

China Tax Alert

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Announcement of State Administration of Taxation on Issues Relating to the Information on Outbound Investment and Related Income Reported by Resident Enterprises

Regulations discussed in this issue:

- *Announcement of State Administration of Taxation on Issues Relating to the Information on Outbound Investment and Related Income Reported by Resident Enterprises [2014] No. 38 ("Announcement No. 38") promulgated on June 30, 2014 and effective on September 1, 2014*

Background

The economic globalization trend has propelled Chinese enterprises to pursue their "going-global" ambitions, expanding outbound investment in both scale and numbers. However, cross-border deals have posed challenges to China's tax administration. To demonstrate its tax supervisory determination and strength, State Administration of Taxation introduces Announcement No. 38 to increase the supervision on offshore investments and curtail potential leakage of foreign-sourced tax revenues. Announcement No. 38 sets out a higher standard of compliance and documentation preparation for taxpayers. Taxpayers are advised to familiarize themselves with this new measure.

Announcement No. 38 requires regular reporting of outbound investments and annual reporting of income earned overseas. The reporting requirements apply to PRC tax resident enterprises, as well as those non-PRC tax residents that have an establishment or a place of business in China and derive income that is effectively connected with such establishment or place of business.

The main contents of Announcement No. 38

The Announcement mentions two major reporting obligations for qualified PRC tax residents and non-PRC tax residents.

- The periodical foreign investment reporting obligation when PRC tax residents establish or participate in foreign companies or sell shares or voting shares in foreign companies. Resident Enterprise's Statement for Participation in Foreign Enterprises is required.
- Annual reporting obligation in relation to foreign-earned income. Statement of Controlled Foreign Enterprises is required.

Please refer to appendix for the details of these two obligations.

KPMG's observations

I. Main features of Announcement No. 38

Announcement No. 38 has not principally changed the existing concepts (such as resident taxpayer) and rules (such as controlled foreign company, foreign tax

credit etc.) under China tax laws, but has placed emphasis on the application of such concepts and rules to ascertain the actual enforcement of relevant tax rules.

As a signal of the Chinese tax authorities to intensify tax administration, the Announcement has touched on many fronts. In terms of applicability, Announcement No. 38 is not only applicable to PRC tax residents, but also certain non-tax residents that have establishment or place of business in China. In terms of obligations, the China tax authorities require reporting of not only a taxpayer's own overseas investment and income, but also related information available regarding other shareholders. In terms of covering period, it not only applies to periods after the effective date of the Announcement but also related information even prior to the effective date (e.g. a currently valid loan agreement signed many years ago).

II. Implications on taxpayers

Through the reporting obligations (i.e. periodic outbound investment report and annual foreign-sourced income report) under Announcement No. 38, China tax authorities could keep track of the foreign investment assets and profits of "going-global" enterprises and increase the supervision of tax information declaration. The main implications on taxpayers include:

- PRC tax resident taxpayers (and qualified non-tax residents) should fulfil stricter report and compliance obligations
 - Chinese enterprises with offshore investments should record and report the changes in their direct or indirect offshore investments, capital expansion and capital reduction in a timely manner. They must also obtain and report necessary information of other shareholders.
 - Chinese enterprises should obtain full understanding of the changes in shareholding and profit distribution of foreign subsidiaries, and timely report these changes to China tax authorities
- If an enterprise fails to fulfil the above reporting obligations (or if the report is untimely or incorrect), China tax authorities have the discretion to make reasonable adjustments to tax liabilities of that enterprise.
- Chinese tax payers need to pay attention to managing the substance of foreign subsidiaries (e.g. functions, decision-making and management engagement, etc.). If the place of effective management is located in China, a company incorporated outside China would be regarded as a PRC tax resident and required to pay PRC CIT on its global income.

III. Pending issues

The following provisions in the Announcement are subject to further clarification through practice:

- When filing the annual corporate income tax return, PRC tax resident enterprises are required to prepare separate financial statements of their foreign subsidiaries and controlled foreign companies that are within the scope of PRC foreign tax credits according to PRC Generally Accepted Accounting Principles. As these foreign companies are established pursuant to foreign laws, it remains unclear how feasible it is to provide support in helping PRC tax resident enterprises prepare those financial statements.
- PRC tax resident enterprises are required to provide shareholding information (i.e. the outbound investment reporting obligations) of other PRC shareholders and "deemed dividends" received by other PRC resident shareholders from controlled foreign companies (i.e. foreign-sourced income reporting obligation). Under the circumstances that a PRC tax resident enterprise holds minority interest in foreign entities, such information may be difficult and impractical to gather.
- Restrictive provisions under foreign laws and regulations or commercial contracts or agreement cannot constitute a valid and appropriate reason to postpone the required reporting. Companies governed by foreign laws or contracts may find difficulties in fulfilling the reporting obligations.

Appendix: Main Content in the Announcement

Reporting Obligation	Reporting Items	Reporting time
Reporting obligation for outbound investment <ul style="list-style-type: none"> • A PRC tax resident that establishes or participates in foreign companies or sells shares or voting shares in foreign companies shall fulfill the reporting obligations, if one or more of the following conditions are met: <ul style="list-style-type: none"> - On the effective date of the Announcement, a PRC tax resident enterprise directly or indirectly holds 10% or more shares or voting shares in foreign companies - After the effective date of the Announcement, the shares in the invested foreign companies directly or indirectly held by a PRC tax resident enterprise increases from less than 10% to 10% or more than 10% - After the effective date of the Announcement, the shareholding in the invested foreign companies directly or indirectly held by a PRC tax resident enterprise decreases from 10% or more than 10% to less than 10% 	<ul style="list-style-type: none"> • Resident Enterprise's Statement for Participation in Foreign Enterprises, including: <ul style="list-style-type: none"> - Reporter's basic information - The invested foreign companies' information, shareholding portion held by the reporter in the invested foreign companies, other shareholders of the that hold 10% or more shares or voting shares in the invested foreign companies, any Chinese resident individuals that serve as senior executives or directors in the invested foreign companies - Changes of shareholding in invested foreign companies - Reporter's statement 	<ul style="list-style-type: none"> • When taxpayers declare the advance payment of the corporate income tax
<ul style="list-style-type: none"> • Note: Non-PRC residents that have an establishment or a place of business in China and derive income from outside China which is effectively connected with such establishment or place of business are also applicable to the above reporting obligations 		<ul style="list-style-type: none"> • During tax inspections (such as tax assessments, tax audits and special tax adjustments)

Appendix: Main Content in the Announcement (continued)

Reporting Obligation	Reporting Items	Reporting Time
Reporting obligation for foreign-sourced income <ul style="list-style-type: none"> In accordance with Article 45 of the PRC CIT Law, a PRC tax residents shall include an amount equal to its effective interest in its controlled foreign enterprise's undistributed or under-distributed profits as a "deemed" dividend in their computation of PRC taxable income in the current tax period Even if a PRC tax resident can be exempted from including the undistributed or under-distributed profits of its controlled foreign enterprise as a "deemed" dividend income under the following circumstances, it is still required to fulfil the reporting obligation: <ul style="list-style-type: none"> The controlled foreign company is located in a non-low jurisdiction designated by the State Administration of Taxation The income of the controlled foreign company is majorly generated from active business activities The annual profit of the controlled foreign company is lower than RMB5 million 	<ul style="list-style-type: none"> Statement of Controlled Foreign Enterprises, including: <ul style="list-style-type: none"> Reporter's basic information Information of controlled foreign companies Applicable reason for constitution of a controlled foreign company Shareholding information of the PRC shareholder in its controlled foreign companies (such as shareholding ratio, shareholding period, etc.) The three exceptional scenarios for controlled foreign companies Profits distribution of the controlled foreign companies (including "deemed" dividends that should have been distributed to the Reporter or other PRC shareholders during historical and current tax years) The invested foreign companies and controlled foreign companies which are within the PRC foreign tax credit scope should prepare separate annual financial statements in accordance with PRC GAAP 	<ul style="list-style-type: none"> When taxpayers submit annual corporate tax income return
<ul style="list-style-type: none"> Note: Non-PRC residents that have an establishment or a place of business in China and derive income from outside China which is effectively connected with such establishment or place of business are also applicable to the above reporting obligations 		<ul style="list-style-type: none"> During tax inspections (such as tax assessments, tax audits and special tax adjustments)

Several notes:

Extension of reporting	<ul style="list-style-type: none"> PRC tax resident enterprises that could provide legitimate reasons and prove that they are unable to report relevant outbound investments and foreign-sourced incomes within the time limit are allowed to raise an extension claim to the in-charge tax authorities Please note that restrictive provisions under foreign laws or commercial contracts should not constitute legitimate reasons
Non-compliances	<ul style="list-style-type: none"> If PRC tax resident enterprises fail to report relevant outbound investment and foreign-source income etc information, the competent tax authority shall order it to rectify within an extended period of time. Where the resident enterprise still fails to report the required information within the extended time limit, the tax authority has the discretion to adjust the tax payable amount according to <i>the Law on Administration of Tax Collection</i> and its implementation rules as well as other relevant laws and regulations based on the recognized facts and currently available information
Date of enforcement	<ul style="list-style-type: none"> This Announcement shall be implemented as of September 1, 2014 The Announcement is also applicable to those information or activities occurred prior to the effective date of the Announcement, provided that they are related to the information that should be reported after the effective date or within the reporting year since the implementation of the Announcement
Taxpayer's legal rights	<ul style="list-style-type: none"> The tax authorities shall facilitate taxpayers to report their outbound investments and income therefrom, process reports submitted by taxpayers without delay and keep confidential of tax payer's information under the law

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