

CHINA TAX ALERT

ISSUE 19 | July 2014

Guidance on Chinese General Anti-Avoidance Rule published for public comment

Regulations discussed in this issue:

- *Discussion draft of Administrative Measures on the General Anti-Avoidance Rules (Draft GAAR administrative measures)*, issued for public comment by the SAT on 3 July 2014
- *Corporate Income Tax Law (CIT Law) of the People's Republic of China (PRC) and the Detailed Implementation Rules (DIR) for the CIT Law of the PRC*, both effective 1 January 2008
- *Circular of Implementing Measures for Special Tax Adjustments*, Guo Shui Fa [2009] No. 2 (Circular 2)
- *Notice of the State Administration of Taxation on Strengthening the Administration of Corporate Income Tax on Gains derived by Non-resident Enterprises from Equity Transfers*, Guo Shui Han [2009] No. 698 (Circular 698), issued by the SAT on 10 December 2009

Background

On 3 July 2014 the Chinese State Administration of Taxation (SAT) released draft GAAR administrative measures for public comment. The draft GAAR administrative measures provide guidance on when a tax avoidance scheme is in point, on the internal tax authority protocols for selection of GAAR cases, on the documentation which may be demanded from taxpayers, and on the manner in which tax adjustments for unwarranted tax benefits can be made.

The draft GAAR administrative measures should provide a greater degree of transparency over the procedures by which GAAR cases are administered. However the guidance on the identification of avoidance transactions arguably also widens the transactions caught in the GAAR net. Interested parties have until 1 August 2014 to lodge their comments with the SAT.

Existing GAAR law and guidance

The Chinese domestic law GAAR, set out in Article 47 of the CIT Law, uses a tax avoidance purpose test to identify impermissible tax arrangements in respect of which tax adjustments may be made. It is directed at arrangements which lower taxable income and lack reasonable business purposes. Article 120 of the DIR equates a lack of reasonable business purposes to having the reduction, avoidance or deferral of tax payments as 'primary purposes'.

Further guidance is provided in Circular 2, which directs the local tax authorities to evaluate potential tax avoidance arrangements with reference to the 'substance over form' principle, while having regard to specific, enumerated aspects of the arrangement; namely, the scheme's form and substance; the time and manner of the establishment of the scheme as well as the steps involved in putting it in place, the financial situations of the scheme parties and the tax outcomes of the scheme.

Circular 2 notes the range of circumstances in which the tax authorities may choose to initiate GAAR investigations, including misuse of tax preferential treatments, misapplication of tax treaties, misuse of corporate organizational

Regulations discussed in this issue:

- *Circular on how to understand and recognise the “Beneficial Owner” in DTAs*, Guoshuihan [2009] No.601 (Circular 601), issued by the SAT on 27 October 2009

forms, use of tax havens to avoid tax and other arrangements with non-reasonable commercial purposes.

Specifically in relation to cross-border transactions, Article 94 of Circular 2 provides that “For an enterprise without economic substance, especially an enterprise which is established in a tax haven and causes its related parties or non-related parties to commit tax avoidance, the tax authorities may negate the existence of the enterprise from the perspective of tax collection”.

This particular focus on ‘economic substance’ finds expression in the practical application of the GAAR to international transactions and structures. In reported cases, particularly the application of the indirect offshore disposal provision Circular 698, the tax authorities have focussed on the staff, premises, business activities and assets attributable to foreign entities, in determining whether a tax avoidance scheme is in point, and have given lesser weighting to the purported reasonable business purposes of the scheme.

Circular 2 also contains a brief discourse on procedural matters, noting that the tax authorities may serve a notice of GAAR investigation on a taxpayer, having obtained approval from the SAT, and that taxpayers must provide documentation to prove the reasonable business purposes of the investigated transaction within 60 days. Third parties, involved in the planning of tax avoidance arrangements, may also be requested to provide documentation.

Where documentation is not provided, or fails to prove reasonable business purposes, the tax authorities are empowered to take back the tax benefits through an adjustment which reflects the economic substance of the arrangement. The notice of such adjustment may equally only be served upon the taxpayer following approval by the SAT.

These procedural rules do not, however, explain the nature of the documentation required from taxpayers, or the manner in which a GAAR tax adjustment is to be conducted, nor do they explain which third parties may be pursued for further information. Existing guidance also leaves unclear the precise manner in which tax-avoidance arrangements are to be identified. The draft GAAR administrative measures provide for greater detail in this regard.

Clarifications in the draft GAAR administrative measures

The draft GAAR administrative measures explain that the main features of a tax-avoidance arrangement are (i) that the sole or main purpose, or one of its main purposes, is to obtain tax benefits, and (ii) that the legal form of the arrangement is in compliance with the tax law and regulations, but not in conformity with economic substance. This reiterates the ‘purpose’ focus of the GAAR test set out in the DIR and the need to consider the form and substance of the arrangement in making the evaluation, as noted in Circular 2.

Ordering rules, for the application of domestic special tax-avoidance rules SAARs before the GAAR, and for the use of treaty SAARs before domestic anti-avoidance provisions, are set out. Under these rules, transfer pricing, cost sharing arrangement, controlled foreign company and thin capitalization provisions are to be applied in preference to the GAAR, and beneficial ownership and limitation on benefits (LOB) rules in treaties are to be applied before domestic anti-avoidance rules.

This approach mirrors the practice adopted in many other countries. It should be noted that the fact that a scheme passes muster under a (domestic or treaty) SAAR does not shield it from further challenge under the GAAR. It might also be noted that the Chinese tax authorities have inserted specific ‘Miscellaneous Rule’ articles in most of their recent tax treaties reserving their right to use the GAAR unfettered by treaty commitments.

The documentation to be provided by taxpayers includes information on:

- The arrangement background and explanations of its commercial purpose
- The internal decision-making process and governance of the taxpayer, including board resolutions, memos and email exchanges
- Transaction documentation including contracts and payment evidence
- Communications between the taxpayer and its tax advisors, and other parties to the transaction
- Documentation proving the arrangement's non-tax avoidance nature and other documents required by the tax authority

It is explicitly stated that documentation may also be demanded by the tax authorities from the tax advisors to the taxpayer. It is provided that, beyond the 60 day limit for supplying documents set out in Circular 2, an extension of 30 days may be available in special circumstances.

The GAAR special tax adjustments which may be used to counter tax benefits are clarified to include (i) re-characterization of the whole or part of the arrangement, (ii) denial of the existence of a party to the transaction for tax purposes, or treating one of the party and other parties to the transaction as one entity, (iii) re-characterization of the income, deductions, tax incentives and foreign tax credits or reallocation of them between the parties to the transaction; and (iv) any other reasonable method. In making tax adjustments, tax authorities must consider the tax effects of the scheme if its form had followed its economic substance.

Where the tax authorities decide to adjust the scheme tax outcomes, a preliminary decision will be issued to the taxpayer, which may be appealed to the tax authority within 7 days, for final determination by the SAT.

The draft GAAR administrative measures, where made final, would apply to all arrangements concluded and executed after 1 January 2008, except where GAAR disputes have already been settled prior to the measures taking effect. Notably, the measures do not apply to solely domestic transactions with no cross-border element, and are also not to apply to Circular 698 offshore indirect transfer cases, for which separate guidance is to be issued.

KPMG observations

Reported cases on GAAR application, particularly those in relation to the offshore indirect disposal rule in Circular 698, have shown that the tax authorities tend to focus strongly on the 'economic substance' of arrangements and attach less significance to the possible 'reasonable business purposes' of using given structures or arrangements, such as the use of offshore SPVs for liability ring-fencing and financing.

Consequently, by re-emphasizing the central importance of the purpose of an arrangement in determining whether the GAAR may be applied, the draft GAAR administrative measures could potentially support the defence of transactions on the basis of their reasonable business purposes and might be viewed positively.

However, it may be viewed that the description of a tax-avoidance arrangement as having as 'one of its main purposes... to obtain the tax benefits' potentially widens the application scope of the GAAR from the previous wording in the DIR. The DIR wording provided that only arrangements with reduction, avoidance or deferral of tax payment as their 'primary purposes' could be subject to GAAR adjustment.

The expressions, 'one of its main purposes' and 'primary purpose', are not defined in the draft GAAR administrative measures. It might be argued that the primary purpose of an arrangement was to obtain tax benefits if the arrangement would not have been carried out at all were it not for the opportunity to obtain the tax advantage, or if any non-tax objective were clearly secondary. Against this, an arrangement could have tax benefits as

one of its main purposes if the transaction would have in any case proceeded on its commercial merits, but was shaped so as to additionally yield the tax benefits. Without additional guidance from the SAT on the meaning of the expression, local tax authorities could push the new description of tax avoidance transactions in the draft GAAR administrative measures to treat a very wide range of arrangements as tax avoidance schemes.

In asserting that a scheme has tax reduction as at least 'one of its main purposes' local tax authorities may be encouraged to pursue tax advisors for supporting documentation, as they are mandated to do by the draft measures. In light of the potential for increasingly assertive GAAR enforcement, there has been some disappointment in industry that suggestions made in earlier GAAR consultations, that a GAAR case review committee with some non-tax authority members be established to ensure fairness in GAAR application, is not to be set up, as this would have provided for some check on overstretch in the application of the GAAR.

It might be noted that LOB clauses, included in the investment income articles of many recent Chinese tax treaties, also seek to deny treaty benefits where 'the main purpose or one of the main purposes' of a person is to take advantage of the relevant treaty withholding tax relief. As such, and notwithstanding the observations above, it may be observed that the description of tax-avoidance arrangements in the draft GAAR administrative measures is aligned with the approach in the treaty LOBs.

The draft GAAR administrative measures provide that treaty beneficial ownership rules should be applied in priority to the domestic law GAAR. The SAT guidance on beneficial ownership, Circular 601 (2009), in addition to requiring that a treaty relief claimant controls the disposition of the relevant income and the underlying property, refers to commercial substance-focused factors in determining whether the beneficial ownership requirement has been satisfied. As such it has been commented that Circular 601 implicitly involves an application of the GAAR to counter treaty shopping.

However, as Circular 601 does not explicitly admit to an application of the GAAR, there are no grounds to appeal that the transaction has a reasonable business purpose, as would be possible with a formal application of the GAAR. Some commentators have called for the substance tests to be carved out of the beneficial ownership guidance in Circular 601, and treated explicitly as an application of the GAAR. However, the draft GAAR administrative measures, by stating that the existing treaty beneficial ownership rules should be applied in priority over the domestic law GAAR, provide for the continuance of the status quo, at least for the time being.

Circular 698 is not covered by the draft GAAR administrative measures. The requirement on taxpayers to provide extensive documentation to the tax authorities, where the Circular 698 reporting is in point, remains at a far tighter 30 days as against the potential 90 days (with extension) provided for under the draft GAAR administrative measures.

In addition to lodging pertinent comments on the draft measures with the SAT prior to 1 August 2014 we would encourage enterprises to re-visit applicable transactions and arrangements that may be at risk of GAAR adjustment, and make preparatory documentation arrangements as appropriate.

Khoonming Ho

Partner in Charge, Tax
China and Hong Kong SAR
Tel. +86 (10) 8508 7082
khoonming.ho@kpmg.com

Beijing/Shenyang David Ling

Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Qingdao Vincent Pang

Tel. +86 (532) 8907 1728
vincent.pang@kpmg.com

Shanghai/Nanjing Lewis Lu

Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Chengdu Anthony Chau

Tel. +86 (28) 8673 3916
anthony.chau@kpmg.com

Hangzhou John Wang

Tel. +86 (571) 2803 8088
john.wang@kpmg.com

Guangzhou Lilly Li

Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Fuzhou/Xiamen Maria Mei

Tel. +86 (592) 2150 807
maria.mei@kpmg.com

Shenzhen Eileen Sun

Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Hong Kong Karmen Yeung

Tel. +852 2143 8753
karmen.yeung@kpmg.com

Northern China

David Ling

Partner in Charge, Tax
Northern China
Tel. +86 (10) 8508 7083
david.ling@kpmg.com

Vaughn Barber

Tel. +86 (10) 8508 7071
vaughn.barber@kpmg.com

Roger Di

Tel. +86 (10) 8508 7512
roger.di@kpmg.com

John Gu

Tel. +86 (10) 8508 7095
john.gu@kpmg.com

Kevin Lee

Tel. +86 (10) 8508 7536
kevin.lee@kpmg.com

Paul Ma

Tel. +86 (10) 8508 7076
paul.ma@kpmg.com

Vincent Pang

Tel. +86 (10) 8508 7516
+86 (532) 8907 1728
vincent.pang@kpmg.com

Michael Wong

Tel. +86 (10) 8508 7085
michael.wong@kpmg.com

Jessica Xie

Tel. +86 (10) 8508 7540
jessica.xie@kpmg.com

Irene Yan

Tel. +86 (10) 8508 7508
irene.yan@kpmg.com

Tracy Zhang

Tel. +86 (10) 8508 7509
tracy.h.zhang@kpmg.com

Abe Zhao

Tel. +86 (10) 8508 7096
abe.zhao@kpmg.com

Eric Zhou

Tel. +86 (10) 8508 7610
ec.zhou@kpmg.com

David Chamberlain

Tel. +86 (10) 8508 7056
david.chamberlain@kpmg.com

Tony Feng

Tel. +86 (10) 8508 7531
tony.feng@kpmg.com

Li Li

Tel. +86 (10) 8508 7537
li.li@kpmg.com

Alan O'Connor

Tel. +86 (10) 8508 7521
alan.oconnor@kpmg.com

Joseph Tam

Tel. +86 (10) 8508 7605
laiyu.tam@kpmg.com

Anni Wang

Tel. +86 (10) 8508 7518
anni.wang@kpmg.com

Sheila Zhang

Tel. +86 (10) 8508 7507
sheila.zhang@kpmg.com

Tiansheng Zhang

Tel. +86 (10) 8508 7526
tiansheng.zhang@kpmg.com

Central China Lewis Lu

Partner in Charge, Tax
Central China
Tel. +86 (21) 2212 3421
lewis.lu@kpmg.com

Anthony Chau

Tel. +86 (21) 2212 3206
+86 (28) 8673 3916
anthony.chau@kpmg.com

Cheng Chi

Tel. +86 (21) 2212 3433
cheng.chi@kpmg.com

Chris Ho

Tel. +86 (21) 2212 3406
chris.ho@kpmg.com

Ho Yin Leung

Tel. +86 (21) 2212 3358
hoyin.leung@kpmg.com

Sunny Leung

Tel. +86 (21) 2212 3488
sunny.leung@kpmg.com

Christopher Mak

Tel. +86 (21) 2212 3409
christopher.mak@kpmg.com

Henry Ngai

Tel. +86 (21) 2212 3411
henry.ngai@kpmg.com

Brett Norwood

Tel. +86 (21) 2212 3505
brett.norwood@kpmg.com

Yasuhiko Otani

Tel. +86 (21) 2212 3360
yasuhiko.otani@kpmg.com

John Wang

Tel. +86 (21) 2212 3438
john.wang@kpmg.com

Jennifer Weng

Tel. +86 (21) 2212 3431
jennifer.weng@kpmg.com

Grace Xie

Tel. +86 (21) 2212 3422
grace.xie@kpmg.com

Bruce Xu

Tel. +86 (21) 2212 3396
bruce.xu@kpmg.com

William Zhang

Tel. +86 (21) 2212 3415
william.zhang@kpmg.com

Michelle Zhou

Tel. +86 (21) 2212 3458
michelle.b.zhou@kpmg.com

Cheng Dong

Tel. +86 (21) 2212 3410
cheng.dong@kpmg.com

David Huang

Tel. +86 (21) 2212 3605
david.huang@kpmg.com

Dylan Jeng

Tel. +86 (21) 2212 3080
dylan.jeng@kpmg.com

Amy Rao

Tel. +86 (21) 2212 3208
amy.rao@kpmg.com

Henry Wong

Tel. +86 (21) 2212 3380
henry.wong@kpmg.com

Southern China Eileen Sun

Partner in Charge, Tax
Southern China
Tel. +86 (755) 2547 1188
eileen.gh.sun@kpmg.com

Vivian Chen

Tel. +86 (755) 2547 1198
vivian.w.chen@kpmg.com

Sam Fan

Tel. +86 (755) 2547 1071
sam.kh.fan@kpmg.com

Angie Ho

Tel. +86 (755) 2547 1276
angie.ho@kpmg.com

Jean Jin Li

Tel. +86 (755) 2547 1128
Tel. +86 (592) 2150 888
jean.j.li@kpmg.com

Lilly Li

Tel. +86 (20) 3813 8999
lilly.li@kpmg.com

Kelly Liao

Tel. +86 (20) 3813 8668
kelly.liao@kpmg.com

Bin Yang

Tel. +86 (20) 3813 8605
bin.yang@kpmg.com

Penny Chen

Tel. +86 (755) 2547 1072
penny.chen@kpmg.com

Grace Luo

Tel. +86 (20) 3813 8609
grace.luo@kpmg.com

Maria Mei

Tel. +86 (592) 2150 807
maria.mei@kpmg.com

Michelle Sun

Tel. +86 (20) 3813 8615
michelle.sun@kpmg.com

Lixin Zeng

Tel. +86 (20) 3813 8812
lixin.zeng@kpmg.com

Hong Kong

Ayesha M. Lau

Partner in Charge, Tax
Hong Kong SAR
Tel. +852 2826 7165
ayesha.lau@kpmg.com

Chris Abbiss

Tel. +852 2826 7226
chris.abbiss@kpmg.com

Darren Bowdern

Tel. +852 2826 7166
darren.bowdern@kpmg.com

Barbara Forrest

Tel. +852 2978 8941
barbara.forrest@kpmg.com

Daniel Hui

Tel. +852 2685 7815
daniel.hui@kpmg.com

Charles Kinsley

Tel. +852 2826 8070
charles.kinsley@kpmg.com

John Kondos

Tel. +852 2685 7457
john.kondos@kpmg.com

Alice Leung

Tel. +852 2143 8711
alice.leung@kpmg.com

Curtis Ng

Tel. +852 2143 8709
curtis.ng@kpmg.com

Kari Pahlman

Tel. +852 2143 8777
kari.pahlman@kpmg.com

John Timpany

Tel. +852 2143 8790
john.timpany@kpmg.com

Wade Wagatsuma

Tel. +852 2685 7806
wade.wagatsuma@kpmg.com

Lachlan Wolfers

Tel. +852 2685 7791
lachlan.wolfers@kpmg.com

Christopher Xing

Tel. +852 2978 8965
christopher.xing@kpmg.com

Karmen Yeung

Tel. +852 2143 8753
karmen.yeung@kpmg.com

Rebecca Chin

Tel. +852 2978 8987
rebecca.chin@kpmg.com

Kate Lai

Tel. +852 2978 8942
kate.lai@kpmg.com

Alex Lau

Tel. +852 2143 8597
alex.lau@kpmg.com

Benjamin Pong

Tel. +852 2143 8525
benjamin.pong@kpmg.com

Adam Zhong

Tel. +852 2685 7559
adam.zhong@kpmg.com