China tax planning to be impacted by BEPS Action 7 permanent establishment proposals

Regulations discussed in this issue:

- OECD Discussion draft "BEPS Action 7: Preventing the Artificial Avoidance of PE Status" issued on 15 May 2015 ("BEPS May 2015 PE discussion draft")
- Interpretations on Clauses of the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and of the Protocol thereto, Guo Shui Fa [2010] No. 75 (Circular 75)
- Australian Federal Budget 2015, Exposure Draft, Tax Integrity: Multinational Anti-Avoidance Law issued by the Australian Government on 12 May 2015
- Announcement of the State Administration of Taxation (SAT) Regarding Corporate Income Tax ("CIT") Matters on Outbound Payments to Overseas Related Parties ("Announcement 16"), issued on 18 March 2015

Background

On 15 May 2015 the OECD released, in the context of the G20/OECD Base Erosion and Profit Shifting (BEPS) international tax reform project, a revised discussion draft on the taxation of permanent establishments (PE). The BEPS PE work in Action Plan Item 7 aims to adjust the definition of PE to prevent the artificial avoidance of PE status, such as through use of commissionaire arrangements or the specific activity exemptions in the PE article.

It is considered that the BEPS PE proposals may foreshadow a significant tightening of Chinese PE enforcement for Multinational Enterprises (MNEs), which may in turn prompt extensive restructuring of existing China operating arrangements. MNEs are advised to monitor these trends and consider the implications for their existing structures and future planning.

BEPS Action 7 - Permanent Establishment

The, by now well advanced, G20/OECD BEPS project is entering the final phase of work on its fifteen point Action Plan. Having already issued a batch of recommendations with the September 2014 Deliverables, as outlined in China Tax Alert Issue 27 (October 2014), the OECD has released discussion drafts of the September and December 2015 Deliverables to invite public comment.

The BEPS May 2015 PE discussion draft for Action 7 refines the work of the original October 2014 PE discussion draft and invites further written comments, though it is understood that no further public consultation will be held. It is generally considered that the new PE discussion draft is unlikely to see significant further change prior to finalization in September 2015.

The PE draft proposes a number of notable changes to the existing Article 5 on PE in the OECD Model Tax Convention (MTC) and Commentary:

Agency PE:

The PE draft proposes a change to the phrasing of the Agency PE provision in Article 5(5). Currently a PE may be deemed to exist where a person in the market state, other than an agent of independent status, acts on behalf of a non-resident and "habitually exercises an authority to conclude contracts in the name of the enterprise", subject to the "specific activity" and preparatory and auxiliary (P&A) exemptions in Article 5(4).

The proposed new wording provides that a PE will arise where a person in the market state acts on behalf of a non-resident and "habitually concludes contracts, or negotiates the material elements of contracts, that are (a) in the name of the enterprise, or (b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or (c) for the provision of services by that enterprise". The independent agent and P&A exclusions are to be narrowed.

The significance of the changes to the wording of Article 5(5) is reinforced by the additions to the OECD MTC Commentary. It is no longer of any importance whether or not the local person has been "authorized" to act for the non-resident. The key is that the activities of the local person are "intended to result in the regular conclusion of contracts to be performed by a foreign enterprise". To this end a Commentary example notes that even if the local person "cannot vary the terms of the contracts does not mean that there is no negotiation but rather means that the negotiation of the material elements of the contracts is limited to convincing the account holder to accept these".

This opens the way for many types of arrangement, through which goods and services of a non-resident are promoted by a related party in a market country but not contracted for sale by that person, to be exposed to PE risk. This sits alongside the ambiguous effects of the new provisions on contracts for 'transfer of ownership/grant of right to use property' and 'provision of services', hopefully to be further clarified in the final version of the BEPS PE proposals.

Specific activity exclusions, anti-fragmentation rule and contract splitting:

The 'specific activity exemptions' in Article 5(4), currently exclude from the scope of PE fixed places of business or dependent agents where the sole activity/function is (a) facilities for storage, display or delivery, (b) stock maintained for storage, display or delivery, (c) stock maintained for processing, (d) fixed place maintained for purchasing or information collection. The OECD proposes to subject all of these exclusions to an overriding P&A test, consequently stripping these exclusions of their current 'safe harbour' value. Clarifications in the Commentary explain how (i) the use of local market warehousing by a foreign enterprise for local sales distribution may give rise to PE, and (ii) how the availability of specific access to source country contract manufacturing and procurement premises, by a foreign enterprise, may give rise to PE.

Complementing this is an 'anti-fragmentation rule' which applies a de facto "force of attraction" approach under which the activities of connected enterprises at the same or separate places in the source country may be aggregated in determining if the P&A threshold has been exceeded, such that a PE exists. Rules dealing with 'contract splitting' strategies, designed to ensure that cross-border construction activities fall under the time limit for a construction PE, have also been proposed.

KPMG observations

In recent years, the Chinese tax authorities have focused (i) on countering the avoidance of CIT on investment gains and income considered to be sourced in China and (ii) on ensuring that, for operational business activity in China, the Chinese contribution to value-creation is reflected in the TP attribution of taxable profits to Chinese operations. This has already led to changes in how MNE investments are structured into China. The BEPS PE developments indicate that a new phase of Chinese international tax enforcement may be opening up, with more thorough-going restructuring of MNE operations potentially necessary.

Existing Chinese government policy indicates that the BEPS PE proposals are very likely to be incorporated into Chinese DTA practice. This process may be accelerated given the strong progress indicated with the BEPS Multilateral Instrument and the SAT's role in leading up this initiative. Even prior to such DTA updates going into effect, the somewhat expansive wording of China's existing guidance on PE interpretation, Circular 75 [2010], may see some local tax authorities push ahead with the application of the new BEPS PE concepts to challenge taxpayer arrangements.

Commonly used cross-border business structures into China which may be particularly affected by Chinese adoption of the BEPS PE proposals include:

- Indent Sales Models: MNEs frequently establish Chinese marketing support companies or representative offices. The staff of the latter assist with product promotion and liaison with Chinese customers, while an overseas marketing hub approves purchase orders placed by customers and concludes sales contracts. Careful documentation of the retention of all significant contract negotiation and execution authority by the marketing hub, and detailed protocols to limit the discretion of local staff, have historically curtailed Agency PE risk. The BEPS PE removal of a focus on grant of authority, and the emphasis on efforts to 'convince' customers to buy, may undermine these models and lead to a shift to onshore buy-sell models

- Contract manufacturing and procurement: The rendering of all 'specific activity exclusions' subject to a case-by-case P&A evaluation may lead to risk of PE where specific areas are reserved for the use of overseas principals at Chinese manufacturing or procurement facilities. What is more, the greater scrutiny of such arrangements by the authorities may well put focus on the level of control and direction which foreign principals exercise over their related party contract manufacturing and procurement facilities, heightening fixed place PE risk. Insofar as many foreign enterprises which manufacture in China also sell a significant quantity of their goods in China, often via their offshore marketing hubs (sometimes making use of Chinese bonded zones), the anti-fragmentation rules may also give rise to many more PEs being identified

Alongside the proposed BEPS PE changes, a further potential influence on Chinese PE enforcement practice is the very recent introduction of PE anti-avoidance measures in other countries. Notably, new Australian rules to go into effect in 2016 target foreign residents, in low tax jurisdictions, who are deriving income from a supply of goods or services to Australian customers, with a related entity in Australia supporting that supply, where the foreign residents are found to be "using contrived arrangements to avoid a taxable presence in Australia". The GAAR can be used to deem the foreign resident to have an Australian PE where the principal purpose of the arrangement was to obtain a tax benefit and the foreign resident does not possess substantial activities. The UK recently introduced a Diverted Profits Tax broadly along these lines and it is understood that other governments, such as those of India, Italy and Spain are interested in also adopting such measures.

The increasing adoption of GAAR-based anti-PE avoidance measures globally may well give the SAT cause to consider this a viable tool for tax enforcement. China has consistently favored the domestic law GAAR as its preferred 'tool in the toolbox', and the use of GAAR for PE cases would reinforce the rollout of the BEPS PE changes.

A key challenge in a China context with PE is the reliance of the Chinese tax authorities on deemed margin profit attribution methods in preference to the 'functions, assets, risks' approach of the Authorized OECD Approach (AOA) to PE profit attribution. While in jurisdictions applying the AOA the identification of additional PEs may not, in end effect, give rise to much additional tax liability, the attribution of profits to a Chinese Agency PE as a percentage of total China sales (the deemed margin) may give rise to significant additional China tax with potentially restricted offsetting foreign tax credit in the residence jurisdiction.

The 'aggregation' of sales and production activities under anti-fragmentation rules may also undermine the use by a foreign principal of transactional net margin TP methods for allocating China profits to its China contract manufacturing operations, and the Chinese tax authorities may push for profit split methods to be applied in such cases, with potentially larger tax leakages.

Such potential for increased CIT leakage sits alongside the administrative costs of registering and conducting tax compliance for multiple China PEs as well as the Individual Income Tax and indirect tax implications. To mitigate the risks of China PE, MNE tax structuring may in future gravitate towards the use of local buy-sell distribution models. However, it would be cautioned that tax planning by means of outbound payments (royalties/services) from controlled China entities is under intense scrutiny as a result of the March 2015 issued SAT Announcement 16, and this will need to be borne in mind.

Going forward, in light of the developments described above as well as the greater information which will be available to the Chinese tax authorities through the enhanced TP documentation requirements in the new Circular 2 (anticipated from 2016), country by country TP reporting, and enhanced tax information exchange by China with other countries, MNEs would be well advised to review their existing business arrangements in China. Enterprises conducting sales into China, or carrying out manufacturing and procurement in China, as well as Private Equity/Venture Capital funds, leasing, engineering and construction firms, and others, should consider the long term sustainability of their existing arrangements, and plan for structure adjustments as necessary.

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