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# CHINA TAX ALERT

ISSUE 1 | January 2015

# New guidance on Chinese General Anti-Avoidance Rule

**Regulations discussed in this issue:**

- *Administrative Measures for the General Anti-tax Avoidance Rules: Trial Implementation ('GAAR Measures'),* SAT Order No. 32, issued by the SAT on 2 December 2014 and effective 1 February 2015
- *Replies to questions from the press regarding Administrative Measures for the GAAR (Trial) by in-charge SAT officials (SAT GAAR Q&A),* posted to the SAT website on 12 December 2014
- *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

## Background

On 2 December 2014 the Chinese State Administration of Taxation (SAT) released the GAAR Measures, having finalized these following an earlier public consultation. These measures define the ambit of tax avoidance schemes and set out in detail the tax authority procedures to be followed for GAAR case selection, examination and conclusion.

The GAAR Measures intend to provide a basis for more transparent and consistent application of the GAAR, going forward, and are part of a suite of new regulations for the enforcement of China's international tax rules, to be issued in the near future, in response to President Xi Jinping's call for a crackdown on cross-border tax avoidance, at the November G20 Leader's summit. The GAAR Measures could have a significant impact on tax enforcement of international tax arrangements in China going forward and close monitoring by MNEs is advisable.

## Existing GAAR law and guidance

The existing Chinese domestic law GAAR framework is described in our *China Tax Alert Issue 19 (July 2014)* on the draft GAAR administrative measures, and can be referred to for a greater background understanding.

In short, the CIT Law and the DIR set out a tax purpose test-based GAAR directed at arrangements which lower taxable income and lack reasonable business purposes (per the CIT Law), with the latter being defined as having the reduction, avoidance or deferral of tax payments as the 'primary purpose' (per the DIR). This is supplemented by Circular 2 which requires a 'substance over form' analysis to guide GAAR application, with specific, enumerated aspects of the arrangement requiring consideration, and with particular cross-border arrangements, notably transactions with tax haven enterprises 'without economic substance', and misapplication of tax treaties, marked out for special attention.

**Regulations discussed in this issue:**

- *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
- *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

In GAAR application the tax authorities have in practice emphasized this particular focus on 'economic substance'. The determination of indirect offshore disposal cases covered by Circular 698 is thus driven by consideration of the staff, premises, business activities and assets attributable to foreign entities and less weight is given to the reasonable business purposes of an arrangement.

Existing guidance had left somewhat unclear the manner in which economic substance considerations were to interface with what the CIT Law clearly sets out as a purpose-based GAAR test. This has made it difficult for taxpayers to argue against tax authority GAAR determinations based solely on commercial substance.

Further, little guidance was provided on the requirements for taxpayers and third parties to supply documentation pursuant to a GAAR investigation, the procedural steps under which a local tax authority is to interface with higher level tax authorities and the SAT in launching and concluding such investigation, and associated timeframes, and the avenues and mechanisms for taxpayer appeal. Now, the GAAR Measures and the SAT GAAR Q&A provide the requisite guidance.

## Clarifications in the GAAR Measures

The GAAR Measures explain that the main features of a tax-avoidance arrangement are (i) that the sole or main purpose of the arrangement is to obtain a tax benefit, and (ii) that the arrangement, in pursuing tax benefits, takes a form permissible under tax rules, but which is not consistent with its underlying economic substance.

This formulation reiterates the 'purpose' focus of the GAAR test set out in the DIR as well as the need to consider the form and substance of the arrangement in making the evaluation, as noted in Circular 2, and clarifies further the manner in which economic substance is to be considered in applying the GAAR purpose test. The SAT GAAR Q&A notes that the Circular 2 GAAR interpretative guidance remain relevant.

The SAT GAAR Q&A usefully adds an illustration of how economic substance is to be taken into account. It notes that where a preferential tax policy is availed of under the CIT Law then, to the extent that the economic substance of the arrangement fulfils the conditions for preferential treatment, then the tax advantage cannot be subject to the GAAR, as the CIT Law offered such treatment.

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 precedence over the GAAR, and beneficial ownership rules (as clarified by Circular 601) and limitation on benefits (LOB) rules in tax 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 as the latter would have residual application. 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.

Where a GAAR investigation is to be initiated, approval must be obtained from the SAT, the local tax authorities having elevated the request for approval through the various higher level tax authorities above them. The documentation to be provided by taxpayers, who bear the onus of proof in a GAAR investigation, 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 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 other parties, including related parties and 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 then following the obtaining of approval from the SAT (with potential SAT modifications) a preliminary decision will be issued to the taxpayer. Notably, the GAAR Measures provide that the local tax authorities are to take no more than nine months to reach their decision before seeking SAT approval. This preliminary decision may be appealed to the local tax authorities within 7 days, for further final determination by the SAT. The SAT GAAR Q&A emphasizes that the involvement of the SAT at every step in the selection and conclusion of cases is a reflection of the complexity of these cases, and the SAT's extensive involvement in the process should alleviate concerns at overzealous use of the GAAR by local tax authorities.

To the extent that domestic double taxation arises from GAAR adjustments then the SAT will seek to resolve this, with mutual agreement procedures noted as the appropriate channel for resolving international double taxation.

The GAAR Measures apply from 1 February 2014, applying not only to arrangements entered into after that date but also to prior arrangements for which GAAR assessment has not yet closed as at that date. Notably, the GAAR Measures do not apply to solely domestic transactions with no cross-border element, and also exclude tax evasion cases, but do apply to Circular 698 offshore indirect transfer cases, in contrast with the position under the draft measures.

## KPMG observations

The SAT GAAR Q&A notes that the GAAR Measures are released against a backdrop of President Xi Jinping's call for a crackdown on cross-border tax avoidance at the November G20 Leader's summit, which is strongly aligned with the G20/OECD Base Erosion and Profit Shifting (BEPS) Initiative (see *China Tax Alert Issue 27 (October 2014)*.

As such, the GAAR Measures fall within a basket of international tax enforcement measures, including clarifications to transfer pricing guidance and anti-treaty abuse rules, new anti-hybrid mismatch rules and an enhanced approach to taxing offshore indirect transfers of Chinese taxable property.

In short, the new GAAR Measures are to be welcomed for the greater clarity they provide on when and how the GAAR is to be applied and for the greater consistency in application which hopefully will result from this. At the same time taxpayers need to be alert to the likelihood that greater numbers of transactions, perceived as artificial by the tax authorities, may now be identified and subject to GAAR scrutiny and may consequently need to be reassessed.

*Purpose test*

The SAT, in refining the final GAAR Measures from the prior draft, have commendably set aside the description of a tax-avoidance arrangement as having as 'one of its main purposes… to obtain the tax benefits', a formulation which would have widened the application scope of the GAAR from the wording in the DIR, and could have introduced much uncertainty.

Furthermore, the refinement of the wording in the GAAR Measures on the role of economic substance considerations in a GAAR assessment, and the helpful supplementary comments in the SAT GAAR Q&A, contribute considerably to clarifying the Chinese GAAR as a tax purpose test.

The wording in the final GAAR Measures is notably clearer in stating that an inconsistency/divergence between the legal form and economic substance of an arrangement is to be considered as a hallmark of a tax avoidance arrangement to the extent that the arrangement is being so structured for the purpose of deriving tax benefits. This means that economic substance considerations are an input into the broader investigation of whether the taxpayer has an overriding tax purpose, and lacks a reasonable business purpose.

Supporting this interpretation, the wording of the SAT GAAR Q&A helps to clarify that economic substance is to be taken into account as an element of a comprehensive factual consideration of whether an arrangement is 'without reasonable commercial purpose'. It notes that an arrangement being 'without reasonable commercial purpose', and the purpose of an arrangement being 'to obtain a tax benefit' are the "two key elements" of a GAAR assessment.

The SAT GAAR Q&A example, in which the economic substance of a taxpayer's arrangement fulfills the tax law conditions for the grant of a preferential tax treatment, shows that the SAT's approach to applying the GAAR is in broad alignment with the approach of many other countries with a statutory GAAR. In many such countries it is inquired whether an arrangement, which does yield tax benefits, frustrates or is in line with the intent of a given piece of tax legislation, in determining whether to apply the GAAR. In such countries this 'intent of the law test' may complement the 'tax purpose test'.

These clarifications should aid taxpayers in defending their transactions on the basis of their reasonable business purposes though, as ever, the manner of implementation by local tax authorities, and the level of review by the SAT for reasonableness and consistency, will prove crucial to the usefulness of the clarifications in the GAAR Measures.

The detail in the GAAR Measures on the tax authority procedures to be followed for GAAR case selection, examination and conclusion are helpful, and the nine month limitation on local authority case determination is a welcome further addition. The clarification in the SAT GAAR Q&A that, in prioritizing use of the SAARs over the GAAR, the GAAR is to be used as "the last resort to counter tax avoidance schemes when all other anti-avoidance tools are exhausted" is also a very welcome assertion which, together with the SAT's approvals process for GAAR investigation initiation and adjustments, should hopefully limit overzealous local authority application of the GAAR.

*Impact on MNEs*

As the new GAAR Measures are likely to be the start of a series of new SAT announcements and measures in the context of their BEPS-aligned three-year international tax work programme, we would encourage MNEs continue to monitor upcoming tax law developments. MNEs should be mindful of the impact of GAAR rules in implementing new cross border transactions, and might be advised to re-visit transactions and arrangements that may be at risk of GAAR adjustment. It is also important to ensure that contemporaneous documentation of transactions is maintained so as to demonstrate and support assertions of the reasonable business purposes for transactions.

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