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People thinking beyond borders in financial services

March 2015

Featuring:

BEPS Update

Key issues for financial services

**Asia Pacific nations join the global move
towards tax transparency**

In the eye of the storm

VAT reform in China

Making the most of R&D tax incentives



cutting through complexity



In this issue

Topics



BEPS update: Key issues for financial services 04

Reporting and transparency	05
Risk transfer, special measures and recharacterization of transactions	05
Avoidance of permanent establishment status	06
Conclusion	06



Asia Pacific nations join the global move towards tax transparency 08

FATCA and beyond 09



In the eye of the storm: VAT reform in China 12

Financial services and insurance industry	13
Real estate and construction industry	13
Looking ahead	15
Conclusion	15



Making the most of R&D tax incentives 16

R&D incentives in China 19
R&D Super Deduction 19
HNTE 19
Other schemes 19

Knowledge 20

New KPMG thought leadership	20
Global Financial Services Tax Leadership Team	21

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Introduction

Asia Pacific: familiar trends, local impacts

One of the major changes currently facing the region is the implementation by the ASEAN nations¹ of the ASEAN Economic Community (AEC) at the end of 2015. This will likely establish a single market and production base in the region, with free movement of goods, services, investment, capital and skilled labor – the AEC's so-called five core elements – within a population of over 600 million people.² In addition, the AEC will see the progressive development of a joint competition policy, promotion of e-commerce, a framework for the protection of intellectual property, and a comprehensive investment protection and dispute resolution system.

As it develops, the AEC could have significant and long-lasting impacts, boosting growth, increasing trade and investment, and attracting further foreign direct investment. ASEAN nations could also benefit from the AEC, driving a further transfer of power and wealth to the East. This rapidly-evolving economic environment is paralleled by similar developments in fiscal policies and frameworks. New approaches to tax – planning, objectives and implementation – are emerging across the region.

This does not, however, appear to imply progress towards fiscal union. All the major economies in Asia Pacific are developing their own regimes to enhance local competitiveness and

attract foreign direct investment. It is true that the region now benefits from a network of double taxation treaties, and many countries are pursuing broadly similar policies, consistent with those in the West. However, fiscal policy is still being used as a tool of intra-regional economic competition. So the overall picture is complex and nuanced. This makes it difficult for companies aiming to enter the region for the first time – or those seeking to expand to other jurisdictions – to articulate the most viable and effective business models.

One key theme visible across Asia Pacific, as in the West, is the growing focus on eliminating abuse and unfair corporate tax practices. Some of this

focus may be driven as elsewhere, by the need to increase tax receipts to help finance deficits and underpin government commitments. But it also reflects what may be an emerging international consensus that corporate tax is a matter of morality and fairness as well as of strict legality. This perspective was recently well summarized – albeit in a different context – by the German Finance Minister Wolfgang Schäuble:

More and more countries are speaking out against allowing too much leeway for large multinationals to minimize their taxes. Just because something is legal, does not mean it is fair in tax terms. Multinationals must contribute their fair share to public budgets – just like any other company has to.³

¹ Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam

² cf ASEAN Economic Community Blueprint, ASEAN Secretariat, 2008. Strictly speaking, liberalisation of capital movement will be subject to "orderly capital account liberalisation consistent with member countries' national agenda and readiness of the economy"

³ Wolfgang Schäuble, commenting on the UK-Germany agreement in relation to preferential IP regimes ("patent boxes"), 11 November 2014, <https://www.gov.uk/government/news/germany-and-uk-agree-joint-proposal-for-rules-on-preferential-ip-regimes>



It is possible that multinational companies will increasingly find that Asia Pacific tax regimes – and public policies – will come to resemble Western ones in their attitudes to tax behavior.

These trends could influence key corporate decisions on issues such as transfer pricing and domicile. The competitive fiscal environment in the region means that individual authorities may be applying new regulations, or, for example, extending their scope to intangible assets, royalty payments and intellectual property valuations. Criteria for recognizing permanent establishment status are generally becoming more extensive, and also more complex to navigate. All of this creates a lot of uncertainty: there is an increased need for deeper understanding of both the regional and local contexts, and of the developing thinking of local fiscal authorities. Without them, companies could make costly mistakes.

But it is still a growing region, offering opportunities across the whole of the manufacturing and services sectors. Alongside the focus on driving up tax revenues, there are also many initiatives designed to attract investment, from tax holidays to specific incentives to a general reduction in overall tax rates.

In this issue we look at developments reflecting a number of the trends noted above:

- The G20/OECD Base Erosion and Profit Shifting (BEPS) program is providing a major stimulus towards tackling abuse and evasion, and a framework for its pursuit.
- Asia Pacific nations are joining the global movement towards tax transparency, with India, Mauritius and South Korea among those countries committed to early adoption of the OECD Common Reporting and Due Diligence Standard for reporting and automatic exchange of information.
- China is halfway through a highly ambitious and complex program to replace its business tax regime with a value-added tax, aiming for greater simplicity and closer alignment with Western economies.
- In many jurisdictions, the drive to attract foreign investment includes incentives to promote research and development as a route to innovation and competitiveness.

I hope these articles shed light on some of the trends in this changing environment.

More and more countries are speaking out against allowing too much leeway for large multinationals to minimize their taxes. Just because something is legal, does not mean it is fair in tax terms.



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BEPS update:

Key issues for financial
services



We have previously reviewed the major efforts now being devoted to tackling the issue of Base Erosion and Profit Shifting (BEPS).¹ Following the lead of the G20, the OECD has been pursuing urgent measures to address the perceived use of mismatches and arbitrage opportunities between national tax systems designed to transfer profits to low(er)-tax jurisdictions. Such action is argued to erode domestic tax bases ('base erosion') and moves reported profits ('profit shifting') to locations where there may be little or no related economic activity. Although such planning may be allowable under tax law, there is an increasing perception that they are *unfair*, and undermine the integrity of tax systems.

The OECD argues that:

"In an increasingly interconnected world, national tax laws have not always kept pace with global corporations, fluid movement of capital, and the rise of the digital economy, leaving gaps that can be exploited to generate double non-taxation."

The BEPS Action Plan is intended to enable tax authorities to determine that profits are taxed where economic activities generating those profits are performed and where value is created.²

However, while this principle certainly presents challenges when applied to manufacturing or trading activities, it may be even less straightforward in the case of financial services. For some, the financial sector is the epitome of globalized business. The buying and selling of risk is core to these businesses, and capital is the bricks and mortar. The financial services industry is highly regulated with specific capital and other requirements and one must determine any transfer pricing guidance appropriately recognizes and addresses these features. There are a number of key implications which companies need to consider. In this article, we briefly review three of them.

Reporting and transparency

A key tool in preventing the perceived inappropriate use of opportunities to shift profits is information. The BEPS project aims to enhance the transparency of revenues, costs and profits by reforming transfer pricing documentation and reporting. The OECD Action Plan emphasizes that:

the rules to be developed will include a requirement that [multi-national enterprises] provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.³

Hence, regardless of formal corporate structures, tax authorities in all jurisdictions where an institution has a presence can expect extensive transfer pricing documentation, including access to master files and country by country reports detailing economic activities, resources, employees, costs and profits across the globe.

This country-by-country (CBC) reporting could represent a particularly significant requirement for multinational financial services companies. Apart from the systems and process implications, a further major challenge will be to determine that the necessary information is presented, explained and interpreted in an appropriate manner. An effective communication *plan* will be essential. Some tax authorities may tend to focus on tangible aspects such as numbers of employees in specific locations. They may find it more difficult to assess the comparative value and profit generated by small numbers of highly senior or expert staff as opposed to the contribution of large numbers of more junior or back office employees. They also may not fully consider the contribution of capital and the need

Regardless of formal corporate structures, tax authorities in all jurisdictions where an institution has a presence can expect extensive transfer pricing documentation.

in cases for it to be rewarded in the jurisdiction where it is provided.

Reporting information will need to be coherent and effective. It will be important to determine that all public information, whether in formal reports, sales promotion, social media or even via channels such as recruitment advertising is consistent with CBC transfer pricing reporting, in order to mitigate misleading – and costly – conclusions being drawn and to minimize conflicts of interpretation.

Risk transfer, special measures and recharacterization of transactions

The OECD is particularly aware of the practice – adopted by a number of multinational organizations – of transferring risk between members of the group and of developing associated capital and funding structures in order to shift profits and reduce tax. The OECD proposes new restrictions on transfer pricing rules to ensure that "inappropriate" returns and tax benefits are not captured by a group company simply as a consequence of its intra-group risk bearing or its capital position. Clearly this approach is driven by the objective of aligning the location of taxable returns with perceived economic value creation.

¹ cf for example BEPS: Time for Action, Frontiers in Tax, KPMG, September 2014

² cf OECD, Bringing the International Tax Rules into the 21st Century: Update on Base Erosion and Profit Shifting (BEPS), Exchange of Information, and the Tax and Development Programme, Report from the Meeting of the OECD Council at Ministerial Level Paris, 6-7 May 2014

³ Action Plan on Base Erosion and Profit Shifting, OECD, 2013

The arms-length principle plays a significant role here in determining whether an intra-group transaction is reasonable, or is being undertaken solely to transfer risk and capital to minimize tax liabilities. New transfer pricing rules could help weed out or prevent transactions which would normally not occur between unrelated parties and which do not exhibit an underlying economic rationale. The intent of the proposed rules is to provide the basis whereby such transactions should be non-recognized or *re-characterized*, and benefits accruing from them should be set aside.⁴

Hence the current discussion draft contains proposed revisions to Section D of Chapter I of the Transfer Pricing Guidelines which “emphasize the importance of accurately delineating the actual transactions,” and includes guidance on the “relevance and allocation of risk, determining the economically relevant characteristics of the controlled transaction, and on recharacterisation or non-recognition of transactions.”⁵ Special measures are also suggested to cope with transfers of hard-to-value intangibles.

However, the application of these principles to the financial services sector can be particularly problematic. Generally, the core business of financial services often involves a risk transfer; and despite being intangible, capital is a key economic factor. An underlying premise of the OECD’s discussion draft is that capital is fungible and fluid and thus easily shifted. The assumption may not be entirely correct for financial institutions because they are regulated and by law must hold capital in fixed and specific locations according to regulation. Therefore it is difficult to reconcile this with the conventional and a simple analysis of key entrepreneurial risk-taking functions for separate legal entities in a financial services group without also acknowledging the special role of capital in this industry and the need for capital to be remunerated appropriately. The

determination of where risk resides in financial institutions needs to reflect a sophisticated understanding of the regulatory framework that financial institutions operate under as well as risk allocation, management and control. Otherwise, there is a danger that the new OECD guidelines could be misapplied and lead to distorted outcomes in the financial services sector.

The financial services industry needs to determine that its case is made effectively.

Avoidance of permanent establishment status

Traditionally, profits recorded by a non-resident company are only taxable in a particular jurisdiction if the economic activities giving rise to those profits are undertaken through a local permanent establishment (PE). A number of factors can contribute to the judgement that a PE exists, such as the existence of an office with staff, retail premises, manufacturing base etc; a company which operates locally through an agent authorized to conclude contracts on its behalf may also be found to have established PE status.

In recent years, there has been increasing concern that globalization and the digital economy have significantly increased the scope to avoid PE status by supplying goods and services from remote geographical locations. Particular concern attaches to the major global e-commerce businesses. However, financial services companies may also in principle offer services without establishing a permanent physical presence in a particular country.

The threshold of activity or presence for determining the existence of a PE has historically been quite high. However, Action 7 of the BEPS Action Plan is directed at preventing the artificial avoidance of PE status; scheduled for introduction in September 2015, new rules could limit substantially the scope

for arguing that a PE has not been established. In particular, these new rules are expected to tackle the practice of fragmenting group activity between separate legal entities in separate jurisdictions; and to restrict the scope for use of “independent” agents or commissionaires. The OECD is currently consulting on a number of possible changes to Article 5 of the Model Tax Convention that would achieve these objectives.

There is also a specific focus on insurers, who can write significant amounts of business in a country without having a PE in that location, in particular through arrangements with exclusive agents. One option under consideration is to establish a bespoke framework for insurers to address this concern. A less potentially burdensome regime would apply the general PE rules to insurers, but in a manner which recognized the particular nature of risk transfer in the industry, and the economic reality of cross-border insurance and reinsurance and the regulatory framework in which the industry operates.

More generally, in light of these impending new rules, financial institutions need to carefully review their current business models, PE status as some reorganization of structures and operations may be necessary.

Conclusion

The BEPS project, though still developing, reflects widespread changes in perceptions around corporate tax practices, and is likely to have far-reaching ramifications. The financial services sector has particular characteristics which make a number of the BEPS initiatives challenging; hence the industry should carefully consider its involvement with the OECD’s BEPS initiative. At the same time, as these examples make clear, there is a need to prepare for potentially significant changes.

⁴ OECD explains that “the term non-recognition is intended to convey the same meaning to that understood to be conveyed by the term recharacterisation.”

⁵ cf BEPS Actions 8, 9 and 10: Discussion draft on revisions to Chapter 1 of the Transfer Pricing Guidelines (including risk, recharacterization and special measures), OECD, December 2014-February 2015



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Asia Pacific nations join the global move towards tax transparency

The seven years since the financial crisis have seen a rapid and fundamental change in perceptions surrounding international tax transparency, and the emergence of automatic exchange of information (AEOI) as a global standard for interaction between national fiscal authorities.

In October 2014, at the Berlin meeting of the Global Forum, 51 jurisdictions signed a multilateral competent authority agreement to automatically exchange information.

In previous editions of *frontiers in tax*, we have reported on the Common Reporting and Due Diligence Standard (CRS) developed by the OECD and G20. The Global Forum on Transparency and Exchange of Information for Tax Purposes was asked by the G20 to monitor and review the implementation of the new standard. While the initial lead was taken by the G20 countries,¹ during 2014 the Forum developed a roadmap for developing countries' participation in the new standard.² This roadmap provides a stepped approach so developing countries can overcome obstacles in implementing CRS, and the roadmap also identifies the fundamental building blocks necessary to meet the standard.

Many jurisdictions have now committed themselves to this standard. In October 2014, at the Berlin meeting of the Global Forum, 51 jurisdictions signed a multilateral competent authority agreement to automatically exchange information.³ In addition, the meeting demonstrated the resolve of members to drive major improvements in tax transparency:

- the overwhelming majority of Global Forum members agreed to implement the new standard for automatic exchange either by 2017 or by the end of 2018;
- members will now be required to maintain beneficial ownership of information, to ensure that the existing standard on exchange of information on request (EOIR) continues to reflect the evolution of the dynamic EOI environment;

- greater support would be given to developing countries to facilitate their participation in AEol.⁴

A group of jurisdictions known as the Early Adopters Group committed themselves to early adoption of the new standard, with the first exchange of information in relation to new accounts and pre-existing individual high value accounts to take place by the end of September 2017. The timetable implies:

- new account opening procedures to record tax residence and entity status will need to be in place from 1 January 2016.
- due diligence procedures for identifying high-value pre-existing individual accounts will need to be completed by 31 December 2016, while that for low-value accounts will need to be completed by 31 December 2017
- the first exchange of information (for new accounts and pre-existing individual high value accounts) will take place by the end of September 2017
- information on remaining accounts will be exchanged either by the end of September 2017 or September 2018 depending on when financial institutions identify them as reportable accounts.⁵

In the Asia Pacific region, the early adopters include India, Mauritius and South Korea. Australia, Hong Kong, Japan and Singapore, the existing major financial centers in the region, have undertaken to begin exchange of information by 2018.

FATCA and beyond

Jurisdictions where major multinational financial institutions conduct business are already focused on implementing exchange of information with the United States under the Foreign Account Tax Compliance Act, and this is proving challenging in many cases. In order to streamline progress on AEol, the CRS has been closely modeled on FATCA. But it is misleading to view AEol as simply FATCA 2.0. The scope of AEol is much broader; and in some respects, solutions already being developed for FATCA may be insufficient as it relates to AEol. Financial institutions and others therefore face the double challenge of responding to both sets of requirements.⁶

The G20 report on the developing countries roadmap stresses that signing a FATCA agreement does not necessarily indicate an advanced state of readiness to move towards AEol: as we have seen, there may be substantial differences in the scope and processes required to implement FATCA as compared with the CRS. Mechanisms designed to send information to the United States directly from individual financial institutions may not translate into implementing the new standard, which requires multilateral information flows with information passing through tax authorities on each side.⁷

Implementing the CRS thus involves four complementary actions:

- translating the reporting and due diligence requirements into domestic law

¹ In particular France, Germany, Italy, Spain and the UK

² cf Global Forum on Transparency and Exchange of Information for Tax Purposes, Annual Report 2014, <http://www.oecd.org/tax/transparency/GFAnnualReport2014.pdf>

³ <http://www.oecd.org/tax/exchange-of-tax-information/MCAA-Signatories.pdf>

⁴ Global Forum on Transparency and Exchange of Information for Tax Purposes, Berlin, Germany 28-29 October 2014, Statement of outcomes, <http://www.oecd.org/tax/transparency/statement-of-outcomes-gfberlin.pdf>

⁵ Joint statement by the Early Adopters Group, October 2014, <http://www.oecd.org/tax/transparency/AEol-early-adopters-statement.pdf>

⁶ cf Automatic Exchange of Information: the Emerging Global Standard, *Frontiers in Tax*, KPMG, September 2014

⁷ cf Automatic Exchange of Information: A Roadmap for Developing Country Participation, Final Report to the G20 Development Working Group, 5 August 2014

- selecting a legal basis for the exchange of information: many jurisdictions already have appropriate legal instruments in place, including bilateral double tax treaties and the Multilateral Convention on Mutual Administrative Assistance in Tax Matters
- putting in place the administrative and information technology infrastructure to collect and exchange the necessary information
- protecting confidentiality and data safeguards by effective legal and operational measures.⁸

Despite the strength of their commitments in principle, countries in the Asia Pacific region, both the existing major centers and the developing countries, have a lot of work to do.

Asia Pacific: early adopters:

- **Mauritius** is currently focused on FATCA implementation. The Mauritius Revenue Authority issued practical guidance on implementation to financial institutions, businesses, their advisers, and officials in November 2014.
- The income tax authorities in **India** are in the process of finalizing common rules for FATCA as well as the CRS: draft rules have been circulated to financial institutions for comment. The authorities have also circulated a draft of the reporting

form, which covers US as well as other reportable accounts. Due diligence for CRS is scheduled to begin on 1 January 2016.

- The Ministry of Finance in **South Korea** announced on 30 October that they would be among the early adopters, and expect to start exchanging information with the US from 2015.

Asia Pacific: major financial centers:

- In **Australia**, the government's recent mid-year economic fiscal outlook indicated that they will start implementing the CRS in 2017, with the first exchange of information in 2018. The Australian Tax Office and Australian Treasury are currently in discussions with industry over the development of local rules, legislation and guidance.
- **Hong Kong's** current policy only allows exchange of information on request (EOIR) under comprehensive avoidance of double taxation agreements (CDTAs) or tax information exchange agreements (TIEAs). Some measures have already been taken to update the legal framework to reflect evolving standards, and the priority now is to expand the network of CDTAs and sign further TIEAs on an as-needed basis. Hong Kong authorities have stated that their commitment to this process rests on the condition that

AEol is conducted on a reciprocal basis with appropriate partners who can satisfy the relevant requirements on protection of privacy and confidentiality of information.

During 2015, the government plans to prepare detailed legislative proposals and engage local stakeholders, while continuing to update the Global Forum on the progress of implementation measures. Following passage of the necessary domestic legislation in 2016, automatic exchange would begin at the latest at the end of 2018.

- In **Japan**, implementation of the CRS is scheduled to begin in 2017. A draft overview of the regulations has been circulated to industry associations for review and comment, and a draft of the full regulation is expected to be published shortly.
- **Singapore** is the world's fourth largest offshore financial center with an estimated SGD\$1.63 trillion of assets under management,⁹ and as one of the existing major financial centers in the region, has undertaken to begin exchange of information by 2018.

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Despite the strength of their commitments in principle, countries in the Asia Pacific region, both the existing major centers and the developing countries, have a lot of work to do.

⁸ Roadmap, *ibid*

⁹ Total assets managed by Singapore-based asset managers as at end-2012. Source: Monetary Authority of Singapore (23 July 2013). MAS Annual Report 2012/13 Press Conference: Opening Remarks by Ravi Menon, Managing Director, Monetary Authority of Singapore.



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In the eye of the storm: VAT reform in China

In 2012 the Chinese government embarked upon an ambitious staged reform program as part of its 12th Five Year Plan, designed to replace Business Tax (BT) with a Value Added Tax (VAT) throughout the services sector of the economy. These reforms were designed to overcome the problem of tax cascading arising whenever business-to-business transactions took place under the BT system. The reforms were intended to overcome mismatches occurring whenever BT taxpayers purchased goods for which they were unable to claim input VAT credits, and similarly overcome the problem of VAT taxpayers being unable to claim credits for the BT incurred on the services they purchased.

To date, the VAT pilot program has extended from the modern services and transportation industry in Shanghai (in 2012), to a national basis (in 2013), and then further expanded to cover television, radio and film broadcasting services (in 2013), and postal and telecommunications services (in 2014).

The main sectors yet to transition to VAT represent the most financially significant for the government, the most challenging from a technical perspective, and the most economically interdependent: these are the real estate and construction industry; the financial services and insurance industry; and 'lifestyle services', which comprises food and beverage, hospitality, entertainment and a general catch-all of all "other services".

One of the most challenging aspects of introducing a VAT is managing the transition; being only partway through the implementation process means there are still many BT taxpayers and therefore the VAT system is yet to fully perform its proper economic function as a consumption tax collected by business but passed on to the end-consumer. In addition, policy changes are regularly being made to remedy unintended consequences or gaps arising from the rules initially released.

Here we look at some of the specific issues affecting the financial and insurance services sector, and the real estate and construction sector.

Financial services and insurance industry

The financial services and insurance industry is expected to transition to VAT from 2015, and the current thinking is that the VAT rate will be either 6 percent or 11 percent. The Chinese VAT system

is expected to be amongst the first in the world to apply full VAT concepts to transactions in this sector.

The rationale for imposing VAT derives partly from the fact that BT currently applies to most financial services and insurance transactions (at a rate of 5 percent), so a loss of revenue would arise if the more traditional approach of exemption were to apply. The proposed imposition of VAT on bank lending activities is being watched with considerable attention internationally, and it will be interesting to see if other countries follow this lead. From a pricing perspective, one question will be whether the banks will absorb all or part of the VAT into their current interest rate pricing models, or whether they will simply pass it on. Clarity on this may take some time to emerge given that the introduction of VAT broadly coincides with the progressive relaxation of the regulated interest rate pricing mechanisms in China. One important consequence for business borrowers is that if the banks choose to absorb some or all of the VAT impost, then potentially those borrowers will benefit from a net reduction in their interest expenses after input VAT credits have been factored in.

For the insurance sector, recent proposals by the Ministry of Finance (MOF) suggest that VAT will apply at the rate of 6 percent to premiums for most forms of general insurance, while life insurance is expected to be exempt. From a claims perspective, it now seems less likely that the authorities will adopt models applicable in countries such as Australia, New Zealand, South Africa and Singapore under which input VAT credits (or their equivalent) can arise from the cash settlement of certain general insurance claims. Instead, recent proposals by the MOF suggest a

move towards the adoption of a hybrid system where insurers' claims-related costs are ineligible for input VAT credits, but non-claims related costs would be eligible. Drawing that distinction in practice will be a challenge for both insurers and the tax authorities.

Real estate and construction industry

The real estate and construction sector is also expected to transition to VAT during 2015, with a rate of 11 percent. There has been some media speculation that the rate could be as high as 17 percent, but that would seem to be unlikely given the potentially adverse impacts it could have on the property market in China. Indeed, one of the challenges in introducing a VAT for the property market is whether it will have an inflationary effect, or whether it will potentially detrimentally impact on demand during a time when the market is already showing signs of coming off a high, at least in many of the larger cities.

The scope of VAT in the real estate and construction sector is expected to be amongst the broadest in the world. A key reason for this is that BT currently applies to virtually all real estate transactions at the rate of 5 percent - whether those transactions involve residential or commercial real estate, sales of new or second-hand real estate, and whether by developers or private individuals.

When it comes to sales by private individuals, it is expected that a form of simplified VAT methodology will apply. That is, private individuals will be unable to claim input VAT credits for their purchase, but equally they will pay a reduced rate of VAT (expected to be 3 percent) on a subsequent sale.

The Chinese VAT system is expected to be amongst the first in the world to apply full VAT concepts to transactions in this sector.

A number of policy questions are raised by this approach, including:

- How will the payment of VAT be collected and enforced? Logically, collection will somehow need to be linked to the property title transfer system.
- Will VAT apply to the gross selling price, or the “margin” between the selling price and the purchase price?
- Will the simplified VAT method be restricted to private individuals selling their own home, or to passive investors, or to speculators too?

The experience with VAT/GST systems in other countries suggests

that these are not easy problems to resolve, and inevitably definitional problems will arise in practice.

Turning now to real estate funds, irrespective of whether they are holding residential property or commercial property, a key feature is that many development projects take place in China through the purchase and subsequent sale of an equity interest in a development entity. In some cases, the equity interest may be held through a chain of entities, some of which are located offshore. The question which this raises from a VAT perspective is whether there will be ‘look through’ rules which will effectively tax the

underlying change of ownership or control of the real estate being developed. If so, how will that tax be calculated, disclosed and enforced?

A further issue is that in many cases, the equity in a development entity may be sold at a time when the development entity has a substantial input VAT credit balance arising from the works already completed. Absent any change of ownership or control rules which vitiate that credit balance, this is an asset of value which should be taken into account by the parties in calculating the price. These issues rarely arise in other countries because refunds of excess VAT credits are routinely given.



Looking ahead

The Chinese VAT system is already exhibiting some distinctive characteristics which depart from pure theories of a VAT. For example, the existence of multiple VAT rates means that the nature of what is purchased may influence the ultimate tax liability of the business making the purchase – in other words, some purchases can be more valuable than others in generating credits. Additionally, the mindset of many businesses sits part-way between BT concepts (which recognize the tax as a P&L item) and modern principles of VAT (where the tax is intended to be passed on in the supply chain). The other major distortion is that businesses are generally ineligible to claim refunds of excess input VAT credits (except for certain exporters). As a consequence, issues that in other countries would give rise to minor timing concerns only can cause timing differences lasting decades long. The primary example where this is expected to arise is for real estate funds who lease the final product – substantial input VAT is incurred during development but the output VAT is generated over an extended period of time.

The real question is whether, in due course, the Chinese VAT system will exhibit more 'typical' characteristics of a VAT system. Looking ahead, the answer would seem to be yes. Over the course of the next few years, a number of changes could take place which should help determine that a more modern VAT system emerges. Those changes may include:

- A reduction in the number of VAT rates (currently 6, 11, 13 and 17 percent) towards a single VAT rate;
- A shift towards potentially the most broadly based VAT system in the world, with few exemptions. The current thinking is that VAT will be introduced for the financial services sector (including taxing interest income), and for residential property transactions, both new and second-hand properties will be taxed, irrespective of whether they are sold by developers, speculators or private individuals;
- A likely reduction in the threshold for registration as a general VAT taxpayer under the VAT pilot program from the current RMB 5 million annual turnover

threshold (approximately \$US800,000) to a lower threshold more consistent with international standards; and

- The eventual abolition of BT, which should help determine that most outputs are taxed under a VAT, and therefore most inputs are creditable to business under a VAT.

Conclusion

The implementation of VAT in China in substitution for BT appears to be a step in the right direction. Policy-makers' focus to date has been on managing the transition as smoothly as possible, which has led to multiple VAT rates being applied, and a staged implementation process. However, over the next few years the policy-makers could shift their focus to the longer-term and address aspects of the Chinese VAT system requiring modernization or further development. The challenges of doing so are considerable, but potentially China could be left with the world's leading VAT system given its unprecedented broad base.

The real question is whether, in due course, the Chinese VAT system will exhibit more 'typical' characteristics of a VAT system. Looking ahead, the answer would seem to be yes.

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Making the most of **R&D** tax incentives

Many governments in the ASPAC region are keen to promote research and development as a route to innovation and competitiveness, and are willing to offer tangible tax benefits to support this in the right circumstances. Many multinational corporations are at least generally aware of the possibilities. But taking full advantage of the opportunity requires a full understanding of the structure of the various incentives; it also requires thorough attention to definition, demonstration and audit.



Many countries in the Asia Pacific region offer tax incentives for R&D as a method to encourage local and foreign direct investment in technology.

Innovation and technology are crucial to enhancing corporate competitiveness; and boosting a country's technology and innovation capability through R&D is a key policy contributor to economic growth. Many countries in the Asia Pacific region offer tax incentives for R&D as a method to encourage local and foreign direct investment in technology.¹ But the details vary from one jurisdiction to another; and it can be difficult to assess the potential tax savings in each. Some key examples include:

- China offers significant tax incentives for R&D. It provides a 150 percent R&D Super Deduction which equates to a net saving of 12.5 percent for eligible expenses. It also offers High and Advanced Technology 'Status' to specific companies that meet a strict set of criteria, and if eligible, the corporate tax rate is reduced from 25 percent down to 15 percent for eligible companies. Given the size and rate of growth of the Chinese economy, this is a major factor in the regional picture (see panel).
- Australia offers an R&D tax incentive or credit of 45 percent for small companies and 40 percent for large companies. In after tax terms, this translates to net tax savings of 15 percent and 10 percent respectively. In addition, if a small company has tax losses, it can 'cash out' the tax deduction and receive a 45 percent cash refund.

- Malaysia offers a double deduction of 200 percent for eligible R&D expenditure, which translates to a net saving of 25 percent. This is one of the highest R&D benefits in the region, although it is important to note that companies must pre-register their intention to claim the R&D benefit and they will be thoroughly audited before receiving any potential benefit. Malaysia also offers tax exemption tax status to approved operational headquarters.
- Singapore has managed to attract significant foreign direct investment over the past decade and has transformed itself into a financial and regional services hub. It offers a 400 percent R&D incentive on the first SGD\$400,000 (\$308,000) and a 150 percent benefit thereafter. It also offers enhanced benefits to small and medium sized enterprises.

Tax is not the only decisive issue in a company's decision on the structure and location of its R&D activities. Other factors such as access to skilled staff, the level of wages and salaries and the broad context of industrial development incentives are at least as important. However, tax considerations are significant determinants of cost and hence return on investment, and deserve greater attention than they may receive. In addition, the tax treatment of technology transfers, transfer pricing and other related local tax issues, is a

vital consideration. It is important that a company evaluate all the R&D incentives available, and the impact of all R&D costs on other tax benefits in countries around the ASPAC region, before coming to a decision on where to locate R&D programs.

In this context, a number of key issues should be considered:

- The net cost of R&D: The relative costs of performing R&D in one country versus another, net of respective available R&D incentives, are important in evaluating where and under what circumstances R&D activities should take place.
- Intellectual Property (IP): In planning how IP will be created, it is important to consider the tax consequences, the arrangements under which it is created, where it will be used, how it will be paid for and where it will be owned. Entities undertaking R&D in the region should be aware that tax authorities in ASPAC countries are focusing on the transfer pricing issues arising from the development, ownership and compensation for use of IP.
- Transfer pricing: Transfer pricing provisions in ASPAC countries are complex. They apply to the economic, legal and tax aspects of transfers of technology, and products or services based on technology, to related entities. These provisions may

¹ For a detailed survey, see R&D Incentives: adding value across ASPAC, KPMG, 2015 edition

encourage companies to locate some of their R&D activities in one country rather than another. India, Australia, China, and Japan have all recently seen an increase in transfer pricing audits, and China and Singapore's tax authorities have recently signalled that they intend to step up their transfer pricing compliance and field audit work.

- **Short-term economic stimulus measures:** Short term measures implemented by governments as economic stimulus packages in response to the global financial issues, such as accelerated deduction programs for investment in tangible depreciable assets, are worth taking into account, as these may top up existing benefits delivered through R&D incentive schemes.

Navigating through these issues, and successfully utilizing the opportunities on offer, is not primarily – or even mainly – a task solely for tax specialists. A company's engineers and scientists are critical to successfully determining whether activities should qualify for relief, and demonstrating that effectively to fiscal authorities. This requires a detailed understanding of the innovative and technically challenging aspects of a company's projects, combined with detailed awareness of R&D programs in question, their intellectual novelty and their potential contribution to innovation and growth. Among the principal issues to consider are:

- Which activities are eligible R&D?
- How do you calculate eligible R&D expenditure?

- What is the claim process and how long does it take?
- What will happen if your claim is audited and how can the audit be defended to enhance outcomes?
- What records are needed to substantiate a claim?

Engineers, scientists, technologists and software specialists should be part of this process. Sustaining eligibility over a period requires a convincing audit program to demonstrate technical progress. Tax specialists are of course needed to understand the precise operation of schemes and to interact with the relevant authorities. But they need to operate as part of an integrated team.

The opportunities exist. Many companies could be doing more to take advantage of them.



R&D incentives in China

China's R&D spending has grown rapidly from RMB461.6 billion (\$US75 billion) in 2008 to RMB1.19 trillion (\$US192 billion) in 2013. In 2011, China surpassed Japan as the world's second highest R&D spender in the world. This growth has been facilitated in part by government support for innovation in eight high-technology areas:

- electronic information technology
- bioengineering and new medical technology
- aeronautical and space technology
- new material technology
- high-tech service
- new energy and energy saving technology
- resource and environment technology; and
- high technology to transform traditional industries.

The Chinese government offers two broad tax incentive frameworks to underpin this support: the *R&D Super Deduction* and the *High or New Technology Enterprise (HNTE)* program.

R&D Super Deduction

The R&D Super Deduction program has been in place for over 10 years. It is available in all industry sectors, and offers:

- 150 percent tax deduction on qualifying R&D expenses incurred during the year. This generates a net saving of 12.5 percent.

The definition of eligible R&D expenses is very broad and can include improvements to products and technologies in many industry sectors such as financial services (usually software development), IT, logistics, retail, food/beverage, agribusiness, manufacturing, engineering and mining – as well as more typical R&D industries such as pharmaceuticals and automotive. However, many companies with operations in China are unaware of the scheme and fail to take advantage of it.

HNTE

Companies working in any of the eight supported high-tech industries are potentially eligible for HNTE status. Qualifying companies are allowed a reduced rate of corporation tax (15 percent as opposed to 25 percent) for a period of three consecutive

years. However, the six eligibility criteria are difficult to meet, especially if the company is increasing sales. Among the principal criteria are:

- the company must own the intellectual property for at least one core technology under development
- its R&D expenditure must be at least 3 percent of total turnover for large companies
- revenue from relevant technological products and services should exceed 60 percent of the total
- it must exceed minimum standards for the proportion of technologists, R&D specialists and graduates on the payroll.

Eligibility for HNTE status is determined by a weighted points system used to score the various criteria. A score higher than 70/100 is required: since the IP component itself scores 30/100, it is a key determinant.

Other schemes

The Chinese government also offers Advanced Technology Service Enterprise (ATSE) status to companies in specific service industries, again with reduced corporation tax benefits, and advantageous tax provisions for purchase of R&D equipment by qualified R&D companies.

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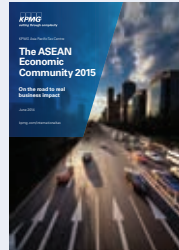
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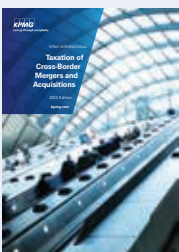
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