in the areas of international tax administration, tax audit and transfer pricing. She specialises in China tax, transfer pricing and customs advisory services. She provides business and tax advisory services to numerous multinationals as well as Chinese domestic companies on their M&A, corporate restructuring, cross-border transfer pricing, outbound investment, supply chain integration and initial public offering (IPO) activities.

In the area of customs and trade advisory, Lilly has assisted many clients in reviewing and improving their customs-related processes and compliance with processing trade. She has also provided support to clients regarding their customs valuation audit defence. Lilly has also actively led and participated in the technical interflows with the respective customs offices in the areas of related-party transfer pricing and customs verification audit.

Biography

Anthony Chau
Tax Partner

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3206
Fax: +86 21 6288 1889
Email: anthony.chau@kpmg.com

Anthony Chau started his tax advisory career in 1999 in the corporate tax department of KPMG in Sydney. Upon returning to Hong Kong in 2000, he started practising in the areas of PRC taxation, customs duty and business advisory matters. He was based in Guangzhou and Chengdu before relocating to KPMG in Shanghai in July 2010. Besides his tax related roles in Shanghai, he manages the tax practice for KPMG in Chengdu and also leads the trade and customs practice for Central China.

Over the years, Anthony has advised multinational clients regarding their expansion plans, holding structures, and operational and related crossborder transactions as well as their restructuring matters from both a taxation and business regulatory perspective. He has also assisted numerous clients negotiate with the PRC tax/customs authorities on their daily compliance and audit matters.

Anthony is also a regular speaker in public seminars on taxation, customs and business advisory matters.

- Provisional Measures for the Pre-valuation of Imports (*Shushuifa* No 419 issued in 2011).

These two regulations are both related to the pre-verification of the customs value of imported goods. No 11 GAC Circular deals with the customs valuation of special products which use formula pricing for transaction value, while *Shushuifa* No 419 applies to A and AA grade companies enterprises that are entitled to apply for a pre-verification of their import price with local Customs.

New rules to assess scrap and consumption rates for processing trade

China Customs is planning to release a new set of rules to rationalise the determination of the proper scrap and raw material consumption rates for finished products under processing trade.

Ascertaining the actual (or the closest approximation of) raw material consumption and scrap rate for finished products is among the biggest challenges in processing trade management. In fact, inconsistencies in consumption rates are among the primary reasons for discrepancies between theoretical and actual customs handbook balances.

These rates are not easy to confirm since they vary from industry to industry and some can only be validated by industry professionals rather than Customs officials. Often, disputes and conflicts between Customs officials and the business community arise due to technical disagreements over what should constitute the proper scrap and consumption rate for a particular product.

In the past, two ways were used to determine consumption and scrap rates:

- The first was to self-report these rates to Customs, which in turn reviews the company's bills of materials (BOM) and decides on what the acceptable rates are. However, this approach may be problematic since Customs officials are generally not technically competent or equipped to make an authoritative determination as to what the proper rates should be.
- The second method was for Customs officials and industry associations to cooperate in investigations to ascertain the acceptability of consumption and scrap rates. Although this approach is more consultative, its main drawback is that practically all of the technical experts come from the business sector, which can cause the investigation to lose its impartiality.

To bridge the shortcomings of these methods, the new rules instil a change in the mindset on how consumption rates are set. These new methods appear to incorporate elements of the WTO valuation methods and are more open to negotiations between Customs and business.

Under the proposed rules, consumption rates would be determined through these hierarchical methods:

1. Analysis – The applicant will supply detailed technical information to the Customs authorities for the latter to conduct a desktop review. If Customs deems the information sufficient and is confident in their knowledge of the industry, it will decide on the applicant's consumption rate.
2. Assessment – If an analysis is not sufficient, Customs will conduct measurements and laboratory testing on the amounts of raw materials consumed in the manufacture of a finished product. At this time, the enterprises will provide detailed production information to Customs.
3. Calculation – If the production information does not yield a satisfactory result, Customs can opt to make input/output calculations based on financial and production records.
4. Comparison – In case no conclusion could be drawn from the calculations, Customs can then compare the company's application with its historical BOM and decide based on past experience.
5. Other reasonable methods – As a last resort, Customs can combine principles from the aforesaid methods and, after possibly negotiating with the company, arrive at a reasonable consumption rate.

Although these new rules are relatively more objective, scientific and efficient, they are not expected to resolve all BOM issues. Rather, they provide an avenue for companies to consult better with Customs and share technical knowledge that would be critical in mending potential gaps between theoretical and actual BOMs. To fully leverage these opportunities, companies would do well to align the objectives and activities of their customs/logistics department with their more technical functions such as production planning and engineering.

Rebranding as business partner

It cannot be denied that China Customs is making a conscious effort to rebrand itself more as a business partner than a trade regulator. The success of this strategy is clearly premised and dependent on the success of its enterprise classification system, which distinguishes between low risk and high risk companies. We can expect Customs to dedicate more resources in maintaining the effectiveness of this selectivity system by conducting more audits and scrutinising companies' internal risk management/internal control systems. After low risk clients have been identified and properly categorised (for example, AA, A), its enforcement will focus more on those with high risk profiles (that is, C and D companies).

Companies therefore are faced with a two-pronged challenge. First, they can vie for an upgrade to a higher enterprise rating which may involve increased interactions and possible validation audits with Customs, though for the right reasons to further improve their internal systems. Alternatively, companies can opt to remain at the higher risk category which would be tantamount to taking a chance at being at the full receiving end of China Customs' enforcement arm. Our recommendation of course is for companies to consider the former and ride on this wave of reforms China Customs is undergoing.

Indeed, with the proper guidance and a sound management of its relationship with China Customs, the benefits of being able to lodge declarations remotely and mitigate scrutiny on its inbound and outbound shipments would definitely outweigh the risks of penalties due to unintentional, non-routine findings of non-compliance.

Finally, the development of newly former special customs-supervised super zones such as the Qianhai Cooperation Zone and the Shanghai Pilot Free Trade Zone will help further liberate trades, simplify customs procedures and improve the infrastructures and logistics that facilitate cross-border transactions. The further guidelines to be issued on the implementation of customs rules of these super zones are definitely something to look forward to in the coming year.

Dong Cheng, Philip Xia and Raphael Madarang of KPMG China also contributed to this article.

Biography

Eric Zhou
Tax Partner

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: +86 10 8508 7610
Fax: + 86 10 8518 5111
Email: ec.zhou@kpmg.com

Eric Zhou worked for China Customs for more than nine years before joining KPMG China in 2004.

Eric specialises in cross-border customs advisory/defence services such as HS (Harmonised System) codes determination, customs valuation and processing trade management concerning multinational enterprises in industrial markets and consumer markets. He also has extensive experience of corporate income tax, customs valuations, and VAT and transfer pricing, which are closely linked to customs issues.

M&A relief – flickering lights at end of tunnel

John Gu, Lily Kang and Eileen Sun of KPMG China analyse the tax challenges for M&A activities in China and share their insights on how tax regulations may evolve to deal with these challenges.

Over recent years, the Chinese regulatory authorities have introduced a suite of measures that, on the whole, have made it easier for foreigners to invest in China. Such measures include the loosening of regulations allowing for foreign investors to gain access to a wider range of industrial sectors that are permissible for foreign investment, quickening the vetting of cross-border M&A proposals, as well as the expansion of the Qualified Foreign Institutional Investor (QFII) investment quota in China's listed markets. As a result of these positive changes in the regulatory environment to make it more foreign investor-friendly, we have seen an increase in the number of inbound investments by foreign investors.

There have, of course, been certain setbacks in regulatory developments which apply to foreign investments in certain sectors, such as the national security review measures, which have increased regulatory scrutiny of inbound M&A transactions into China and the limitations imposed on the use of Variable Interest Entities, but the general trend has been to facilitate greater foreign investment.

In tandem with the growth in inbound M&A transactions, we also see a greater volume of corporate restructures taking place to facilitate or accommodate the foreign investors' tax or commercial requirements. However, the tax rules on corporate restructuring remain less flexible and in some circumstances impose unreasonable conditions for corporate restructures to obtain tax relief. This has created challenges and sometimes resulted in significant tax liabilities being crystallised for legitimate corporate restructure transactions in China, which is unhelpful to inbound M&A into the country.

Reasons for undertaking pre-acquisition or post-acquisition restructuring

Restructuring transactions may involve the incorporation of new subsidiaries or holding companies, the transfer of assets or companies from one group company to another, spinning off assets/splitting companies, the merger of several entities and the liquidation of legal entities.

Companies typically carry out internal group restructuring transactions before or after the investments by foreign investors, for a variety of commercial reasons, including:

- The foreign investor may only want to acquire a certain division(s)/part(s) of the group's China business (for example, if the group has various business divisions) or certain specific assets (for example, real estate properties) of the People's Republic of China (PRC) company. Or due to inherent historical tax liabilities, the foreign investors may just want to acquire the business assets and operations, but not the business entity. Hence, a spin-off or carve-out of the target business division(s) or asset(s) will be required to be carried out by the seller before the acquisition by the potential foreign investor to enable the potential foreign investor to acquire only the target business division(s) or asset(s).

- To introduce strategic investors into the business operations, it may be necessary for shareholders to create an onshore or offshore platform to allow co-investments by strategic investors (such as private equity funds).
- The existing shareholders and/or the potential foreign investor(s) may want to list the group offshore and eventually exit from their investments after the initial public offering (IPO). However, the group structure may (and in fact, is often) not be readily listable/suitable for listing; this could be the case if, for example, the group to be listed does not have a company that is incorporated in a jurisdiction which is acceptable to serve as the listing vehicle under the relevant listing rules, and/or the shareholders may only want to include certain specific business division(s) in the listing group while some other business division(s) (for example, those that may adversely affect the ability to market the securities or may not be capable of operating independently of its controlling shareholders) may need to be carved-out from the group to be listed. In view of this, it is often the case that certain internal group restructuring transactions will be required to bring the group to a suitable listing structure.
- For certain take-private transactions where companies are listed on US stock exchanges and which have operations in China, these would, typically be effected through some forms of corporate merger at the offshore level. Such corporate mergers could involve the direct or indirect transfer of the equity interest of the PRC companies.
- For strategic take-overs or partial acquisitions of PRC group companies by foreign multinational corporate buyers (for example, multinational business acquisitions), it may be necessary to undertake some form of group restructuring post-acquisition to integrate the two group's operations to achieve cost-savings, improvements in tax and cost efficiencies, and/or maximisation of enterprise value.

The Chinese regulatory rules generally do not restrict/prohibit PRC companies from conducting internal group restructuring transactions, which could take different forms, such as equity transfers, asset transfers, corporate mergers (including mergers by absorption), or corporate splits/divisions/ spin-offs.

However, such corporate restructuring transactions generally are treated as taxable under PRC tax laws, unless the specific restructuring transaction qualifies for the so-called special tax treatment under the corporate restructuring rules provided for in the China corporate income tax (CIT) law (as discussed below), which would effectively allow any PRC tax liabilities otherwise triggered to be deferred. In some cases, the PRC tax liabilities arising from corporate restructuring could be significant, particularly if it involves the direct/indirect transfer of immovable properties in China, which have generally increased in value over the years.

To mitigate these corporate restructure tax costs, many Chinese companies have sought to obtain relief from special tax treatment under corporate restructure provisions of the CIT Law or to conduct their internal corporate restructuring transactions at cost so that no gain or loss would arise for both accounting and tax purposes. However, the corporate restructure tax rules are somewhat rigid and have been less helpful in providing tax relief to legitimate internal corporate restructuring transactions due to the stringent conditions required for tax deferral relief and the uncertainty surrounding how certain conditions are applied. This situation is exacerbated by the fact that the PRC tax authorities have began to apply transfer pricing adjustments aggressively to internal restructuring transactions. This has made tax costs the major hurdle for the implementation of corporate restructures and prompted calls for the need for a change to make the tax rules more business friendly.

Challenges to obtain corporate restructuring relief

While special tax relief, known as the special tax treatment provides for tax deferred treatment under circular *Caishui* [2009] No 59 (Circular 59), this tax relief is difficult to obtain for certain corporate restructuring transactions because of these restrictions and issues:

Biography

John Gu
Tax Partner

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: + 86 10 8508 7095
Fax: + 86 10 8518 5111
Email: john.gu@kpmg.com

John Gu is a partner and tax leader for inbound M&A and private equity for KPMG China. He is based in Beijing and leads the national tax practice serving private equity clients. John focuses on regulatory and tax structuring of inbound M&A transactions and foreign direct investments in the PRC. He has assisted many offshore funds and RMB fund formations in the PRC and has advised on tax issues concerning a wide range of inbound M&A transactions in the PRC in the areas of real estate, infrastructure, sales and distribution, manufacturing, and financial services.

John has bachelor of business and master of finance degrees. He is also a member of the Institute of Chartered Accountants in Australia and a member of the Hong Kong Institute of Certified Public Accountants.

- One of the conditions for tax relief on equity transfer requires the transferee to acquire at least 75% equity interest of the enterprise being transferred – this condition is unnecessarily restrictive as this will make most joint venture interest not eligible for corporate tax relief;
- Another condition for tax relief under Circular 59 is that the purchaser should pay no less than 85% of the total consideration in the form of equity. However, it may sometimes not be commercially feasible for the transferee enterprise to issues its or its subsidiaries' shares to the transferor enterprise as transfer consideration; this could perhaps be due to the commercial consideration that the transferor and transferee enterprises may want to exist as sister companies rather than create a direct shareholding relationship. An example of this would be where a certain business division/asset that needs to be carved out to a separate group and the transferor and transferee enterprises are operating in different business divisions;
- Where a merger takes place between two foreign holding companies, one of which holds a PRC tax resident company's equity interest, it is not clear whether this would qualify for a special tax treatment under Circular 59, as it does not fall squarely into the provisions under a domestic merger and the situations qualifying for special tax treatment referred to under cross-border restructure;
- For domestic corporate mergers, it appears that Circular 59 only provides relief for horizontal mergers but not for vertical mergers based on local interpretations;
- And Circular 59 imposes unduly rigid conditions for tax relief for cross-border group restructuring transactions – where the restructuring involves the transfer of PRC resident enterprises between two non-PRC tax resident enterprises, there is only one permissible type of transaction structure that can qualify for tax deferral relief; that is, the non-PRC tax resident transferor enterprise must transfer its equity interest in a PRC resident enterprise to another non-PRC tax resident transferee enterprise in which it holds a 100% direct interest; and there is no change in the withholding tax (WHT) position on the gains from the alienation of the equity interest in the PRC resident enterprise. In practice, we note that not many restructuring transactions can fall within this specific transaction structure to obtain tax relief; and
- Also in relation to an offshore equity restructure, there is no special relief available for Circular 698 reporting obligations in relation to a corporate restructure, which adds further uncertainty to corporate restructures. Although a draft circular has been prepared to provide for such a relief, it has yet to be issued in final form. *Guoshuihan* [2009] No 698 (Circular 698), was issued by the SAT on December 10 2009 with retrospective effect from January 1 2008, to require offshore indirect equity transfers of PRC resident enterprises by foreign investors to be reported to the PRC tax authorities where the specified reporting condition is satisfied.

With all of this in mind, we have, in a general meeting with the SAT, asked whether it has any plans to relax the specified restructuring conditions or otherwise expand the types of restructuring transactions (particularly cross-border restructuring transaction) that can enjoy the special tax treatment. However, the SAT indicated that they do not have any plans to relax the rules. Hence, it is likely that the challenges will remain for the above corporate restructuring and no relief would be granted for those corporate restructuring transactions.

Reasonable commercial purposes

Even if the particular restructuring transaction *prima facie* satisfies all of the specified conditions for enjoying tax deferral relief under Circular 59, in practice, another challenge facing the transaction parties is to convince the PRC tax authorities that the corporate restructuring transaction has "reasonable business purposes" when negotiating with the relevant PRC tax authorities for the grant of the special tax treatment. In this regard, no special tax treatment would be granted by the PRC tax authorities for the corporate restructure transaction, if the transaction does not have reasonable commercial purposes or if the PRC tax authorities consider that the main purpose of carrying out the transaction is to achieve the reduction, elimination or deferral of tax. SAT Announcement [2010] No 4 (Circular 4) seeks to clarify this

Biography

Lily Kang
Tax Partner

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3359
Fax: +86 21 6288 1889
Email: lily.kang@kpmg.com

Lily Kang is a tax partner based in Shanghai. She focuses on assisting multinational corporations and private equity funds with China inbound tax planning and due diligence support for structuring their investments into China. Having worked in KPMG's North America office for more than eight years, Lily also has extensive experience in international tax planning. She has helped many Chinese domestic clients in expanding their operations overseas.

Lily holds a master of taxation degree and is a Washington State licensed certified public accountant.

by setting out these indicators, which, among others, will need to be demonstrated by the transaction parties when seeking the tax relief:

- Potential changes in tax positions of the restructuring parties; and
- Any abnormal economic benefits or potential obligations arising to any restructuring parties which would not have otherwise arisen under ordinary market conditions.

However, in practice, we note that the PRC tax authorities have generally taken a rather restrictive interpretation and have therefore often asserted that a restructuring transaction should not be regarded as having reasonable commercial purposes if the restructuring happens to lead to a reduction in the PRC dividend WHT rate (from the general WHT rate of 10% to the reduced tax treaty relief rate of 5%) after the corporate restructuring for ongoing dividends distributed by the PRC resident enterprise to its offshore shareholder(s). This would typically apply to corporate restructuring transactions where the PRC resident enterprise is transferred from a tax neutral jurisdiction (say, the Cayman Islands or British Virgin Islands) to an offshore holding company located in a jurisdiction which has a favourable tax treaty with China (for example, Hong Kong or Singapore).

In reaching this conclusion, many local tax authorities have simply taken the view that a group restructuring transaction that interposes a tax treaty holding company would be regarded as being primarily driven for the purposes of reducing future dividend WHT, and thus should be considered as lacking reasonable business purposes and cannot enjoy the special tax treatment provided under Circular 59. This appears to contradict the criteria imposed in Circular 59 that only a reduction in capital gains withholding tax would be relevant for denying the special tax relief on corporate restructuring.

It also appears that the PRC tax authorities pays no attention to the many non-tax reasons for carrying out a restructuring transaction, such as to reorganise the sub-group to be held by a regional headquarter (for example, in Hong Kong or Singapore) to better align the management reporting structure or to transfer a target group to a suitably held structure for offshore acquisition by the foreign investors. The reduction in dividend WHT could be considered incidental but should not be the "primary purpose" of the restructure.

In this respect, based on our recent meeting and discussion with the SAT on the issues and uncertainties arising from Circular 59, we understand the SAT is also of the view that the mere fact that the dividend WHT rate would be reduced after a corporate restructuring transaction should not by itself cause the transaction to be considered to be lacking "reasonable business purposes" and thus, should not result in the special tax treatment being denied for the corporate restructuring. That said, the SAT emphasised that in a situation where the PRC resident enterprise has a large amount of undistributed profits pre-restructuring, the restructuring parties would not be entitled to enjoy the special tax treatment unless the new offshore shareholder(s) provide a written representation/undertaking to the PRC tax authorities that they agree to forfeit its/their entitlement to enjoy tax treaty relief (that is, a reduction in dividend WHT) for the undistributed profits pre-restructuring. While this may not be the best solution, this at least provides a middle ground for companies to conduct group restructuring transactions without the need to crystallise built-in tax liabilities at that point that the corporate restructure takes place.

To eliminate inconsistent views taken by local tax authorities, it is hoped that the SAT will issue another supplemental circular to clarify this position. However, at this stage, it is unlikely that it will and taxpayers will have to continue to face the challenge of dealing with local tax authorities who are taking different views from the SAT.

Biography

Eileen Sun
Tax Partner in Charge of Southern China

KPMG China
9th Floor, China Resources Building
5001 Shennan East Road
Shenzhen 518001, China
Tel: +86 755 2547 1188
Fax: +86 755 8266 8930
Email: eileen.gh.sun@kpmg.com

Eileen Sun has the advantage of having worked at the Chinese Tax Bureau as well as in international accountancy firms. She is a respected specialist in value added tax, transfer pricing, tax audit and customs practices.

Eileen has been providing China tax consultancy services in Hong Kong and Shenzhen to foreign investors for more than 10 years. Before this, she worked in the UK for a chartered accountancy firm.

Transfer pricing challenges to corporate restructuring

Apart from the challenge of getting the special tax relief noted above, corporate restructuring transactions are also subject to greater scrutiny by PRC tax authorities from a transfer pricing perspective. Under PRC tax laws, if a corporate restructuring transaction is considered a related-party transaction for PRC transfer pricing purposes, it has to be conducted on an arm's-length basis. Otherwise, the transaction value could be adjusted for tax purposes.

It is evident from recent enforcement cases that the PRC tax authorities will no longer accept group or corporate restructuring transactions to be conducted at cost or net book value (NBV), except where the transaction satisfies the special tax relief conditions under Circular 59 as noted above. The PRC tax authorities have the power to adjust transaction prices where the transaction is conducted between related parties and the transfer consideration is not determined in accordance with the arm's-length principle, resulting in a loss of or reduction in tax revenue for the PRC tax authorities.

In increasing numbers of enforcement cases in recent years the PRC tax authorities have begun to challenge the transaction price of corporate restructuring which is not determined in accordance with the arm's-length principle, for example, where the transaction price is at cost or NBV and the transaction is adjusted based on the fair market value (FMV) for the purposes of calculating the PRC capital gains tax for the transferors.

To enforce the transfer pricing rules, many PRC tax authorities now tend to require a valuation report to be submitted by the transaction parties to substantiate that the consideration represents the arm's-length pricing for equity and asset transfers. Such a valuation report would typically need to be prepared by an independent third-party qualified PRC valuation firm, although the form of valuation report and qualification of the local valuation firm is subject to local variation. A qualified valuation firm refers to a valuation firm which has obtained the Certificate of Asset Valuation Qualification and hence is recognised by the PRC government and tax authorities.

That said, the transfer pricing risk of corporate restructuring needs to be carefully managed, particularly where the corporate restructure takes place close to, or immediately before, an external party's acquisition of the equity stake in the post-restructure group where the valuation gap will need to be clearly explained to avoid any transfer pricing adjustments.

Looking ahead

Given the challenges noted above, it is hoped that the SAT will introduce more flexible business friendly and clear guidance on how the reasonable business purpose should be interpreted for the provision of special tax treatment for corporate restructure transactions and that further relief will be brought to existing tax laws to address the challenges facing many legitimate corporate restructuring transactions which otherwise are unable to attain special tax treatment in the PRC.

Yvette Chan of KPMG China also contributed to this article.

Private equity – exit challenges

In tandem with the rapid increase in private equity (PE) activities in China over recent years, Chinese tax authorities have taken seemingly aggressive steps to protect its tax base. John Gu, Paul Ma and Henry Wong of KPMG China consider the tax challenges that will or will continue to be faced by PE investors especially and advise on measures to mitigate those exposures.

China remains as one of the Asia Pacific region's premier destinations for PE investments and fund raising in the first half of 2013. China funds drew 38% of capital allocated to, and 28% of the investments made in, the region in the first half of 2013, similar to the second half of 2012 (see diagrams 1 and 2).

While PE activities in China have grown steadily over recent years, Chinese tax authorities have correspondingly taken steps to protect its tax base and are sometimes perceived to have widened their tax net through increasingly sophisticated approaches on general anti-avoidance rules (GAAR) enforcement, including the use of the infamous Circular 698 to target, among other things, the offshore indirect disposal by PE investors of Chinese portfolio companies.

Along with the domestic approach, China has also actively participated in global efforts to clamp down on tax abuses. With the official accession to the OECD-led Multilateral Convention on Mutual Administrative Assistance in Tax Matters in August 2013, which enables the signatories to automatically and spontaneously exchange information, the Chinese government has another mechanism to combat any perceived aggressive tax planning and evasion.

Though Chinese tax authorities are moving to enforce stricter and more sophisticated GAAR measures, PE investments and structures are expected to continue, if subject to close scrutiny. There are some key tax challenges facing PE investors on managing exits from their investments in China.

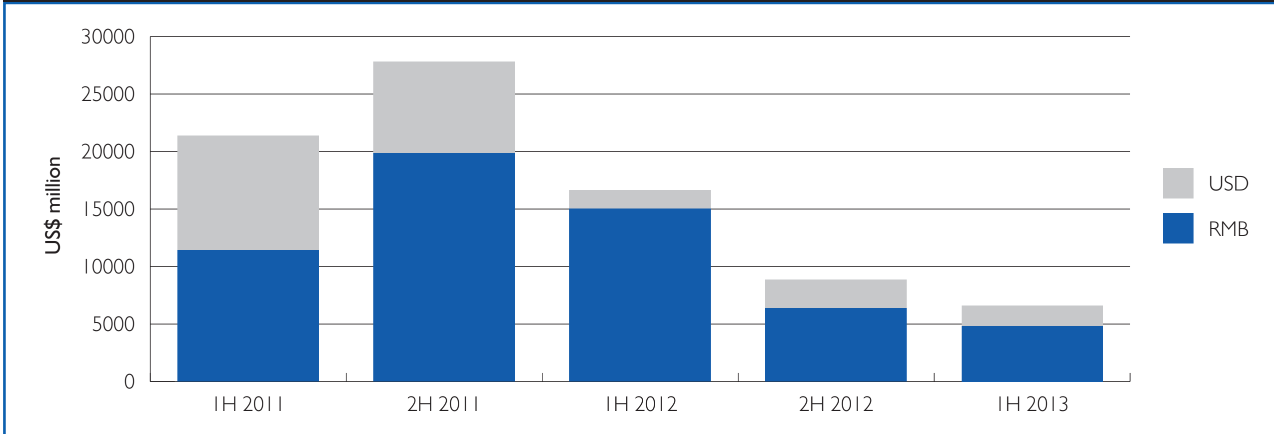
Tax challenges under the stretching arms of GAAR and potential further development on Circular 698

Since its introduction in 2009, the potential Chinese tax risk of *Guoshuihan* [2009] No 698 (Circular 698) has quickly become a major Achilles heel for foreign PE investors when structuring, holding and exiting their Chinese investments, particularly via the use of offshore special purpose vehicles (SPVs).

To recap, the State Administration of Taxation (SAT) released the circular in December 2009 as part of its effort to ramp up the enforcement effort under the GAAR in the corporate income tax (CIT) law. Circular 698 imposes a reporting requirement on offshore transferors to report and submit specific information/documents to Chinese tax authorities on offshore equity transfer transactions involving an indirect transfer of the underlying Chinese entities.

Under the circular, where an offshore indirect transfer is viewed by the SAT as lacking reasonable business purposes and constitutes an "abuse of organisational form", the SAT may invoke the GAAR to re-characterise the transaction as a direct sale of the equity interests in the Chinese companies, thereby enabling them to impose a 10% CIT on the gains assessed.

Diagram 1



As PE investors typically raise offshore funds to hold their investments in China through either single or multiple tiers of offshore SPVs and exit their investments by selling one of the SPVs at the offshore level, the enforcement of Circular 698 by Chinese tax authorities has resulted in serious ramifications regarding the investment structure and exit planning for PE investors.

In practice, the most challenging aspect of dealing with Circular 698 for PE investors remains the way in which Chinese tax authorities apply the "reasonable business" test in assessing whether the GAAR should be triggered. From the various published Circular 698 enforcement cases involving well-known PE investors and listed companies where millions of taxes were being collected, it is evident that when assessing the case, Chinese tax authorities are focusing predominantly on the economic substance level of the offshore SPV structure set up to hold the Chinese investments in determining whether the said structure has reasonable business purposes. They tend to ignore other commercial reasons such as the need to use offshore tax neutral SPVs to ring-fence liability, to introduce co-investors and financing as well as other commercial purposes. This approach was considered unfair and unreasonable to PE investors.

The critical criteria which Chinese tax authorities look at typically include the number of employees, the physical business premises, the scale of operation, the amount of business assets and the level of capitalisation of the offshore SPVs. These assessment criteria and angle do not help PE investors as they typically do not require a substantive operational presence in the offshore SPVs, their business models and investment holding structures.

During 2012-2013, industry and market intelligence suggest that the SAT may issue further guidelines on Circular 698 in the form of supplementary rules. The key scope of the draft supplementary rules under the SAT's consideration was widely believed to include:

- A certain form of relief on Circular 698 reporting and tax imposition for qualifying internal restructuring;
- Specific rules on tax cost base adjustment for purchasers in the event of non-conformity with Circular 698 reporting by the vendor; and
- A deeming provision for the assessment of reasonable business purposes.

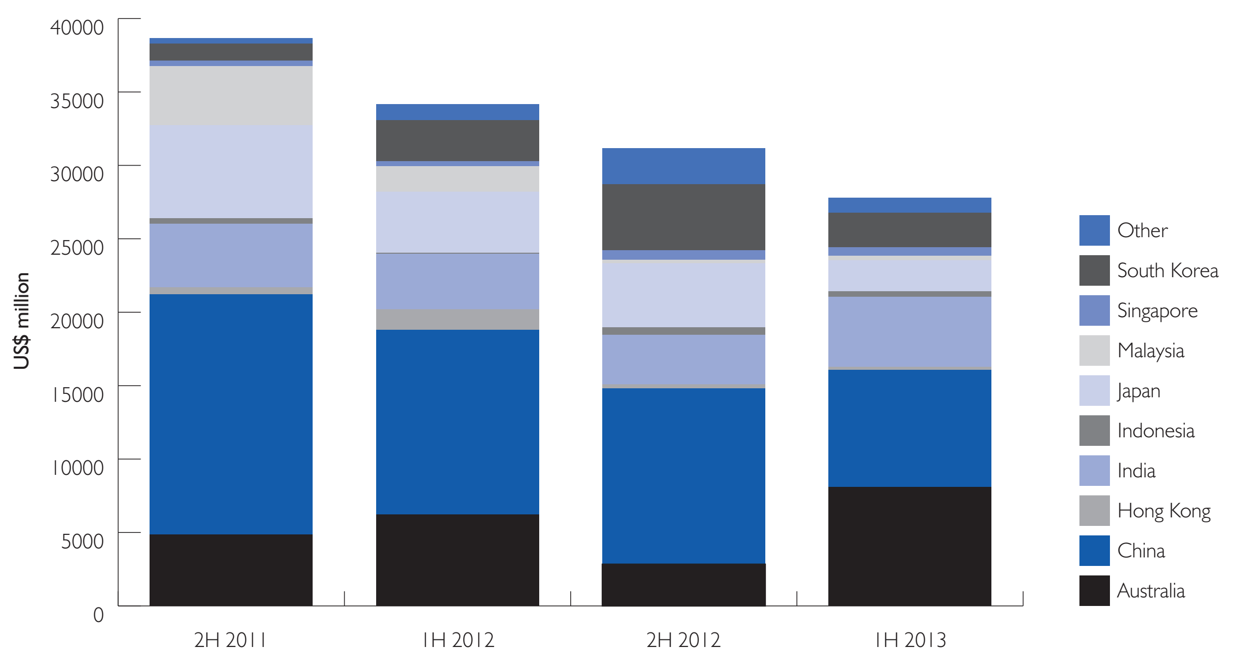
Private equity investors and the wider investment industry would welcome any Circular 698 relief on qualifying indirect transfer transactions which form part of an internal group restructuring, as it would remove a layer of uncertainty for portfolio company group reorganisations to achieve business strategy alignment.

As for the potential tax cost base adjustment mechanism, which the SAT is widely believed to be considering, the purchaser may run the risk that Chinese tax authorities revise down its Chinese tax cost base of the shares of the offshore SPV acquired so that the Chinese tax unpaid by the vendor in the transfer under Circular 698 can be recouped from the purchaser when the purchaser disposes of the shares in the future.

To mitigate the risk of the potential loss of tax basis from this proposal, it is evident that PE purchasers are increasingly forcing and requiring the fulfilment of Circular 698 reporting and settlement of any resulting Chinese taxes by the vendor as a condition precedent during deal negotiation for transactions involving offshore SPV structures. This has also become the main risk that PE investors need to manage on their exits from investments in China.

The proposed draft supplementary rules for Circular 698 moves one step further to enable PRC tax authorities to tax certain specific offshore transactions by deeming them as lacking reasonable business purposes. This is operated by the introduction of a deeming provision for the assessment of reasonable business purposes. In this regard, it is understood that if any of these conditions is present in an offshore indirect transfer transaction, Chinese tax authorities may be entitled

Diagram 2



to deem such transactions as lacking reasonable business purposes and may invoke the GAAR to impose the 10% CIT on the gains:

- The offshore SPV being transferred has no substantive operating activities;
- The transfer consideration is primarily based on either the valuation of the underlying Chinese entities or the immovable properties situated in China; and
- The relevant equity transfer document or the public announcement released by the purchaser discloses that the actual target of the equity transfer transaction is to acquire the underlying Chinese entities or the immovable properties situated in China.

If officially released in this form, the draft deeming provision could adversely affect the exits of offshore real estate funds targeting Chinese real estate investments as such offshore transactions would nevertheless be treated as a direct disposal of PRC assets and 10% PRC withholding tax would be applied on the gains realised on the indirect disposal by offshore PE funds. Perhaps more importantly, it may be considered necessary for PE investors to factor in the potential 10% CIT in their valuation modelling when assessing the investment returns from such real estate transactions.

It is important to note that as of the date of this article, the draft supplementary rules for Circular 698 have not been officially released and there is no clear guidance on status of their release. It is understood that the SAT is considering the draft supplementary rules for Circular 698 in conjunction with other GAAR rules on a collective basis.

Enforcement

When selecting cases for enforcement, another trend that emerged from the published Circular 698 enforcement cases appears to indicate that Chinese tax authorities are becoming very adept to and resourceful in tracking down offshore indirect transfers of Chinese entities by PE investors and MNCs, in particular listed companies, through various online sources such as public announcements.

Hence, PE investors should pay greater attention to their exits from public companies as such transactions are more likely to be tracked and selected for Circular 698 enforcement.

Tax challenges under the stepping up of GAAR enforcement based on deemed tax resident enterprise (TRE)

In our article last year, we stated that Chinese tax risks may exist for foreign investors including PE investors for the disposal of shares in foreign incorporated companies in the absence of Circular 698.

This is evident in a 2010 case involving Vodafone's disposal of China Mobile, which was a Hong Kong (HK) incorporated company, but was treated as a Chinese TRE because its place of effective management was in China. The gains derived by Vodafone from the share disposal were deemed to be China-sourced income due to the TRE status of China Mobile, and as a result, were subject to Chinese CIT.

Under the prevailing CIT regulations, a foreign incorporated entity could be deemed to be a Chinese TRE if its place of effective management and control is located in China. In assessing the TRE, Chinese tax authorities typically examine factors such as the location where the day-to-day operation, production, financing and human resource decisions are made, the location of the board meetings, whether a majority of the board directors or key personnel of the entity are ordinarily reside in China, and whether the books and records and corporate seal are kept in China.

Recently, another high profile case was reported: Chinese CIT was assessed against a US PE investor based on a deemed Chinese TRE status of the foreign incorporated publicly listed company whose shares were being transferred, after a Circular 698 reporting by the vendor of the transaction.

In the case concerned, the shares of a HK publicly listed company's investment holding company (incorporated in the Cayman Islands), which held multiple Chinese entities, were transferred to a US publicly listed company under a take-private transaction. The Cayman Islands-incorporated vendor, which was controlled by a US PE fund, duly made a Circular 698 reporting. It was reported that the vendor filed the case with the PRC tax authorities under the circular and then had sought to argue that no Chinese CIT should be assessed under it on the transaction as the company whose shares were being transferred had business substance and the holding structure had reasonable business purpose due to its public listing status.

It was reported that the filed case received great interest from PRC tax authorities; while they gave due consideration to the argument regarding the public listing status of the company being transferred and acknowledged the difficulties in looking through the public listed company structure by asserting its lack of economic substance under Circular 698, Chinese tax authorities had still dug deeper to explore from all possible GAAR angles. This eventually led to a shift of focus of the Chinese tax authorities from "abuse of organisation form" under Circular 698 to investigating the TRE status of the HK publicly listed company whose shares were transferred.

Through the various publicly available financial documents, including the IPO prospectus, stock exchange announcements and audited accounts, and information requested from the seller, Chinese tax authorities concluded that senior executives and the management team located in China exercised the effective management of the HK publicly listed company and the same executives and management team also exerted effective management control on the group's Chinese operations.

Consequently, the HK publicly listed company was deemed to be a Chinese TRE and the seller was assessed with a 10% CIT on the gains derived, which was deemed to be Chinese-sourced income under PRC GAARs. While the conclusion appears to be clear, it is unclear whether the SAT has approved the TRE status of the HK listed company given the TRE status of the offshore company requires SAT approval and also requires a registration in the PRC under the law. It is also unclear whether the enforcement has also implicated other offshore investors in the HK listed company or whether the case simply represents a selective enforcement of the rules against one particular investor in that case.

The case highlighted the risk of the willingness and relentlessness of Chinese tax authorities in their continued efforts to protect the perceived erosion of the country's tax base or tax net by foreign investors using offshore SPVs. This can be effectively done by PRC tax authorities through taking countered actions in applying various GAAR measures and enforcement angles, other than solely relying on Circular 698.

The rules regarding Chinese TRE (including in the CIT law, its detailed implementation rules and various tax circulars) have been well publicised, so it should not be a surprise if Chinese tax authorities continue to scrutinise the place of effective management of overseas entities, including those offshore listed companies with substantial Chinese operations during GAAR enforcement, particularly in relation to public exits where the PE industry has a long understanding that a look-through should not apply to a publicly listed Chinese-controlled offshore company under Circular 698.

Whether attacking the TRE risk or not (as noted above) will become a future trend is unknown, but it reinforces the need

Biography

John Gu
Tax Partner

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: + 86 10 8508 7095
Fax: + 86 10 8518 5111
Email: john.gu@kpmg.com

John Gu is a partner and tax leader for inbound M&A and private equity for KPMG China. He is based in Beijing and leads the national tax practice serving private equity clients. John focuses on regulatory and tax structuring of inbound M&A transactions and foreign direct investments in the PRC. He has assisted many offshore funds and RMB fund formations in the PRC and has advised on tax issues concerning a wide range of inbound M&A transactions in the PRC in the areas of real estate, infrastructure, sales and distribution, manufacturing, and financial services.

John has bachelor of business and master of finance degrees. He is also a member of the Institute of Chartered Accountants in Australia and a member of the Hong Kong Institute of Certified Public Accountants.

for PE investors to ensure that the offshore structure adopted, not only by the PE funds, but also by the portfolio company, to hold the Chinese investments are considered and executed properly. This includes ensuring that the place of effective management of the key offshore entities are located outside China, so as not to fall within the Chinese tax net inadvertently, or leave room for PRC tax authorities to challenge.

Uncertainties surrounding the imposition of business tax (BT) on disposal of A-shares acquired pre-listing

Another common way through which foreign PE funds invest in China is to become a strategic or financial investor of a promising Chinese entity before its domestic listing in the A-shares market. The pre-listing equities acquired in the Chinese entity by foreign PE funds are typically non-tradeable. Upon the listing of the Chinese entity and the end of the lock-up period, the pre-listing equities would be converted into publicly tradeable shares through which an exit could be executed on the relevant domestic stock exchange.

From a Chinese tax perspective, it is clear that the disposal of A-shares held by foreign investors (for example, including foreign PE funds) would attract a CIT of 10% on gains (as a China-sourced income).

The relevant BT position on such A-share exits, however, has remained unclear and in dispute between the taxpayer and tax authorities over the years. The uncertainties are primarily due to a lack of clear rules to govern, in particular, whether the disposal of A-shares which were originally acquired as pre-listing non-tradeable equity, and which were subsequently converted to publicly tradeable shares, would fall within the scope of "trading of financial products", which is taxable under the updated BT Law effective from January 1 2009 for all taxpayers (including all domestic or foreign financial and non-financial institutions). Before January 1 2009, the old BT Law only imposed BT on financial institutions (not other taxpayers) for gains from the trading in financial products. Given the risk profile of the pre-IPO equity investment, an alternative view was that the disposal of A-shares acquired by PE and other investors as pre-listing non-public tradeable equity should be treated as an equity transfer transaction, which is specifically exempted from BT under a tax circular issued by the SAT in 2002 (*Caishui* [2002] No 91). Even if BT was determined to be imposed on the gains from such transactions, it is considered necessary that an allowance should be given to exclude the gain attributable to the holding the shares as equity interest before the company goes to an IPO and becomes publicly listed.

The lack of clear guidance from the SAT on the same issue, and the absence of previous BT enforcement precedence regarding similar disposals by Chinese tax authorities did not help defuse the long outstanding uncertainties regarding the BT position on post-IPO sales or exits of pre-IPO investment in A-shares.

Biography

Paul Ma
Tax Partner

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: +86 10 8508 7076
Fax: + 86 10 8518 5111
Email: paul.ma@kpmg.com

Paul Ma is a M&A tax partner in KPMG China's Beijing office. His focus areas include advising on tax structuring issues in complex M&A transactions including cross-border and domestic acquisitions and divestments; corporate restructuring; take-private transactions and PIPE [Private Investment Public Entity] transactions; performing tax due diligence on a wide range of industries including real estate, telecommunications, energy and resources, consumer markets, e-commerce and financial services; advising on onshore and offshore fund structuring and formation and representing institutions' limited partners in general partner due diligence.

Paul previously worked at Morgan Stanley in both New York and Hong Kong as an in-house tax counsel. He also worked at Ernst & Young New York as a US tax specialist.

Paul has a masters of accounting degree from the University of North Carolina at Chapel Hill, a masters in economics degree from Kent State University and a bachelor in economics degree from Nankai University. He is a member of the American Institute of Certified Public Accountants (AICPA).

In early 2013, a report of a BT enforcement case in Liuzhou (in Guangxi Province) was made public, signalling that Chinese tax authorities may start collecting BT on the sales of A-shares acquired as pre-listing non-tradeable equity.

In this case, a Chinese listed non-financial institution acquired the A-shares concerned as non-tradeable equities in 1999, as one of the pre-listing founders of a prominent domestic securities company. Upon the domestic listing of the Chinese investee entity, the equities acquired were converted into fully tradeable A-shares. The taxpayer subsequently disposed of the A-shares in tranches between 2009 and 2011, realising a significant amount of gains. No BT was assessed at the time of the disposals by the local in-charge tax bureau.

The public announcement released by the taxpayer after an inspection conducted by the SAT in 2012 stated that the local in-charge tax bureau was instructed to collect the BT (along with the applicable local surcharges) from the taxpayer arising from the previous disposal of the A-shares. Despite an appeal from the taxpayer, the amounts were settled in early 2013.

Biography

Henry Wong
Tax Director

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3380
Fax: +86 21 6288 1889
Email: henry.wong@kpmg.com

Henry Wong is a tax director based in Shanghai with KPMG China with more than 12 years of tax advisory experience in the financial services and M&A sectors. He focuses on serving clients across different industries on direct and indirect tax advisory projects, due diligence work, M&A advisory, cross-border tax compliance and tax planning. His involvement in the investment fund advisory sector includes all phases of the fund lifecycle, such as onshore and offshore fund formation and structuring advisory, profit repatriation planning, investment entry and exit planning, executives/employees compensation/incentive planning and carried-interest structure planning as well as helping clients address specific partnership taxation issues.

Before joining KPMG China, he worked with KPMG Canada in Toronto, specialising in serving financial institutions and investment fund clients on international and Canadian tax matters.

Henry has bachelor of mathematics and masters of accounting degrees from the University of Waterloo in Canada. He is a Canadian chartered accountant, US certified public accountant (Illinois State Board of Accountancy) and chartered financial analyst.

This case understandably provoked strong interest from investors including foreign PE funds, as the imposition of BT on A-shares acquired pre-listing as non-tradeable equity would adversely affect the expected return on investment, particularly on the expected exit gains. As we understand, it is not common that the investment valuation would have factored in the BT cost, principally because the long-standing position was that BT was not applicable on an equity transfer or the trading of financial products by non-financial institutions (including PE funds) before 2009.

To date, PE investors continue to be frustrated that there has been no further guidance from the SAT regarding the relevant BT position on post-IPO exits of pre-IPO investments. In practice, the BT enforcement on similar A-shares disposal cases appears to be inconsistent across the nation with BT enforcement cases reported from locations such as Fujian province, Liuzhou, Shenzhen, Tianjin and Nanjing while the local tax authorities in Beijing and Ningbo appear to have not imposed the BT on such transactions, pending official guidance from the SAT.

Even if BT were to be imposed on similar A-shares disposals going forward, it remains unclear what the calculation basis should be to arrive at the net gains amount for BT imposition. In particular, what cost base should be used?

In the Liuzhou case, it was reported that the SAT initially calculated the net gains based on the original acquisition cost of the founders' shares. However, the final BT liabilities were reportedly assessed based on the difference between the final selling price and the closing price of the A-shares on the first day after the non-tradeable equities were converted to fully tradeable. It remains to be seen whether the basis adopted under this case represents the standard for cost base determination for future cases.

It is also unclear how the VAT reforms, which are expected to replace the BT regime for the financial services sector, would interplay and affect this issue.

After the BT case in Liuzhou, it is notable that many local tax authorities have been encouraged by this case and have stepped up their efforts in collecting BT against public exits made by PE investors including both onshore and offshore funds. In many cases, except for Tianjin and Xiamen, due to the lack of specific guidance from the SAT, local tax authorities tend to apply the BT on the gains computed on the gross sale proceeds less the original costs of the investment by not allowing the deduction for the IPO price offered to public investors.

Given the inconsistent treatment adopted across different locations, it is hoped that the SAT will soon provide more clarity on the BT position on such post-IPO exits of pre-IPO investments and the tax cost determination basis for such transactions (and in due course, the VAT position under the VAT reform going forward). Meanwhile, PE investors holding the A-shares acquired pre-listing or planning to become the strategic investor of a Chinese entity through the same investment form, should factor in the relevant potential BT liabilities on future exits.

Looking ahead

With the continued policy push by the Chinese government to boost domestic spending through urbanisation and to drive economic growth, the changing economic landscape in China is expected to continue to offer foreign PE investors many good investment opportunities.

When it comes to managing tax leakages on China investments, PE investors should be mentally prepared that the PRC tax authorities would not be shy to apply the GAAR and other sophisticated approaches or measures to protect its tax net, as illustrated in recent enforcement cases.

Private equity investors should keep a keen eye on tax developments and enforcement practices in China. They will need to navigate carefully within the uncertain tax environment to achieve the expected return on investments on their Chinese investments.

Melvin Ng of KPMG China also contributed to this article.

From Qianhai to Shanghai – resurgence of regional incentives?

Preferential tax incentives specific to certain areas were supposed to be things of the past after the 2008 corporate income tax (CIT) reform. However, the recent launch of the Qianhai Cooperation Zone and the Shanghai Pilot Free Trade Zone (PFTZ), suggests otherwise.

Karmen Yeung and Chris Mak of KPMG China examine the implications for foreign investors.

Qianhai Cooperation Zone

The Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone (Qianhai Cooperation Zone) is a 15 square kilometre area located in western Shenzhen, on the east coast of the Pearl River Delta adjacent to Hong Kong and Macau. Plans for Qianhai's development envision four modern service industries: finance, modern logistics, information services and science and technology services, along with other professional services sectors.

The key milestones of the development of Qianhai Cooperation Zone are:

Table 1

August 26 2010	The State Council approved "The Overall Development Plan for the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone".
June 27 2012	The State Council approved the preferential policies to facilitate the development of Qianhai Cooperation Zone (*Guohan* 2012 No 58).
March 6 2013	The National Development and Reform Commission issued the Permitted Industry Catalogue for Qianhai Cooperation Zone (*Fagaichanye* 2013 No 468).

Qianhai development policies

The circular, *Guohan* No 58, grants pilot development policies to Qianhai Cooperation Zone that are more preferential than those applied to Shenzhen Special Economic Zone in the financial, legal services, human resources, education, medical and telecommunications sectors. The key preferential pilot policies available at Qianhai Cooperation Zone are shown on Table 2.

Financial and taxation policies of Qianhai

Guohan No 58 emphasises that under the prevailing national tax reform framework, Qianhai will play a pilot role in the exploration of tax reform in the modern service industry. Key preferential tax incentives will include:

- A reduced CIT rate of 15% for qualified companies newly incorporated in Qianhai. Qualified companies must fall within the scope of the Permitted Industry Catalogue and Preferential Catalogue for Qianhai. The Permitted Industry Catalogue was issued in March 2013 and will be discussed in the following section, while the Preferential Catalogue is yet to be released.
- The excess of China individual income tax (IIT) over the personal income tax on employment income in an individual's home jurisdiction will be subsidised for highly skilled individuals or those whose skills are in shortage in Qianhai. The subsidies will be exempt from China IIT. The detailed criteria and implementation

Table 2

Development area	Policies
Financial sector	• Encouragement for Hong Kong-based banking institutions to grant RMB loans for enterprises and projects in Qianhai. • Support for enterprises and financial institutions registered in Qianhai for the issuance in Hong Kong of RMB bonds designed for the construction and development of Qianhai. • Promotion of the establishment of an equity investment parent fund in Qianhai.
Legal services	• Potential establishment of Qianhai branches by Hong Kong arbitration institutions. • Potential joint operation of law firms in Mainland China and Hong Kong.
Human resources	• Permission for Hong Kong professionals to practise in Qianhai • Permission for Hong Kong professionals with qualifications from the Chinese Institute of Certified Public Accountants (CICPA) to become partners of accounting firms in Mainland China, using Qianhai as a pilot district.
Education and medical sector	• Permission for qualified Hong Kong service providers to establish wholly-owned international schools or hospitals in Qianhai.
Telecommunications sector	• Promotion of the establishment of joint ventures between Hong Kong/Macau telecommunications operators and mainland operators in Qianhai. • Support for local telecommunications operators in offering preferential telecommunication tariff schemes.

rules remain to be clarified. One possibility is that the excess IIT will be subsidised by the Shenzhen municipal government in a levy first, refund later fashion.

- Exemption of business tax (BT) for revenue derived from international transportation insurance services provided to companies registered in Qianhai by insurers registered in Shenzhen.

Other tax incentives include:

- BT on a net basis will be available to qualified modern logistics enterprises registered in Qianhai, as with the prevailing national preferential policy for pilot logistics enterprises. However due to the value added tax (VAT) reforms pilot scheme in China, logistics enterprises have been subject to VAT instead of BT from August 1 2013 and the BT net basis incentive becomes irrelevant.
- Revenues derived from offshore outsourcing services by enterprises registered in Qianhai will be exempt from BT.
- Qualified advanced technology enterprises will enjoy a reduced CIT rate of 15% and its employee education expenses will be deductible up to 8% of total salaries in calculating the taxable income for CIT purposes.

Permitted Industry Catalogue

On March 6 2013, the National Development and Reform Commission (NDRC) issued the Permitted Industry Catalogue for Qianhai Cooperation Zone.

The six industrial sectors listed in the Permitted Industry Catalogue are an extension of the four key focus areas which were previously announced – financial services, modern logistics, information services and other professional services – in the State Council's consent on the Overall Development Plan for Qianhai Cooperation Zone in 2010.

The release of the Permitted Industry Catalogue is a clear message from the Chinese Central Government about its commitment to encouraging further development and opening up in Qianhai. It provides important guidance regarding the direction of investment, the administration of investment projects and the implementation of preferential policies in relation to tax and finance.

The Permitted Industry Catalogue and the Preferential Catalogue are two crucial elements contained in the announcement of the preferential policies for Qianhai Cooperation Zone (*Guohan* [2012] No 58) and form part of the preferential policies for Qianhai. The promulgation of the Permitted Industry Catalogue also indicates that the Preferential Catalogue will probably be finalised soon.

The Permitted Industry Catalogue covers six industry sectors: financial services, modern logistics, information services, technology services, professional services as well as public services. It covers a total of 112 industrial segments:

- The financial services sector contains 23 segments including banking, financial institutions, non-banking financial institutions, securities, insurance, funds, production exchange markets, financial leases, financing guarantees, offshore financial services and other innovative financial services.
- The modern logistics sector contains 18 segments including supply chain management, shipping transactions, freight brokerage and consultation services, logistics distribution and express delivery services for e-commerce, aircraft and repair parts transaction services, bonded logistics services (for example, bonded exhibitions and bonded transactions) and other e-commerce related commercial services.
- The information services sector covers 16 segments including basic telecommunications services, value added telecommunications services, electronic

authentication services, e-commerce, digital content services, development and application of internet digital content, technology and the application of high trustworthy computing, intelligent networks, the internet and mobile internet.
- The technology services sector includes seven segments covering domestic and overseas research institutions and their branches, international institutions of technological innovation, scientific research services, technological consultation services, transformation and application services of scientific and technological achievements, quality certification, testing and inspection services, information technology outsourcing, business process outsourcing and knowledge process outsourcing.
- The professional services sector contains 39 specific services under nine segments: accounting, valuation, legal services, consultation services, engineering services, cultural and creative services, exhibition, educational and medical services and intellectual property services.
- The public services sector includes urban public support facilities, technological development and application of environmental protection, resource recycling and energy-saving, leisure services including yachts and aviation, social work services, high-end property management and leasing services.

Other preferential and supportive policies for Qianhai

Since November 2012, the government and regulatory authorities have continually issued regulations to support foreign-invested equity investment enterprises and IIT preferential policies for overseas talent and professionals in short supply in Qianhai. These policies aim to encourage and support modern financial services providers and talent to settle in Qianhai.

Looking ahead for Qianhai Cooperation Zone

It is reported that Qianhai Cooperation Zone will be developed in units, with 22 development units being planned initially. Although the construction and developments of the entire zone may take several years to complete, enterprises which are interested in investing should pay close attention to its progress and approach the Qianhai Administrative Bureau as early as possible.

As we have learned from the Qianhai Administrative Bureau, which is the statutory department performing administrative activities and public services in Qianhai, the approval and registration of enterprises in Qianhai has already commenced, although certain implementation rules for Qianhai is still in process. Many companies have already been registered in Qianhai and are operating on a trial basis.

Preferential policies in Qianhai are aimed at attracting new and incremental investments to the area, rather than mere relocation of existing enterprises, especially companies incorporated in other districts of Shenzhen. For example, the relocation of a logistics company from Luohu District, Shenzhen, to Qianhai may not qualify for CIT incentives. But if the company retains its operation in Luohu District and subsequently establishes another qualified project in Qianhai, it may enjoy CIT incentives for the Qianhai part.

The release and implementation of the Permitted Industry Catalogue provides a positive message that the launch of the Qianhai pilot programme will be accelerated. It also indicates that the regulatory authorities of the central government will continue to speed up the process of policy approval and release.

Circular, *Guohan* [2013] No 58, under the national tax reform states that the government encourages and supports Qianhai to explore and gain more experience with tax system reforms for the modern services industry. It states that qualified enterprises are eligible to enjoy a reduced CIT rate of 15% if they meet the requirements contained in the Permitted Industry Catalogue and Preferential Catalogue. The Preferential Catalogue, which is yet to be released, will provide a better understanding of when enterprises are eligible to enjoy a reduced CIT rate.

In addition, the details as to how the 15% CIT will be collected from the qualified enterprises is another uncertainty that needs to be addressed by the government.

When establishing an enterprise in Qianhai, foreign investors must also comply with the restrictions set out in the Foreign Investment Industries Catalogue. Examples of such sectors include basic telecommunication services and value added telecommunication services as listed in the

Biography

Karmen Yeung
Tax Partner

KPMG China
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
Tel: +852 2143 8753
Fax: +852 2845 2588
Email: karmen.yeung@kpmg.com

Karmen Yeung has extensive experience providing PRC corporate and individual tax advisory advice to foreign investment enterprises in the PRC. She has advised multinational corporations on their investment structures in China and on establishing tax efficient supply chain models, particularly relating to sourcing, manufacturing, distribution and retailing in China from the corporate income tax, transfer pricing, value added tax and customs duty perspectives.

permitted industry section in the Foreign Investment Industries Catalogue.

For high-end property management services under the public services sector, clarification will also be required as to whether there are requirements or restrictions on the location of the property and whether the property assets must be located within the Qianhai area or if the applicable scope can be extended outside Qianhai. The definition of high-end property and other related issues is also yet to be clarified.

Although some of the implementation details and specific requirements are not yet entirely clear, there are indications that the government and authorities are working towards issuing specific regulations and clarification of the policy details soon.

Shanghai Pilot Free Trade Zone

The Shanghai PFTZ consists of four areas that are under the special supervision of the Chinese Customs authority:

- The Waigaoqiao Free Trade Zone;
- The Waigaoqiao Bonded Logistics Park;
- The Yangshan Bonded Port; and
- The Shanghai Pudong Airport Comprehensive Bonded Zone.

The development of the Shanghai FTZ has proceeded at a breathtaking pace, as can be seen from this timeline:

Table 3

July 3 2013	The State Council passed Overall Plan for the Shanghai PFTZ.
August 22 2013	The State Council approved the establishment of the Shanghai PFTZ.
August 30 2013	The Standing Committee of the National People's Congress released resolution in relation to the Shanghai PFTZ.
September 27 2013	The State Council released the Circular on Overall Plan for the Shanghai PFTZ.
September 29 2013	Shanghai PFTZ was officially launched.

The framework as set out in the Overall Plan for the Shanghai PFTZ is:

Main goals and measures

1. Accelerating transformation of government functions

- To reform the current government management system and build up an administrative management mechanism in line with the international standards on investments and trades.
- To shift from current prior approval mechanisms to post-event supervision mechanisms, and build up efficient government service operations.
- To increase and improve government administration transparency and information disclosure mechanisms to meet international standards.

2. Opening up new investment opportunities

- To further expand certain industries for investments including financial services, shipping services, commercial trading services, professional services, cultural services and other social services.
- To suspend or eliminate restrictions on investments in certain areas in terms of the qualification requirements, equity holding limits, business scope constraints and other access restrictions.
- To relax certain restrictions on foreign investors, for example, to ensure they are granted a level playing field, to formulate the "negative list" investment administration model, that is, only those investment areas specified on the list are prohibited and the others are automatically taken to be permitted, and to replace the advance approval system with a "referential filing" system for projects falling outside the scope of the negative list. The negative list has been released setting certain projects that will require prior approval in 18 categories, for example, investment in methane gas projects and car manufacturing projects.
- To adopt a referential filing management system for setting up subsidiaries abroad in order to facilitate outbound investments; in addition, to encourage the establishment of special purpose vehicles (SPVs) specialising in overseas equity investments and to encourage the setting up of parent funds to conduct equity investments overseas.

3. Accelerating trade reform

- To encourage multinational companies to set up their Asia-Pacific headquarters and operation centres; to further develop international trading settlement centres; to support companies in the zone to promote their offshore business.
- To explore a platform for large-sum international commodities trading and resource management for international merchandise trade and extend and improve the pilot programme on bonded futures delivery and to expand functions such as financing collateralised on warehoused goods.
- To promote various outsourcing services; to encourage various finance leasing companies to set up SPVs to conduct onshore and offshore leasing business; to encourage establishment of third-party inspection and certification institutions; to pilot cross-border high value added and high-tech maintenance service and to promote cross-border e-business services.
- To upgrade the international shipping services and leverage off the interaction among the Waigaoqiao port, the Yangshan

port, and the international hub of Pudong airport; to develop shipping finance, international shipping, international vessel management and brokerage.

4. Opening up financial services sector through innovation

- To promote RMB capital account convertibility, financial market interest rate liberalisation, cross-border use of RMB as long as the associated risks are well-managed; to allow financial asset pricing to be determined by financial institutions within the zone.
- To reform foreign debt administration to facilitate investment, trade and cross-border financing, and to encourage multinational companies to set up regional or international fund management centres.
- To open up financial services to private and foreign capital; to encourage the establishment of foreign-funded banks or Sino-foreign joint venture banks; to allow foreign enterprises to gradually participate in commodity futures transactions; to support equity custodians to set up a platform for comprehensive financial services; to support RMB cross-border reinsurance business.

5. Improving current legal framework

- To align the regulations in the PRC Law on Wholly Foreign-owned Enterprises, the PRC Law on Sino-foreign Equity Joint Ventures and the PRC Law on Sino-foreign Cooperative Enterprises regarding the prior approval procedures to support the development of the Shanghai PFTZ.
- To set up management policies that matches the pilot requirements for the pilot zone by Shanghai municipal legislation.

Supervision and tax policies

- To simplify entry and exit itemised records and the declaration formalities for international transits of goods; to strengthen the electronic information network, and to set up the inspection and quarantine supervision mode to facilitate entry and exit of goods.
- To introduce favourable tax measures to promote investments and trades, especially settlement of tax by instalment for gains derived from asset revaluation and income derived by individuals from stock-based incentive schemes; to grant export tax rebates for financial leasing companies; to grant reduced import VAT to domestic leasing companies or their SPVs that purchase aircraft with unladen weight of 25 tonnes or above from offshore and in turn lease such aircraft to domestic airlines; to optimise tax policies that facilitate overseas equity investments and offshore business developments.

Key investment areas of PFTZ

See Table 4 on page 51.

Biography

Chris Mak
Tax Partner

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3409
Fax: +86 21 6288 1889
Email: christopher.mak@kpmg.com

Chris Mak has experience in advising multinational clients in the consumer, industrial and manufacturing industries in relation to appropriate corporate holding and funding structures to conduct their proposed business activities in Australia. Since joining the Shanghai office, he has been heavily involved in assisting foreign companies on PRC tax issues arising from their investment into China including proposed global restructuring, company set-ups, due diligence, foreign exchange remittance issues and M&A transactions for the industrial, auto and real estate industries.

The future of the Shanghai PFTZ

With the public announcement of the Overall Plan of the Shanghai PFTZ by the State Council of the PRC and the official launch, the overall direction and goals of the Shanghai PFTZ have now been established. The detailed regulations and guidelines following the Overall Plan will be issued progressively especially with respect to the practical implementation issues going forward.

Based on the Overall Plan of the Shanghai PFTZ, we note:

- Financial sector-related reform is one of the key highlights in the Overall Plan. It is expected that further reforms will take place to promote the convertibility of the RMB, the cross-border use of the RMB and interest rate liberalisation. Once the implementation details are released, we foresee that financial institutions will develop innovative financial services and products to allow China to be even more competitive on an international basis; foreign and private capital can explore the opportunities in market entry of financial services; enterprises need to review and restructure their treasury management policies accordingly.
- Detailed implementation rules concerning the relaxation of the restrictions in the six major services industries are gradually being released. We have seen some rules being released already which aim to ease the set up process and capital requirements and allow greater investment opportunities for investors.
- Although tax reforms do not appear to be the key drivers under the current Overall Plan, we expect that the government may potentially develop preferential policies towards promoted industries through local subsidies to increase their competitiveness at home and abroad.

Table 4		
Financial services		
1.	Banking	• Qualified foreign investors will be allowed to set up foreign-owned and Sino-foreign joint venture banks and limited licence banks. • Qualified Chinese banks will be allowed to conduct offshore business.
2.	Healthcare insurance	• Foreign-owned healthcare insurance companies will be allowed.
3.	Finance lease	• Minimum registered capital limitation for SPVs will be removed. • Finance lease companies will be allowed to be engaged in factoring related to their primary business.
Shipping services		
1.	Shipping	• Foreign shareholding limitation in cargo shipping joint ventures will be relaxed. • Foreign ships owned or controlled by domestic companies are allowed to take coastal shipping business between Shanghai port and other domestic ports.
2.	International ship management	• Wholly foreign-owned shipping management companies will be allowed.
Trade services		
1.	Value added telecommunications	• Qualified foreign companies are allowed to conduct value added telecommunication services in specific forms.
2.	Entertainment and game machines	• Foreign companies are allowed to manufacture and sell entertainment and game machines.
Professional services		
1.	Law firms	• To explore mechanisms of the business cooperation between Chinese law firms and overseas (including Hong Kong, Macau and Taiwan) law firms.
2.	Credit investigation	• Foreign-invested credit investigation companies will be allowed.
3.	Travel agency	• Qualified Sino-foreign travel agencies are allowed to conduct overseas travel business (except Taiwan).
4.	Human resources agency	• Foreign shareholding limitation will be relaxed. Minimum registered capital of Sino-foreign or wholly foreign owned human resource agency will be lowered.
5.	Investment management company	• Foreign holding companies will be allowed.
6.	Engineering design	• Entry requirement for engineering design companies which provides service in the Shanghai PFTZ will be relaxed.
7.	Construction service	• Wholly foreign-owned construction enterprises in the Shanghai PFTZ will be allowed to conduct Sino-foreign joint construction projects in Shanghai regardless of the level of foreign participation.
Culture services		
1.	Performing agencies	• Wholly foreign-owned performing agencies are allowed to provide services in Shanghai.
2.	Entertainment venues	• Wholly foreign-owned entertainment venues are allowed to provide services in the Shanghai PFTZ.
Public sector services		
1.	Educational, training and professional skills training	• Educational training and professional skills training institutions can be established as Sino-foreign joint ventures.
2.	Medical services	• Wholly foreign owned medical institutions are allowed to be established.
Note: The above standards only apply to the companies registered in the Shanghai PFTZ.		

- Breakthrough reforms are required in terms of foreign exchange control under the proposed trade remodelling and financial reform. We expect that foreign exchange policies applied in the Shanghai PFTZ will be released in due course.
- To simplify the customs supervisions effectively, inspection and quarantine measures play a critical role in promoting cross-border and cross-zone trade. It will be interesting to see how this could be achieved once the related regulations are released.

New incentives

It is likely that the Qianhai Cooperation Zone and the Shanghai PFTZ will not be the only zones in China that offer investment advantages and tax incentives to both domestic and foreign investors. Local governments will continue to explore various official channels including investment policies to attract investments into their respective regions and cities. The Central Government will have to do its utmost to balance the interests and aspirations of all the areas. To foreign investors, these developments can bring plenty of opportunities through ease of investment and operations and the reduction of tax burdens. However, they can also present challenges relating to choice of location and investment and operational structure and dealing with uncertainties that will inevitably arise during the transitional periods. Overall, however, the impact of these developments on the foreign investors should be positive.

Henry Ngai of KPMG China also contributed to this article.

Hong Kong – new tax initiatives in the pipeline

Hong Kong's status as an international finance centre has been enhanced by recent developments relating to double taxation agreements, Islamic finance and tax information exchange agreements. Ayesha Lau, Darren Bowdern and Garry Laird of KPMG China examine these developments and consider how the OECD's BEPS project may have an impact on Hong Kong.

Hong Kong's network of comprehensive DTAs

Hong Kong has expanded its network of DTAs to 29 with the signing of agreements with Italy, Guernsey and Qatar in January, April and May 2013 respectively. The agreements with Kuwait and Jersey became effective in July 2013, bringing the total number in force to 25. Negotiations are underway with a number of other jurisdictions, including South Korea, India and South Africa.

The development of Hong Kong's DTA network continues to enhance its position as a regional investment and trading hub. Hong Kong continues to look for new treaty partners to expand its network of double tax treaties further. However, it should, where possible, prioritise DTAs with its major trading partners such as Germany, the US, Australia and Taiwan, as well as countries in South America and Africa, which all remain the focus of Chinese outbound investment.

Islamic finance

The Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013 was enacted in July 2013. The ordinance, which amends the Inland Revenue Ordinance (IRO) and Stamp Duty Ordinance (SDO), places common types of Islamic bonds on a level playing field with the taxation of conventional bonds, thereby removing a perceived impediment to the development of a *Sukuk* market in Hong Kong.

The legislation was preceded by a consultation in March 2012 on the proposed amendments and was a policy initiative first articulated by the SAR [Special Administrative Region]'s chief executive in his 2007 policy address and most recently by the financial secretary in the Hong Kong Budget for 2012-2013. The legislation reflects the importance attached by the government to support alternative financing arrangements such as Islamic finance.

As the leading financial services centre in the Asia-Pacific region, Hong Kong is committed to ensuring that it has a legal and tax framework to support the development of Islamic financing in the region. The introduction of Islamic finance in Hong Kong will help diversify its financial platform and add to the breadth and depth of its financial market by widening the spectrum of financial products and range of market participants. This will, in turn, reinforce Hong Kong's position as an international finance centre.

The ordinance does not confer special tax concessions on the Islamic finance sector, but ensures that financial instruments of similar economic substance are afforded similar tax treatment. In addition, it does not make specific references to Shariah terminology, but adopts a religion-neutral approach using the term "alternative bond scheme" (ABS), rather than *Sukuk*, to denote the arrangement to which the proposed tax treatment will apply.

Four types of investment arrangements are specified that correspond to the different underlying structures by which investment returns are generated in the five most common types of *Sukuk* in the global market. The types of investment arrangements specified are:

- a lease arrangement (*Ijarah*) where a bond issuer enters into a lease for an acquired asset with an originator to generate an investment return;
- a profit sharing arrangement (*Musharakah* and *Mudarabah*) where a bond issuer enters into a business undertaking with an originator to carry on business activities to generate an investment return;
- a purchase and sale arrangement (*Murabahah*) where a bond issuer sells an acquired asset to an originator with a markup to generate an investment return; and
- an agency arrangement (*Wakalah*) where a bond issuer appoints an originator as its agent to manage an acquired asset to generate an investment return.

The ordinance also contains a provision to empower the financial secretary to expand the coverage of eligible ABS, by way of subsidiary legislation in the future.

The ABS must satisfy certain conditions to be a "qualified bond arrangement". These conditions are that the ABS must: (i) generate a reasonable commercial return; (ii) the bond arrangement represents a financial liability; (iii) there is a Hong Kong connection; (iv) the ABS has a maximum term of 15 years; and (v) overall, the arrangements must be performed according to the terms.

The new rules also contain safeguards to minimise tax avoidance and to ensure the ABS has a nexus with Hong Kong, thereby promoting the territory's financial market development.

The rules also provide for extended record-keeping requirements. They are obliged to inform the commissioner of Inland Revenue and the Collector of Stamp Revenue of any disqualifying event, which may lead to a withdrawal of the relief granted in its entirety under the IRO and SDO. The time limits for raising additional profits tax assessments/recovery of stamp duty are also extended where a disqualifying event occurs.

Tax information exchange agreements

The Inland Revenue (Amendment) (No 2) Ordinance 2013, enacted in July 2013, allows Hong Kong to enter into stand-alone TIEAs with other jurisdictions. Before the enactment of this legislation, Hong Kong's position was that it was only prepared to exchange tax information in the context of a broader DTA.

The legislation was introduced after a recommendation of the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes (the global forum) which conducted a Phase 1 review of Hong Kong in 2011. The review strongly recommended that Hong Kong introduce legislation allowing it to enter into stand-alone TIEAs. In particular, the OECD noted Hong Kong's policy to agree to the exchange of tax information only in the context of a DTA and not to enter into TIEAs. Given Hong Kong's importance as an international financial centre, the global forum considered it essential that Hong Kong enters into agreements (regardless of their form) that meet the international standard on the exchange of tax information (the international standard) with all relevant partners.

Hong Kong went through a Phase 2 review by the global forum which examined how well its legal framework for exchange of tax information does in practice. The review assigned a rating both for its compliance with each element of the global forum's terms of reference as well as an overall rating. The ratings were applied on the basis of a four-tier system: compliant, largely compliant, partially compliant or non-compliant and were finalised by the global forum at its plenary meeting in Jakarta in November 2013.

Biography

Ayesha Lau
Tax Partner in Charge of Hong Kong SAR

KPMG China
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
Tel: +852 2826 8028
Fax: +852 2845 2588
Email: ayesha.lau@kpmg.com

Ayesha Lau is a partner with KPMG China and is the partner in charge of tax services in Hong Kong. She has been a specialist in the tax field for more than 20 years, initially with KPMG in London before joining KPMG in Hong Kong.

Ayesha is a regular speaker and writer on tax matters and is the co-author of "Hong Kong Taxation: Law and Practice" (Chinese University Press), a leading textbook on Hong Kong taxation.

Ayesha was the chairperson of the Hong Kong Institute of Certified Public Accountants' Taxation Faculty executive committee and its former taxation committee. She is a member of the Joint Liaison Committee on Taxation. She was elected as a member of the 2011 Election Committee for the Accountancy subsector.

Ayesha is passionate about community service and has been appointed by the Hong Kong SAR Government as a member of various advisory bodies. Ayesha has served on the Lump Sum Grant Independent Review Committee, the Taskforce on Economic Challenges, the Women's Commission and the Financial Reporting Review Panel of the Financial Reporting Council.

Had Hong Kong not introduced the legal framework for TIEAs, there was a risk that it would be labelled an uncooperative jurisdiction. Such an outcome would have been detrimental to its international reputation and could have undermined Hong Kong's position and competitiveness as an international business and financial centre.

A TIEA will allow Hong Kong to exchange information in relation to any tax imposed by the laws of Hong Kong and the other jurisdiction. The coverage of the types of taxes that are covered by the existing exchange of information (EoI) agreement is expanded from direct taxes or similar types of taxes, to taxes of any type. In the case of Hong Kong, direct taxes are limited to profits tax, salaries tax and property tax whereas other jurisdictions generally have a broader range of taxes. The government has indicated that it will seek to list in the relevant DTA/TIEA details of the types of taxes that are subject to EoI.

The ordinance also enhances the existing EoI arrangements which Hong Kong can incorporate into a DTA. Under the new provisions, information can be exchanged and used for other non-tax related purposes if such use is permitted under the laws of both jurisdictions and the competent authority of the supplying party authorises such use.

The commissioner of Inland Revenue's powers have also been extended to include not only tax information in a person's possession, but also to tax information in a person's control. In the future, however, the commissioner will be able to obtain information, which is in the control of a person, even if the information may be in another jurisdiction. It remains to be seen how 'control' in this context will be interpreted.

The limitation on disclosure of information relating to a period before the relevant agreement has taken effect has also been relaxed. In future, the commissioner will be allowed to disclose tax information generated before the effective date of the relevant DTA or TIEA where he is satisfied that the information relates to the carrying-out of the provisions of the relevant arrangements. The government has also indicated that it will continue to adopt a policy of imposing a limitation on information to be exchanged. Information to be exchanged must relate to the carrying-out of the provisions of the relevant agreement or the administration or enforcement of the tax laws of the DTA/TIEA partner concerning taxes imposed in the periods after the agreement came into effect. Examples of the type of information that may be exchanged under this provision, relate to the identity of individual taxpayers or information concerning transactions, which occur after the DTA/TIEA comes into operation, for instance, details of the original purchase price of an asset purchased before, but subsequently sold after the effective date of the arrangement.

Even with these amendments, Hong Kong will still only meet the minimum requirements of the 2012 version of the EoI article of the OECD's model tax convention. For example, it will neither entertain requests for tax examinations abroad nor will it provide assistance in the collection of taxes.

However, the enactment of the Bill demonstrates Hong Kong's commitment to implementing the internationally agreed standards of transparency and exchange of tax information and is further evidence that it is a cooperative jurisdiction. In the future, the tax information to be exchanged under a DTA/TIEA will have a broader coverage and the commissioner will have wider powers to collect and disclose tax information.

One concern that the enactment of the legislation raises is whether there will be sufficient incentive for jurisdictions to enter into a DTA with Hong Kong when they can obtain tax information under a TIEA. There are good reasons why Hong Kong should conclude TIEAs with jurisdictions such as the Cayman Islands and the British Virgin Islands. However, it is important that Hong Kong continues with its efforts to conclude DTAs with its major trading partners.

At this point, it should also be noted that the international tax landscape continues to evolve. In June 2013, an OECD report, prepared at the request of the G8, outlined a number of steps required to put in place a model agreement on automatic EoI. This followed the endorsement in April 2013 by the G20 finance ministers and central bank governors of automatic EoI of taxes as the expected new standard, rather than

Biography

Darren Bowdern
Tax Partner

KPMG China
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
Tel: +852 2826 7166
Fax: +852 2845 2588
Email: darren.bowdern@kpmg.com

Darren Bowdern is a partner in corporate tax. For more than 19 years, he has been involved in developing appropriate structures for investing into the Asia Pacific region, tax due diligence reviews in connection with M&A transactions and advising on cross-border transactions.Many of these projects comprise 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. He also advises on establishing direct investment, private equity and other investment funds in Hong Kong.

Darren has a bachelor of commerce degree from the University of Melbourne and is a fellow of the Hong Kong Institute of Certified Public Accountants and a member of the Institute of Chartered Accountants in Australia.

exchange of tax information on request. In June 2013, the OECD presented a report to the G8 summit on delivering a standardised and global model of automatic exchange and it is likely that at some time in the future, Hong Kong will come under pressure to comply with this new standard.

Base erosion and profit shifting

In July 2013, the OECD produced, at the request of the G20, an action plan on base erosion and profit shifting (BEPS). This action plan follows a call by the G20 finance ministers for the OECD to develop one to provide governments with the domestic and international instruments to prevent corporations from paying little or no tax and address BEPS in a coordinated and comprehensive manner. The action plan arose from concerns that the development and interaction of domestic tax laws by sovereign states does not deal adequately with the way in which globally integrated groups operate and structure their tax affairs.

Rapid globalisation has resulted in the increased integration of businesses, domestic economies and markets. This integration has been accompanied by operating models that have progressed from country-specific models to globally integrated ones with functions centralised at a regional or global level. Against this background, there is a consensus that tax reform is required to achieve tax symmetry between jurisdictions.

BEPS strategies in themselves are not illegal, but take advantage of rules which do not reflect an environment where intangibles and risk management are of increasing importance. As a result, many governments have concerns that tax planning arrangements allow global organisations to take advantage of the interaction of domestic tax laws and perceived weaknesses in international tax rules, leading to double non-taxation or less than single taxation. These outcomes principally arise because domestic or international tax rules are not seen as taxing profits adequately in accordance with where the economic interests or value creating activity occurs.

Globally the OECD report on BEPS has had a noticeable impact on raising the debate on the topic of harmful tax practices. Neither Hong Kong nor China will be immune from the outcome of the OECD's initiatives on BEPS and businesses in the region cannot ignore the discussion. It is also notable that China has recently signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, which means that all G20 countries have now signed the convention. China has also come out in support of the OECD's initiatives on BEPS.

The OECD's report contains 15 broad actions designed to address a number of areas of perceived harmful tax practices. The report highlights key areas such as:

- arrangements which may involve shifting profits to locations with more favourable tax rules;

Biography

Garry Laird
Senior Tax Adviser

KPMG China
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
Tel: +852 2143 8795
Fax: +852 2845 2588
Email: garry.laird@kpmg.com

Garry Laird is a senior tax adviser with KPMG. Before joining the firm he was a tax specialist for over 30 years, initially with the Australian Taxation Office before joining the Inland Revenue Department (IRD) in Hong Kong. His responsibilities with the IRD included the preparation of departmental interpretation and practice notes, examination of advance clearance applications, negotiation of double taxation agreements and assisting in the introduction of new tax legislation.

Garry advises clients on a wide range of technical issues and has assisted clients in obtaining tax clearances from the IRD on a range of issues, such as Islamic financing, source of profits and the deductibility of interest expenses.

He is the co-author of Hong Kong Taxation Law & Practice. Garry holds a bachelor of economics degree from the University of Tasmania.

- the differences in tax treatment applied to similar types of transactions in different countries;
- the effectiveness of current transfer pricing methodologies; and
- the application of tax treaty concepts to modern business operating models.

Businesses will therefore need to monitor these developments carefully to evaluate the potential impact on their business models as the debate evolves.

While the action plan is in its consultative phase, the general direction and the broad types of recommendations that are likely to come out of the OECD's review seem clear. However, there is still time for taxpayers to review their arrangements and structures and where necessary, modify existing arrangements and structures to better align with the general principles outlined in the action plan.

If broad consensus can be achieved, the BEPS developments could lead to a fundamental overhaul of how global profits are taxed in the future. Companies should review their existing business structures, operating models and transfer pricing policies against the OECD's initiatives to ensure they are sufficiently robust to withstand any scrutiny of the tax authorities in the jurisdictions in which they operate. The impact of the action plan is likely to result in:

- increased disclosure obligations on taxes;
- more scrutiny of transfer pricing methodologies particularly where payments are not taxed at all and closer scrutiny of transactions with tax haven jurisdictions; and
- more attention being paid to whether payments of dividends, interest and royalties qualify for the benefit of lower withholding tax rates under double taxation agreements.

The OECD's review of BEPS should not have an adverse impact on Hong Kong's status as an international financial centre. Hong Kong will remain a global financial centre due to its geographic location, business friendly environment and stable rule of law. However, the worldwide tax environment is undergoing change and there is a debate about jurisdictions receiving a fair share of tax revenues as part of the wider corporate social responsibility agenda. To the extent a company's tax strategies are viewed by the public as overly aggressive or unfair, a company may also risk suffering reputation damage.

The action plan relies heavily on the ability to build a consensus-based framework. Given the number of jurisdictions involved and the historic use of fiscal policies to attract foreign direct investment, achieving success will be an ambitious task.

As a member of the global forum, Hong Kong should take an active role in the discussions and in formulating the recommendations from the review. Hong Kong is an open economy, a well established international financial centre, and a jurisdiction in which many multinationals have established their regional operations. It is therefore imperative that the government engages with the international community in this debate.

One interesting question for Hong Kong is whether the work on BEPS will lead to any change to Hong Kong's territorial basis of taxation. Is it possible that in the future a territorial basis of taxation would be regarded as a harmful tax practice in the new global landscape? And what will be the impact on the application of benefits under Hong Kong's double taxation agreements benefits?

Real estate – the tax landscape in China and Hong Kong

Chris Abbiss, Lewis Lu and Jean Jin Li of KPMG China foresee significant changes to the tax and regulatory environment in both Hong Kong and Mainland China over the next 12 months.

Although Mainland China and Hong Kong maintain separate tax and regulatory frameworks, both governments are seeking to address concerns that a bubble is developing in their property markets by using the tax and regulatory systems to try and constrain prices. This similarity, however, disguises a number of critical differences in the markets. China continues to move in a direction broadly focused on modernisation and relaxing controls. For instance, while the introduction of value added tax (VAT) to the real estate sector is likely to result in increased costs and impact internal rates of return (IRRs), it also replaces business tax (BT), an antiquated taxing mechanism, with one more familiar and appropriate to a modern economy. Conversely, Hong Kong, a city founded on the convictions of free trade and with free movement of capital enshrined in its constitution, appears to be moving in the opposite direction, by attempting to control the property market through punitive stamp duty charges. Due to the disparity between the two markets, this article will address Hong Kong and Mainland China separately.

Mainland China

Property tax expansion

Statistics issued in September 2013 in *China Real Estate Index System 100 City Price Index, August 2013* show that China's housing prices continue to rise. Average new home prices in 100 major Chinese cities climbed 0.92% in August from the previous month, the price of new homes increasing in 71 cities and decreasing in 29. The price of new homes in Beijing and Shanghai have increased by 12.18% compared with last year.

The Chinese government introduced property taxes in Chongqing and Shanghai on a trial basis in 2010 as part of efforts to cool the property market amid growing public complaints about skyrocketing residential property prices.

The Chongqing trial focused on taxing high-end housing, while Shanghai's programme mainly targeted the ownership of multiple houses. The taxes which ranged from 0.5% to 1.2% were seen as too low to be effective to keep local housing prices in check. This is borne out by the recent new home price increases in Shanghai and Chongqing that demonstrated that property tax at those rates may not be an effective measure to control the price increase.

In 2013, the State Administration of Taxation (SAT) announced several times that it will research the possible expansion of property tax pilot programmes. Large cities facing high home price increases, such as Hangzhou, Shenzhen and Beijing, could be the next ones to implement the tax. The Ministry of Housing and Urban-Rural Development (MOHURD) is also working on a nationwide database of homeowner information that would aid the implementation of the tax. It is expected that the trial programme will be expanded to more cities in 2013.

VAT

The first stage of the VAT pilot programme for the modern services and transportation sectors has been implemented in many of the major commercial centres in China and attention is now turning to those industries which are yet to transition from BT to VAT.

It is widely speculated that the construction and real estate sectors will be among the next to transition, probably in mid-2014. Real estate is significant for two reasons. Firstly, in 2011, it represented more than half of the BT revenue collected in China, so the transition from BT to VAT could have a big impact on tax revenues. Secondly, as experience of VAT in other countries shows, real estate is typically one of the more difficult areas to which to apply VAT. Transaction values are often high and there is usually a large number of different taxes already applying to the sector with which the VAT needs to fit, including, in the case of China, corporate income tax, land appreciation tax, stamp duty, land use tax and real estate tax.

The effect of taxation policies on property values evokes enormous interest among the general population, and it is debatable whether passive increases in land values should be included as part of the value add underpinning the concept of VAT.

So far, the government has provided only limited information on its proposals for the real estate sector. Circular *Caishui* [2011] No 110 announced that construction services would be subject to VAT at the rate of 11%. The taxation of real estate transactions was not mentioned, although it is speculated that these may also be taxed at 11%.

Beyond this basic information, little else has been provided, and given the diverse approaches to VAT on real estate internationally, a range of options remains open. One particular difficulty is that in most countries, VAT liabilities only accrue to entrepreneurs, such as property developers, rather than passive investors. Similarly, sales of second-hand residential real estate are ordinarily excluded from the tax base for VAT purposes. Conversely, in China, BT is levied on all vendors, be they developers, landlords or private individuals, selling or leasing either new or second-hand real estate. As such, the government is faced with a choice of implementing a VAT system which is consistent with international norms, but which may come at a cost to the treasury, or to implement a radically new VAT system requiring private individuals to register for VAT on certain transactions.

Another significant issue for the sector is the potential impact of timing differences. In most VAT jurisdictions, where a business incurs more VAT on its expenses than it charges on its sales, it is entitled to a refund from the tax authorities. This makes sense as VAT is supposed to be a tax on end consumers rather than businesses and is supposed to tax the value added by businesses in the supply chain rather than taxing transactions *per se*. However, the Chinese VAT system does not generally allow refunds of VAT (except to certain exporters) and instead VAT credits may be carried forward and offset against future liabilities. If this policy is implemented, this could have a significant impact on the real estate sector where upfront expenditure, either on construction or on purchase, can be high, followed by moderate revenues either from rental or business use. At current yields, this could result in input credits only being recovered over a period of 20-plus years. This could have a significant impact on rates of return and will need to be factored into business models.

Biography

Chris Abbiss
Tax Partner

KPMG China
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
Tel: +852 2826 7226
Fax: +852 2845 2588
Email: chris.abbiss@kpmg.com

Chris Abbiss has extensive experience on tax issues in the property and infrastructure industries. He advises a number of significant funds and investment advisers on fund structuring, the structuring of pan-Asian real estate investments and efficient investment management structures. His 20 years in tax practice include experience in New Zealand and the UK as well as Hong Kong.

His recent experience has included taxation structuring for a number of pan-Asian and country-specific real estate and infrastructure funds and advising on the fund/asset management and investment advisory structures for these funds; providing real estate infrastructure and private equity investment structuring advice into a number of Asia Pacific (Aspac) countries including advising sovereign and pension investors; advising on efficient remuneration/carry structures for fund stakeholders; and providing tax advice on the establishment of a number of Hong Kong real estate investment trusts.

As Hong Kong is a key Aspac hub for the funds industry, Chris acts as single point of contact, coordinating KPMG's Aspac services to a number of fund industry participants. This includes regional coordination of local country tax compliance for pan-Asian funds utilising project management technology.

Chris is a member of KPMG's global financial services taxation steering group and chairs KPMG's international real estate funds taxation network. He is a past chairman of the New Zealand Institute of Chartered Accountants's tax committee.

Biography

Lewis Lu
Tax Partner in Charge of Central China

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3421
Fax: +86 21 6288 1889
Email: lewis.lu@kpmg.com

Lewis Lu is the tax partner in charge of Central China in KPMG China. He has been involved in many China tax advisory engagements across a wide variety of industries, particularly real estate and financial services, with extensive experience in advising multinational clients on their investments in China. He assists many foreign investors in structuring tax-efficient entry and exit strategies, on the acquisition of existing PRC entities and in discussing tax policy matters with the tax authorities.

Lewis is a member of the Canadian and Ontario institutes of chartered accountants and a fellow of the Hong Kong Institute of Certified Public Accountants.

Biography

Jean Jin Li
Tax Partner

KPMG China
9th Floor, China Resources Building
Shenzhen 518001, China
Tel: +86 755 2547 1128
Fax: +86 755 8266 8930
Email: jean.j.li@kpmg.com

Jean Jin Li has more than 10 years experience in the China tax practice. She is stationed in Shenzhen and has previously worked in the US and Shanghai.

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

Jean has extensive experience in real-estate tax matters. She has advised many companies in the sector on tax efficient holding structuring, tax-free restructuring, business operation restructuring, tax dispute resolution and on addressing tax issues in the initial public offering (IPO) process.

Jean is a certified public accountant and also holds a lawyer practitioner qualification in China.

Based on previous experience, it is likely that the changes will be introduced quickly, with few transitional relief options. Given the long-term nature of many real estate projects, it is important that investors and developers consider and model potential variables resulting from the introduction of VAT now and prepare for contingencies that may arise. They should also ensure that legal contracts are clear on how VAT will be treated and where the liabilities will fall.

Hong Kong

The last 12 months have seen two major changes to the stamp duty rules in Hong Kong, both of which are designed to take the heat out of the property market.

On October 26 2012, the financial secretary announced the introduction of buyer's stamp duty (BSD) on residential properties. The measures took effect from October 27 2012 and imposed a potential additional 15% stamp duty charge on top of the existing stamp duty and any special stamp duty (an additional stamp duty applying on the resale of residential real estate within two years of acquisition). The charge does not apply to Hong Kong permanent residents, but does apply to any transactions in residential property by, for example, all corporations and partnerships, and to any individuals who are not permanent residents.

On February 22 2013, the financial secretary announced a doubling of the *ad valorem* stamp duty (AVD) rates to a maximum of 8.5%. The increased charges applied to any property (including non-residential property) acquired from February 23 2013. An exception was provided for individuals who are Hong Kong permanent residents for the purchase of a single-owned residential property. The date on which stamp duty becomes chargeable on non-residential property was also brought forward from the date of conveyance to the date of agreement of sale (non-residential property was already taxed at the earlier date).

The Hong Kong Legislative Council has not yet passed either measure, partly due to vocal opposition from various business groups. Nevertheless, the Bills will have retrospective effect if they are passed. It is hard to say whether this increased tax is the sole reason, but sales of commercial property in Hong Kong fell by 80% between February and July 2013.

There are a number of reasons why this uncertainty in the Hong Kong property market is likely to continue over the next 12 months. Firstly, the eventual fate of the two stamp duty bills is still not certain. Hong Kong's chief executive has indicated that he remains committed to active intervention in the real estate markets, but it is clear that he is unable to put together a majority very easily for the bills in their current form. While one can expect that some form of increased stamp duty will be passed, it remains to be seen whether the government is willing to grant any concessions to secure a majority. While uncertainty remains over whether stamp duty will be due at, in the most extreme variation, 4.25% or 23.5%, buyers and sellers are finding it hard to agree the correct valuation for a transaction.

The new stamp duty bills create a new environment for property transactions, which shows a government prepared to interfere with the markets more actively than has previously been the case. By discriminating against non-permanent residents, the government is also for the first time bringing in tax laws designed to favour the permanent resident population. The EU courts have consistently held that using discrimination in the tax system to disincentivise foreign nationals from making investments is a restriction on the free movement of capital. As Hong Kong has a similar clause in its Basic Law, it is disappointing to see the government taking these sorts of steps. However, in Asia the situation is not so *laissez faire* and a number of countries do discriminate in this manner and in other ways to restrict foreign ownership.

For investors wishing to invest in the Hong Kong property market, the case for investing through a corporate shell is stronger than ever. Hong Kong does not have any look-through provisions for raising stamp duty on the transfer of land-rich companies, so the sale of shares in a special purpose vehicle only attracts a stamp duty of 0.2% in the case of a Hong Kong company (or 0% in the case of a British Virgin Islands or Cayman Islandsd company) rather than rates of up to 43.5% in the case of a short-term asset transfer. There are some potential downsides with undertaking share transactions. Firstly, due diligence costs are likely to increase as the buyer will take on the historic risks and tax exposures of the vendor. This may be particularly relevant where the vendor is a property developer. Secondly, for tax purposes, it is harder to get tax deductions for increased leverage. Thirdly, with new properties, capital allowances may only be available on the developer's cost. These matters will need to be weighed against the stamp duty savings, but given the how high stamp duty costs, we ultimately expect to see more share transactions rather than direct asset purchases over the next year.

Transportation and logistics – challenges of VAT reform

China's unification plan for indirect taxes will see the dual business tax (BT) and value added tax (VAT) regime gradually replaced by a single VAT system. Many businesses in the transportation and logistics industry are still wrestling with the uncertainties and local variations created by the reform, so far introduced on a pilot basis. Jennifer Weng, Tracy Zhang and Bin Yang of KPMG China provide advice on how these issues may be resolved.

Before the full unification, VAT is levied on sales of tangible goods and repair services in China, and BT applies to sales of immovable assets, transfer of intangible assets and provision of other services in China. Considering the complexity that would arise from the overnight revocation of the widely-applied BT system, the unification is taking a phase-by-phase approach with the first pilot programme rolled out in Shanghai on January 1 2012. Under the pilot programme, the VAT rates for transportation services and ancillary logistics services are 11% and 6% respectively. The term "ancillary logistics services" is a broadly-defined concept, which basically covers almost all non-transportation business such as freight forwarding, shipping agency, warehousing and customs clearance.

More provinces and cities including Beijing, Jiangsu, Anhui, Fujian (including Xiamen), Guangdong (including Shenzhen), Tianjin, Zhejiang (including Ningbo) and Hubei, were included in the pilot programme in 2012 with effective dates that fall from September 1 to December 1 2012.

As anticipated, the VAT reform pilot programme was implemented nationwide in China from August 1 2013 by Circular *Caishui* [2013] No 37 (Circular 37). Some more service sectors (that is, the film and media sectors) have also been included in the covered industries. Equally, companies carrying transportation and logistics business will be subject to VAT starting from that date, including foreign enterprises, which provide such services to customers in China.

Yes, a welcome reform, but …

The above geographic and scope expansion, after less than two years of the pilot programme in Shanghai and other provinces, may imply that the government has been satisfied with the experiment in these selected locations. No doubt, in due course the unification will simplify tax code – one set of regulations instead of two, and rationalise tax administration –VAT and BT collection are handled by the state tax bureau and the local tax bureau respectively. More importantly, as BT does not carry input credit like VAT, it creates a tax cascading effect that disadvantages business-to-business transactions, creating tax leakage on acquisition of services and discouraging businesses from outsourcing some of their functions. The replacement of BT with VAT should generally eliminate such cascading effect.

The VAT pilot programme also prescribes special VAT treatments for exported services. Until the programme started, special VAT treatments were only available to the exports of tangible moveable goods. Generally, a zero rating is now available to international transportation services provided by domestic companies that have the relevant licences. With a zero rating, the service provider will not be required to charge output VAT and it can apply for a refund of input VAT incurred on its purchases. On the other hand, for international transportation services provided by companies without the relevant licence, or other logistics companies, a VAT exemption will be available. With a VAT exemption, the service provider will not be required to charge output VAT but will not able to obtain any refund or credit on the input VAT incurred on purchases either.

However, in reality, the responses of the companies in the transportation and logistics industry have been rather mixed. Certain taxpayers, including some transportation companies, shipping agents and freight forwarders, are concerned that the new VAT regime may even increase their tax costs. To understand the issues facing these taxpayers, it is necessary to understand how the rules used to work under the old BT regime.

Before the reform

For BT purposes, the applicable tax rates and basis would be dependent on the business category of the taxpayer. Specifically:

- For "transportation business", that is, sea, air, road or railway (railway transportation services and courier and express services under "postal services" are not included in the VAT reform at present), the applicable BT rate is 3% on gross revenue. For joint transportation activities, the main contractor is allowed to deduct transportation costs paid to a sub-contractor from gross revenue in calculating the amount subject to BT. A PRC company providing international transportation services (that is, moving cargo or passengers cross-border or outside China) is also exempt from BT
- For courier and express service providers, the taxpayer may be assessed as providing either postal services or transportation services. The BT rate is also 3%
- For "agency services", which include shipping agency, freight forwarding, customs agency and other logistics services with an agent role, the BT rate is 5% on the actual agency fees received from the consignor. That is, BT should be levied on a net basis with gross receipts less allowable deductions. In practice, it is generally accepted that external costs paid to third-party service providers (either onshore or offshore) can be deducted, such as:
  - Freight costs paid to carriers (for example, air and sea)
  - Miscellaneous charges incurred in the transportation (for example, handling charges and harbour fees)
  - Sub-contracting costs paid to other freight forwarders.
- For other services in transportation and logistics industries (such as warehousing services, port services), the BT rate is 5% on a gross basis except for some circumstances under which an effective net basis may be applied.

The effect of these rules on transportation and logistics companies are:

- For eligible companies, although an input credit system as in VAT is not available, the net-basis BT treatment has effectively allowed BT to be calculated on value add only. Companies that fall within this category include those providing agency services which are allowed to exclude third-party costs and reimbursed expenses in calculating the amounts subject to BT.
- For companies engaging in transportation services and postal services, a more favourable BT rate of 3% as compared with 5% will apply. A transportation company can also deduct subcontracted transportation costs (not including other third-party costs).

In other words, to some extent, the cascading effect that would otherwise exist under a BT regime has already been eliminated under the net-basis BT method. Moreover, the applicable BT rate of either 3% (for transportation services) or 5% (for other services) is more favourable than the corresponding rates of 11% and 6% under the VAT reform. (Of course, if the customer of the transportation or logistics services is generally a VAT payer, the higher rate VAT would be creditable whereas the lower rate BT would form part of its tax costs.)

Transportation industry – winners and losers

Because of the differences between the VAT rules and BT rules, there are winners and losers under the pilot programme. The impact of the programme does not only depend on the type of company a business is but also the type of services (for example, domestic or international) it is involved in.

For domestic companies involved in international transportation businesses, the pilot programme will bring benefits in many cases as they are potentially eligible for zero-rated VAT or

Biography

Jennifer Weng
Tax Partner

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3431
Fax: +86 21 6288 1889
Email: jennifer.weng@kpmg.com

Jennifer Weng specialises in providing PRC tax advisory services to clients in the real estate and logistics industries.

Jennifer assists multinational clients to formulate entry and exit strategies in relation to their PRC investments. She regularly undertakes due diligence work and restructuring projects, and frequently assists foreign multinationals in discussing tax policy matters with the PRC tax authorities.

Jennifer was seconded to the international corporate tax group of the KPMG New York office for a year to assist US companies focusing on various international tax projects.

Biography

Tracy Zhang
Tax Partner

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: +86 10 8508 7509
Fax: + 86 10 8518 5111
Email: tracy.h.zhang@kpmg.com

Tracy Zhang joined KPMG China's Beijing office in 1996. In 2006, she was seconded to the Qingdao office and was the head of the local tax practice. From April 2007 until July 2008, she worked with both the international corporate tax practice in KPMG New York as well as the financial services practice in KPMG London, respectively.

Tracy is a PRC regulatory and tax specialist on China investment related issues. Since 2004, she has been functioning as one of the leaders of the financial services tax team in KPMG Beijing, looking after domestic and foreign financial services, logistics, and real estate clients. She has also been involved in developing structures for foreign investments into China; tax due diligence reviews in connection with M&A transactions; and advising on cross-border transactions.

exemption from VAT. To start with, they will not have to charge output VAT as compared with 3% BT. Secondly, for those which can enjoy zero rating, a refund of the input VAT will be available which would not be possible under the BT system.

However, for a domestic company involved in domestic transportation businesses, the result can be mixed. If and to the extent that the domestic company can pass on the output VAT to the customers, the VAT pilot programme can be beneficial since the company can obtain credit on input VAT on its purchases which it would be unable to under the BT pilot programme. And if its customers can get full credit on VAT charged by the company, the company may be able to negotiate for a higher fee to share the tax cost savings with the customers. However, here is the rub, some customers, for example, individuals or small businesses or those which have not come under the VAT pilot programme or are still unable to get credit on the VAT charged by the company. In those cases, there might be resistance from the customers to pass on the VAT in full because under the BT system, they would only have to bear 3% BT.

On the other hand, the domestic transportation company may not be to claim credit on input VAT incurred on its purchases in full because the VAT special invoices are generally not available, for example, those for fuel costs charged to individual drivers by gas stations and road tolls collected by the authorities. And a large portion of costs of transportation companies are staff costs, which do not carry input VAT credit. There is also no grandfathering relief for input VAT on fixed assets that were acquired before the VAT pilot programme began. This shortfall can create an unlevel playing field for businesses which are at different phases of investment.

For foreign transportation companies, the benefit of input VAT credit will not be available. They will not be able to enjoy zero rating or VAT exemption even for international transportation services, either. In other words, they will have to charge VAT at 11% even for international transportation services provided to customers in China. For carriers that operate through an agent in China, the agent will be obligated to withhold the VAT. In these circumstances, however, if the relevant tax treaties or international transportation treaties are available, the foreign transportation companies may avail themselves of an exemption from VAT on top of one from corporate income tax.

We understand that the central government and local governments in various cities has received feedback about these concerns via different channels. Some businesses and groups have expressed a wish for lower VAT rates and the alignment of tax calculation basis between domestic transportation companies and foreign transportation companies. Some local governments have agreed to provide financial subsidies to mitigate additional tax burdens during the transition periods. However, no measures that will provide more sustainable solutions for these issues have been issued.

Logistics industry – no more net basis

Many sectors in the logistics industry, principally shipping agents and freight forwarders, fall within the category of auxiliary logistics services and are subject to 6% under the VAT pilot programme as opposed to 5% under the BT system. Assuming that the service providers' customers can claim full credit on the VAT charged by the service providers and the service providers themselves can claim full credit for VAT on their own purchases, the reform should be beneficial to both parties.

Confusion and uncertainty have arisen however because during the transition period, that is, before August 1 2013, while only Shanghai and the other nine cities were covered by the VAT pilot programme, the rules allowed companies, such as logistics companies, that used to account for BT on a net basis to continue to apply a net basis under the VAT pilot programme. In practice, during the transitional period, the net basis would be applied as follows:

- The service provider would still charge output VAT on its gross revenue without any deduction and issue VAT invoices based on the gross revenue as well.
- The service provider would claim credit on input VAT on costs which had been subject to VAT and were supported by special VAT invoices (including previously BT-deductible items and some BT non-deductible items such as general consulting fees)

- The service provider would also claim credit on deemed input VAT on costs that used to be deductible under the BT system but were not supported by VAT invoices, using this formula:

$$\text{Input VAT} = \text{Deductible costs} / (1+6\%) \times 6\%$$

In other words, the concept of deeming input VAT credits is merely a mechanism designed to achieve a result so piloted taxpayers would pay VAT on a basis similar to what they would under the BT system in the past.

The deemed input VAT so claimed by freight forwarding companies and shipping agency companies would include:

- domestic expenses paid to external vendors which were still paying BT, such as transportation costs to sub-contractors outside of piloted locations;
- overseas expenses paid to foreign entities which could not issue VAT invoices, such as sub-forwarding fees to overseas affiliates and overseas handling charges; and
- air and sea freight charges from overseas carriers, many of whom were exempted from PRC indirect taxes under treaty protection.

The rationale for such grandfathering rules at that time might be that, at the point, logistics companies in other regions of China would still be applying a net basis under the BT system, which could create a disadvantage with those covered by the VAT pilot programme. This could explain why since August 1 2013, when the VAT pilot programme started to be applied nationwide, the net basis has no longer been available.

As it can be imagined, freight forwarders and shipping agents have not welcomed these changes with open arms. Before August 1, many found the 1% increase in tax rate bearable due to the net basis on top of the potential availability of input VAT credit on future investments such as equipment. Officials from SAT and the Ministry of Finance have recently confirmed that the net basis would not continue. Some officials also felt that such a method would create a mismatch between output and input, that is, the service recipients are entitled to claim input VAT on gross payments while the service providers only account for output VAT on the net basis, thus breaking the credit chain and leading to tax losses for the government. Therefore, logistics service providers will suffer a heavier tax burden than before if they cannot pass on the VAT in full to their customers.

Biography

Bin Yang
Tax Partner

KPMG China
38th Floor, Teem Tower
208 Tianhe Road
Guangzhou 510620, China
Tel: +86 20 3813 8605
Fax: +86 20 3813 7000
Email: bin.yang@kpmg.com

Bin Yang worked with the Guangdong government and a multinational foreign investment company for 14 years before he joined KPMG. When working with the government, he was responsible for regulations consultation and project management regarding foreign investment to China.

Since joining KPMG in 2006, Bin has been mainly responsible for regulatory and company structuring advisory and implementation.

Bin is knowledgeable in business laws and regulations, and has good understanding of enterprise investment practice; he is also familiar with the business environment in China. He has plenty of experience in enterprise set-up, advisory and implementation of corporate restructuring. He has successfully assisted many multinationals as well as medium and small companies from the manufacturing, trading, property and service industries to enter the China market and improve company structures.

Bin also has an in-depth knowledge of R&D incentives in China and he has been actively assisting multinational companies as well as China domestic enterprises is R&D planning, R&D incentive application and R&D audits.

Looking ahead

As the transportation and logistics industries are connected to the whole economy, the way these industries are taxed can have far-reaching knock-on effects. It is understandable that the central and local governments take seriously the feedback of the businesses in these industries about their concerns with the VAT reform, many of which might not have been foreseen by the authorities. We are aware that dialogue is going on at different levels with a view to developing workable solutions to the issues raised by the key industrial players, both domestic and foreign service providers.

Healthcare industry – under closer scrutiny than ever

China will be a crucial player in the healthcare & life sciences industry soon, including being a global leader in drug discovery and innovation. It is unsurprising then that the pharmaceutical industry has come under the scrutiny of Chinese authorities, including those in tax. Grace Xie, Henry Ngai and Ho-Yin Leung of KPMG China discuss the challenges facing the healthcare industry in China in 2014.

The healthcare & life sciences industry in China is experiencing significant growth. It has transformed itself from a loose group of inward-looking domestic companies into an aggressive player with a global impact. The Ministry of Health believes it will generate healthcare opportunities worth more than $500 billion by year 2014 to 2015. Along with the rest of the economy, China's healthcare & life sciences market has grown dramatically, now accounting for 5.6% of the global market.

Policies enabling the healthcare & life sciences boom

The primary force driving healthcare & life sciences is the government's determination to provide quality healthcare for all citizens, which led to the sweeping healthcare reform of 2009. The 12th Five-Year Plan is another important booster, triggering increased opportunities and investment for all healthcare & life science players. Other reasons, including demand generated by robust economic growth and a rising middle class, the pressure brought about by urbanisation and changing lifestyles, as well as an ageing population and an increasing awareness of the need for quality healthcare, are also key drivers of the industry boom.

Implementation Plan of deepening the healthcare reform during the 12th Five-Year Plan (2012-2015)

The goal of the healthcare reform is to provide safe, effective and affordable healthcare services to all urban and rural residents by 2020. The main objectives of this implementation plan include:

- Accelerating the development of comprehensive medical insurance coverage for the entire population: an additional 3% of the population (compared with the coverage in 2010), is covered by one of the three main medical insurance programmes, which handle urban employees, urban non-working residents and rural populations. Medical subsidies to the covered urban non-working residents and rural populations are to rise to RMB360 ($59) or above a head by 2015. The broader coverage will enable vast number of people to afford drugs and is opening up the grassroots market.
- Improving the essential drug system: the Essential Drug List (EDL), first introduced in 2009, has grown from an initial list of 300-plus generic drugs to 520 kinds of drugs. The prices of drugs listed on the EDL are under control and the National Development and Reform Commissions (NDRC) will issue the ceiling price of the drugs later. The effect of the EDL and price control on pharmaceutical companies is profound and may force companies to operate on wafer-thin margins.
- Improving a new grassroots medical institution management mechanism: by 2015, at least 95% of grassroots hospitals and clinics are expected to provide quality

Biography

Grace Xie
Tax Partner

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3422
Fax: +86 21 6288 1889
Email: grace.xie@kpmg.com

Grace Xie started her career as a professional accountant in 1993 in Sydney, Australia. She joined KPMG Hong Kong in 1998 to specialise in Chinese tax, and moved to KPMG Shanghai in 2001.

In her career as a tax consultant, she has advised multinational clients across a wide variety of industries, including the manufacturing, trading and service sectors. She advises clients on corporate and personal taxation, and business matters relating to the establishment of business entities in the PRC, the structuring of remuneration packages and ongoing operations. Grace also has extensive experience advising multinationals on restructuring and M&A activities in China.

Grace has assisted many foreign investors regarding their China transactions, tax due diligence and tax structuring. She has in-depth knowledge of the key tax risks and exposures for manufacturing companies in China.

medical services. It is expected that the grassroots market will become an intensely competitive area and penetration into this market will lead to more opportunities.
- Strengthening the public hospital reform: this includes gradually abolishing drug price additions as one income channel of public hospitals, strengthening the supervision of the increase of medical expenditures and setting up a modernised hospital management system. The public hospital reform will focus on the county-level public hospitals and commence a pilot programme in city-level hospitals.
- Pushing forward with healthcare reform in the related areas: the government programmes cover equalisation of public medical services, optimisation of the medical resources, development of the medical talent pool, deepening the reform in pharmaceutical supply chains as well as the healthcare supervision system.

Robust opportunities attract more attention

Healthcare is a politically and socially-charged topic in China, and the government has demonstrated its determination to make significant changes to the situation and bring visible and practical benefits to the entire population. To ensure the implementation of healthcare reform and achieve the above set of objectives gradually, the government has been experimenting with different policy instruments to focus on the operation of the pharmaceutical companies, domestic and multinational, which are the important players in this market, to understand the value chain in the pharmaceutical industry to achieve the objective of lowering healthcare costs for the people.

Transfer pricing target and relevant competing interests

Unlike general industrial manufacturing, the pharmaceutical industry has a rather different value chain. For example, the R&D cycle alone can be more than 10 years. The significant spending during this period cannot bring immediate sales and/or profits to the company, but on the other hand, substantial failure in these efforts can result in a negative impact on the company's financial position. On the manufacturing side, there are a variety of observed arrangements for manufacturing entities. Some manufacturing entities may own patented product formulae, and manufacture, market and sell drugs into the market.

At another extreme, some manufacturers do not own any product formulae and instead import the active pharmaceutical ingredients (API) (which consist of product formula) and perform simple processing locally. On the surface, the related-party transactions may appear to be similar, for example, if certain raw materials are purchased from related parties and all products are sold to third parties, and activities may also appear similar, that is, conducting manufacturing operations. However, because of the difference in the functions, risks and assets profile – for example, carrying out risky R&D and owning patents in one case, and not the other – from a transfer pricing perspective, the expectations of profitability for these entities is very different.

Chinese tax officials have noticed these complexities, and in turn, have paid substantial attention to them. In 2009, the State Administration of Taxation (SAT) issued two circulars relevant to the pharmaceutical industry from a transfer pricing perspective. One identified 15 industries to be targeted, including the pharmaceutical industry. The other set out various measures to strengthen tax collection and administration, and identified pharmaceutical companies as major transfer pricing audit targets, with an emphasis on the valuation of intangible property. The attention on pharmaceutical companies has been lasting.

In late 2012, and as discussed more fully in the chapter focusing on transfer pricing generally, the SAT published the China Country Practices article in the UN's Practical Transfer Pricing Manual for Developing Countries, asserting again its understanding of location specific advantages (LSAs), which are advantages arising from assets, resource endowments, government industry policies and incentives that exist in specific localities. The SAT asserted that companies operating in China are entitled to additional profits arising from LSAs in China in many cases, and also discussed a variety of ways in which it takes them into account in transfer pricing investigations and analyses. The implication for pharmaceutical companies operating in China (where it is highly regulated and is a vast and growing market, and a number of other potential sources for LSAs), is that Chinese tax authorities may expect a high level of profits to be earned, and taxed, in China. This expectation of profitability, however, touches on a variety of issues.

Companies importing drugs or API from overseas related parties, similar to other companies importing tangible goods from related parties, are subject to scrutiny from the Chinese Customs Office. If they earn high levels of profit in China, then the office may suspect that the related-party import price is inappropriately low, triggering underpayment of customs duties. This is particularly relevant to pharmaceutical companies importing drugs or API, especially if there are patents in effect. Companies face challenges compounded by the fact that the tax authorities and the customs office are two distinct organisations: rulings and assessments issued by one authority have no binding effect on the other.

Potentially more important from a business perspective, high profits earned by pharmaceutical companies in China might attract price push-down by the NDRC, which regulates the prices of many drugs (please refer to the ensuing section for a more detailed discussion on the NDRC's actions.) In the worst case scenario, (excessively) high profits may be deemed to have violated NDRC regulations. The NDRC has various regulations to monitor and control certain drug prices with the goal to ease patients' financial burdens. In essence, the NDRC regulations impose maximum mark-ups at the wholesale and retail levels. The regulations also obligate pharmaceutical companies to report the drugs' specific information periodically to the NDRC. This includes, for example, the import price (if the drugs are imported), the ex-factory price (if the drugs are manufactured locally) and selling expenses. The result is that the NDRC can effectively monitor drug prices and require pharmaceutical companies to make a price reduction where appropriate. The result, however, is an expected shrinkage of supply chain profits, which may run counter to the expectations of the tax authorities regarding corporate profit levels.

Various authorities in China are keeping a close eye on pharmaceutical companies. Each authority's focus comes from different perspectives, and in some is contradictory and opposing in others. There is no single solution which will resolve all of these issues for all taxpayers. As a result, companies operating in the pharmaceutical industry have to establish a sound, technical approach to their transfer pricing, without compromising the flexibility for doing business, to manage the associated risks arising from each of these areas.

Biography

Henry Ngai
Tax Partner

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3411
Fax: +86 21 6288 1889
Email: henry.ngai@kpmg.com

Henry Ngai started his career with KPMG PRC tax practice in Hong Kong in 2002 and moved to KPMG Shanghai in 2007.

Henry has extensive experience in advising multinational clients in different sectors, including pharmaceutical, chemical, real estate, industrial and consumer markets. He advises clients on business matters associated with existing and proposed investments in China from the tax, foreign exchange, customs and regulatory perspectives, such as holding structures, ongoing operations and fund repatriation strategies. Henry also provided assistance to many foreign investors for their acquisition projects in China regarding tax due diligence and tax structuring advisory.

With more than 11 years' China tax experience, Henry has assisted many multinational companies to set up their establishment in China. He also has in-depth experience in facilitating his clients to improve tax risk management system and develop appropriate exit strategies for their investment in China.

NDRC's investigation into pharmaceutical pricing

China's NDRC has issued a roadmap for medical and pharmaceutical pricing reforms, covering off-patent drugs, generics and medical devices, which propose allowing market-determined pricing where appropriate.

In early July 2013, the NDRC announced that to have a better understanding of costs, prices and other related information about pharmaceutical companies with an objective to set and adjust drug prices accordingly, it would launch a wide-ranging probe into the costs of drugs. Instead of reducing drug prices immediately, this probe aims to pave the way for drug price reform in the future.

The probe has two parts:

- An investigation on 33 domestic drug makers and international drug distributors in relation to their ex-factory (import) prices for drugs sold at government-set prices as well as financial and operation information of manufacturers in the year of 2012
- A special cost investigation on 27 international and domestic pharmaceutical companies with respect to production cost, distribution expenses and prices of drugs over the past three years from 2010 to 2012.

Biography

Ho-Yin Leung
Tax Partner

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3358
Fax: +86 21 6288 1889
Email: hoyin.leung@kpmg.com

Ho-Yin Leung is a partner in KPMG's global transfer pricing services (GTPS) group in Shanghai. Before joining KPMG, he worked for another big-four accounting firm where he provided transfer pricing, tax advisory, dispute and compliance services. In addition, Ho-Yin has extensive experience in advising corporations in tax-related business restructuring and reorganisation, and in allocating headquarters' costs.

Ho-Yin has experience in providing transfer pricing services to multinational clients in various industries such as diversified industrial manufacturing, semiconductors and electronics, automotive, pharmaceuticals, healthcare, consumer goods, food and beverages, chemical companies, oil and gas, and alternative energy.

Ho-Yin has also provided tax and transfer pricing advisory services to multinational clients in various tax efficient supply chain management and tax restructuring projects, including business transformation for supply chain structures and operation models as well as change management. In addition, he has experience in helping clients conclude bilateral advance pricing arrangement applications and he is working on several advance pricing arrangements for clients.

Ho-Yin has frequently published articles in leading tax and transfer pricing publications around the world, including articles in the IBFD International Transfer Pricing Journal, BNA Forum, *International Tax Review*, the Asia Pacific Journal of Taxation and the HKICPA's [Hong Kong Institute of Certified Public Accountants] monthly journal.

Unlike previous rounds of drug price investigation, which required pharmaceutical companies to self-declare their ex-factory prices, the latest probe is much more thorough. The NDRC assigned specific teams to conduct the on-the-spot investigation at the target companies from July to October 2013. The investigation covered not only the purchase price of ingredients and the ex-factory price of the drugs, but also the financial system, financial statements as well as related accounting vouchers, bills and contracts of the companies concerned. The NDRC expected to uncover a more accurate cost structure through this detailed review of the financial related documents of the target pharmaceutical companies, facilitating it to develop effective action plans and arrange the subsequent implementation of drug pricing reform.

In fact, the NDRC's further announcement in August 2013 provided certain proof about the intention of the latest probe. To make market-determined pricing mechanism workable, the NDRC plans to advance the drug pricing reform from these four perspectives:

- exploring a new price management model focused on the instructed payment price;
- improving pricing procedures with the introduction of pricing methodology based on pharmaceutical economic evaluation and international drug price comparisons;
- creating a pricing policy that encourages innovation including the patent drugs, confidential ingredients, and drugs with state-award or sound quality; and
- improving the management model of low-priced drugs, and encouraging the manufacturing scale by pricing leverage.

Trend towards growing collaboration

Fuelled by the government's ambitious healthcare targets and policy backing, domestic and multinational pharmaceutical companies are positioning themselves enthusiastically as vital links in this industry. However, China's complicated pricing mechanism will continue to dictate future plans for all pharmaceutical companies. As mentioned above, the healthcare regime is likely to implement price controls for the next five years, at a minimum, in an effort to contain expenditure. Pharmaceutical companies thus have little option but to work around this complex landscape.

From a business perspective, the impact of price control is severe. Prices of mature products are under intense pressure and experience frequent reductions, even as manufacturing and marketing costs as well as other expenses are growing. Consequently, two major approaches have been adopted by the pharmaceutical companies to maintain a reasonable level of business profits.

One is economies of scale, either by horizontal or vertical consolidation, and the other approach is to localise manufacturing. If you take the period of 2011-2012 as an example, 132 deals took place in China's pharmaceutical sector, with a total disclosed transaction size of $5.2 billion for 94 deals. This indicates that the consolidation-collaboration trend is becoming entrenched in the healthcare & life sciences market, with both foreign and Chinese companies becoming unusually active. Big multinationals as well as leading domestic players are adopting either M&A or joint venture arrangements as a short-cut to rapid development.

The government welcomes this collaborative approach to accelerate the development of the healthcare & life sciences industry, which concurrently facilitates the implementation of the healthcare reform. For this purpose, qualified M&A transactions could enjoy tax deferral treatment in relation to the capital gains generated from such corporate reorganisation arrangements. Various authorities could also grant financial subsidies and other monetary incentives to attract large pharmaceutical groups to establish holding companies and regional headquarters in China.

As an alternative, many companies are now contemplating the development of new products, which are not subject to price controls. Innovative drugs and first generics can enjoy exclusive pricing rights, guaranteeing relatively high profit margins for the population and sales of the new products. This approach is essentially in line with the government's support of innovation and R&D activities in the healthcare & life sciences industry.

As pharmaceuticals is one of the industries listed in the High and New Technology Areas with Key Support by the State and Guidance for Development of Prioritised Key Areas of High Technology Industries, the government has outlined the these key tax incentive policies applicable to R&D activities, with an objective of encouraging companies in China's healthcare & life sciences industry to carry out R&D activities continuously and improve their R&D capabilities:

- Preferential corporate income tax (CIT) rate of 15% for recognised high and new technology enterprises;
- Preferential CIT rate of 15% for recognised advanced technology service enterprises;
- Bonus deduction of R&D expenses incurred for the development of new technologies, products and technological processes;
- Value added tax (VAT) exemption for revenue from technology transfers, development and related consultation and service provisions; and
- VAT exemption for revenue from qualified offshore outsourced service, e.g., knowledge processing outsourcing.

There are certain conditions to be satisfied to avail of the respective tax treatments. To enjoy some of the above favourable tax treatments, multinational pharmaceutical companies may consider reviewing or revising their business model for the production, distribution and sale of drugs in China. For example, they can consider arranging R&D centres or divisions set up in China to lead certain projects for part of their non-core business within the group and allow these centres or divisions to have ownership over the intellectual property resulting from the activities to satisfy the requirements for the relevant tax incentives.

Recent pharmaceutical investigation and tax risk management

The pharmaceutical industry in China is undergoing changes and such a fast-growing market is characterised as one of vast opportunities with extensive competition. It is inevitable in the business world that where there is high return, there is high risk, especially in an environment where the development of a mature regulatory and monitoring system is still on the way.

A recent high profile investigation into a leading pharmaceutical company in China, which resulted in arrests or detention of several senior executives, has now escalated into a more prolonged industry-wide investigation, amid concerns that illicit payments and other inducements are being made routinely to public health officials or other medical practitioners.

It is not a single or incidental event in pharmaceutical industry. It signals the government's recognition that supply chains and pricing in this industry need to become more transparent. Good corporate governance and developing guidance for sound tax risk management is crucial, particularly where the companies are subject to high levels of regulation, make high-margin consumer products or rely upon agency-distributor models to drive sales.

Since 2009, the SAT has been encouraging enterprises to establish effective tax risk control systems. An effective tax risk control system will help businesses detect tax risks at the embryonic stage and address these risks before they materialise into major tax non-compliance, which could lead to penalties for the taxpayers and bring a negative impact on the taxpayers' reputation. For instance, an effective tax invoice management system is fundamental to tax collection and administration in China.

The SAT considers tax risk management as an increasingly important area of tax supervision and consequently senior management of a company has a personal stake in the implementation of an effective system to ensure that tax risks are adequately controlled and that tax considerations are factored properly into the corporate decision-making process for major transactions and business strategies.

Due to rapid economic growth and limited government resources, the SAT started to focus on the tax administration of large-scale enterprises in recent years. Therefore, within China, there is a reason to believe that any domestic regulatory actions may lead to a higher probability of audit from the tax authorities. Demonstrating good tax governance, supported by a sound tax risk management framework, can be another important element in any response to the tax authorities. For example, as a result of the recent investigation of the pharmaceutical companies, you can expect the tax authorities to consider conducting a special audit on pharmaceutical companies to obtain access to their tax compliance status.

While the situation is evolving fast, we believe there are six areas that senior management needs to consider urgently:

- Review third parties and intermediaries. Any companies that are reliant upon distributors and other agency models need to establish and maintain up-to-date information about third parties as a matter of utmost urgency. Clear policies are now needed to eliminate the risk associated with a company's entire ecosystem of business partners.

- Consider compliance procedures in the local context. One important consideration for any multinational operating in China is whether their global compliance policies are proportionate and appropriate in a local context.
- Ensure compliance activities are well documented. Having information clearly documented can remove uncertainty and delay from the process, and give a business more visibility about where it stands as well. In practice, this can require changes to deep-seated behaviours that need to be tackled through training and awareness programmes.
- Consider the capacity of the finance function and IT infrastructure. Over the past decade, many in-house accounting and tax functions in China have not expanded or matured at the same pace as the rest of the business, meaning they are poorly placed to respond to an evolving and complex situation such as that now facing the pharmaceutical industry. The invoice (*fapiao*) system or receipt issuance in China is particularly prone to abuse in the absence of strong checks and balances by internal audit and finance functions. Similarly, executives should consider whether their IT systems can enable them to capture and aggregate the data that may be needed for an investigation or whether they have the tools to effectively detect and remediate anomalous patterns of behaviour.
- Consider the implementation of an effective tax risk management system. Tax risk management should be considered as part of the overall risk management of the company. The relevant tax risk controls and documentation requirements should also be integrated into the enterprise-wide internal control program of the company. By implementing effective tax risk management, the company is poised to realise various benefits, including but not limited to reducing tax exposure and related financial costs; lowering tax audit risks and compliance costs; increasing certainty in preparing financial statements; and avoiding the surprise element which affects business' reputation.

Looking ahead

The latest investigations into the pharmaceutical industry should cause other companies to reconsider the balance of opportunities and risks associated with operating in China.

These are serious concerns that will have global implications for many multinationals. In many cases, they need to be addressed through changes to working culture that can only be effected with carefully chosen improvements to internal controls, remuneration and incentive policies, and other systems.

Obviously China will become one of the largest healthcare consumption markets in the world as the huge demand potential of its 1.3 billion-plus population is released over the next 10 to 20 years. Satisfying the substantial demand is not only a major task for the government, but a mission and an opportunity for the players in the healthcare & life sciences industry. The market calls for the emergence of strong players that can ensure that quality healthcare services can be delivered to China's massive population, but also needs those players with good corporate governance and sound tax risk management to set an example to their peers and ensure the healthy development of this industry as well as make a sustainable economic and social contribution to the country.

Auto industry – bumpy rides ahead

With the auto industry in China growing at a breakneck pace, the Chinese authorities are placing it under close scrutiny on issues ranging from Customs duties, indirect tax and transfer pricing. William Zhang, David Ling and Sam Fan of KPMG China examine the tax challenges lying ahead for car manufacturers and producers of auto parts and components in China, and ways to deal with those challenges.

KPMG's 2013 Global Automotive Executive Survey shows that automotive markets continue to mirror the general economic gloom in Western Europe and Japan, with a significant proportion of respondents believing that sales and production will continue to decline in the next five years. Though the exception is the US, where more than 40% of the executives surveyed believe that both sales and overall vehicle output will either stay the same or go up, the global focus in the automotive world appears to be overwhelmingly shifting to emerging markets. Indeed, China appears to be the top choice for investment from all automakers globally, with 70% of respondents indicating that they will begin or increase investments into China.

At the same time, regulations are getting tougher in China for the establishment and operation of production facilities. Respondents to the Global Automotive Executive Survey expect environmental restrictions to remain challenging and foresee increases in governmental interventions and rises in import and export duties. As is often the case in most economies, government interventions can come under the guise of taxation.

Already, we are seeing increasing audits on companies with the High-New Technology Enterprise (HNTE) status so often enjoyed by many players in the auto parts industry as well as growing scrutiny being placed by customs officials on the classification of imports. On the other hand, the shifting sands of the regulatory environment are keeping companies on their toes as the HNTE qualification criteria has been made more difficult to meet by changes to Chinese labour law and the phasing-out of the 2+3 corporate income tax (CIT) holiday has foreign auto companies rethinking their structures in China. Even new reforms that seemingly have little to do with the auto industry can still have an impact as the VAT reforms could influence logistics costs; however, existing regimes such as the foreign currency controls continue to present challenges to the auto industry.

However, these challenges are by no means insurmountable so long as appropriate planning is in place and properly executed.

HNTE incentives

China is increasingly seeking to transform itself from a manufacturing powerhouse to an innovation centre. Authorities across different levels, functions and locations in China are keen to offer incentives and special tax benefits in an effort to attract investment and encourage innovation. This bodes well for the auto industry, whose executives, like many of those in other industries with competitive markets, now recognise that the path to success lies in innovation.

The HNTE qualification is a popular incentive often accessed by auto parts manufacturing companies that grants a 15% preferential CIT rate to companies in China that meet the criteria. However, expanding business activities coupled with ever-changing regulations have made it more difficult for certain companies to continue to satisfy certain HNTE qualification criteria.

Personnel requirements

One of the HNTE qualification criteria requires at least 30% of a company's personnel to hold college or higher degrees, at least 10% of which must be engaged in R&D activities. Yet many auto parts companies, being typically manufacturing businesses, find this criterion challenging to fulfil due to the labour-intensive nature of their work and the high number of staff they usually require.

Therefore, a common arrangement adopted by companies seeking to qualify this criterion is to arrange for staff loans with labour agents. Under these arrangements, workers legally employed by labour agents are loaned to the companies to provide manufacturing services. The companies then argue that the loaned workers should not be considered as their employees and therefore should be excluded from total headcount.

However, China's new labour contract law effective from July 2013 stipulates that the employment of labour forces by way of staff loan arrangements should only be applicable for temporary or auxiliary positions and such positions should not last for more than six months. This means that workers loaned to a company from labour agents may need to be employed by the company as its own employees in the future if these workers are to be employed for more than six months. As a result, total number of staff of the company will increase and the percentage of the qualified scientific technology staff over the total number of staff may drop to a level below the threshold.

In light of this development, companies should:

- assess the possibility that the labour authority will implement the revised PRC Labour Contract Law strictly and require the manufacturer to employ loaned staff as its own employees.
- re-consider its staffing arrangements and closely monitor the headcount ratio to ensure it satisfies the criteria for HNTE.
- consider measures that might minimise the exposure, such as outsourcing labour-intensive, but low-profit manufacturing processes to a related-party manufacturer (who is not seeking HNTE status) or splitting the company into two legal entities, with one engaged in labour-intensive and low-profit manufacturing activities and the other maintaining operations qualifying as an HNTE.

R&D expenditure requirements

Companies seeking to qualify as an HNTE must also ensure that their ratio of R&D expenditure to total sales is no less than 3% to 6% (depending on the total sales of the company). This poses a challenge for companies expanding their businesses and growing their sales, who may need to keep increasing their R&D expenditure to satisfy the said R&D expenditure requirement and to maintain their HNTE status.

An alternative, however, would be to reduce total sales. For instance, a company may consider selling its products to a related-party trading company at a price lower than the price it would ordinarily sell to third-party customers at. This reduction in total sales would make it easier for the company to satisfy the R&D expenditure requirement.

Although this arrangement would mean that the portion of the profit transferred to the related-party trading company would be subject to the higher standard CIT rate of 25%, the majority of the profit would still remain with the HNTE, subject to the lower preferential CIT rate of 15%. This is still preferable to the situation where the company loses its HNTE status entirely so that all its profits are subject to 25% CIT.

In implementing such an arrangement, it is important to ensure that the sales between the HNTE and the related trading company are still conducted on an arm's-length basis. A detailed transfer pricing study supporting the arm's-length range of pricing charged by the HNTE to the related trading party based on the risks and functions transferred to the trading company should be conducted, and the necessary documentation should be put in place.

Imports/exports to be scrutinised

Of the auto industry executives surveyed in the 2013 KPMG Global Automotive Executive Survey, 54% of respondents anticipate increases in import/export duties in China in 2013, compared with just 27% in 2012. Given this more intense focus on imports and exports, tariff classification is increasingly being scrutinised by China Customs officials.

China provides a Harmonisation System (HS) code for most goods imported into China. As well as customs duties, the HS code also determines the appropriate import licences/certificates that a company needs to hold and the value added tax (VAT) refund rates. More and more companies have been challenged by customs authorities over the HS codes they have adopted for some of their goods. The incorrect adoption of an HS code can result in penalties if it leads to the underpayment of duties and taxes, excessive VAT refunds, or the failure to hold the appropriate licences/certificates.

This issue is especially important when it comes to the importation of auto parts, where special rules mean that detailed studies need to be carried out by technical specialists before the right HS code can be determined. For example, issues such as how the composition of rubber elements and the level of processing a part has undertaken could change the HS code. And different HS codes also apply depending on the physical state of the product; different tariff classifications and rates apply when the goods are assembled and when they are broken down into components, sub-assemblies or individual parts.

Given the nuanced nature of tariff classification for the auto parts industries, it is important for the companies carrying out these businesses to pay close attention to the rules governing how and when different tariff classifications come into play.

Branch vs legal entity

A common conundrum often faced by foreign car and auto parts companies expanding their presence in China is whether to incorporate a new legal entity or to use their existing Chinese subsidiaries to set up a new branch. Where previously foreign auto companies have almost always preferred to set up legal entities instead of branches to enjoy the 2+3 CIT holiday policy, this is no longer the case.

The 2+3 CIT holiday was a tax incentive scheme introduced to encourage foreign investment into China, where Foreign Invested Enterprises (FIEs) were entitled to two years of exemption from CIT followed by three years of a 50% reduced CIT rate. However, with the phasing out of the 2+3 CIT holiday under the new CIT regime, many foreign car and auto parts companies are looking into streamlining their legal structure in China and converting existing legal entities into branches or setting up new branches under an existing Chinese subsidiary. Unlike legal entities, no additional registered capital is required to set up a branch. Under the branch structure, tax losses can be used more efficiently due to the consolidated CIT filing mechanism for head office and its branches.

Even so, it is still pertinent to consider some of the pitfalls of setting up a branch instead of a legal entity; compared with a legal entity, branches often find it more difficult to be awarded local financial subsidies and to obtain local government approval for establishment. Uncertainties also remain about whether branches are required to file CIT and VAT returns locally, and if so, how the taxes should be calculated. This is because, despite the ability to file a consolidated CIT return, a portion of the total CIT is still payable to the local tax authority by an "operational branch" (manufacturing branches are very likely treated as operational branches) where that branch is located.

For example, a Chinese company whose head office is incorporated in Shanghai has an operational branch in Nanjing; under consolidated CIT filing, the CIT liability will be calculated on a branch-head office consolidated basis. While a portion of the total CIT payable under the consolidated filing is payable to the local tax authority in charge of the Nanjing branch, how this portion is calculated is still subject to uncertainties. That is, although regulations stipulate that the portion of the CIT belonging to the local authority is to be calculated based on operating revenue, salaries and wages, and total assets, questions remain as to how these factors are to be determined (for example, whether the equipment purchased by the head office but used by the branch should be considered the branch's asset).

On the other hand, while there is no technical requirement for a manufacturing branch, which does not conclude a sales contract with and collect sales proceeds from customers directly, to file VAT returns locally, some local tax authorities may still ask for it on the basis that the branch is carrying out manufacturing activities locally and consumes local resources. This then begs the question of how revenue should be determined for VAT purposes for branches carrying on manufacturing activities, a question that cannot be clearly answered based on VAT regulations.

In light of this, it is important to appreciate and weigh up fully the benefits of establishing branches over legal entities. The relevant regulations and local practices regarding CIT and VAT filing obligations must be understood to minimise

Biography

William Zhang
Tax Partner

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3415
Fax: +86 21 6288 1889
Email: william.zhang@kpmg.com

William Zhang has been providing China business, tax and regulatory advisory services for various multinational companies since 1997. He has assisted many multinational companies in making investments in China and has extensive experience in serving clients engaged across a wide spectrum of industries.

William's experience includes assisting multinational companies in formulating expansion strategies into China; setting up and structuring their business operations in China; fulfilling relevant registration and filing requirements to the stage of working out practical solutions to various tax issues; and exploring possible tax planning ideas for clients.

In particular, William has advised many multinational companies engaged in the industrial and consumer markets (including the electronics industry, home appliance manufacturing, auto and auto components, and chemistry) on their day-to-day operations, including performing tax health checks to identify non-compliance tax issues and tax planning opportunities; performing tax due diligence work; and providing tax restructuring advice for M&A activities, and advising on tax efficient investment and exit strategies.

Biography

David Ling
Tax Partner in Charge of Northern China

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: + 86 10 8508 7083
Fax: + 86 10 8518 5111
Email: david.ling@kpmg.com

David Ling is the China tax partner in charge of the Northern China tax practice.

David joined an international accounting firm in the US in 1992 after obtaining his master's degree in US taxation. He transferred to China in 1993 and has worked in the Hong Kong, Beijing, Shanghai and Shenzhen offices. He became a tax partner in 2002 and joined KPMG's Beijing office the same year.

David has extensive experience in China tax planning and tax negotiation with counterparties. His expertise includes advising foreign companies in establishing operations in China, particularly in the establishment of investment holding companies and foreign invested trading companies. He also has extensive knowledge of China Customs regulations, foreign exchange control policies, and other regulatory regulations.

David has long-standing relationships with various Chinese authorities including the Ministry of Commerce, the State Administration for Industry and Commerce, the State Administration for Foreign Exchange, Customs and the tax authorities at both central and local levels.

Biography

Sam Fan
Tax Partner

KPMG China
9th Floor, China Resources Building
5001 Shennan East Road
Shenzhen 518001, China
Tel: +86 755 2547 1071
Fax: +86 755 8266 8930
Email: sam.kh.fan@kpmg.com

Sam Fan started his tax consulting career in Hong Kong in 2001. In 2003, Sam relocated to Shenzhen to focus on China tax advisory. With more than 12 years in the Southern China region, Sam has extensive practical experience.

Sam provides China tax compliance and consultancy services to multinational companies. He also advises clients on taxation and business regulatory matters relating to their initial investment, ongoing operations as well as their holding/funding structures of Chinese business entities.

Sam has also been involved in a number of due diligence projects in different sectors, including consumer markets, infrastructure, mining and manufacturing. He focuses on regulatory and tax structuring aspects of various inbound M&A transactions and foreign direct investments in the PRC.

Sam specialises in the trade and customs areas. Sam provides customs advisory services in relation to processing trade, customs valuation and classification. He has extensive experience in handling customs audit cases for clients.

potential challenges from the tax authorities not only in charge of the head office, but also in charge of the branch.

VAT reform

Some of the discussions above involve interventions and policies that more or less have a direct impact on the automotive industry in China. But it is equally important to appreciate that other areas of reform in China have produced unintended consequences for the automotive industry. One such example is China's VAT pilot programme.

This reform programme rolled out across all remaining cities and provinces in China from August 1 2013. In anticipation of the rollout, the Ministry of Finance (MoF) and the State Administration of Taxation (SAT) jointly issued Circular *Caishui* [2013] No 37 (Circular 37), setting out new regulations and consolidating previous VAT regulations.

One significant change introduced in Circular 37, the repeal of the net basis calculation method under business tax (BT) due to the substitution of BT with VAT for certain types of services, has wide-ranging consequences for a number of industries. Under the BT rules, the net basis calculation method allowed intermediary companies such as forwarding companies and shipping agents to claim a deduction on freight fees paid to airlines and shipping companies for international transportation services and to pay 5% BT on the net amount. However, since the VAT pilot programme seeks to replace BT with VAT for the transportation and logistics industries (among others), the net basis calculation method is effectively redundant.

Instead, the VAT pilot programme provides that the provision of transportation service is subject to VAT at 11% and the provision of logistics and ancillary services is subject to VAT at 6%. Chinese companies providing international transportation services enjoy a VAT rate of zero, while many international shipping companies are exempt from VAT under bilateral tax treaties between China and their home countries.

Purchasers of these services can claim a VAT input credit when valid VAT special invoices are obtained.

Therefore, under the VAT pilot programme, freight forwarding companies and shipping agents can no longer claim a deduction for the freight fees, but instead, are directed to apply for a VAT input credit incurred on the freight fees. The problem with this treatment is that in practice, it is difficult for freight forwarding companies and shipping agents to obtain VAT special invoices, which are required by them to claim the VAT input credit.

Without the ability to claim the VAT input credit, an additional tax burden falls on these companies and their financial performance can be affected significantly. Therefore, to mitigate this additional tax burden, some forwarding companies and shipping agents have begun to pass the cost onto their customers.

As an industry that normally has substantial import and export transactions, the automotive industry, particularly companies in the auto parts business, would do well to anticipate increased international logistics charges from their forwarding and shipping agents. This could mean that auto industry companies should take a fresh look at their existing supply chains and seek to optimise existing transaction flows, and work together with their forwarding companies and shipping agents to minimise VAT costs.

Mould payments

Lastly, though not a new measure, the foreign exchange regime in China has often posed challenges for both foreign and domestic entities that conduct international transactions. Moreover, attempts to overcome difficulties in remitting money abroad with changes to contractual terms can also result in unintended tax consequences. Although these difficulties are encountered by all participants in the automotive industry in China, this issue is of particular relevance to auto parts manufacturers that seek compensation from their customers (for example, auto original equipment manufacturers (OEM) or higher-tier auto parts manufacturers) for the cost of developing or purchasing the moulds required for production.

The foreign exchange regime in China makes it difficult for Chinese auto OEM or auto parts manufacturer customers to make such payments to a foreign entity since there is no actual physical importation of the moulds into China. One solution that has been employed to circumvent these foreign exchange restrictions is for overseas suppliers to incorporate the cost of the moulds into each unit price. However, this can cause the unit price of the products to fluctuate substantially, particularly where suppliers seek to recover the costs earlier rather than evenly over a period of time. Moreover, such an arrangement also makes it difficult to justify any transfers of the legal title of the moulds.

Alternatively, PRC customers should consider settling the payment as a form of compensation for mould R&D expenses or rental expenses with overseas suppliers, which should minimise the unit price fluctuations. Under this alternative, though the settlement of compensation in the form of service fees overseas may be relatively straightforward under the newly promulgated foreign exchange regulation Circular 30 (as only a simple referential filing with tax authority is required before the settlement for single payments of more than $50,000), additional taxes such as CIT and VAT or BT may apply on such cross-border payment of R&D expenses.

It should be noted that similar tax and foreign exchange issues may also arise where the situation is reversed and foreign companies attempt to make the same payments to auto parts manufacturers in China. Conversely, where both the supplier and the customer are located in China, the credibility of the input VAT on the payment for moulds may be called into question if the moulds are not physically delivered to the customers.

In light of this, it is important for both parties to perform a full analysis of current arrangements and consider if an alternative structure can mitigate any identified tax and customs risks.

The road ahead

With the auto industry in mature markets such as Europe and Japan in decline for the time being, it is little wonder that the industry is looking to engage more with emerging markets. At the same time, the rapid upskilling and development of China's abundant workforce and growing demand from its increasingly affluent middle class has made it an attractive place for foreign auto companies to invest in.

The government has made innovation one of its priorities in its 12th Five-Year Plan, and it is certainly an opportune time for foreign auto companies, whose route to success depends in part on the success of new R&D, to take advantage of the incentives being offered.

On the other hand, the rise of the Chinese car industry has also attracted scrutiny from customs and tax authorities, keen to ensure that a fair share of the industry's success remains in China. The topics discussed here are only a sample of the common issues faced by auto companies in China; other questions on consumption tax, permanent establishment exposure and transfer pricing rules also regularly challenge the auto industry. As an industry sensitive to changes in the regulatory environment, changes in these areas need to be closely monitored by companies.

Green tax policy – slow but steady

China has made some progress recently regarding resource tax, consumption tax and an emission trading scheme. It may be only time before this more holistic approach culminates in an environment tax or green tax. Jean Ngan Li, Sunny Leung and Jessica Xie of KPMG China consider what progress may be made in China's tax policies on environmental protection.

To achieve the objective of sustainable growth, the Chinese government aims to achieve the national objectives in energy conservation/environmental protection shown in Table 1 by the end of the 12th Five-Year Plan (FYP).

As part of the efforts to meet these targets, a carbon trading market in China has been launched. The government has also introduced new rules in the regulations on resource tax and consumption tax to discourage excessive energy use and pollution.

Table 1

Criteria	2015 target
Reduction in energy use	16% reduction per unit GDP
Reduction in carbon dioxide emissions	17% reduction per unit GDP
Power industry investment	RMB5.3 trillion ($870 billion) investment
Use of non-fossil fuels as a percentage of total energy use	11.4% of total energy use

Emission trading scheme

China launched its first pilot emission trading scheme (ETS) in June 2013. Seven municipalities/provinces have been selected to participate in the pilot scheme. This development could be a major milestone in China's efforts to reduce greenhouse gas (GHG) emissions.

An ETS was first incorporated into the national Clean Development Mechanism (CDM) plan in 2004 and has subsequently been amended twice. However, the establishment of such a system was never implemented.

In 2011, the National Development and Reform Commission (NDRC) announced that Beijing, Tianjin, Shanghai, Chongqing, Hubei Province, Guangdong Province and Shenzhen (participating regions) would initiate the carbon trade pilot programme. The NDRC required the participating regions to:

- design their own implementation measures and rules;
- determine their local greenhouse gas emission targets and emission quota allocation methodology; and
- establish local carbon trade exchanges.

The government expects the participating regions to commence regional carbon trade transactions by the end of 2013 and aims to establish a preliminary national carbon trade system by the end of 2015.

Since the announcement of the launch of the ETS, the participating regions have started studying the feasibility of establishing a carbon trade mechanism in their respective locations.

Some of the participating regions have specified their own carbon trade system development plan and timeline; some have already started carbon trading.

Shenzhen

Shenzhen launched the first Chinese ETS. The Shenzhen Carbon Exchange, which involves 635 industrial companies from 26 industries, generating about 30 million tonnes of carbon dioxide emissions a year.

Eight transactions were completed on June 18 2013, the first trading date of the exchange. According to the exchange's management, by early August 2013, cumulative transaction volume yield was 12,000 tonnes and the cumulative transaction amount hit RMB473,000, standing for an average price of RMB40.75. By the end of August 2013, about 500 enterprises were under the carbon emission control and some individuals have created carbon exchange accounts.

Shenzhen has set an ambitious target for its ETS compared with existing national or local commitments. The 635 companies will be given about 100 million metric ton carbon dioxide emission allowances for free over the next three years. If the companies only emit their allotted amount, this would be equal to a 32% reduction in terms of GDP emission intensity. To put things into perspective, China is committed to reduce its emission intensity by 40% to 45% by 2020, and Shenzhen's carbon intensity reduction target during the 2011-2015 FYP is 21%. It is worth noting that the allowances are determined by emissions intensity rather than in absolute terms, meaning that the government will review companies' Industrial Added Value on an annual basis and increase or decrease the absolute emission allowance to maintain a fixed emissions-to-GDP ratio.

Guangdong Province

Guangdong Province plans to initiate carbon trading in the primary market in the second half of 2013.

The pilot programme will involve 827 enterprises from high energy consuming industries such as electricity generation, cement production, steel and ceramics production. The Guangdong authority plans to involve investment organisations, individuals and other legal persons in the carbon trading system gradually (see Table 2).

These other cities and provinces below follow a similar timeline as Guangdong Province, although the strength of enforcement may vary.

Beijing

As of the end of August 2013, Beijing had set up its carbon trade exchange and transaction under the Beijing Environment Exchange and its carbon trade policies are already in place. But carbon emission transactions have not been initiated yet.

The Beijing carbon trade pilot programme involves 504 organisations, including 435 enterprises from thermal electricity generation, cement production and petrochemical industries.

Shanghai and Hubei Province

Shanghai and Hubei Province have released a draft of their regional carbon trade management ruling in 2013. The draft ruling sets out general guidelines regarding the methodology of the emission quota management and allocation, reporting and supervision of actual carbon emission, and trading methodology. However, the detailed rules are yet to be put in place.

Shanghai plans to include 197 enterprises from the steel, petrochemical, textile and fibre industries in the scheme. Hubei plans to include 153 enterprises from high energy consuming industries such as steel, petrochemical, cement, car manufacturing and electricity generation.

Tianjin

In February 2013, Tianjin announced its implementation rules for a carbon trade pilot programme. The issuance of the implementation rules signifies that the establishment of the carbon trade system has moved from the preparatory stage to the implementation stage.

Similar to Beijing, Tianjin has established its regional carbon trade exchange. However, no transactions have taken place yet.

Chongqing

Chongqing has established its regional carbon trade exchange, although no transactions have taken place yet.

Table 2

Phase	Timeline	Major tasks
Preparation period	2012 – June 2013	• Design carbon emission quota management plan • Design carbon emission management and trading scheme
Implementation period	July 2013 – December 2014	• Preliminary study for the commencement of carbon trade mechanism and allowance-based carbon trade
Intensification period	2015	• Initiation of provincial carbon trade

Biography

Jean Ngan Li
Tax Partner

KPMG China
9th Floor, China Resources Building
Shenzhen 518001, China
Tel: +86 755 2547 1198
Fax: +86 755 8266 8930
Email: jean.li@kpmg.com

Jean Ngan Li started in the tax profession in Australia in 1997, and was seconded from the KPMG Sydney office to the Beijing office in 2001.

In the last 11 years in China, Jean has acquired significant experience in advising multinational clients on taxation and business regulations for business activities in China and cross-border transactions.

She also has extensive experience in handling the anti-avoidance cases, including Circular 698 indirect transfer cases and transfer pricing audit defence cases. In addition, she assisted Danish clients to conclude bilateral advance pricing arrangements (APA) in 2010 and 2012, respectively, and also worked on the first APA case, which involved the Large Enterprise Division of the State Administration of Taxation in 2011.

Biography

Sunny Leung
Tax Partner

KPMG China
50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel: +86 21 2212 3488
Fax: +86 21 6288 1889
Email: sunny.leung@kpmg.com

Sunny Leung started her career in New York in 1997. She joined KPMG's New York office, specifically the federal tax practice, in 2000 and provided US tax compliance and advisory services to various multinational companies.

Sunny joined KPMG China's Shanghai tax team in 2005. Since then, she has been providing China tax advisory and compliance services to multinational companies in the manufacturing and service industries. She has had extensive involvement in advising clients on setting up operations in China, M&A transactions and cross-border supply chain planning. She has also been providing tax due diligence and tax health check services in China.

As of September 2013, there has been no announcement of entities to participate in the carbon trade pilot programme. However, it is anticipated that the enterprises involved will mainly come from the electrolytic aluminium, ferroalloy, calcium carbide, caustic soda, cement and steel production industries.

Challenges

Based on the progress of the pilot programme, the issues discussed below may adversely have an impact on the effectiveness of the mechanism.

Emission cut vs economic growth

The political will to reach the ambitious reduction target is yet to be tested. There are some concerns that cutting emissions will consequently slow down economic growth. Therefore, it is important that local governments' performance evaluation system for the, strikes the right balance between performance on economic growth and performance on environmental protection.

Determination of total emission quota

Different from the European mechanism, under which the emission quota was determined based on historical emission records, the emission quotas under the pilot programme are determined based on the emission reduction target.

The main problem with such a methodology is whether the emission quota is realistic and whether it serves the goal of emission reduction if no historical data is considered.

Allocation of emission quota

Under the pilot programme, most emission quotas are allocated to selected enterprises/organisations free of charge while a small portion are placed for auction.

The allocation of an emission quota could raise an issue on fairness. The major concern is to which industries and enterprises should the quota be allocated and how much should be allocated.

Even under a properly designed total emission quota, the pitfalls of misallocation among participating organisations are there. Specifically, over-allocation of the emission quota will not serve the objective of emission reduction and those with an excessive quota could benefit from carbon trading in a secondary market. Under-allocation, however, will increase an organisations' costs because they would need to purchase additional quotas from auctions/secondary markets and may potentially weaken their willingness to participate.

Data quality

Data quality is another frequently cited challenge. The government has not yet mandated a unified methodology to

Biography

Jessica Xie
Tax Partner

KPMG China
8th Floor, Tower E2, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel: +86 10 8508 7540
Fax: + 86 10 8518 5111
Email: jessica.xie@kpmg.com

Jessica Xie specialises in advising clients on tax issues concerning the energy and natural resources industry as well as the manufacturing industry.

Jessica has also been active in assisting many foreign companies in designing their corporate and operational structures in China to meet their business objectives. She also focuses on providing M&A tax services to foreign companies and assists in tax due diligence, transaction structuring, post-acquisition structuring as well as setting up various forms of legal entities for acquisition or operational purposes.

Jessica also provides advice to multinational companies in the areas of company regulations, foreign exchange and customs issues.

account and report GHG emissions. Although the ETS pilots are adopting internationally recognised GHG accounting and reporting frameworks, each ETS pilot is likely to develop similar, but slightly different methodologies, making it more difficult to make comparisons between pilots or scale them up to the national level. The ETS pilots are also generally hesitant to put in place stringent data-quality requirements out of fear that companies do not have enough capacity. The fact that caps are derived from intensity targets adds another layer of uncertainty, as economic data such as Industrial Value Added may also be subject to judgmental consideration.

Supporting mechanisms

Actual emissions should be monitored and over-emission penalised to complete the emission reduction objective. To make the carbon trade scheme effective, penalties for non-compliance with the new emissions programme must not be too low to pose a real threat. If profits outweigh the costs of flouting the law, companies have no incentive to reduce pollution.

However, based on the carbon emission and carbon trade systems of the participating regions, no concrete monitoring and enforcement systems are established yet. Without proper monitoring and enforcement mechanisms, the effectiveness of the emission reduction and carbon trade system may be impaired.

What to expect next

Recent discussions have arisen as to whether the carbon trade pilot programme should be expanded. Some argue that the pilot programme should be expanded to cover more regions while others believe that expansion should only be considered upon obtaining more information and experience from the participating regions.

The vice chairman of the NDRC expressed the view recently that the state government encourages voluntary, project-based emission trading; in 2015, the carbon trade pilot programme is expected to be expanded to explore the possibility of establishing a national carbon trade mechanism.

To ensure the effectiveness of the carbon trade mechanism, authorities in participating regions of the carbon trade pilot programme intend to develop a monitoring mechanism on enterprises' carbon emissions. Such a system is likely to involve third-party institutions that measure and investigate participating organisations' actual carbon emissions. Along with a penalty regime, the effectiveness and intensity of enforcement of the carbon trade mechanism will likely improve.

As well as the carbon trade mechanism, some regions have participated voluntarily in the pilot programme of the development of a low-carbon region. In August 2013, the NDRC approved Wuhan and Hainan's proposal for developing low-carbon municipality/province. The proposal consists of a development plan on environmental assessment factors such as the consumption of non-fossil fuels, forest coverage and carbon emissions.

The growth of tax as a green policy tool

KPMG's Green Tax Index ranks China as sixth with a green tax policy that is balanced between incentives and penalties and focused on resource efficiency (energy, water and matters) and green buildings.

Existing tax incentives

At the time of this article, China offered incentives in corporate income tax (CIT) and value added tax (VAT).

Corporate income tax

- A reduced CIT rate of 15% is given for qualified advanced and new technology enterprises. Applicable fields include solar energy, wind energy, biomaterial energy and geothermal energy.
- A CDM fund is exempt from CIT on certain qualified income.
- A CIT incentive of a three-year exemption and a three-year 50% rate reduction is available on income derived from specified CDM projects or qualified environmental protection and energy or water conservation projects, starting from the year in which the relevant revenue is first generated.

Table 3

Resource	Old tax policy	New tax policy
Crude oil	• RMB8 to RMB30 per tonne	• 5% tax on the sales price
Gas	• RMB0.02 to RMB0.15 per cubic metre	• 5% tax on the sales price
Rare earths	• RMB0.5 to RMB3 per ton or cubic metre	• Light rare earths: RMB60 per tonne • Heavier rare earths: RMB30 per tonne

- Ten percent of the amount invested in qualified equipment is credited against CIT payable for the current year, with any utilised investment credit eligible to be carried forward for the next five tax years if such equipment is qualified as special equipment related to environmental protection, energy, or water conservation and production safety.
- Only 90% of the revenue derived from a transaction is included in calculating taxable income for CIT purposes if such revenue is derived from the use of specific resources associated with synergistic use of resources as raw materials in the production of goods.

Value added tax

- 50 percent refund of VAT is paid on the sale of wind power.
- 100 percent refund of VAT is paid on the sale of biodiesel oil generated by the use of discarded animal fat and vegetable oil.
- VAT paid on the sale of goods produced from recycled materials or waste residues is refundable.
- VAT exemption on the sale of self-produced goods including recycled water, qualified powered rubber and certain construction materials made from waste residuals (a minimum 30%).
- VAT exemption on sewage treatment, garbage disposal and sludge treatment services.
- VAT refunds at rates ranging from 50% to 100% of the VAT payable on sales of self-produced goods by using the prescribed recycled materials, waste residues and agricultural residues.

Tax law changes to protect the environment

A recent report presented by Jia Chen, head of the tax division at China's Ministry of Finance (MoF) stated China will introduce a set of new taxation policies designed to preserve the environment: "The Chinese government will collect the environmental protection tax instead of pollutant discharge fees, as well as levy a tax on carbon dioxide emissions, and the local authorities will be responsible for the tax collection," Jia said in the report.

The potential targets of the environmental protection tax are sulphur dioxide, waste water, solid waste and carbon emission. The tax base will be the quantity of actual emission or effluence of pollutants.

There is no precise timeline on passing the environmental tax law in China. Draft environmental protection tax legislation has been submitted to the China State Council for review; however, at the time of drafting this article, the Standing Committee of the State Council has not specified any timeline to review and approve it.

Extend the resource tax reform to cover coal

Resource tax in China has a dual role of (i) raising revenue for local governments and (ii) encouraging resource conservation (through higher downstream prices if costs are passed on to end users). The new resource tax law became effective from November 1 2011. The amendment to the resource tax law mainly consists of a change of tax base from quantity to value to produce a fair distribution and allocation of the tax revenues of the areas where mineral resources are located and exploited and those of the areas where downstream operations are carried out and consumers are concentrated. As a result, crude oil and natural gas are now subject to resource tax at 5% of the sales revenue (see Table 3).

In 2012, China raised the resource tax on six minerals – iron ore, tin, molybdenum, magnesium, talc and boron – in a bid to conserve resources.

As part of continuous efforts to enhance the efficiency of energy usage, the next step of the resource tax reform is to expand the tax to coal based on prices instead of sales volume. It is expected that the change will drive the coal industry to enhance technologies, curb overcapacity and protect the environment. Similar to the resource tax reform in 2011 and the VAT reform, the coming resource tax reform will probably start with a pilot programme in major coal production regions, with the objective of obtaining realistic data and a better assessment of the impact of the reform.

Apart from the resource tax, Chinese mining enterprises are also subject to the Mineral Resource Compensation Fee, which is based on a certain percentage of their sales revenue. The forthcoming resource tax reform will involve the merger of the Mineral Resource Compensation Fee to form a unified mining levy. However, there are likely to be obstacles in the path of such unification given that it will affect the revenues of different government bodies. Resource tax is collected by the tax authorities while the Mineral

Resource Compensation Fee is levied by the agencies under the Ministry of Land and Resources.

Although the resource tax reform proposal has already been submitted to the State Council, there is no specific timeline for the roll-out of the resource tax reform yet. Nevertheless, the government has made the resource tax reform a high priority, thus it is expected that it should be implemented in the near future.

Consumption tax reform expected to debut soon

The government is planning to implement consumption tax reforms, which may include adjustments of the collection scope, tax rates and collection procedures. Consumption tax is levied on 14 consumer products, including alcohol, cosmetics, jewellery, and tobacco. The list may be expanded to cover high energy-consuming items (that is, goods that could cause severe environmental pollution and over-exploitation of resources).

A step forward

The launch of the Shenzhen carbon trading exchange proves that China is stepping up its efforts to tackle environmental issues. While there are still some obstacles to overcome, the ETS pilot programme does offer a strong starting point for a market-based approach to constrain emissions in China. If successful, these pilots can then be scaled up nationally and will help demonstrate that China is serious about tackling its emissions and addressing the growing threat of climate change.

The introduction of the environmental protection tax will be another significant step forward. The shift from a volume-based to a value-based resource tax on coals is the latest signal from the government that it is hoping to make the country less dependent on coal in the long run. While at the time of drafting this article, there is no timeline for the implementation of the environmental protection tax and the resource tax reform, it was expected that the tax reform timeline would be seriously considered in the third plenum of the 18th Communist Party of China Central Committee, which was held in November 2013. There are reasonable chances that both the environmental protection tax and the resource tax reform will be implemented in 2015.

KPMG

cutting through complexity

INTERNATIONAL TAX.

INNOVATIVE SOLUTIONS.

Cross-border tax issues for China are complex and must be carefully managed. KPMG China's highly experienced international tax team is adept in resolving difficult Chinese tax and regulatory problems for multinational enterprises. We help companies develop and implement solid tax and business strategies, and overcome the challenges of cross-border investment into China. Our deep knowledge and global network allow us to identify planning opportunities for our clients and create value for their business.

For more information, please contact:

Abe Zhao
International Tax Country Leader, China
KPMG China
abe.zhao@kpmg.com

kpmg.com/cn