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China

Looking Ahead 5th edition

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China – Looking Ahead

INTERNATIONAL TAX REVIEW™

Editorial

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International Tax Review

There is no such thing as a quiet year for China's tax system.

The fifth edition of KPMG's *China – Looking Ahead* guide shows that all parts of the system covered in previous versions of this publication underwent change in 2015 and more is on the way. For example, Announcement 7 has replaced Circular 698 as the definitive word on the reporting and taxation of indirect offshore disposals, the Special Tax Adjustments discussion draft, covering new transfer pricing guidance and controlled-foreign-company rules, is expected to be finalised before the end of the year, and the transition from Business Tax to a national VAT is expected to be completed in 2016.

Many of the changes are, of course, inspired by, if not taken directly from, the OECD's Base Erosion and Profit Shifting (BEPS) Action Plan, whose final recommendations came out in September 2015. China will have a particularly important role to play in the implementation of the plan in 2016 as president of the G20 group of the world's biggest economies, which commissioned the OECD to reform the international tax system in 2012.

China will be in the global tax politics and diplomacy spotlight for another reason next year. It hosts the next meeting of the OECD-organised Forum on Tax Administration, when more than 100 tax commissioners from around the world will meet in Beijing to discuss ever-constant priorities such as how they can cooperate more and better, and how to resolve disputes quicker and more efficiently.

China wants to use these responsibilities to make a real impact on international tax, but it reserves the right, as it has made clear many times previously, to sculpt any measures according to the needs of its own tax system and economy. For example, it has decided not to adopt, for now, the BEPS proposals on interest deductions and value chain apportionment, the SAT's new transfer pricing method, is nowhere to be seen in the BEPS action plan.

So what does this all mean? It means, to borrow a phrase from a different time, an international tax system in China with Chinese characteristics. It is a situation that taxpayers everywhere will have to monitor closely and we hope the fifth edition of KPMG's *China – Looking Ahead* will be a valuable tool in helping them do this.

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Foreword

The Year of the Sheep, now drawing to a close, has been a signature year both economically and fiscally for China. China had surpassed the US as the world's largest economy, in purchasing power parity terms, in 2014. It had similarly become the world's largest recipient of foreign direct investment (FDI), also overtaking the US, in that year. Remarkably, while China takes the top position as a recipient of FDI, Chinese outbound direct investment (ODI) is projected to overtake FDI for 2015 as a whole, making China a net exporter of capital. Projections further show China overtaking the US in ODI terms to become the world's premier source of ODI within a short few years. There is no doubt that China is becoming ever more central to the global economic order. Nevertheless, as the Chinese government seeks to shift her economy from reliance on investments, exports and heavy industries to a more consumption and service sector-driven model, the pace of economic expansion in China will ease off before picking up again. In the meantime, the government will go to every length to safeguard her tax revenues.

It is also particularly timely that the G20/OECD Base Erosion and Profit Shifting (BEPS) project should now enter into its implementation phase. This happens just as China assumes its role as the 2016 host of both the G20 summit and the OECD's Forum on Tax Administration. China's State Administration of Taxation (SAT) has taken a lead role in the BEPS process, contributing substantially to the final shape of the proposals. Senior SAT officials have also indicated repeatedly how seriously they take China's responsibilities to ensure that the new BEPS rules are rolled out nationally.

Even before the finalisation of the BEPS deliverables, China started to incorporate some of the ideas contained in the BEPS programme proposals into its domestic tax regulations. This was especially so after President Xi Jinping's November 2014 address to the G20 Leaders' Summit in Australia, at which he pledged China's support for global cooperation on tax reform. These changes are set to continue into 2016 and beyond.

And at the Fifth Plenary Session of the 18th Chinese Communist Party (CCP) Central Committee on October 26 to 29 2015, the Chinese leadership proposed the outline of the country's 13th Five-Year Plan for economic and social development, which will cover the years 2016 to 2020. The Plan, once fully elaborated by subordinate government bodies, is expected to include key measures on real estate, consumption and environmental taxation. It is also expected to include the revision of the Individual Income Tax (IIT) Law and the restructuring of the way in which tax revenues and collection responsibilities are shared between the central and local governments. These reforms will be made alongside the finalisation of the transition of the indirect tax system from Business Tax (BT) to VAT which is due to complete in 2016.

Against this backdrop, in this fifth edition of China – Looking Ahead, KPMG China's tax experts examine recent developments and explore what the Year of the Monkey may bring for foreign investors in China and Chinese multinational enterprises (MNEs) investing overseas. It should be noted, however, that the content of this publication is not intended as predictions or forecasts of Chinese tax policies and should not be relied upon as such.

The chapter, *China at the forefront of global BEPS implementation*, maps the final BEPS 2015 deliverables against the items in the SAT's tax policy agenda . The chapter details the alignment of the China anti-treaty shopping provisions with the BEPS deliverables as well as the revised controlled foreign company (CFC) rules. The chapter also discusses how the SAT may look to rigorously enforce the permanent establishment (PE) rules in line with the BEPS proposals. This development may well have a significant impact on the existing operating structures of MNEs doing business in China.

More specifically, the chapter, *China's new Transfer Pricing Guidelines and BEPS*, discusses a raft of changes to transfer pricing (TP) rules. These changes are contained in the SAT's exposure draft of the guidelines on special tax adjustments. Alongside BEPS-related updating of TP rules, the draft calls for the introduction of a new TP methodology, that is, the Value Contribution Apportionment Method (VCAM). VCAM would seek to allocate profits to China with reference to a MNE's global value chain including assets, costs, sales, and employees. The use of VCAM would generally require the preparation of value chain analysis which needs to be included in the local file TP documentation of a MNE's Chinese subsidiary.

The BEPS-related tax changes will have a pervasive effect on many aspects of Chinese taxation. One example is M&A transactions, as made clear in the chapter, *A New Era for M&A Tax in China*. Alongside the BEPS-related changes to anti-tax treaty abuse provisions, other significant measures to consider include the much relaxed, and far more useful, restructuring tax relief rules and the challenging changes to the indirect offshore disposal rules as set out in the SAT's Announcement 7.

The Chinese tax authorities are also changing their approach to administering the tax law. The chapter, *FATCA and CRS: the Changing Landscape of Fiscal Disclosure*, considers the challenges that the introduction of new automatic cross-border tax information exchange systems are bringing to global financial institutions with operations in Hong Kong and China.

The chapter, *New Challenges to Tax Risk Management in China*, considers how new rules are transferring the responsibility for the interpretation and application of tax law from the tax authorities to the taxpayers. The changes include the provisions on tax deductions, and conditions for eligibility for treaty benefits and tax incentives. Tax authorities are rapidly relinquishing the power for pre-approvals of tax treatments, while redoubling efforts and resources to "follow up" on filed returns and to conduct post-filing audits. Going forward, tax authorities will have access to far more tax information and will have more technologies and resources to conduct data analysis. Under these circumstances, the changes may drive tax authorities and taxpayers to work more closely together in future to manage tax processes and risks, with more emphasis on tax internal controls and compliance agreements.

Casting an eye even further into the future, the chapter, *Indirect Taxes in China — 2020 and Beyond!*, considers how the China indirect tax landscape may evolve subsequent to the completion of the continuing BT to VAT reforms. Possibilities considered include:

- the expansion of the VAT base;
- the modernisation of rules and systems to better capture cross-border dealings in intangibles and services; and

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Khoonming has worked throughout China, including in Beijing, Shanghai and southern China, and has built strong relationships with tax officials at both local and state levels. He has also advised the Budgetary Affairs Committee under the National People's Congress of China on post- WTO tax reform. Khoonming is also actively participating in various government consultation projects about the ongoing VAT reforms.

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- the deployment of data analytics by the tax authorities to enhance VAT administration.

In addition, the chapter, *Strengthening of Administration and Enforcement of IIT Law in China*, considers the heightened enforcement efforts for high-income earners and equity compensation schemes. The chapter, *Moving up the Value Chain – Greater Access to R&D Incentives*, takes a timely look at the newly updated Chinese innovation tax provisions and considers how they fare in the global competitive landscape of technology incentives. The chapter, *New Customs Opportunities and Risks in China*, considers:

- the changing customs duty implications for e-commerce enterprises;
- the impact of the new free trade zones: and
- China's growing network of free trade agreements.

The publication concludes with an overview of Hong Kong's latest and future developments in tax incentive and treaty network enhancements in the chapter, *Hong Kong Looks to the Future*, and a review of the opportunities offered by *Taiwan: An Innovative Centre with Attractive Investment Options*.

As will be clear to the readers of this edition of China – Looking Ahead, as predicted in the last edition, the Year of the Sheep has been anything but docile in terms of tax changes. The Year of the Monkey looks set to be even more animated.

Checklist of hot China tax issues for multinational enterprises (MNEs) in 2016

In 2016 MNEs should in particular be alert for the following anticipated China tax developments

- **Permanent establishment (PE) enforcement** – The Chinese tax authorities may step up their PE enforcement efforts in 2016 and we expect new guidance from the SAT to support this. There may be particular risks for cross-border distribution structures. This would put existing representative offices and local 'Support WFOEs' in the spotlight.

- **Countering treaty abuse** – In 2016 the China tax authorities will likely be more active in the surveillance and follow up on perceived cases of tax treaty abuse. Multinational enterprises will need to devote more resources to preparing detailed documentation to support their positions. Withholding agents will also need to give particularly close consideration to their tax management approach.

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- **Transfer pricing (TP) documentation** – In 2016 the Chinese tax authorities will have more information at their fingertips than ever before for administering TP for MNEs operating in China. This includes the new BEPS country-by-country reporting requirement and the higher standard for local TP documentation with value chain analysis. This may significantly influence MNEs' TP practices in China, in terms of meeting compliance requirements, assessing TP risks, coping with TP investigations, and negotiating unilateral and bilateral advance pricing agreements (APAs)

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- **Completion of VAT reforms** – In 2016 three key sectors are due to transition from Business Tax to VAT: (a) real estate and construction; (b) financial services and insurance; and (c) lifestyle services, comprising hospitality, food and beverage (F&B) and other services

- **VAT zero rating and electronic invoicing** – In 2016 several categories of exported services are to shift from VAT exemption to the more generous VAT zero rating concession. The transition of high transaction volume industries, such as financial services, to VAT is expected to drive progress on electronic invoicing.

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- **M&A tax rules will have a larger impact on economic activities** – The impact of the expanded M&A tax rules will be felt in 2016 as the upward trend continues in industry consolidation and cross-border M&A activity. How the PRC tax authorities interpret these rules, especially the concepts of economic substance, step transactions, and hybrid instruments should be closely observed to effectively take advantage of these new rules, while managing tax risks in corporate restructuring and M&A transactions.

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- **Accelerated customs reforms and rigorous enforcement** – 2016 should bring enhanced customs and trade facilitation from the integration and optimisation of special customs zones (SCZs), pilot free trade zones (FTZs), and new rules for cross-border e-commerce, as well as more free trade agreements (FTAs). In parallel, we expect more customs post-clearance audit in the areas of import pricing, royalty payments and bonded inventory management.

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- **New R&D super deduction and HNTE opportunities** – New rule changes mean that in 2016 taxpayers must consider for R&D super deductions whether they (i) are eligible for three-year retrospective claims, (ii) can gain additional benefits under the expanded eligible scope, (ii) are up-to-date with the streamlined registration process. For HNTE taxpayers must consider whether they (i) qualify under the new science personnel and intellectual property requirements and (ii) are ready for the new documentation procedures.

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- **Enhanced monitoring of tax risk management systems** – In 2016 large enterprises in China will be pushed harder to self-identify tax risk, and to establish systems and procedures to control and pre-empt tax risks. This will prompt MNEs to re-visit its tax risk control mechanisms, identify gaps, and enhance controls.

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- **Strengthened administration of Individual Income Tax (IIT)** – In 2016 the Chinese tax authorities will further enhance their collaboration with other authorities to enforce the IIT Law. Multinational enterprises will need to assess and manage more actively the IIT and PE risks arising from deployment of employees to China on short term and business travel basis, to control the overall costs of assignments.

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China at the forefront of global BEPS implementation

The G20/OECD BEPS proposals are being rolled out into Chinese tax law and practice, with implications for multinational enterprises (MNEs) doing business in China. The focus of this chapter by Chris Xing, William Zhang, Lilly Li and Conrad Turley is recent and upcoming regulations and guidance which are positioning China at the forefront of global BEPS implementation

Introduction

The G20/OECD initiative for multilateral cooperation to address tax base erosion and profit shifting (BEPS) culminated in the release of the 2015 BEPS Deliverables on October 5 2015. These set out certain minimum standards, agreed between the countries participating in BEPS, as well as certain best-practice recommendations, on improvements to domestic laws and tax treaties. These changes seek to enhance the integrity and fairness of the international tax system by realigning jurisdictional taxing rights with the location of value creation and the place where business activities are actually conducted.

In response, on October 10 2015, the Chinese State Administration of Taxation (SAT) issued the Chinese language versions of the BEPS reports. At the same time senior SAT officials set out their plans for China BEPS implementation in advance of China's hosting of the G20 and the Forum on Tax Administration (FTA) in 2016. In fact, China has already gone a long way towards localising the BEPS Deliverables, as the SAT has issued significant recent draft guidance on transfer pricing (TP), controlled foreign company (CFC) rules, tax treaty relief, and a rapid succession of new guidance is promised for coming months.

The BEPS Action Plan is an ambitious programme to overhaul the global tax rules to improve the fairness and integrity of the international tax system. It is the largest such undertaking since the groundwork was laid by the League of Nations in the 1920s. While the BEPS Action Plan was initiated by the G20 and carried forward by the OECD, China has been actively engaged in the BEPS tax policy formulation process. As senior SAT and OECD officials emphasise repeatedly in public statements, it is the first time that China, among other emerging economies, has sat at the table with the major OECD countries as equals in this redesign of the global tax system. China's influence on the shape of the final BEPS proposals has been much remarked upon, and the SAT is treating very seriously its responsibility to carry forward the BEPS implementation work falling to the G20 and the FTA in 2016. This is manifesting itself in the speed with which, in advance of other countries, China is integrating substantial elements of the BEPS proposals into its domestic law and treaties.

It is important to note that China will not adopt all of the BEPS proposals and will naturally tailor them to China's circumstances and needs. The BEPS changes also occur in parallel with other new tax rules, such as indirect offshore disposal rules, which do not have counterparts in the BEPS programme but which have a strong anti-abuse orientation as they seek to preserve China's taxing rights over value created in China.

The multitude of tax changes that have occurred as a consequence of BEPS are covered in different chapters in this volume. This chapter considers the BEPS Action Deliverables at a high level and focuses particularly on the China treaty, CFC and permanent establishment (PE) issues and measures arising from BEPS. The separate TP chapter entitled, *China's new Transfer Pricing Guidelines and BEPS,* considers both the many proposed changes to China TP rules under the new SAT public discussion draft on 'Special Tax Adjustments' (yet to be finalised at the time of writing) as well as changes to thin Capitalisation rules. Further chapters in this volume, *A New Era for M&A Tax in China,* and, *New Challenges to Tax Risk Management in China,* also set out further echo effects of BEPS on China tax practice.

The 2015 BEPS Deliverables

The chapter in last year's edition of *China Looking Ahead*, *BEPS: China makes its mark on global tax rules and strengthens international tax enforcement*, considered the contents of the original seven BEPS 2014 Deliverables reports. It looked at the impact of BEPS proposals on a new TP approach to intangibles and on new tax treaty safeguards, and contemplated to what degree the SAT might be receptive to BEPS PE and CFC proposals then under development. However it was only in 2015 that the SAT really picked up the pace in issuing new guidance and the direction of SAT BEPS policy became clearer. Given that the final BEPS 2015 Deliverables adjusted further the original BEPS 2014 reports, a full consideration of the recommendations under the 13 BEPS 2015 reports is necessary to fully appreciate their mapping into Chinese law and practice.

Digital economy (Action 1)

Reiterating the conclusions of the 2014 Action 1 Deliverable, the Task Force on the Digital Economy (TFDE) did not recommend specific, ring-fenced, digital economy tax measures. The combined effect of other BEPS actions is argued to effectively combat aggressive tax planning in the digital economy space. The relevant other actions include:

- The Action 7 PE changes, impacting online cross-border sellers with large sales forces and/or large local warehouses in the market state;
- The TP actions (8, 9, 10), tackling shifting of contractual risk and transfer of intangible asset returns to low tax jurisdictions;
- The Action 6 use of treaty anti-avoidance concepts to justify applying withholding tax (WHT) to outbound digital business payments which would otherwise be treaty protected from WHT; and
- The Action 5 clampdown on abusive intellectual property (IP) tax regimes, as well as the potential Action 3 inclusion of digital business income under CFC rules.

While digital economy BEPS issues are expected to be largely tackled through these other actions, the final Action 1 report does include VAT guidance tailored for digital business B2B/B2C cross-border supplies. What is more, the report indicates (while not advocating) that countries could consider use of specific digital economy corporate tax concepts. These are:

- a significant economic presence nexus concept;
- a specific digital transaction WHT; or
- an "equalisation levy".

The TFDE is to continue work on income characterisation (for example, cloud computing), the value of data in TP analysis, and monitor digital economy tax issues.

Hybrid mismatch arrangements (Action 2)

The 2014 Action 2 Deliverable made recommendations for changes to domestic law and treaties to counter the effects of hybrid entity, instrument and transfer-driven tax mismatches. This included a set of linking, automatic rules; these are now supplemented in 2015 by an extensive series of examples. New rules are also added to ensure that treaty relief is applied appropriately in the case of 'wholly or partly fiscally transparent' entities, such as partnerships and trusts.

CFC rules (Action 3)

The report sets out a series of recommended 'building blocks' which countries may use, at their own discretion, to construct a robust set of CFC rules. No CFC minimum standard could be agreed on between the BEPS participant countries, despite US efforts. The building blocks include:

- defining the CFC (type of entity, and type and level of control);
- CFC exemptions and tax rate thresholds;
- CFC income inclusion;
- CFC income computation;
- CFC income attribution, and
- double tax elimination.

The potential CFC income determination approaches include:

- categorical approaches (targeting income based on legal classification, origin from related parties, or geographic source, which may also be explicitly made to include income from digital sales/services);
- substantive analysis (determining whether CFC income was separated from underlying substance on basis of substantial contribution of employees, a TP-linked significant functions approach, a staff/premises substance approach); or
- an excess profits approach (covering, among other things, transfers of intangibles and risk shifting transactions).

A combination of these approaches is possible.

Interest deductions (Action 4)

The TP chapter in this volume considers the proposed revisions to Chinese thin capitalisation rules and notes that China has decided for the moment not to adopt the BEPS proposals on interest deductions. In short, BEPS proposed an earnings stripping rule which limits interest tax deductions to a percentage of earnings before interest, tax, depreciation and amortisation (EBITDA). This may be supplemented by a worldwide group ratio rule which allows increased interest deductions where the MNE group at a global level is more heavily indebted/has a greater relative interest servicing burden than the local entity. The OECD will in 2016 refine the rules further for banking and insurance. The necessity of a China Corporate Income Tax (CIT) Law amendment to roll out the BEPS rules is understood to have been a factor in SAT's decision not to adopt them.

Harmful tax practices (Action 5)

The 2015 Deliverable finalises the 2014 initial progress report prepared by the Forum on Harmful Tax Practices (FHTP). The substantial activity requirement for preferential tax regimes, proposed in the 2014 report, has been finalised with a nexus approach'. This uses expenditures on R&D activities, in the context of IP regimes, as a proxy for activity. A review of preferential regimes in OECD and non-OECD states found that all the IP regimes reviewed failed the substantial activity test and these are now being revised. The FHTP plans to next roll-out its review using the substantial activity test to non-IP preferential regimes. The parallel framework for the compulsory spontaneous inter-tax authority exchange of rulings on preferential regimes, as well as, for example, advance pricing arrangements (APAs), PE cases and conduits, takes effect with the first rulings from April 1 2016, for those countries with the necessary legal basis already in place.

Treaty abuse (Action 6)

The 2015 Deliverable refines (but does not finalise) the 2014 report, adding further notable proposals. The core proposals remain the required adoption in treaties of either or both of a 'principal purposes test' focused on the subjective tax motivations of a taxpayer and a US-style Limitation on Benefits (LOB) provision. However, the release in May 2015 by the US of a proposed new version of the US Model DTA's LOB provision has led to a postponement of the finalisation of the BEPS LOB proposal until mid-2016. It will be included in the planned roll-out of the multilateral instrument at the end of that year.

The updated treaty wording and guidance also clarifies that domestic anti-avoidance rules can be applied (without being blocked by treaties), facilitating, among other things, the application of exit taxes. In addition to the targeted anti-abuse provisions from the 2014 report, dealing with dividend, capital gains and PE-based planning, the 2015 report now also contemplates adoption of recent US anti-abuse proposals. These would deny withholding tax (WHT) relief on payments to special tax regimes or where a treaty-partner state introduces an exemption for interest, royalties or dividends after the conclusion of a treaty. These latter proposals, along with additional guidance on the applications of treaties to collective investment vehicle (CIV) and non-CIV (for example, private equity) funds, will be finalised by mid-2016.

Permanent Establishment (Action 7)

The 2015 Deliverable adjusts further and finalises changes proposed in the May 2015 BEPS PE discussion draft. The agency PE concept, which had previously turned on whether a non-resident had authorised a local market-based person to habitually negotiate/contract with local customers on the former's behalf, has now been replaced. The new rule looks at whether the local market-based person 'habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the [non-resident] enterprise'. Contracts that transfer property owned by the non-resident (or grant a rise to use that property) are now covered. This is intended to catch cases where the non-resident is not legally bound by the contract but his property is the contract object matter (for example, commissionaire structures).

The revised OECD Model Tax Convention (MTC) Commentary makes clear that the focus of the new test is on whether the local market-based person convinces, through relationship-building efforts, customers to contract. Formalities related to legal authorisation of local persons to contract, and formalistic final 'rubber stamping' approvals of contracts by non-residents, which previously provided support for a 'No PE' position, are no longer determinative. Consequently, given the de-emphasis of 'legal agency', the provision might be better regarded as a local representative PE concept, rather than as an agency PE concept. All previous references to agency PE have been removed from the Commentary. The independent agent concept is now also curtailed where the local person acts largely for foreign related parties.

Furthermore, the 'preparatory and auxiliary' (P&A) PE exemptions for specific activities (for example, warehousing, purchasing and information collection) are now to be all subject to an overriding P&A test (though this is left to country discretion) and to an anti-fragmentation test. The latter appears to amount to 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. Finally, it is clarified that the principal purposes test (and a more mechanical rule if a country does not apply this test) should be applied to deal with 'contract splitting' strategies directed at having cross-border construction activities fall under the time limit for a construction PE.

The PE changes are represented as a key plank of the BEPS resolution of digital economy tax planning as they would treat

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online cross-border sellers with large sales forces and/or large local warehouses in the market state as having a local PE, dealing with existing weaknesses in the agency PE rule and P&A PE exclusions.

Transfer Pricing (Action 8, 9, 10, 13)

The 2015 TP deliverables are considered in detail in the TP chapter in this volume and reference should be had to the analysis and views in that chapter on future directions in China TP practice. Of most significance in a Chinese context are the clarifications on how to determine the contributions of MNE group entities to the value of intangible assets, the importance of local market features, and enhanced TP documentation, all now incorporated into the draft new Chinese TP guidance on 'Special Tax Adjustments', which is due to be finalised towards the end of 2015.

However, it should be noted that divergences from the recommended OECD approach may potentially be quite significant in practice. Other significant new BEPS TP guidance, on the proper allocation of contractual risk and associated returns through 'proper delineation of the transaction' and guidance on use of post-transfer profitability information in valuing hard to value intangibles, has not yet been integrated into China guidance, and SAT scepticism towards giving too much weight to contractual risk, however controlled, in allocating MNE group profits may see divergence from other countries' TP practices and potential for double taxation. The new China TP guidance also imposes severe restrictions on deductions for outbound related-party service and royalty payments, a trend already remarked upon in last year's edition of *China Looking Ahead*.

Mandatory disclosure rules (Action 12)

Recommendations (not a minimum standard) are set out, according to a modular framework, for the design of rules which would give the tax authorities early warning of aggressive arrangements and would deter promoters and taxpayers (both with potential reporting obligations) from entering into such arrangements in the first instance. The guidance covers 'hallmarks' of avoidance which would be the trigger for disclosure, tracking arrangements and penalties.

Dispute resolution mechanisms (Action 14)

A minimum standard has been developed for the resolution of treaty-related disputes, together with a peer monitoring mechanism, falling under the Forum on Tax Administration (FTA) Mutual Agreement Procedure (MAP) Forum. The forum will commence work in 2016, with first reports due by end of 2017. The minimum standard contains commitments to include MAP clauses in treaties and ensure taxpayer MAP access, time to complete MAP procedures (target 24 months) and avoid MAP adjustment time-barring, as well as MAP case and procedure transparency. Beyond this (non-binding) best practices are also set out, while a group of 20 Western countries have committed to mandatory binding arbitration, with the mechanism to be developed in time for its inclusion in the multilateral instrument in late 2016.

Multilateral Instrument (Action 15)

The 2014 Deliverables concluded that a multilateral instrument to update many of the world's 3,500 bilateral tax treaties simultaneously would be feasible and more than 90 countries have joined an ad hoc group (led up by China and the UK) to negotiate the instrument by the end of 2016.

'Mapping' the BEPS Deliverables to China – A rapid process with significant 'localization' to Chinese circumstances

Main themes of SAT international tax policy

On the release of the Chinese-language versions of the BEPS 2015 Deliverables, senior SAT officials noted how China's role and level of involvement in contributing to the global debate on the international tax system, as well as its practical influence in shaping that system, had undergone a sea-change since the commencement of the BEPS process just over two years ago. This occurred against a backdrop of China becoming a net capital exporter, encouraging many tax commentators to argue that China's interest lay more in de-emphasising source taxation rights (in a break from past China tax policy) and emphasising more residence taxation given the increased investments of Chinese MNEs all over the world. However, senior SAT officials have appear to indicate that China's focus remains on the strengthening of source taxation rights.

Senior SAT officials note that while China may now be, marginally, a net capital exporter, developed countries have significant accumulated capital stock overseas, which yields substantial profits from historic investments; Chinese overseas investment stock is more recent, relatively limited and has not yet yielded significant profits. What is more, while progressively more innovation is occurring in China, China still functions, within the global economic system, as a manufacturing hub; a very significant portion of foreign FDI in China relates to the processing trade. As such, the policy standpoint of the SAT appears to be that they will continue to focus on strengthening application of source taxation rules. Changes to China's economic structure, movement by China up the global value chain, and changes to the nature, composition and extent of Chinese FDI overseas will be monitored, and if circumstances favour an adjustment in China's policies at a later stage, then the SAT would likely then consider this at that time.

The manner of localisation of the BEPS Deliverables in China can best be understood against the backdrop of this SAT policy thinking and is particularly noticeable in the approach to TP. The TP chapter in this volume deals with the China localisation of the BEPS work in more detail. Nonetheless, it is worth noting here that the 'Special Tax Adjustments' discussion draft takes the position that, in determining the value contribution of MNE group entities to intangible assets (and the consequent TP profit allocations), emphasis is to be put on the 'middle value chain activities' frequently carried out by MNEs in China (for example, trial production and enablement of mass production) as well as China market-building activities. As the OECD guidance would not consider these as the most important factors for intangibles value creation, divergent TP approaches between China and other countries could ultimately lead to double taxation.

Involvement of intangible assets in transactions between local and foreign related parties, and indeed the presence of local market features (location specific advantages, or LSAs), more readily require departure from comparables-based TP methods under the new Chinese guidance than is the case under the OECD BEPS guidance. China sets out the new Value Chain Apportionment TP method to cater for such circumstances. The application of this approach is complemented by the information from the new Value Chain Analysis section in the TP local file, much as new TP information requirements on cross-border related party services fuel a tightened approach on deductions for related payments, tightening China's source country taxing rights over business profits.

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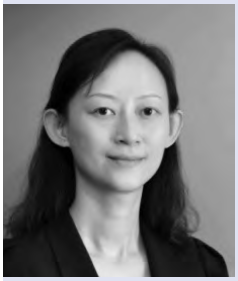
Beyond TP, the new emphasis on PE is set to further raise the challenges of managing China taxation of business income from Chinese sources. The treaty developments are not so much expected to tighten Chinese anti-treaty shopping rules, as to clarify the manner of their operation. At the opposite end of the spectrum, the CFC rule enhancements introduced through the draft new 'Special Tax Adjustments' guidance are expected to bring a new rigour to Chinese residence-based taxation of Chinese MNEs' overseas operations.

BEPS as a 'turning point' for Chinese PE enforcement

The new BEPS PE concepts could, depending on the manner of their roll-out in China and their application in practice, result in challenges under the new agency PE concept for existing MNE cross-border distribution and procurement structures into China. Some foreign MNEs have in the past used offshore sales hubs in low tax jurisdictions, which liaise



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Lilly has extensive experience in dealing with tax disputes and tax policy lobbying. For example, she and her team have successfully assisted 13 Asia Games Sponsors in applying for business tax exemptions with the SAT; they also assisted a number of listed groups in lobbying for tax rulings with SAT, which allows PRC companies to deduct stock option experiences before corporate income tax.

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with their Chinese customers via onshore marketing support affiliates. Strict internal protocols and documentation trails were used to support the position that the Chinese entity staff were not authorised to negotiate and contract with Chinese customers on behalf of the foreign sales hub, and did not in fact do so. Such measures may now be insufficient under the new BEPS PE 'convincing' threshold'. Further enhanced documentation and operating protocols, adjustments to existing business practices and, in some cases, movement from the offshore sales hub model to an onshore buy-sell distributor model, may be required. The impact of the anti-fragmentation rules on multi-subsidiary arrangements (for example, China manufacturing, sales, and R&D all in separate MNE subsidiary entities) will need to be considered, as well as the impact of contract-splitting rules on dispatches of staff from multiple overseas MNE entities to China.

The SAT is understood to be committed to the roll-out of the new BEPS PE concepts. In fact, the SAT went so far as to incorporate the rules from the May 2015 BEPS PE draft proposals into the PRC-Chile DTA signed on May 25 2015, which is China's 100th DTA and its most recent. This DTA also includes innovative Chinese enhancements to the BEPS PE proposals, including an application of the BEPS Construction PE 'anti-contract splitting' provision to also cover Service PE. The SAT plan to set up a national information exchange platform so PE cases can be better tracked and processed by local tax authorities. Senior SAT officials have referred to the BEPS PE proposals as a 'turning point' for PE enforcement in China.

The SAT is also understood to be contemplating how to improve PE profit attribution guidance. Given the difficulties with the existing 'deemed percentage of sales' PE profit attribution approach, such guidance will be keenly anticipated, and the PRC-Chile DTA does move in the direction of determining PE profits based on functions, assets and risks. This being said, the SAT is expected to retain some aspects of its deemed PE profit approaches. On the whole, PE is set to become a far more challenging element of China tax management strategies.

Whether Chinese PE approaches may be further nuanced to deal with cross-border digital business into China remains to be clarified by the SAT, though senior SAT officials have repeatedly noted their interest in the BEPS significant economic presence nexus concept. It should be noted that the new Tax Collection and Administration Law, due to go into effect in 2016 or 2017, will introduce reporting requirements for online retail platforms (through which the bulk of Chinese B2C e-commerce is conducted) with respect to the companies conducting e-commerce through their platforms; this new reporting may well supply the data required to enforce such PE concepts. The BEPS reports suggest that payments for goods and services, purchased through cross-border e-commerce, though normally protected from WHT under the PE article, might be subject to WHT in an application of treaty anti-abuse rules; it remains to be seen how the Chinese tax authorities might apply such approach and how they might enforce it.

Chinese anti-treaty shopping rules clarified

China already has a rigorous approach to treaty shopping and since 2010 MNEs have frequently struggled to convince the Chinese tax authorities that their overseas treaty-benefit-claiming entities have sufficient economic substance to merit qualification for the tax authority pre-approval for DTA WHT tax relief to be applied by WHT agents.

A long-standing difficulty has been that SAT Circular 601 [2009], in setting out the Chinese interpretation of beneficial ownership for DTA relief, effectively combined together a beneficial ownership test (which in most countries is a test of control over income and the assets from which it derives) with an economic substance-focused treaty-shopping test. Application of the treaty-shopping test as an element of the beneficial ownership test, rather than as an application of the PRC general anti-avoidance rule (GAAR) prevented taxpayers from arguing their 'reasonable business purposes' in using an overseas holding/financing/IP/leasing company, as the GAAR procedures would allow them to do. These updated GAAR rules, in SAT Order 32, were discussed in detail in last year's international tax chapter.

However, this is now being rectified with the roll-out of a new DTA relief system in SAT Announcement 60 [2015]. The new DTA relief system, which took effect from November 1 2015, abolishes the DTA relief tax authority pre-approval system, providing instead that the taxpayer self-determines whether DTA relief applies, and then informs the WHT agent (or the tax authority directly where no WHT agent is involved) that it will be using the DTA relief. To facilitate the WHT agent to process the relief without taking excessive risk and uncertainty on to himself, the detailed DTA relief forms, completed by the taxpayer, set out a section of the form with information that the WHT agent will check before using the DTA WHT rate, and another separate, more detailed, section which the tax authorities may refer to in carrying out their 'follow up procedures. The WHT agent's section includes, alongside basic details of how the taxpayer satisfies the terms of the DTA, a beneficial ownership test shorn of its Circular 601 economic substance baggage, being a control test along the lines of that applied in other countries.

The tax authority follow up procedures are linked, by Announcement 60, to the use by the tax authorities of specific treaty-based anti-avoidance rules and the PRC GAAR, as governed by the GAAR procedural measures. China has, over the past few years, experimented with a few different approaches to including anti-abuse provisions in its DTAs. These have ranged from 'tax as a main purpose of the arrangement' tests in the dividend, interest, royalties and other income articles of treaties, to the use of 'miscellaneous articles' in DTAs which reserve the right to China to use its GAAR against treaty abuse, to the inclusion of straight-out treaty-based GAARs.

A possible window on how the SAT's approach may be standardised in future is provided by the PRC-Chile treaty. The SAT's statement on the release of the Chinese-language versions of the BEPS 2015 Deliverables refers to this treaty as exemplary of the post-BEPS China treaty policy. This treaty incorporates both the BEPS LOB and 'principal purposes test' approaches into a new 'entitlement to benefits' article. At the same time, the treaty foregoes the earlier approaches of including 'main purpose' tests in the dividend, interest, royalties and other income articles or the 'miscellaneous articles'. The SAT's leading role in the group developing the Action 15 multilateral instrument and China's role as host of the FTA and the G20 in 2016 may point towards an interest at SAT level in Chinese adoption of the multilateral instrument in late 2016, though it remains to be seen how this project evolves. If China does ultimately adopt the multilateral instrument then the manner in which the anti-abuse provisions are integrated into the Chile DTA may be indicative of the manner in which the SAT might look to update all China treaties.

It might also be noted that while the new DTA relief system instituted by Announcement 60 is a marked improvement on the previous system, many matters of administrative complexity remain, including the interrelationship of the new system with the foreign-exchange remittance rules.

Senior SAT officials have recently confirmed their intent to roll out anti-hybrid rules in the near future, though it must be said that, for a variety of reasons, including features of the tax law and regulatory environment, hybrid mismatch arrangements are not a prevalent feature of the Chinese tax landscape. It remains to be seen whether treaties would also be updated to facilitate the application of anti-hybrid rules. Further, the BEPS hybrid mismatch paper suggests that

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treaties might be updated to facilitate granting of DTA benefits to 'transparent and partially transparent' entities, such as partnerships and trusts; given the need for such DTA clarifications in China this would also be keenly anticipated.

Outbound – The new dimension in Chinese international tax practice

The Chinese tax authorities have recently begun to enforce their CFC rules in actual cases, notably the Hainan and Shandong cases in 2014. As regards the BEPS CFC 'building block' recommendations, while the SAT have largely left unchanged the definition of control in the existing Chinese CFC rules', as well as the CFC exemptions/thresholds (*de minimis* test and reasonable purpose test for non-distribution of CFC profits), it has co-opted the BEPS CFC attributable income guidance into the revised Chinese CFC rule guidance in the 'Special Tax Adjustments' discussion draft (yet to be finalised at the time of writing).

In this regard a BEPS categorical approach is taken with CFC income inclusion stated to be generally appropriate for:

- dividends earned by non-securities trading companies;
- interest earned by non-finance business companies;
- insurance premiums earned by non-insurance companies;
- royalties earned from related parties;
- sales and service income earned where goods and services have been bought-in from related parties and no or low value has been added, and;
- in a nod to the BEPS excess profits approach, excess profits derived from intangible asset or risk transfers.

This is supplemented/overlaid with a BEPS substantive analysis approach; this provides that all three of the BEPS proposed alternatives (that is, substantial contribution, TP analysis and staff/premises) may be used by the tax authorities but does not give guidance on their application or prioritisation.

Given the rapid ramp-up of tax enforcement against outbound Chinese MNEs, further SAT refinements in the final guidance on Special Tax Adjustments, and the precise application of these provisions, will be of key interest.

Into the future and recommendations

The SAT's rapid moves to implement the BEPS programme truly put it in the vanguard among the countries of the world. The finalisation of the new TP guidance and the CFC rules in the Special Tax Adjustments draft, expected by the end of 2015, to go into effect from January 1 2016 (and for some provisions, retroactively), is hotly anticipated. With the new TP documentation set to enter effect, and with China rolling-out information exchange arrangements with other countries, a new era of transparency has started.

The changes to China treaty practice are now in train, though the final shape of the SAT's model treaty anti-abuse rules is still to emerge. The workings of the new treaty relief system are still to be tested in practice. As for PE, the SAT promises a turning point – where PE enforcement is turning and how tax risk management challenges are to be managed going forward, remains to be seen.

For other BEPS actions, such as the Action 14 dispute resolution mechanisms, the spontaneous exchange system for tax rulings under Action 5 , and the Action 12 mandatory disclosure rules, the SAT has yet to clarify its position. Nonetheless, the shape of the post-BEPS Chinese international tax rules is now emerging and MNEs should start to prepare for the tax risk management challenges this will raise.

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China's new transfer pricing guidelines and BEPS

The highly significant changes to transfer pricing guidance planned for under the SAT's public discussion draft on 'Special Tax Adjustments' (yet to be finalised at the time of writing), and the impact of these changes in the light of evolving Chinese transfer pricing enforcement practice is the focus of this chapter by Chi Cheng, John Kondos, Simon Liu, and Kelly Liao

Introduction

The Base Erosion and Profit Shifting (BEPS) initiative aims to enhance the integrity and fairness of the international tax system by realigning jurisdictional taxing rights with the location of value creation and where business activities are actually conducted. On October 5 2015 the OECD publicly released its 2015 Deliverables under the BEPS initiative, corresponding to the original 15 actions of the 2013 BEPS Action Plan work programme and following the 2014 Deliverables. Beyond simply implementing these deliverables, China tends to pursue a selective approach to the BEPS measures, leveraging BEPS guidance to apply a unilateral approach to key issues, a trend we already remarked upon in last year's edition of *China Looking Ahead*.

That China adopts such a selective approach has been confirmed by the contents of the long-awaited public discussion draft guidance on the implementation of 'Special Tax Adjustments' (the Draft), released by China's State Administration of Taxation (SAT) on September 17 2015. The Draft explains that China will not adopt all BEPS proposals and will naturally tailor them to China's circumstances.

The Draft is a substantial document, comprising 16 chapters and 168 articles. It encompasses an expansive range of source materials including:

- the existing transfer pricing (TP) guidance in SAT Circular 2 [2009] and other records of the SAT's TP views, particularly in the UN TP Manual;
- the evolution of the TP enforcement approach of the Chinese tax authorities observed in recent years; and
- the proposals emerging from the BEPS process.

Below, we explore the TP issues to which multinational enterprises (MNEs) in China may want to pay special attention. Other BEPS measures which have been localised for China in the Draft or in other recent regulations are dealt with in the separate chapter in this volume, *China in the forefront of global BEPS implementation*.

Location specific advantages (LSAs)

The references to LSAs in the Draft do not appear to be at odds with the discussion on location savings and local market features in the BEPS TP report. However, the discussion on LSAs in the Draft is far less detailed than in the BEPS intangibles report, and latitude is left for local authority interpretation and application. Notably, while the BEPS paper discusses how location savings may ultimately dissipate, being passed on to independent customers or suppliers, the Draft makes no such observation.

Neither does the Draft indicate, as the BEPS report does, that where there is availability of reliable local market comparables, with other companies in the market having access to the benefit of equivalent location savings or local market features, then the need for making any LSA comparability adjustments may be dispensed with. Furthermore, while the BEPS report does not indicate that the presence of LSAs could lead to application of a non-comparables based TP method, the Draft indicates just that.

In the BEPS TP report, the OECD urges restraint on the part of taxpayers and tax authorities in rejecting potential comparables. However, the SAT has frequently taken the position that the existence of unique Chinese LSAs may deprive available potential comparables of their validity (reliable adjustments being argued to be not possible) and local tax authorities have been actively using this rationale as a basis for pushing for the profit split method (PSM) to be used. The LSA references in the Draft now provide a useful reference point for tax authorities when making such challenges, and may also be leveraged in pushing use of the new value contribution apportionment method (VCAM) in the future.

Intangible assets

The Draft sets out a 'DEMPEP' approach, including a final 'P' for promotion alongside the BEPS DEMPE (Development, enhancement, maintenance, protection and exploitation) factors. This reinforces the historic Chinese emphasis on the importance of China market promotion and Chinese consumer-product-awareness building as value drivers for foreign brands, supported in the past by the Chinese local marketing intangibles concept. This emphasis is bolstered by a further statement on the key importance of taking into account market factors and product localisation in determining contributions to intangible value.

The Draft DEMPEP approach and the description of 'important functions' as those typical 'middle value chain activities' frequently carried out by MNEs in China (for example, manufacturing and trial production) as well as China market-building activities, could readily lead to a divergence between profit attributions from intangible assets by Chinese and foreign tax authorities, with the potential for double taxation this brings. It is also quite possible, drawing on past China enforcement practice and the practical absence of references to 'control' in the Draft, that the Chinese tax authorities will focus on the performance of DEMPEP functions, to a greater degree than on their control (the preference of the OECD).

The Chinese tax authorities are expected to leverage the open wording of the Draft, concerning the circumstances in which ownership of intangibles (or contribution to their value creation) by transacting related parties might invalidate use of one-sided methods, to push for more use of PSM and VCM.

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In addition to lecturing at many national and local training events organised by the Chinese tax authorities, Cheng has provided technical advice on a number of recent transfer pricing legislative initiatives in China. He has been recommended as a leading transfer pricing adviser in China by the Euromoney Legal Media Group since 2009 and as a tax controversy leader by *International Tax Review*.

This would be in line with, and further support, the frequent current assertions by the Chinese tax authorities in TP audits that local intangibles (in the same way as LSAs) render potential comparables unusable and beyond reasonable adjustment. The use of the term 'significant intangibles' could, for example, include local marketing intangibles, which might not be considered 'unique and valuable' by the OECD but might readily be argued by the Chinese tax authorities to be 'significant'.

The identification by the Draft of an 'economic owner' of intangible assets is not expected to have a major impact on TP outcomes. However, it remains to be seen whether the concept might also be used, outside the TP space, by other tax authority departments, leading to further complexity (for example, withholding taxes on transfer).

The clarifications on deductibility of royalties paid to overseas related parties may be viewed as positive, and may assist in securing deductions for payments to overseas IP holding companies (in danger with the previous (mis)reading of Announcement 16). Still there is a pressing need for more clarification on the required level of 'substance' in overseas entities.

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Value contribution apportionment method

The Draft introduces the VCAM as one among the 'Other TP Methods'. Under this method MNE profits are to be allocated across the value chain based on analysis of how value creating contributions have been made to group profits, with reference being made to assets, costs, sales and number of employees. It is stated to be appropriate to use where comparability information is difficult to obtain and where, at the same time, the consolidated profit for the MNE and value creating factor contributions can be reasonably determined.

With the explicit introduction of the new VCM method, it remains to be seen whetherthe Chinese tax authorities will be even more inclined to dismiss potential comparables, on grounds of LSAs, local intangibles or other factors, and use the absence of comparables to push in the direction of using this new method.

In addition to VCM, the value chain analysis requested in the TP documentation local file is further evidence of SAT's ardent support for the value chain theory. Moreover, the Draft requests that, regardless of the TP method selected, the enterprise shall state its contribution to the overall profit or residual profit of the group in the local file documentation.

Special tax adjustment provisions

The Draft introduces a re-characterisation provision, among other key changes. The re-characterisation rules provide that if a contract for transaction between related parties would not have occurred under equivalent economic circumstances between unrelated parties then the transaction may be deemed not to have occurred or may be re-characterised by the tax authorities. Furthermore, where the functions conducted/risks borne by a related party for another related party are more than that which an independent party would have been willing to do then compensatory arrangements will be made.

The exact application of the broadly worded re-characterisation provision remains unclear. It would be preferred if the Chinese tax authorities would allow for regard to be had to the relevant BEPS guidance in negotiations with taxpayers over whether re-characterisation should be applied.

Adopting the SAT's position, as set out in the UN manual, on adjustments which need to be made to calculate appropriate profits for toll manufacturers, the Draft provides that the tax authorities may make adjustments for the value of materials and equipment legally held in the ownership of the offshore principal when determining the appropriate profit for a toll manufacturer.

The Draft explicitly sets out that, in cases where a foreign company transacting with a Chinese taxpayer is low-tax and has a limited function/risk profile, then the foreign company can be used as the tested party in a TP audit. There is a danger that a reverse transactional net margin method (TNMM) approach could be applied which awards a limited return to an overseas company for its functions, with the entire residual profit in the global value chain being allocated to China.

The Draft also sets out that, before an enterprise which engages in cross-border transactions is deregistered with the tax authorities, they can conduct special tax adjustment risk analysis targeting the enterprise and focus on whether it has transferred lowly priced or non-priced intangible assets to overseas entities. If any transactions are found not to comply with the provisions herein, special tax adjustments and investigations should be carried out.

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SAARs and GAAR

The existing Circular 2, while it deals primarily with TP matters, also extends to dealing with the Corporate Income Tax (CIT) Law's Special Anti-Avoidance Rules (SAARs), including controlled foreign company (CFC) rules and thin capitalisation (thin cap) rules, as well as the PRC General Anti-Avoidance Rule (GAAR), and these are now updated by the Draft. A significant change for both the GAAR as well as the SAARs is that the statute of limitations for these measures has now been extended to 10 years. This had always been the case for TP cases but the extension of the time limit for the other rules will have a significant impact on tax risk management for MNEs. The chapter in this volume, *China at the forefront of global BEPS implementation*, probes into the proposed changes to CFC.

For thin cap rules, debit balances under cash pooling arrangements and interest-bearing current and long-term liabilities (including interest-bearing trade payables) are now considered to be related-party debt investments. Furthermore, the calculations for related-party debt and equity are revised; this may become highly complicated if a taxpayer engages in a cash pool, as its debit balance is different on a daily basis, but the rules are likely less to be prone to manipulation in the future. The SAT has declined to introduce the earnings stripping or group limitation rules proposed by the BEPS interest deductions draft. It is understood that this may be partly because an update to the CIT Law itself would have been necessary to facilitate the roll-out of these measures, and the SAT was disinclined to push for such a change.

Services

As much as China continues to adhere to the internationally accepted arm's-length principle and OECD-sanctioned "benefit test" (that is, a service payment made must be one which an independent enterprise would also have willingly made), the brand new Chapter 7 of the Draft demands an examination of the 'direct or indirect economic benefit' of a given service for a service recipient and takes a very strict view on determining whether and to what extent outbound service fee payments can be deducted for CIT purposes. Such language and rationale are basically aligned with what has been detailed in previous SAT Announcement [2015] No 16 (Announcement 16).

More importantly, the Draft indicates that for a positive assessment to be reached that a service has generated a direct or indirect benefit for the service recipient, a Chinese entity may have to demonstrate a connection between the service fee payment and an incremental marginal profit. This approach would go beyond what the equivalent OECD rules would demand to see. As a result, taxpayers may find it hard to reconcile China's approach to intra-group services with other countries' approaches. The risk of double taxation is very real.

As a supplement to the direct or indirect economic benefit test, the Draft also provides the detailed documentation requirement in the Special Issues File regarding intra-group services. Extensive recording and reporting of information on the pricing of related-party service transactions is also provided for under the services chapter, with a separate services section in the local file as part of the TP documentation also now required.

The Draft also integrates the guidance in Announcement 16 on payments to 'low function entities'. This denies outright deductions for service fee payments to such entities, a harsher approach than envisioned under OECD rules. The SAT also chose not to integrate the safe harbour, proposed by the OECD BEPS work, for low-value adding services on the basis that all intra-group services are high-risk transactions.

Nonetheless, it remains to be seen what evidence would be deemed sufficient to substantiate direct or indirect economic benefit in practice. An implicit incremental profit approach could make it very challenging for MNEs to support their deductions for outbound service fees. Taking this together

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with the local file value chain analysis and the country-by-country reporting (CbCR) information, service fee payments are now at higher risk of scrutiny like never before.

Documentation

With reference to the BEPS report on Action 13, Guidance on TP documentation and CbC reporting, the Draft creates a new TP documentation structure composed of master file, local file and special issues file. Meanwhile, the CbCR requirements have also been incorporated as part of related-party transaction disclosures in filing the annual CIT return for certain taxpayers who met the criteria/threshold set out in the Draft.

The Draft formally expands the scope of parties obliged to prepare the master file and local file from those with more than the existing Rmb200 million ($31 million) (buy-sell transactions) or Rmb40 million (other transactions) transactions thresholds, to also cover entities with limited risk and function profiles but suffering operating losses regardless of their related-party transaction amount. This requirement is a slight modification from Circular 363 [2009], which provided that single-function entities incurring losses shall prepare TP documentation.

The master file requirements, which include an organisational chart and information on and a description of a MNE's business, intangibles intercompany financial activities, financial and tax positions, are in line with the BEPS action plans. The Draft includes only one additional requirement: the name and the location of the legal entity preparing and filing the CbCR for the group. Obviously, a MNE's Chinese taxpayers may find it difficult to prepare the master file on its own since the preparation requires extensive information and profound understanding of the group's operation/business, value chain and core competitiveness. On the other hand, the higher standard for the quality and scope of analysis in connection with related-party transactions indicates the value chain analysis of the intra-group transactions may not be easy to prepare.

As for the local file, the Draft's requirements include:

1) Company profile (including management team, business lines, and industry profile);
2) Related-party relationships;
3) Related-party transactions;
4) Comparability analysis; and
5) Selection and use of a TP method.

Throughout the description of the contents, the Draft sets out in finer detail than is done in the BEPS Local File description, what precise details must be set out. This being said, at least in respect of (1), (2), (4) and (5), the detail does not significantly expand on what could reasonably be expected to be included in the BEPS local file (though there is a requirement to set out the effective tax rates of related parties similar to the documentation requirements under existing Circular 2, which is not included in the BEPS Local File).

Where the Draft does depart significantly from the BEPS local file (and this is also additional content which had not been required under Circular 2) is the value chain analysis segment within (3) Related party transactions. This requires significant disclosure of information on a MNE's value chain relevant to the Chinese taxpayers.

In particular, the transaction, goods and funds flows within each value chain in the MNE group must be set out in the local file. A MNE must also provide an overview of the attribution of its global profits to the different countries within its value chain, both in terms of how profits are allocated across the value chain and also in terms of the actual amounts of profits earned by each value chain participant. What is more, it also demands that standalone and consolidated financial statements for every entity within the MNE value chain be retained in the local file. Depending on how such requirements are applied by the tax authorities in practice, this could go well beyond the requirements of BEPS CbCR, which is much more summary in nature.

The rationale for the inclusion of such extensive requirements for value chain information in the local file was provided by the SAT panel in a recent seminar releasing the BEPS Chinese language reports. The panel said the information being requested in the value chain analysis' segment

of the local file is what is typically sought during a TP audit. Based on the SAT's TP audit experiences, existing TP information was frequently seen as inadequate. Thus, it had been planning to include a requirement for such value chain information in the Chinese TP documentation requirements of the revised Circular 2, before the BEPS work commenced. The initiation of the BEPS project led the SAT to adapt their original proposals so that the BEPS TP documentation framework was adopted; nonetheless, the SAT chose to preserve the requirement for the value chain analysis segment of the local file.

The inclusion of value chain analysis in the local file demonstrates that the SAT is conscientious about ensuring that the Chinese taxpayers are allocated their fair share of MNEs' global value chain profits, and that any potential mismatches can be easily identified in the local file. It also provides the fuel for the Chinese tax authorities to apply PSM and VCM TP methods.

As a very interesting addition to the above master file and local file, taxpayers engaging in intra-group services arrangements, cost-sharing arrangements (CSAs), or falling under thin-cap requirements are required to prepare a special issues file without a transactional threshold.

Subject to the above, MNEs are advised to evaluate their capability in preparing the files, set-up an effective system to collect information and better allocate resources. Meanwhile, they should also consider reviewing and updating the group's TP policies without further delay so they can adapt to the new requirements set forth in the Draft.

Advance pricing arrangements

Refinements have been made to guidance on advance pricing arrangements (APAs), providing that priority will be given to applications from taxpayers who provide thorough value chain analysis and/or have duly considered LSAs such as market premium and location savings, and who plan to adopt appropriate TP mechanisms.

The concept of median is further reinforced in the APA provisions. The Draft provides that the tax authorities may adjust the pricing or profitability to the median of the agreed range if the pricing or profitability falls outside the agreed range in any particular year during the APA. The tax authorities may also adjust the weighted average pricing or profitability to the median of the agreed range if it is below the median of the agreed range (even if within range). The Draft also provides that tax authorities may turn away applications for extensions from taxpayers whose weighted average pricing or profitability fell below the median of the agreed range (even if within range) during its in-force APA period.

The Draft also made changes to the administrative proceedings. The notable ones include the requirement to provide the application materials with the submission of the letter of intent" and the abolition of anonymous pre-filing meetings.

Looking ahead

The issuance of the Draft was timed to coincide with the release of the 2015 Deliverables of the G20/OECD BEPS international tax reform project and integrates elements of the BEPS proposals for TP. However, , in parallel, it also formalises many of the novel China TP concepts which the SAT has developed in recent years, thus localizing the BEPS TP work in a China context.

The Draft is a highly significant document, clarifying the Chinese approach to TP investigations and analysis, introducing new TP methodologies, and significantly expanding TP documentation requirements. The guidance spells out, more clearly than ever, the types of transactions and the nature of the TP adjustments which the PRC tax authorities consider themselves entitled to investigate and make, respectively. At the same time, the Draft gives great latitude to local tax authorities to apply the often broadly drafted rules. Ultimately it remains to be seen in practice what precise effect the new guidance will have. Incidents of double taxation for MNEs may be set to increase in the future, and MNEs may in many cases be compelled to adjust their existing business models and/or TP policies.

The authors would like to thank Conrad Turley and Mimi Wang for their contributions to this chapter.

A new era for M&A tax in China

The 2015 enhancements to China's restructuring tax relief rules, the challenging new indirect offshore disposal rules in SAT Announcement 7, developments in financial instrument tax classification and the revamped tax treaty relief procedures are the focus of this chapter by John Gu, Paul Ma, Josephine Jiang, Chris Mak and Yvette Chan

Over the last few years, M&A tax rules had not seen significant development in China. The previous most significant M&A tax developments were the release of Special Restructuring rules under Circular 59 and Circular 698 governing indirect transfers of PRC equity interest back in 2009. However, since 2014, the Ministry of Finance (MOF) and State Administration of Taxation (SAT) have been going to great lengths to put new regulations into effect for the better management and facilitation of M&A. These new measures broadly fit into three categories:

- the extension of the scope of M&A transactions that qualify for tax free or tax deferral treatments;
- the transition of tax administrative procedures from a pre-approval to a self-assessment and reporting approach; and
- enhanced anti-avoidance rules.

The acceleration of the development of M&A tax rules is a direct result of the central government's determination to use M&A as an effective way to revitalise the economy, optimise the industrial structure and help absorb the excess capacity in the manufacturing sector.

These new measures came with good timing and are generally welcomed by the taxpayers. In the latest M&A statistical information available, in the first half of 2015, outbound M&A volumes surged 67% (to $55 billion) compared with to the first half of 2014, while inbound M&A was up 14% (to $19.5 billion) over the same period. These regulatory changes mean that Chinese M&A tax rules, while still at a developmental stage compared with equivalent rules in the US or Europe, are increasingly capable of facilitating more complex transactional arrangements and allow for more tax efficient structures to be put in place.

Restructuring reliefs

In the course of 2014 and 2015 a number of key improvements to the Chinese tax restructuring reliefs were made, both lowering the thresholds for enjoying the Special Tax Treatment (STT), which results in tax deferral treatment for corporate restructurings, and introducing new ways in which STT can be accessed.

It is worth having a brief recap of SAT Circular 59 [2009), the principal tax regulation on restructuring relief, which sets out in what circumstances companies undergoing restructuring can elect for STT. Absent the application of STT, the general tax treatment (GTT) requires recognition of gains/losses. The STT conditions include a 'purpose test' akin to the PRC general anti-avoidance rule (GAAR) (that is, the transaction must be conducted for

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reasonable commercial purposes and not for tax purposes) and a 'continuing business test' (that is, there is no change to the original operating activities within a prescribed period after the restructuring) as well as two threshold tests directed at ensuring the continuity of ownership and the continued integrity of the business, following the restructuring. The first threshold test is that consideration must comprise 85% of equity. The second threshold test was that 75% of the equity or assets of Target must be acquired by the transferee.

Though the purpose of Circular 59 was to provide favorable tax treatments in restructuring transactions, STT had not been widely used due to the high thresholds. SAT Circular 109 [2014] lowers the 75% asset/equity acquisition threshold to 50%. This facilitates the conduct of many more takeovers/restructurings in a tax neutral manner. In addition to the ratio relief, Circular 109 introduced a new situation for STT which removes both the 75% ownership and the 85% equity consideration test. The new situation permits elective non-recognition of income on transfer of assets/equity between two Chinese tax resident enterprises (TREs) which are in a '100% holding relationship' provided no accounting gains/losses are recognised. Both the purposes test and the continuing business test from Circular 59 hold, and the tax basis of transferred assets for future disposal is their original tax basis. The supplementary SAT Announcement 40 [2015] spells out in detail the situations to which the relief applies.

Given that China does not, in contrast to many other countries, possess a comprehensive set of group relief or tax consolidation rules, the institution of this intra-group transfer relief is a real breakthrough in Chinese tax law. However, the relief notably does not cover transfers of Chinese assets by non-TREs (whether between two non-TREs or between a non-TRE and a TRE). Taxpayers would also need to be aware of the emphasis being placed by tax authorities on the purposes test, particularly in light of the fact that the intra-group transfer relief opens the door to tax loss planning strategies that previously were not possible under Chinese tax law.

The tax deferral treatment of non-cash contribution

A third novel provision, introduced under SAT Circular 116 [2014], allows for deferral of tax on gains deemed to arise on a contribution of assets by a Chinese TRE into another TRE in return for equity in the latter. The taxable gain can be recognised over a period up to five years so allowing for payment of tax in instalments. This relief, potentially also extending to the contribution of assets by minority investors into a TRE, sits

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alongside and complements the intra-100% group transfer relief outlined above, which SAT Circular 33 [2015] confirms may be elected for in preference to the Circular 116 relief, where applicable.

Aside from lowering the STT thresholds and providing for new means to access STT, SAT Announcement 48 [2015] also abolishes the tax authority pre-approvals previously needed for STT to be applied, moving instead to more detailed STT filing at the time of the annual CIT filing. The transition from tax authority pre-approval to taxpayer self-determination on the applicability of STT is in line with the broader shift in Chinese tax administration away from pre-approvals, as discussed in the chapter in this volume, *New Challenges to Tax Risk Management in China*. As noted in that chapter, the abolition of pre-approvals, while it potentially expedites transactions, also places a greater burden on a taxpayer's risk management procedures and systems, to ensure that treatments adopted are justified and adequately supported with documentation.

It might be noted that these enhancements to the tax rules for M&A and restructuring transactions occur against a backdrop of a significant improvement in the Chinese regulatory framework within which such transactions take place. Limitations on foreign investment into the various Chinese economic sectors have been steadily reduced under successive 'Catalogues Guiding Foreign Investment'. A shift to a more streamlined 'Negative List' system (setting out a limited number of sectors off-limits to foreigners), on the model of the free trade zones (FTZ) anticipated in the not too distant future. MOFCOM Decree No. 8 [2012] had already eased the use, by foreign investors, of equity in foreign-invested enterprises (FIEs) as M&A transaction consideration in place of cash, facilitating transactions and the set-up of onshore holding entities; SAFE [State Administration of Foreign Exchange] Circular 19 [2015] more recently abolished SAFE Circular 142 [2015] to allow FIEs to convert F/X capital to Rmb at their discretion, so further facilitating use by foreign investors of onshore acquisition vehicles. Given the degree to which the enhanced STT and tax restructuring treatments rely on all parties to the transaction being Chinese TREs, the regulatory changes facilitate the greater use of the enhanced tax treatments.

New offshore indirect disposal rules with reorganisation exemption

In a further highly significant 2015 tax change impacting China M&A and restructuring transactions, China's existing indirect offshore disposal reporting and taxation rules were

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completely revamped, with SAT Announcement 7 [2015] supplanting the earlier Circular 698 [2009]. The rules seek to ensure that the China tax imposition cannot be avoided through the interposition of an offshore intermediary holding entity, which holds the Chinese assets. Compared with Circular 698, Announcement 7 expanded the scope of the transactions covered, enhanced the enforcement mechanism, and provided more certainty with the introduction of the safe harbour and the "black list":

- A much broader range of 'Chinese taxable property' is potentially subject to indirect transfer case assessment. Whereas Circular 698 solely caught transfers of offshore holding companies that ultimately own China assets such as shares, Announcement 7 now also scopes in those holding Chinese real estate, and assets belonging to Chinese permanent establishments of foreign companies. The types of offshore transaction which can trigger the rules are also expanded from simple offshore equity transfers to also cover transfer of partnership interests/convertible bonds, as well as restructurings/share dilutions.
- A withholding tax (WHT) mechanism is introduced, coupled with a new approach to reporting transactions. Whereas Circular 698 made the seller responsible for reporting transactions and for paying any additional tax which the tax authorities regarded to be due, Announcement 7 requires the buyer to apply 10% WHT to the purported transfer gain. The WHT agent faces stringent penalties for failure to pay tax within the allotted timeframe, though can mitigate penalties, by making a timely reporting of the transaction. It might be noted that the seller is still on the hook for tax not withheld by the buyer.
- Extensive new guidance on whether a transaction lacks 'reasonable business purposes' and thus should be subject to tax under the PRC GAAR, as well as provision of safe harbour rules. This includes a "7 factors test" which holistically considers:
  - whether the offshore company's principal value or source of income is derived from China;
  - the functionality, duration of existence and "substitutability" of the offshore holding company; and
  - the overseas taxation position of the offshore transfer, including the application of double tax treaties.

  A parallel "automatic deeming" test applies to treat a transaction to be without reasonable business purpose if, amongst others reasons, more than 75% of the value and 90% of the income or assets of the offshore holding company are derived from China. Safe harbours apply to:
  - foreign enterprises buying and selling securities on the public market;
  - where a tax treaty would apply to cover a transaction recharacterised as a direct disposal; and
  - for an intra-group reorganisation undertaken within a corporate group which meets the group ownership tests.

In practice, Announcement 7 is challenging in application due to the difficulties with aligning buyer and seller positions in an M&A transaction. In the absence of referrable precedents it is difficult to know whether a transaction would be considered to lack reasonable business purposes and therefore whether it is at risk of being subject to tax. Given the stiff penalties which could apply, particularly to buyers as WHT agents, and given the potentially mitigation of penalties through timely voluntary reporting, there is great potential for disputes between transacting parties over whether transactions should be reported at all and whether, and how much, tax needs to be paid or withheld. In practice, escrow and indemnity arrangements have historically been used, although we are seeing buyers increasingly require sellers to timely settle the tax or report the transaction to the tax authorities as a condition for the closing of the deal.

Since its issuance, Announcement 7 has since been supplemented by SAT Circular 68 [2015] which provides implementation guidance. Taxpayer reporting will be given a formal receipt (so giving assurance in relation to the penalty mitigation measures), single reporting for transferred Chinese assets in multiple tax districts is provided for, and GAAR procedures (including SAT review and appeal procedures) are embedded in Announcement 7. This being said, there is still a need for a clarified refunds process, confirmation on applicability of safe harbours, and timeframes on GAAR investigation conclusion.

Hybrid instruments

Financial instruments with both debt and equity features including preference shares, convertible bonds, debt with attached warrants, mandatory convertible notes, contingent payment debt, participating loans or perpetual debt are commonly used in M&A transactions. In China, however, company law as well as financial sector regulation has long limited the variety of debt and equity instruments which can be created, and the rules for distinguishing debt and equity have commensurately been underdeveloped. However, this is now changing, with Chinese enterprises now permitted to issue preferred shares and perpetual debts. It is also common in China for debt investments to be structured as equity investments in practice. The SAT is consequently moving to fill the gap on debt-equity classification guidance.

SAT Announcement 41 [2013] provides that an instrument must possess all of the following features to be considered as debt financing:

- The company has the obligation to pay interest (or equivalent payment) periodically at the rate stipulated under the investment contract;
- There is a definite investment term or specific investment condition, and the company has the obligation to redeem the investment or repay the principal;
- The investing company has no ownership interest in the net assets of the company;
- The investing company has no right to vote or to be elected to governing bodies of the company; and
- The investing company does not participate in the ordinary operating activities of the company.

If any one of these features is missing, then the instrument will be treated as an equity financing and payments on the instrument will not be tax deductible as interest.

In a recent private ruling, the SAT recharacterised a structured equity investment by an insurance company with a fixed and guaranteed return as debt investment. As such, the income received by the investor will be taxable as interest rather than a non-taxable dividend. These developments show that the SAT is increasingly focused on the use of hybrid instruments and will take a substance over form approach in asserting tax treatments on hybrid instruments.

Treaty relief

The chapter in this volume, *China at the forefront of global BEPS implementation,* provides a detailed overview of the new China double tax agreement (DTA) relief system being rolled out from November 1 2015 in SAT Announcement 60 [2015]. Depending on how this is implemented in practice this could allow for more efficient access to DTA relief and might aid the conduct of M&A and restructuring transactions. The new DTA relief system abolishes the tax authority pre-approval system for DTA relief, providing instead that the taxpayer self-determines whether DTA relief applies. The taxpayer then informs the WHT agent (or the tax authority directly where no WHT agent is involved) that it will be using the DTA relief supplying a detailed form and extensive supporting documentation. The WHT agent is obliged to review the form and observe that the taxpayer makes assertions corresponding to the DTA relief criteria, and is expected to review that the supporting documentation does not directly contradict the taxpayer's assertions on the form, after which the WHT agent may use the lower DTA WHT rates. Documentation is passed on to the tax authorities who are to apply enhanced follow-up procedures to review claims, and launch GAAR challenges where appropriate.

It remains to be seen in practice how the tax authorities deal with the administrative complexities arising from the new system, including the interaction of the new rules with the existing system of tax recordals and the interrelationship of the new system with the foreign exchange remittance rules. It also remains to be seen how local tax authorities interpret the due diligence obligations of the WHT agent, and how the WHT refunds system works in practice.

Reforms help transactions

The surge of investment flows in and out of China, and the ramp-up in the number of M&A and restructuring transactions has called for more responsive tax rules, and MOF and SAT have been moving to meet those calls with more responsive, better tailored rules. The new measures recognise that corporate restructuring transactions play an important role in optimising industrial structure and enhancing business competitiveness, and seek to facilitate them through lowered thresholds for merger and share swap relief, an intra-group transfer relief and a capital contribution relief, as well as potentially better treaty relief rules. At the same time, tax avoidance is being safeguarded against by coming anti-hybrid mismatch rules and enhanced indirect offshore disposal rules, which are at the same time also sensitive, in the latter case, to the needs of business restructuring. The changes mean that Chinese M&A tax rules, while still at a developmental stage compared to equivalent rules in the US or Europe, are increasingly capable of facilitating more complex transactional arrangements, and allow for more tax efficient structures to be put in place.

The authors would like to thank Conrad Turley for his contribution to this chapter.

FATCA and CRS: the changing landscape of fiscal disclosure

The progress with, and challenges of, rolling out the FATCA and CRS technology and platforms in Hong Kong and Chinese financial institutions is the focus of this chapter by Charles Kinsley, Khoonming Ho and Lewis Lu

With the increase in cross-border business and access to global financial services, it is common for wealth to be held by individuals in offshore accounts. Offshore tax evasion has therefore become a growing concern for jurisdictions around the world and has attracted the attention of governments who are now looking at collecting tax relating to such undisclosed accounts by obtaining data from the offshore financial institutions that hold them. As a result, there is a coordinated effort by governments to obtain a more accurate picture of income and assets held by citizens worldwide. Global initiatives commencing with the US Foreign Account Tax Compliance Act (FATCA) and more recently, the Common Reporting Standard (CRS) provide a foundation for exchange of information to combat tax evasion by individuals and entities.

Introduction to FATCA

The US federal income tax system relies on voluntary compliance by taxpayers in computing, reporting and remitting their tax liability each year. The US Congress, driven by concerns that taxpayers have achieved sophisticated means of investing offshore to potentially avoid US taxation, enacted FATCA. US persons are taxed on their worldwide income regardless of where they live. FATCA is meant to encourage the proper reporting of all investment income and all dispositions of securities of a US person, including those held offshore.

FATCA, effective from July 1 2014, is a reporting regime aimed at the disclosure of US persons with offshore accounts and investments. Generally, FATCA requires the identification and reporting of US taxpayers by Foreign Financial Institutions (FFIs), that is, institutions located outside of the US, to the US Internal Revenue Service (IRS). FATCA imposes a penal withholding tax of 30% on US sourced withholdable payments made to FFIs and other foreign entities that fail to comply with the disclosure requirements.

IGA status for Hong Kong and China

The FATCA regulations also introduced the concept of government-to-government reporting under intergovernmental agreements (IGAs). There are two types of IGA:

- A Model 1 IGA generally requires financial institutions to report account information of US taxpayers to their own government, who commits to exchanging such information on an automatic basis at a governmental level with the IRS.

- A Model 2 IGA generally requires financial institutions to report account information of US taxpayers directly to the IRS.

The IGAs also help overcome jurisdiction-specific legal barriers (for example, data privacy regulations), simplify practical implementation and facilitate compliance with FATCA by financial institutions in the countries concerned.

Hong Kong

Hong Kong and the US signed a Model 2 IGA on November 13 2014. Under the Hong Kong-US IGA, FFIs in Hong Kong may rely on a set of streamlined due diligence procedures to screen and identify US indicia to locate US accounts and clients for reporting purposes, for example, in determining whether a new individual account is a US account, based on a customised self-certification received from the applicant, rather than more esoteric procedures under FATCA regulations, such as the use of US-centric withholding certificates. Foreign financial institutions are required, however, to confirm the reasonableness of such certification which can be accomplished by reference to other documents obtained during the account opening process.

As noted above, as Hong Kong is a Model 2 jurisdiction, FFIs there are required to report the relevant account information of US taxpayers directly to the IRS, as opposed to reporting to local authorities under the Model 1 IGA. This is supplemented by group requests made by the IRS to the Hong Kong Inland Revenue Department (IRD) for the exchange of information about relevant US taxpayers at a government level on a need basis. Foreign financial institutions in Hong Kong should have completed the 2014 FATCA reporting before June 30 2015 pursuant to the timeframe applicable to Model 2 IGAs.

China

China, as one of the US's largest trading partners, reached an "agreement in substance" for a Model 1 IGA with the US on June 26 2014. As of September 30 2015, China is yet to finalise an IGA to address the US reporting requirements. No local guidance notes have been publicly issued by the Chinese government either regarding FATCA compliance to-date.

Under China's "agreement in substance" status, Chinese financial institutions may register at the IRS FATCA Registration Portal as Registered Deemed-Compliant FFIs within a Model 1 IGA jurisdiction. However, as of September 24 2015, only 1,066 entities in China have registered as FFIs on the IRS portal versus the 3,170 that have registered for Hong Kong. The relatively low FFI registration rate suggests a substantial number of China-headquartered financial institutions are taking a wait-and-see approach on FATCA registration and compliance pending the issuance of guidance from the Chinese government.

China has state secret laws governing the disclosure of sensitive commercial information, particularly cross-border.

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Similar to other Model 1 IGA jurisdictions, after the signing of an IGA between China and the US, financial institutions in China should be able to report information pertaining to US account holders directly to the Chinese authorities. The Chinese government will then exchange such information with the IRS on an automatic basis, thus alleviating the need for Chinese institutions to report such information abroad. The delay in China finalising an IGA with the US and issuing FATCA guidance notes creates some uncertainty for Chinese branches of overseas financial groups about complying with their requirements under FATCA (including new customer onboarding and existing customer due diligence procedures). To ensure certainty and compliance, it is hoped that further guidance will be provided shortly by the Chinese government on how financial institutions can fully comply with their FATCA obligations and details of any local exemptions. This would also encourage China-headquartered financial institutions to comply with the FATCA registration and reporting requirements.

Framework for CRS

The OECD CRS is another significant step towards a globally coordinated approach to the exchange of information on

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income earned by individuals and organisations. As a measure to counter tax evasion, it builds upon other information-sharing legislation, such as FATCA and the EU Savings Directive. Cayman Islands, the British Virgin Islands and most European countries will be early CRS adopters, that is, implementing the CRS requirements from January 1 2016 and undertaking the first exchange of information in respect of the financial information of foreign tax resident account holders in 2017.

Hong Kong, China and the majority of Asian countries, while generally committing to adopt CRS, will not adopt CRS before January 1 2017 and will therefore only undertake the first exchange of information in 2018 at the earliest. As a result, while there is a general awareness of automatic exchange of information (AEOI), a number of financial institutions in Asia have not started considering the impact of CRS on their business operations. This lack of awareness has been further exacerbated by a number of Asian jurisdictions not having finalised their IGAs, including Indonesia, Malaysia, Taiwan and Thailand as of September 30 2015. Therefore, the local focus is still on FATCA and not CRS.

The CRS provides a common global approach for jurisdictions to obtain financial information from their financial institutions and to automatically exchange that information with multiple jurisdictions on an annual basis. It has a similar reporting basis to FATCA Model 1 IGA's, except that the CRS is a single framework to be adopted and implemented by various participating jurisdictions.

Comparison with FATCA

There are a number of inherent similarities between CRS and FATCA. Both regimes mainly impact financial institutions and require annual reporting on similar information on the account holders and assets held, for example, the identity and residence of financial account holders (including certain entities and their controlling persons), account details, reporting entity, account balance/value and income/sale or redemption proceeds.

However, there are a few key differences between the two regimes. In particular, CRS is based upon tax residence rather than US citizenship under FATCA. Under CRS, financial institutions are required to report to their local tax authorities on information about financial accounts held by overseas tax residents. The laws regarding tax residency are complicated, and differ by country/jurisdiction, so the validation procedures may not be straightforward. It is hoped that individual governments will make tax residence definitions and examples available on their websites, which could assist account holders in making the determination.

Another difference is the increased scope and volume of reporting. The CRS does not provide the option of electing a *de minimis* threshold for individual account holders as in FATCA, therefore increasing the number of customers in scope for further due diligence and reporting. Also, CRS does not provide for exemptions available to low-risk financial institutions available under FATCA, bringing more financial institutions in scope for CRS. For example the following entities perceived to have a low risk for tax evasion under FATCA would not be excluded from reporting under CRS: financial institutions with a local client base, local banks, certain retirement funds, financial institutions with only low-value accounts, sponsored investment vehicles, certain investment advisors and investment managers, and certain investment trusts. This would mean that far more entities and accounts would be subject to CRS reporting, therefore increasing the amount of due diligence work significantly.

Unlike FATCA, there is no withholding obligation under CRS, so no new withholding systems will be necessary. Penalties for non-compliance will, however, be introduced by each government under local law. Also, CRS introduces a simplified indicia search which allows financial institutions to rely on the current residence address of account holders in determining the tax residency of an individual for pre-existing accounts with balances of less than $1 million. If no such address is held by the financial institution, a search of electronic records for any of six defined indicia for overseas residency must be performed.

CRS Status in Hong Kong

Hong Kong does not allow for the automatic exchange of information. An exchange of information can only be made under a comprehensive avoidance of double taxation agreement (CDTA) or tax information exchange agreement (TIEA) and on a request basis. The Hong Kong government indicated its support for implementing CRS in September 2014, though new legislation will be required to allow the government to exchange information automatically. It issued a consultation paper on April 24 2015 to gather feedback on the proposed CRS model to be adopted in terms of the legislative regime and operational framework. In particular, views were sought on the following key aspects:

- the proposed scope of financial institutions, non-reporting financial institutions and excluded accounts;
- the types of information financial institutions have to secure from account holders;
- the due diligence procedures and reporting requirements that financial institutions have to follow;
- the powers of the Hong Kong IRD to collect relevant information from financial institutions and forward such information to designated bilateral AEOI partners;
- the proposed sanctions for failure to comply with the AEOI requirements;
- the mechanism for financial institutions to meet the confidentiality safeguards; and
- the related information technology infrastructure to support the implementation.

The Hong Kong government has indicated that AEOI will be conducted on a bilateral basis with jurisdictions with which Hong Kong has signed a CDTA or TIEA, rather than under a multilateral instrument (that is, the Multilateral Convention on Mutual Administrative Assistance in Tax Matters) for flexibility in choosing AEOI partners. In identifying AEOI partners from among Hong Kong's CDTA or TIEA partners, the Hong Kong government will take into account their capability to meet the CRS requirements and to protect data privacy and the confidentiality of the information exchanged.

Forty-three submissions were made in response to the Hong Kong consultation paper. As mentioned above, Hong Kong does not plan to sign a multilateral instrument for CRS implementation which allows the exchange of information between the Hong Kong government and other participating jurisdictions directly. This gave rise to one commonly expressed view which was the ability for financial institutions in Hong Kong to collect and keep information of all non-Hong Kong tax resident account holders (the wider approach). Most financial institutions in Hong Kong prefer to adopt the wider approach because the narrow approach, that is, limiting financial institutions to collect information relating to account holders in countries only where agreements have been reached to share such information would lead to financial institutions being required to perform due diligence procedures each time Hong Kong signs a new bilateral competent authority agreement for CRS purposes, resulting in very high compliance costs and inefficiencies. However, under the existing Hong Kong Personal Data (Privacy) Ordinance (PDPO), financial institutions in Hong Kong would only be able to implement the wider approach if they are "required or authorised" to collect the personal data in question. For such financial institutions to lawfully adopt the wider approach, amendments to the Hong Kong Inland Revenue Ordinance (RO) or the PDPO would be required. In the consolidated response to the consultation paper published by the Hong Kong government on October 12 2015, the Hong Kong government has decided to maintain its initial proposal to impose a narrow approach for CRS due diligence, but will permit financial institutions to adopt the wider approach as an option.

Another view expressed in the submissions is that the proposed offences and sanctions under CRS should be limited to the financial institutions themselves and not extended to

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employees. To the extent that employees of a financial institution are subject to penalties, the employees must have taken deliberate steps rather than merely permitting the offence to occur, given the nature of these reporting duties. After the Hong Kong consultation process, the Hong Kong government has maintained its stance that appropriate deterrent penalty provisions are necessary to ensure the effective implementation of CRS. The proposed sanctions, will however, be refined by confining them to those employees who have willfully caused or permitted the financial institutions to provide incorrect returns.

The Hong Kong government is working towards a very strict timeframe to meet its commitment to CRS. The first automatic information exchange is expected to commence by the end of 2018. Financial institutions in Hong Kong will therefore be required to commence due diligence procedures in 2017. The government is proposing that a Bill be introduced into the Legislative Council in early 2016 and the necessary legislation be passed by the summer of 2016.

CRS status in China

Similar to other jurisdictions in Asia which have not finalised their IGAs for US FATCA to date, CRS is not the focus of the Chinese government yet. As a late adopter jurisdiction to CRS, it is expected that China will aim for a first exchange of information in 2018. In this regard, it may need to expedite its process (including the signing of the Multilateral Competent Authority Agreement) to meet the global timeline.

Strategies for handling CRS

The OECD CRS initiative involves governments obtaining information from their financial institutions and exchanging data automatically with other jurisdictions. Financial institutions will have significant additional reporting responsibilities to disclose details of their account holders after the implementation of CRS, with potential penalties for those unable or unwilling to comply fully. The new global standard poses significant challenges for financial institutions in China and Hong Kong in terms of customer due diligence, including reviewing self-certifications for reasonableness provided by customers and other documentation remediation. This is in line with the tightened rules on anti-money laundering (AML) and Know Your Customer (KYC) requirements globally in recent years.

Most financial institutions, after the implementation of FATCA, accept that the increased cost of compliance is now part of their normal business expenditure. However, CRS does not include the minimum $50,000 threshold, and thus all of a financial institution's accounts are subject to review and potential reporting under CRS. This, combined with the fact that the review must be done with respect to multiple reportable jurisdictions (rather than only US accounts under FATCA), means that financial institutions will have to collect and remit information for significantly more accounts under CRS when compared to FATCA. Given this higher volume, some financial institutions that have implemented manual review processes for FATCA will not be able to use the same procedures for CRS.

For those financial institutions in China and Hong Kong with a significant customer or investor base outside their home jurisdiction, CRS means a big increase in the volume of data to be reported to the local tax authority. In integrated regions such as Asia, the sheer scale of reporting will make manual or semi-manual solutions impractical. Similarly, it would impact due diligence and customer data monitoring, as financial institutions may have to store more than one classification for a customer or investor with multiple tax residences, and track all changes to customer status or residence, to keep up-to-date.

Financial institutions which took a tactical approach to their FATCA solution, either by creating temporary manual processes or by excluding US persons from maintaining accounts with them, cannot now simply upgrade their existing framework to cater for CRS. Some financial institutions chose to limit their burden under FATCA, including closing accounts of US individuals to reduce reporting, or centralising all US investments in one entity. These strategies will not work for CRS given the expected increase in the number of clients impacted. Furthermore, CRS allows for additional requirements to be introduced bilaterally between reportable jurisdictions. Financial institutions must therefore keep a close eye on regulatory developments, and face the possibility of additional operational issues and associated cost increases for reporting, including repeated remediation of customer or investor information, as each new group of jurisdictions enters into competent authority agreements. Financial institutions in China and Hong Kong should look to invest in a sustainable and flexible IT architecture that can adapt to evolving regulations and to new jurisdictions coming on board for CRS purposes.

As a response to the coordinated effort by governments to obtain a more accurate picture of income and assets of their taxpayers worldwide and get a fairer share of tax revenue, financial institutions in China and Hong Kong need to keep abreast of new regulations locally, manage relationships with tax authorities, and educate staff and clients on reporting requirements and account opening procedures. Above all, they should be sensitive to how their customers react to additional information requests. All these changes will have a significant impact on their systems and processes, and will require an understanding of regulatory developments and enhanced controls accordingly.

The authors would like to thank Eva Chow for her contribution to this chapter.

New challenges to tax risk management in China

The changing face of the Chinese tax administrative environment, and the shifting of more responsibility to taxpayers, coupled with greater tax authority scrutiny, is the focus of this chapter by Tracy Zhang, Grace Xie, David Ling and Karmen Yeung

Enterprises conducting business in China will be well aware that the rigour of Chinese tax enforcement has stepped-up significantly in the past few years. On the whole, from the SAT down through the various tiers of the Chinese tax administration, more systematic, Big Data-driven approaches to taxpayer monitoring, audit and investigation are being adopted. These allow for more effective targeting of tax avoidance and evasion, and better use of limited tax authority resources.

With the same mindset of improving the use of tax authority resources, there are efforts to limit time-intensive and low value-adding activity such as tax treatment pre-approvals, with taxpayer self-assessment becoming the rule. The removal by the State Administration of Taxation (SAT) of pre-approval authority from local tax authorities may also be linked to the wider central government efforts to limit discrepancies in the application of local authority discretion. SAT efforts to make the tax law more detailed and specific, and to improve administrative review procedures, combine with the efforts to limit local tax authority discretion, to produce more consistently applied tax law across tax authorities nationwide.

These developments bring potential benefits to taxpayers both in terms of certainty and more expeditious access to tax reliefs (for example, treaty benefits), but carry also greater risks for the non-compliant or the unprepared. Intentionally non-compliant taxpayers may find that they struggle to stay under the radar in future as tax authority detection efficacy improves and as taxpayer capacity to make deals with local authority decreases with the reduction in their discretion in applying the national law. Taxpayers intending to be compliant but lacking effective tax risk management (TRM) systems and procedures may be ill-equipped to deal with the greater latitude they are being given to self-assess the applicability of special tax reliefs and treatments without need for pre-approval. Where inappropriate determinations are made or insufficient documentation/support is retained, in consequence of poor TRM procedures, this may come back to haunt the taxpayer on conduct of tax authority follow-up procedures.

As China moves into this new era of tax administration and as taxpayers need to effect a step-change in their tax risk management practices, it is worth briefly surveying some of the key trends driving these developments. This chapter examines how the SAT is working to improve the consistency and clarity of the tax law as well as the consistency of tax enforcement and certainty in tax outcomes with a view to facilitating moves to greater taxpayer responsibility for assessing their own tax position.

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At the same time, taxpayers, having assumed greater responsibility for managing their own tax treatments and risks, must be aware that the Chinese tax authorities increasingly have at their disposal more tax information than ever before and have rapidly improving capabilities in pooling tax information for better tax audit targeting.

Ultimately, from both taxpayer and tax authority perspectives, it may ultimately concluded that the answer lies in closer taxpayer-tax authority cooperation.

Consistency and clarity of the tax law

The SAT is taking a tighter rein over the tax law-making process in China to ensure greater consistency. This includes measures which prohibit local tax authorities from making local tax rules at odds with existing SAT rules and the national law, as well as programmes to clean up and abolish existing local incentives. Notable in this regard was State Council Circular 64 [2014], though the very ambitious timeframe of that measure was tempered somewhat with the subsequent SAT Circular 25 [2015].

Such bolstering of the consistency of nationwide tax law is also reinforced by procedures through which taxpayers can initiate a SAT review of locally promulgated tax rules which they consider to be at odds with the national tax rules. The SAT is also making efforts to have more enforcement case decisions published on tax authority websites, such as where local tax authorities seek provincial level tax authority or SAT approval for application of the general anti-avoidance rule (GAAR), transfer pricing (TP) adjustments, or granting of treaty relief. Such measures should ensure the consistency of the rules, while the increased transparency supports a common understanding of the tax law among taxpayers and tax authorities in the future.

It might also be noted that the SAT has become much more open in its use of public consultations on significant tax law changes, and taxpayers and their advisers have seen their views taken on board to craft workable tax rules, consistent with other Chinese tax law provisions and guidance. Guidance from the SAT is also progressively becoming far more detailed and specific; witness, for example the indirect disposal rules in Announcement 7 [2015] as against the previous Circular 698 [2009], and the TP guidance in the Special Tax Adjustments discussion draft [2015] as against Circular 2 [2010]. Such greater specificity by the SAT ties the hands of local tax authorities to a greater degree and, in the absence of substantial involvement by the courts system in the interpretation of Chinese tax law, detailed SAT guidelines are the main channel through which the tax law is made more concrete.

At the same time it is noted that many aspects of the Chinese tax law remain to be clarified and provided with greater guidance, and, in the absence of a historic record of decided tax cases, obtaining clarity on the precise application of Chinese tax provisions continues to be inherently difficult.

Consistency of tax enforcement and certainty in tax outcomes

The SAT's efforts go beyond ensuring consistency of tax rules to also seeking consistency in the enforcement of the rules in individual cases. New rules require local tax authorities to obtain approvals from higher level authorities, including from the SAT, for tax adjustments in individual tax cases. An example of this is treaty cases where Announcement 60 [2015] requires that SAT Order 32 [2014] on GAAR Measures be followed. As noted above mechanisms now exist for such higher level decisions to be publicised on tax authority websites. Guidance from the SAT, such as the GAAR Measures, also allows taxpayers to appeal their individual cases up from the local tax authorities to higher level authorities including the SAT. Strict new SAT guidance is also being set out, such as in SAT Announcement 10 [2015], on the circumstances in which local tax authorities are permitted to penalise taxpayers, with clear rules on the higher level prior approval which is required. The collective effect of such measures is expected to be the limitation of the arbitrary exercise of discretion by local tax authorities.

The new Tax Collection and Administration Law (TCA Law), which is in draft form and expected to be finalised in 2016 or 2017, will strengthen taxpayers' access to administrative reconsideration and mediation, and will institute the principle that the relevant authorities may not make decisions which would lead to a worse outcome for the review applicant. Importantly, given the extent to which taxpayers can be caught in the crossfire in disputes between local tax authorities over taxing jurisdiction in practice, the TCA Law also requires that such disputes be elevated to a common higher tax authority for resolution.

The TCA Law is also set to provide for a system of formal private rulings, which should allow for greater tax certainty for taxpayers in the future. Already, in practice, the SAT had been issuing rulings to the limited number of enterprises covered under the Tax Compliance Agreement programme, and the pilot scheme provided under SAT Circular 145 [2013]. The tax authorities in the free trade zones (FTZ) in Shanghai, Guangdong, Tianjin and Fujian have also recently started to provide, under SAT Circular 208 [2015], advance tax rulings (confirmed by the SAT) where the taxpayers have proven internal tax risk controls and an A-grading for tax credit rating purposes.

While all these SAT efforts to improve consistency of enforcement and certainty in outcomes for taxpayers are very welcome, it must be noted that China is a vast country with thousands of subordinate tax authorities, all managing tax districts with varying levels of economic sophistication and particular local circumstances. As such, a degree of tax enforcement inconsistency will always remain, to some degree, inevitable.

Moves to greater taxpayer responsibility

In parallel with these SAT efforts to improve the consistency and clarity of the tax law, and the consistency of enforcement with certainty in tax outcomes, is a progressive move towards abolition of tax authority pre-approvals. Chinese tax administration has long been characterised by a need for local tax authority pre-approvals for various deductions and exemptions. This could lead in practice to extensive hold-ups as taxpayers sought to persuade tax officials of the merits of their case, even in relation to quite straightforward cases (for example, tax deduction of losses arising on asset disposals against other income), and the great discretion it gave to officials could negatively affect the neutrality of the tax system towards taxpayers. On the flip side, taxpayers, having received tax authority pre-approvals, could be reasonably sure that the tax position adopted would not be overturned on later tax audit, assuming the officials who granted the approval remained in place. Written tax authority pre-approvals also served a variety of further purposes in China's highly regulated business environment, such as providing evidence to banks that tax had been settled on outbound payments such that a remittance could be processed.

In the future, the intent is that tax deduction/exemption/incentive treatments provided for under the tax law will simply be adopted by taxpayers in their tax filings, based on their own assessment and evaluation. These can be audited and adjusted by the tax authorities at a later time if claimed inappropriately. These changes are allied to a nationwide campaign to remove excessive administrative discretion from local officialdom and may be viewed as allied to the government's anti-corruption campaign.

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Since March 2013 the State Council has issued 10 circulars abolishing administrative approval powers for 537 items. In 2014 the SAT had identified 87 remaining tax approval items in Announcement 10 [2014] of which 80 have been abolished since. The abolition of the pre-approvals have been accompanied by the issuance of new guidance setting out in detail how taxpayer filing and tax authority follow-up procedures are to operate in the future, with a view to ensuring more consistent procedures applied by local authorities. Examples of such shifts include:

- Accelerated tax depreciation – pre-approval abolished in State Council Circular 27 [2015] and new filing procedures issued in SAT Circular 56 [2015]
- Cost sharing agreements – pre-approval abolished in State Council Circular 27 [2015] and *ex-post* supervision procedures put in place under SAT Announcement 45 [2015]
- Tax treaty relief – pre-approval system abolished under State Council Circular 27 [2015] and replaced with system of taxpayer self-assessment and tax authority follow-up procedures in SAT Announcement 60 [2015]
- Tax clearance before remitting payments out of China – abolished under SAT Announcement 40 [2013] and replaced with a recordal system

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In addition to his connections with the tax authorities at central and local levels, David also has long-time relationships with various PRC authorities including the Ministry of Commerce, the State Administration for Industry and Commerce, the State Administration for Foreign Exchange, Customs as well as the tax authorities at both central and local levels. He is also the industry faculty member for the graduate study program of the People's University, one of the top universities with the tax programme.

- Special tax treatment for corporate tax restructurings – pre-approval abolished under State Council Circular 27 [2015] and new information reporting procedures provided under SAT Announcement 48 [2015] and SAT Announcement 72 [2014] for non-residents
- Tax incentives for software and integrated circuit enterprises, western regions, infrastructure projects, recycling, environmental protection, water/energy conservation projects and environmental equipment, venture capital, and technology transfer, and sundry other preferential treatments – pre-approvals abolished under SAT Announcement 58 [2015]
- Non-residents taxed on their China establishments or place of business or PE – approval for use of PE profit calculation methods abolished under SAT Announcement 58 [2015]
- Foreign enterprises registering as Chinese tax residents – approval abolished and new procedures introduced under SAT Announcement 22 [2015]
- Use of foreign tax credits and tax sparing relief in treaties – approval abolished and new filing and follow up procedures set out in SAT Announcement 70 [2015]
- VAT exemption for designated "exported services" – pre-approval abolished when excluded from the list of 'in-effect' approvals in SAT Announcement 10 [2014]
- Deduction of asset losses – pre-approval abolished when excluded from the list of 'in-effect' approvals in SAT Announcement 10 [2014]
- R&D expenses bonus deduction – pre-approval abolished when excluded from the list of 'in-effect' approvals in SAT Announcement 10 [2014]

Alongside the abolition of pre-approvals, new guidance in SAT Announcement 43 [2015] has made clear that a requirement for record filing before enjoying benefits may not be applied by local tax authorities. In practice, some local tax authorities, despite the abolition of pre-approvals, had used such prior record filing requirements as *de facto* pre-approval processes. The tax authorities could refuse to accept a prior record filing unless they were satisfied that tax had been paid; this was an issue will the abolition of tax clearances under Announcement 40 for remittances out of China. Announcement 43 now makes clear that record filing is rather to occur either at the time of the standard tax returns or thereafter. This is accompanied by efforts to reduce frequency of filings, for example in relation to treaty relief where filings on a once-off or every-three-year basis suffice for multiple uses of DTA benefits in the interim.

To cap off these extensive changes, in November 2015 the SAT issued a comprehensive 'Catalogue' of Chinese tax incentives with Announcement 76 [2015]. To facilitate administration of tax incentives the Catalogue give each tax incentive a specific unique code. The Catalogue also sets out specifically which documents are needed to be filed and to be kept on file as support. The Catalogue is a highly welcome restatement by the SAT of the existing incentives, their rules of application and necessary documentation. It is promised that the Catalogue will be updated on a rolling basis, as a useful guide to taxpayers and as a mechanism for the SAT to ensure consistency of administrative requirements by local authorities.

Whether these fundamental changes to the operation of the Chinese tax system will benefit or hinder taxpayers is a matter of some debate and will clearly depend on the circumstances of individual taxpayers. It should be noted that, in each case where pre-approvals have been abolished, significantly more detailed filing forms and documentation are being requested from taxpayers to feed tax authority follow-up procedures. In this regard, the extremely detailed new forms for treaty relief and restructuring special tax treatment might be noted, as well as the creation of a new category of TP Special Documentation for CSAs, which must be prepared by enterprises without reference to standard TP documentation preparation thresholds, under the draft new Special Tax Adjustments guidance.

For taxpayers, under the new system, it is ever-more crucial that:

- tax certainty can be obtained through clarity in the law;
- SAT procedures are sufficiently detailed and actually followed by tax authorities in practice and
- that risk of taxpayer internal error can be managed through TRM systems and protocols.

Where, for a particular tax issue:

- the SAT guidance is very clear and specific with little room for local interpretative discretion;
- the SAT procedural guidance on filings in relation to the relief/deduction, and procedures for administrative review up to the SAT are highly specified and effective in practice; and
- where the TRM systems and procedures of the taxpayer are sufficient to pick up and deal with risk areas,

then the new system may bring benefits.

Where any of these aspects are lacking then the new system may simply heighten taxpayer tax risk, outweighing any potential benefits.

The individual circumstances of taxpayers are crucial. Where, for example, a Chinese subsidiary makes regular payments to a foreign parent, then the abolition of tax pre-approvals for DTA WHT relief may constitute a great improvement. This expedites the remittance of amounts from China with reduced WHT rates and if the tax authorities, on their follow-up procedures, determine that DTA WHT relief was not warranted and extra tax must be paid, the Chinese subsidiary and foreign parent are in any case part of the same group. Where the Chinese payer is unrelated to the Chinese payee, unless further guidance can clarify remaining uncertainties on WHT agent liability and procedural matters, indemnities from non-residents may be necessary to allow the new system of DTA WHT relief up-front to apply as intended. Of course, the garnering of any benefit from the new procedures in terms of remittance efficiency is dependent on adequate guidance being given to banks on new procedures for remittances. Overall then, the jury is out on whether the new procedures will be beneficial for taxpayers but, if they are to be, then effective TRM is a crucial ingredient in the recipe.

It might be noted that, in tandem with lessening taxpayer-tax authority direct interaction by abolishing pre-approvals, the FTZs are also pushing various measures to allow all tax matters (for example, export tax refunds) to be handled remotely online, as detailed in SAT Circular 208 [2015]. If these prove to work acceptably and reduce taxpayer compliance costs, they are likely to be rolled out nationwide. This move online is also linked to efforts to handle all tax matters, where practicable, digitally (for example, move from paper to digital customs declarations, and corresponding use of the digital customs declaration in claiming export VAT refunds online; SAT Announcement 26 [2015]).

All of these moves outlined above, towards giving the taxpayer greater control of and responsibility for the tax determination process, are being accompanied by a clarification of when penalties apply for failure to meet the required taxpayer responsibility standard. The TCA Law will:

- clarify that late payment interest will be calculated at the prevailing market RMB loan rate (replacing the current 0.5% late payment surcharge); and
- reduce the upper threshold of penalties from five times to three times tax outstanding.

At the same time the TCA Law will:

- both increase (from three to five years) the standard statute of limitations period as well as capping the time limitation for evasion cases (15 years) and collection of unpaid taxes (20 years); and
- will remove the requirement to prepay taxes before a tax administrative appeal can be initiated.

More tax information

The corollary of the tax authorities stepping back from pre-approvals and giving taxpayers more latitude to manage their own tax treatments and risks is that tax authority monitoring

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and follow up procedures take on an increasingly vigorous character. A big dimension of this shift is the exponential expansion of the sources of information at the Chinese tax authorities' disposal, which can then be harnessed for better tax audit targeting.

- As noted in the TP chapter in this volume, TP documentation is being radically stepped up. Along with the addition of the BEPS-driven master file and country-by-country reporting (CbCR), an extensive value chain analysis is called for in the TP local file. This is accompanied by specific TP documentation reporting on equity transfers and outbound investments, and by special documentation, for outbound service payments, which applies without threshold.
- Enhanced controlled foreign company (CFC) reporting under SAT Announcement 38 [2014]
- "China FATCA" under SAFE Circular 642 [2014] under which Chinese residents must report their foreign financial assets and liabilities, and all cross-border transactions
- China has significantly enhanced capacity for cross-border tax information exchange:
  - Enhancements to the information exchange articles in China's treaties and entry into tax information exchange agreements (TIEAs) with the 10 major tax haven jurisdictions
  - FATCA-related intergovernmental agreement with the US for automatic exchange
  - Automatic information exchange under the OECD's Common Reporting Standard (CRS) system from 2018
  - Multilateral exchange of intelligence on aggressive tax planning strategies through the OECD Forum of Tax Administration (FTA) and the Joint International Tax Shelter Information Centre (JITSIC) *[Since renamed Joint International Tax Shelter Information and Collaboration].*
- The TCA Law is set to introduce a taxpayer identification number (TIN) system under which both individuals and enterprises will be obliged to use their TINs when signing contracts/agreements, paying social insurance premiums, registering real estate and handling tax matters. Banks and other financial institutions shall record TINs in the bank accounts of taxpayers; where business-related payments are more than Rmb5,000 ($783) in a tax year, then the TIN of the payee must be provided by the bank to the tax authorities; for individual payment of more than Rmb50,000 the payee TIN must be provided to tax authorities within five days. The TIN is seen to provide an important underpinning for a general Real Estate Tax Law and revisions to the IIT Law.
- The TCA Law also introduces reporting on e-commerce businesses, with online trading platform operators required to provide the tax authorities with registration information of e-commerce traders operating on their platform, as well as trading status and payment history information on request.
- Tax authorities are also radically enhancing the information they collect on taxpayers' tax risk management systems. Originally carried out on an *ad hoc* basis, reviews of such TRM systems has become a steadily more standardised component of routine tax audit work, as well as in taxpayer self-investigations, and the public discussion draft on Special Tax Adjustments now directs tax authorities to conduct tests of taxpayers internal control systems as standard.
- As noted above, the "Follow Up" documentation being demanded by the SAT, consequent on the abolition of tax pre-approvals, is radically enhanced. Note, for example, in this regard the extremely detailed new forms needed for treaty relief under SAT Announcement 60 [2015]

It should be noted that the capacity of the Chinese tax authorities to store, manipulate and interrogate this data is greatly enhanced by the shift to use of digital formats. Most of the enhanced tax information items outlined above will be received in digital formats. Digitisation is further propelled by the efforts, for example in the FTZs, to push all taxpayer-tax authority communications into the online realm, as well as by the customs and VAT efforts to handle all documentation digitally (noted above). Such digitisation also crucially supports the pooling and sharing of such data for enhanced tax administration, as discussed below.

Pooling tax information for better tax audit targeting

In parallel with this torrent of rich, new data sources becoming available to the SAT and to various local tax authorities within the Chinese tax administration, efforts are afoot to improve the degree to which data is shared and pooled across tax authorities. The authorities continue to push the construction and expansion of information platforms to integrate information from multiple tax authorities with data from customs offices, commerce departments and administrations of industry and commerce. Both the TCA Law and the SAT public discussion draft on Special Tax Adjustments also further push for government database sharing mechanisms. It might be noted how information pooling is also being driven by the government's business administration simplification programme. In this regard one might consider the integration of the taxpayer, social security, and business licence certificates and codes (all regulated by three different authorities) into a common certificate and code, in SAT Circulars 160 and 482 [2015], supported by an information sharing arrangement.

Pooled data, including information on taxpayer TRM systems and historic compliance as well as business and transactional information, is then to be harnessed for the tax risk classification of taxpayers (referred to as a 'tax credit rating'). This allows for the concentration of audit resources on risky segments, with low risk taxpayers commensurately accorded a lower level of scrutiny and audit. The Special Tax

Adjustments draft mandates the setting of such tax credit ratings for taxpayers, building on the steps taken so far in SAT Announcement 40 [2014] and Announcement 47 [2015] on tax credit ratings, and on earlier efforts such as the TP comprehensive indicator system.

The tax credit rating of taxpayers is also linked to the availability of preferred treatments. So, for example, as noted above, accessing the rulings system in the FTZs turns on the taxpayer having a sound TRM system and an A-grading under the tax credit rating system. In the FTZs SAT Circular 208 [2015] also provides that tax authorities will supply tax credit ratings to banks, who are then to give preferential funding to clients with an A grade tax credit rating. It is indicated that access to tax incentive treatments and other preference may in future turn on tax credit ratings.

It might be noted that the Chinese tax authorities are making very significant investment in data warehousing technology to support the analysis and use of these enhanced and pooled information resources. SAT Circular 25 [2015] on Special Tax Inspections for 2015 notes that tax authorities should leverage their 'Comprehensive Data Management Systems' for undertaking risk screening processes and identify key targets for further review and investigation, as well as use of web crawler technology to collect tax-related public information on taxpayers from the internet. The sophistication and capacity of these data warehousing systems will become crucial for the Chinese tax authorities in future years as the turning on of the data spigot, particularly with TIN, will demand capacity to match billions of transactions each year.

Closer taxpayer-tax authority cooperation

Ultimately, in this new Chinese tax administrative environment, where taxpayers are taking on greater tax responsibilities while being subject to greater tax authority scrutiny, the optimal solution for both tax authorities and taxpayers may lie in greater communication and cooperation.

Since 2008 the SAT's Large Enterprise Taxation Department (LETD) has sought to build a closer and more transparent working relationship with large taxpayers. The LETD has over the years been central to the rollout of the SAT's Tax Compliance Agreements (TCA) programme, which seeks to leverage the sound tax internal control systems of enterprises participating in the programme to minimise the need for inspection of taxpayers' tax reporting and compliance. The LETD has also been a platform for the SAT to experiment with issuance of private rulings.

These initiatives are now being taken wider. The SAT and provincial level tax authorities are planning the collective establishment of a national Risk Management Office, which will be responsible for identifying the major tax risks of different industries and for coordinating deeper liaison with large domestic enterprises and MNEs. Large domestic enterprises and MNEs are to be compelled to establish proper centralised risk management, and the large domestic enterprise and MNE risk management functions will liaise with the national Risk Management Office.

The attraction of the national Risk Management Office is seen as allowing the Chinese tax authorities to have a full picture of a large enterprise or MNE's operations across the whole country (rather than just a province-by-province view) and that it will also forestall local governments from intervening in national anti-avoidance investigations.

As noted above, the review of large enterprise TRM systems, central to the proper functioning of the national Risk Management Office approach, is becoming ever more a routine part of tax audit work (and tax self-investigation) and is set to become standard under the new guidance on Special Tax Adjustments. The SAT is also understood to be working with the State-Owned Assets Supervision and Administration Commission (SASAC), the Chinese government body overseeing many of China's SOEs, with a view to including tax risk management as part of SOEs' internal control supervision and evaluation systems. The carrot approach of offering, as with enterprises in the FTZs covered by SAT Circular 208 [2015], advance tax rulings to those taxpayers with proven internal TRM systems (detailed above) is also considered likely to be quite effective at spurring adoption of TRM systems when rulings are rolled out to the national level.

To interface optimally with the Chinese tax authorities in relation to their new TRM-focused approach, large enterprises, including MNEs, will need to consider in particular a number of TRM relevant matters:

- Determine at board level how their tax strategy aligns with their overall corporate business strategy and, if they have not done so already, establish an internal tax management department.
- Identify control points (tax risk owners) throughout the business for tax control procedures, supporting this with automation and standardisation of the procedures to the extent possible. In this regard, for the proper conduct of the control procedures the business should set up checklists of major tax risks, and establish tax manuals and protocols (in particular for effective invoice management given the roll out of the new e-invoice system).
- Tax risk communication mechanisms, which streamline information sharing and reporting flow group-wide, need to be put in place, and it needs to be ensured that the tax and finance departments share the same data, as well as the same related technology and processes.
- Finally, regular health checks of tax compliance and reporting systems, as well as post-implementation review of tax planning ideas need to be conducted, alongside evaluating the professional ethics and capabilities of tax staff.

The authors would like to thank Conrad Turley for his contribution to this chapter.

Indirect taxes in China – 2020 and beyond!

Potential expansion of the VAT base, modernisation of rules and systems to better capture cross-border dealings in intangibles and services, as well as the deployment of Big Data analytics by the tax authorities to refine and enhance VAT administration are the themes dealt with in this chapter by Lachlan Wolfers, Shirley Shen, John Wang and Jean Li

In past editions of *China Looking Ahead*, we examined the indirect tax landscape in China with a particular focus on the value added tax (VAT) reform initiatives. For the most part, our predictions as to the VAT rates and key policies relating to the VAT reforms have been surprisingly accurate. However, in last year's edition we had expected that the remaining sectors yet to transition from Business Tax (BT) to VAT, being real estate and construction, financial services and insurance, and lifestyle services, would be implemented during 2015. However, this has not yet occurred.

The VAT reforms

Rather than devoting another chapter to the VAT reforms, in this edition of *China Looking Ahead* we focus more on longer-term domestic and international trends and how they will impact on China's indirect tax system. We raise the question of whether China will be a global leader, or a follower, in terms of indirect tax trends.

Before doing so though, it would be remiss us of not to provide at least a very brief update on the progress of the VAT reforms. During the middle of 2015, it is understood that the proposed policies for the remaining sectors to transition to VAT were due to be submitted to the State Council for approval. However, this occurred at a time when the Chinese economy was in a state of considerable uncertainty. The Shanghai Stock Exchange was experiencing near-double digit gyrations over the course of a single day; there was concern that the transition from a manufacturing based economy to a service economy was slowing growth, at least in the short-term; and the previously overheated property market in Tier 1 and 2 cities was flat-lining. Not surprisingly, the State Council likely concluded it was not an ideal time to introduce a major tax reform initiative such as the VAT reforms.

Other countries which have attempted similar reforms, such as India, Malaysia and the member states (Bahrain, Kuwait, Qatar, Saudi Arabia, Oman and the United Arab Emirates) of the Gulf Cooperation Council, chose to delay their indirect tax reform agenda when confronted with similar economic headwinds. Put simply, implementing significant VAT changes during periods of economic uncertainty and instability is extremely challenging.

It is now expected that the VAT reform policies for the remaining sectors will be introduced shortly, with implementation expected to take place in the latter part of 2016. Whether that timeline will still be met remains to be seen, and much depends on the Chinese economy re-stabilising. It is understood that the government is still fully committed to implementing the VAT reforms, so their implementation is more of a matter of "when" rather than "if". After all, leaving the job half-finished creates additional policy, compliance and administrative burdens for tax authorities and taxpayers alike.

Trends in indirect taxes internationally and how China's system compares

With the VAT reforms expected to be fully implemented in China in the near future, attention will then turn to the long-term development of its indirect tax system. Here we take a look at four trends which we are seeing internationally, and how China's system compares. The central conclusion which we reach is that China's indirect tax system has the potential to be a world's leader which actually sets the trend for other countries to follow, rather than being a late adopter of policies which have been road-tested and implemented elsewhere. This would be a dramatic development given that China's VAT system (in anything resembling its current form) was only introduced in 1994 (about 40 years after the French first introduced it), and even then, it was not until 2008 that its VAT system became more of a consumption-based tax rather than production-based tax (with input credits being allowed for fixed assets).

First trend – more comprehensive VAT base

The first trend is the anticipated shift towards more comprehensive VAT bases. (In this article, any reference to VAT also includes a reference to a goods and services tax (GST) which is the name given to the same tax adopted in countries such as Australia, New Zealand, Canada, Singapore and Malaysia.)

The OECD recently released its 'Consumption Tax Trends 2014', which highlights the fact that 21 out of 34 OECD member countries increased their VAT/GST rates at least once over the period from 2009 to 2014, with the average VAT/GST rate among OECD member countries now more than 19%. The obvious opportunity now is for governments to broaden the base – because their rates may be starting to reach a natural ceiling; to plug revenue gaps most commonly associated with the digitisation of global economies; or to continue the shift from corporate taxes to indirect taxes given the relative ease of collection and stability of the latter in times of economic uncertainty.

Interestingly, the OECD recently concluded (in OECD/Korea Institute of Public Finance (2014), "The Distributional Effects of Consumption Taxes in OECD Countries", OECD Tax Policy Studies, No 22), that reduced rates and other concessions were not an efficient way to protect lower income individuals and address the so-called regressivity of indirect taxes, which is the oft-cited reason given by policy makers for providing such concessions in the first place. A recent OECD study shows that many of these reduced rates actually benefit higher income households more than lower income households. This is particularly the case for reduced VAT rates on restaurant meals, hotel rooms and cultural goods, such as books, theatre and cinema tickets. This suggests that a better way to achieve equity and social objectives would be to remove these reduced rates and provide more targeted relief measures, such as income-tested benefits and tax credits.

Another "concessionary" area which will be watched closely is financial services. Historically, financial services were exempted from indirect taxes on the basis that it was considered

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too difficult to measure the value added on a transaction-by-transaction basis. However, the goalposts gradually shifted when countries such as South Africa recognised the ease with which VAT could be applied to financial services remunerated on an explicit fee or commission basis. General insurance policies also became subject to VAT/GST in countries such as New Zealand, South Africa, Singapore and Australia; and even in Europe, the exemption from VAT has been substituted by insurance premium taxes.

In the area of financial services, China's VAT system will potentially emerge over the next five years as being world leading. In particular, if the VAT reforms result in all, or nearly all, financial services being taxed under a VAT (as is proposed), then it can be expected that other countries will quickly follow suit. Only Argentina and Israel are known to apply a VAT to financial services, and in the latter case the VAT system deviates significantly from the traditional credit-offset VAT system.

If the Chinese experiment is successful, expect the debate about reforming financial services to be reignited in Europe, Canada, Australia and elsewhere. With the entry of market disruptors such as high-tech companies and traditional retailers into financial services, the rise of fee-based products, and more sophisticated pricing models used by financial institutions, many of the traditional arguments used to rebut the application of VAT to financial services now appear weakened. After all, the blurring of the lines between traditional banking products engaged in by the likes of the big 4 banks – ICBC, Bank of China, China Construction Bank and Agricultural Bank of China – and the tech sector, led by companies such as Alibaba with products such as Alipay, highlight the anomalies which would arise if the products of one were taxed under a VAT and the other was not.

Second trend – shift to a single rate VAT system

A related trend is the shift from multiple rate VAT systems to single rate systems.

Time and again it has been shown that complexities arise in VAT systems which have either multiple rates, or rely on excessive exemptions and concessions. Well known international cases highlighting everyday consumer transactions emphasise the problems which arise for both taxpayers and tax authorities – for example, whether a meal served on board an international flight should be treated as a separate taxable supply from the flight, which is zero rated (See *British Airways plc v Customs & Excise Commissioners* (1990) 5 BVC 97) ; whether medicines given to a patient visiting a doctor should be treated as a separate supply of goods from the medical service of seeing the doctor (See *Dr Beynon & Partners v Customs & Excise Commissioners* [2005] STC 55) ; and whether the supply of software is a good, or an intangible.

China, with its multiple rates of 3%, 6%, 11%, 13% and 17%, will inevitably need to consolidate into a single rate, or at least to drastically reduce the number of VAT rates in existence. Already, the use of multiple rates has posed a number of challenges, with sectors such as transportation being subject to 11% VAT, while the related logistics services are subject to VAT at a 6% rate; and in the telecommunications sector, the supply of a mobile phone may be subject to 17% VAT, whereas the use of data attracts a 6% VAT and calls attract an 11% VAT rate. The government officials have apparently recognised these complexities and are reportedly proposing to rationalise the number of VAT rates and move towards a single rate, with a reduced rate for some supplies.

One wonders whether the move to a single-rate VAT system in China could have been achieved in one hit during the implementation of the VAT reforms, though it is understood the policymakers were keen to manage the tax burden impact on business, and therefore adopted VAT rates which most closely mirrored the tax burden impact previously felt under BT. It is understood that the government would like to move towards a single VAT rate in the near future, and in so doing, one anticipates the rate would likely be towards the upper end of the current rates being used – somewhere between 13% and 17%.

Third trend – global framework for cross-border services and intangibles

The third trend, though perhaps likely to miss a 2020 target, is the shift towards a global framework for applying VAT to cross-border flows of services and intangibles. That global framework is expected to result in a high level of consistency between countries in the VAT treatment of international trade flows, based on the destination principle. This is the principle that VAT should be levied in the place where goods and services are consumed, not the place where they originate. The destination principle provides a very powerful response, in an indirect tax context, to the base erosion and profit shifting (BEPS) debate , which is ongoing in a corporate tax context.

As Professor Rebecca Millar recently noted (Millar, R. (2014). Looking ahead: potential global solutions and the framework to make them work. *The Future of VAT in a Digital Global Economy* 2014, Vienna, Austria: Presentation), there is a real contrast in the challenge for policy makers in taxing cross-border transactions under corporate taxes as compared with indirect taxes:

> Yet the conclusion that "something needs to be done" simply does not have the same significance for VAT as it does for income tax. This is not because VAT on global digital transactions is easy to collect: it is not. Nor is it because VAT raises different collection problems than income tax: for the most part, it does not. What is different about VAT is the almost universal agreement on the substantive jurisdictional principle that should be used to determine the tax base. Some countries might pay lip service to the destination principle, particularly countries with limited tax collection capacity and a high reliance on VAT to meet their revenue needs. Other countries – or their tax administrations and/or courts – might disagree about what the destination principle requires in particular circumstances. Nonetheless, there is little or no significant disagreement on the fundamental principle. Nor is there any significant disagreement about the most important aspect of the neutrality principle, which entails the notion that there should generally be no tax burden on business-to-business (B2B) transactions under a VAT. Thus, whatever it is that needs to be done, it is unlikely to involve a fundamental re-think of the jurisdictional basis upon which decisions are made about which country has the right to tax consumption.
>
> [Footnotes omitted]

While a single set of rules to be applied globally may be an unrealisable dream, agreement on framework principles is not. As the OECD has recently recommended (OECD (2015), *Addressing the Tax Challenges of the Digital Economy*, Action 1 – 2015, Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris), supplies of services and intangibles in a business-to-consumer (B2C) context should be taxed based on the place of performance where they are consumed "on the spot", such as services physically performed on a person, accommodation, restaurant and catering services, entertainment and sporting events, exhibitions and trade fairs. Business-to-consumer supplies should be taxed based on the "usual residence" of the customer for other supplies of services and intangibles, such as consultancy, accounting and legal services, financial and insurance services, long-term rental of movable property, telecommunications and broadcasting services, and online supplies of content, storage and gaming. And business-to-business (B2B) rules, where the emphasis is on achieving neutrality, should focus not only on where the business customer will use its purchases that final consumers will acquire, but also on facilitating the flow-through of the tax burden to the final consumer.

The logical consequence of this approach is the need for simplified registration and compliance regimes to enable suppliers without a physical presence in that jurisdiction to properly account for VAT. Governments will be incentivised to do so, given that they otherwise run the risk of having to rely on more difficult and costly enforcement and collection mechanisms.

Already we have seen movement towards the implementation of these principles with the adoption from January 1

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Jean is a certified public accountant and a holder of the lawyer practitioner qualification in China. With her strong accounting, auditing, taxation and legal background, Jean is well known as a China tax expert and is frequently invited as speaker by professional associations (for example, ACCA) and many universities across China.

2015 of the EU's Mini One Stop Shop, which not only invokes the destination principle for B2C transactions, but also seeks to simplify the compliance burden for business across EU member states. Similar measures have also recently been implemented in countries such as Norway, South Africa, Korea and Japan, with others such as Australia and New Zealand shortly to follow. It would not be surprising to see whole trading blocs, such as the Association of Southeast Asian Nations (ASEAN) economic community, banding together to administer collection systems on a more simplified basis. This is key: unless governments can come together to simplify or overcome the need for separate country registrations, tax filings, and compliance, they will in many cases be resigning themselves to an 80/20 level of tax collection: the idea that 80% of the revenue can be collected from 20% of taxpayers. The other 20% of revenue would likely go largely uncollected given limited enforcement options where the supplier does not have a taxable presence in that country.

From the perspective of China, the new VAT system already adopts the destination principle. However, for China there is both an opportunity and a challenge in applying this principle to cross-border B2C transactions. The opportunity is that if the Chinese VAT system can accommodate foreign suppliers registering and accounting for VAT on the supply of digitised services and other intangibles to end-consumers in China, then this will plug an ever-increasing revenue gap. At present, the liability to account for VAT is more theoretical than real, with compliance difficult to achieve in practice, and enforcement not known to be active. The challenge though is that the Chinese VAT system does not allow foreign businesses without a taxable presence in China to register and account for VAT. It also does not enable them to issue special or general VAT invoices, or to claim input VAT credits.

The registration system for Chinese VAT is inextricably linked to the system of business licensing, to foreign exchange controls, and many other aspects of the general regulatory environment in China. Any change to the VAT registration system in China to allow foreign entities to opt in, is difficult to achieve in isolation from broader regulatory change. Put simply, enabling foreign entities to register and account for VAT is no small change to implement in China. But it must be done.

If developments in technology such as 3-D digital printing mean, in the future, cars or houses effectively being supplied cross-border in an intangible form, then the consequences of not taxing (or at least not enforcing) cross-border B2C transactions, knows no real bounds.

Fourth trend – big data

This decade has seen a seismic awakening in the business world to the power of data and analytics. Historically the domain of the IT expert, data and analytics are now harnessed to drive business growth; to enter new markets; to drive change across operations, supply chain and finance; to understand and anticipate customer needs; and to implement new business models.

At a recent KPMG Global Indirect Tax Services event held in Hampshire, UK, participants from many of the largest multinational companies around the world debated eight key statements around the future impact of Big Data on indirect taxes. These statements, while deliberately provocative, paint a picture of the potential of Big Data post-2020. The eight propositions are:

1) No more periodic returns – tax will be settled in real-time. Already we have seen innovation in countries such as Brazil, which recently implemented a public system of digital accounting used to approve, store and certify commercial and tax bookkeeping documents, to enable tax authorities to make a complete assessment of their tax accounting information. China is well placed here too,

with its Golden Tax System providing a data download of transaction-level information to the tax authorities on a monthly basis. While not yet real-time, that solution is not far away and is inevitable. Interestingly, in a recent article published by Bloomberg BNA, two academics put forward a thought-provoking proposal as to how indirect taxes could be transformed into something more akin to a retail sales tax through real time tax collection.

2) Big data will close the VAT gap. While there is an abundance of anecdotal evidence supporting increased requests for information by tax authorities from business, much of that data has not been harnessed yet. This will change. Data analytics enables tax authorities to develop sophisticated risk profiles and conduct trend analysis, flag potential audit issues, and screen out higher risk cases for deeper investigation – cutting off avenues for fraud before they even occur. In China, data is being captured by the tax authorities through the Golden Tax System – now the challenge is for them to harness and utilise it to best effect. By analogy, just as we expect immigration officials to use data to pre-screen passengers before arriving at their destination, so too will tax authorities in China. Random audits will become a contradiction in terms.
3) The tax transparency debate will shift to indirect taxes. Several recent high profile media cases have highlighted a disconnect between community expectations around the contribution that multinational companies should make to tax collection in the countries in which they operate, and their actual contributions. This has led to mandated disclosure obligations in a number of countries, as well as new initiatives such as country-by-country reporting. The role of indirect taxes in that debate has been somewhat muted to date, raising issues such as: whether indirect taxes should be reported as part of a company's total tax obligations; and does a multinational company bear some responsibility if it is legitimately able to provide goods or services into a country without VAT? Arguably the consumer is the winner, but equally it may be contended that the supplier has secured a competitive advantage over locally-based businesses. Plainly in China, where B2C supplies of intangibles cross-border often escape the VAT net (in practice), the roles and obligations of these large technology companies will come to the fore.
4) Data quality and analysis will be the new audit battleground. The new tax audit battleground will be around the testing of business systems and processes, to better understand controls around manual interventions, and to see how those systems respond to changes as a result of new products or services, or new rates and indirect tax rules. The debate in tax audits will be around whether one data set is better than another – in other words, whether tax authorities' data which shows a certain correlation or trend is more accurate or robust than that of the company being audited. Tax authorities in Singapore have been among the leaders in this area, recognising the mutual benefit for both companies and governments in the former investing in controls over indirect taxes as a means of securing enhanced compliance, with the latter co-funding the costs of implementing it. China's recent foray into tax compliance agreements to encourage companies to implement better processes and controls, is a first step in a long journey.
5) Businesses won't control all their own data anymore. Banks and credit card processors are already playing an increasing role as *de facto* tax collectors around the world, with their data routinely being requested for analysis and to validate transaction-level data. Interestingly, that same transaction-level data which is so critical in an indirect tax context will increasingly be leveraged by tax authorities in a corporate or personal income tax context.
6) Your data will become very interesting to others. Increased information exchanges between governments will facilitate multi-country tax authority audits. Indirect tax systems will also increasingly rely on the VAT registration status of parties, or their address details, and that information will likely become publicly available.
7) Indirect tax rules will be written with data analytics in mind. For example, place of supply rules will cease to be based on vague or uncertain concepts such as residency for tax purposes. The use of proxies which rely on information already collected by the supplier will become the norm. For example, in China, the destination principle will not simply rely on vague concepts such as whether the supplier or the recipient is in China, but rather, will focus on more precise measurements, such as IP address or credit card information entered by the customer as part of the transaction.
8) You [the tax manager] will be redundant by 2020! This was a tongue-in-cheek suggestion designed to highlight the changing roles and responsibilities of tax managers as a result of the Big Data phenomenon. In the future tax managers will be more focused on issues such as how systems respond to changes in products, services and technology; testing the integrity of systems; and analysing trends and exception reporting. Big Data demand is expected to reach 4.4 million jobs globally, with two-thirds of these positions remaining unfilled. The point is simple – businesses need to retrain, recruit or upskill their tax staff to respond to the Big Data challenge. China is well placed given its tech-savvy population, but the major area for development will be in upskilling people to analyse the increasing volume of data being produced.

What does it all mean?

The truly fascinating issue to consider is how these megatrends will interact. If we have a shift towards single rate VAT systems with a more comprehensive VAT base, the adoption of a global framework for applying VAT to cross-border flows of services and intangibles, what happens when this is overlaid with the Big Data phenomenon?

Consider the following:

- The place of taxation for cross-border flows of services and intangibles will, in the near future, be based around proxies such as the customer's IP address, their credit card information, or the address they use as part of an ordering process. What this highlights is that data collection will drive the direction of the tax rules, rather than tax rules framing businesses' data collection needs. Put another way, tax rules will respond to business needs, rather than business responding to tax rules.
- The convergence of traditional financial services with the digital economy is likely to bring about a broadening of countries' VAT base, at least in the financial services sector. China's proposal to apply VAT to all, or nearly all, financial services, will make it world leading.
- Real-time tax collection potentially represents a win-win for both governments and business – while output tax may be paid more quickly, input taxes should similarly be refunded on a real-time basis. In theory this should lead to VAT systems operating in practice more like single layer retail sales taxes.
- The more comprehensive the VAT systems used throughout the world, and the more globally consistent the framework for dealing with cross-border flows of services and intangibles under a VAT, the better able business is to implement powerful tax engines. Auditing, both by business and tax authorities, will be focused on the quality and integrity of their systems, rather than technical detail.
- Technological development will allow developing countries to make quantum leaps in their tax collection and administration systems. Just as mobile payments are enabling more sophisticated banking and financing transactions in many parts of the world, so too will technology enable the gap between tax collection in developing and developed countries to be bridged. China is well placed here with its infrastructure (being the Golden Tax System) largely already in place, and with improvements progressively being made, including a move towards electronic invoicing.
- Increased volumes of goods now cross borders in non-physical form (for example, digital downloads), and as a result, the focus of collection and enforcement infrastructure operated by tax authorities will need to respond and adapt. With technological developments we could not have contemplated only a few years ago, such as 3D printing technology, over time the scope of what we deliver electronically is expected to substantially increase.

By international standards, certain aspects of China's VAT system still have room for considerable improvement, such as the need to shift towards a single rate VAT system, and the need to expand its VAT base to better enable the collection and enforcement of VAT on B2C cross-border supplies of digitised services and intangibles. However, once China emerges from the VAT reforms with a very comprehensive VAT base, and with the natural evolution of the Golden Tax System towards real time tax collection, China may emerge with a world-leading indirect tax system from 2020 and beyond.

Strengthening of administration and enforcement of IIT Law in China

The drivers and nature of increased IIT enforcement efforts by the Chinese tax authorities are considered in this chapter by Michelle Zhou, Chris Ho, Vincent Pang and Angie Ho

The PRC tax authorities have been strengthening their efforts on the administration and collection of individual income tax (IIT) from high income earners, including employees, through means of tougher enforcement and more frequent tax audits. This trend is considered likely to persist into coming years, driven in part by the need to compensate for tax revenue reductions arising from VAT reform. It should be noted that even greater changes are on the cards in subsequent years as China's 13th Five Year Plan looks to launch IIT reform and an estate tax.

IIT collection efforts spurred on by tax reductions arising from VAT reform

It has been three years since the Chinese government embarked upon an ambitious reform program in 2012 designed to replace Business Tax (BT) with a value added tax (VAT) throughout the services sectors of the Chinese economy. Though certain key sectors, such as the real estate and construction industries, the financial services and insurance industries, have yet to start the transition to VAT, the VAT pilot programme has expanded to cover most of the other services sectors.

According to the data released by the SAT, the VAT reform has resulted in a tax reduction for taxpayers in the three years since 2012 of Rmb374.6 billion ($58.8 billion), of which the tax reduction for 2014 is Rmb191.8 billion. For the period for 2015 recorded so far (January to June), the tax reduction due to the VAT reform has been more than Rmb110 billion.

Under the existing tax revenue distribution system, BT is distributed to the local government while VAT is distributed to the state at national level. While, with a view to promoting and supporting the VAT reforms, the VAT revenue arising from sectors and activity covered by the VAT reforms has been left for the moment with local governments, the tax reduction due to the VAT reform is obviously impacting the local government's revenue from taxation. Factoring in the future expansion of the VAT reform to cover all services sectors, the increasing VAT reduction resulting from VAT reform will continue to impact on local government revenues in the coming years.

In this connection, local governments have to seek more tax revenues from other tax sources, such as IIT, to meet their financial needs, given that IIT is one of the major sources of tax revenues retained by the local governments. As a result, strengthened IIT administration and collection will continue to be a focus of tax enforcement by local government in coming years.

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Over the years, she has undertaken speaking engagements at events held by the American Chamber of Commerce, Australian Chamber of Commerce, Canada Business Council and EU Chamber of Commerce to update their members on the latest regulatory developments and trends in Chinese individual income tax, as well as, for example, topics covering remuneration packaging and equity based compensation structuring. Michelle has also delivered lectures to students in the finance discipline of Fudan University on expatriation taxation. In recent years, Michelle and her team have successfully assisted clients with the tax and foreign exchange registration of equity-based plans in China since the introduction of the relevant regulations. She has also actively participated in various projects relating to design, implement and roll-out of employee incentive plans, including equity-based compensation plans.

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IIT reform and estate tax are anticipated for future years

As one of the six reforms reviewed by the China's leading group for overall reform during a recent meeting, fiscal policy and tax system reforms will be vitally important under the 13th Five-year Plan (2016-2020), which was high on the agenda of October's plenary session of the Communist Party of China Central Committee.

Tax reform will focus on the introduction of real estate tax, adjustment of the consumption tax and an overhaul of IIT. The theme for the tax reform is to "cut indirect taxes" like consumption tax and "add direct ones" such as real estate tax.

The reform of IIT is not just about thresholds, but will also consider overall income and spending, such as mortgage costs . The reform aims to practise "comprehensive tax levying" in China. Individuals are taxed at different rates for different category of income, such as salary & wages, independent service income, capital gains and house rental income. Under "comprehensive tax levying", all income sources of an individual will be collectively taxed at a uniform rate. The more a person earns, the more he pays. This will make it possible for the government to adjust the national income distribution. It will also help to narrow the gap between the rich and the poor.

The basis of IIT reform is the anticipated introduction of an individual tax identification system. Each taxpayer will have one personal tax identification number in the future which will be valid for all of his/her life. As of today, there is still no clear schedule for the IIT reform.

In addition to the IIT reform, the government wants to use estate tax to boost social programmes. In recent decades the Chinese economy has expanded greatly. As is often the case in countries that experience rapid economic expansion, most of the new wealth is concentrated in a small percentage of the population. Communist Party officials have started discussing the implementation of an estate tax for China. There is also no clear schedule, however, for implementation. Before the IIT reform and estate tax are implemented, the government will continue to focus on the enforcement of IIT administration and collection.

Increased efforts on tax enforcement

A local tax bureau in southern China hosted a conference on the common IIT issues for expatriate employees working in China and issued a list of key points which it focuses on in tax

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Vincent started his career with professional accounting firms in Canada in 1991 and has experience in various disciplines including tax, auditing and consulting. He arrived Beijing in 1998 and started to focus on providing PRC tax services to foreign investors in the areas of tax structuring, tax planning, general tax advice as well as tax compliance services.

Vincent has also been active in assisting many foreign companies in designing their corporate and operational structures in China to meet their business objectives, as well as many Chinese domestic companies on their pre-IPO restructuring and outbound investments.

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audits. The local tax bureau has been strengthening the administration of expatriate employee's IIT, and investigating under-reporting or evasion of the tax. Using IIT assessments, this local tax bureau collected nearly Rmb230 million in tax payments.

Similar to this local tax bureau, the tax bureaus in most of the cities in China have been strengthening the administration and collection on IIT.

Widening the net for tax audits

In the past 12 months, we have observed the PRC tax authorities applying enhanced methods for enforcement of IIT collection:

- comparison of employment income data collected from market research with income reported through tax withholding system to determine the reasonableness of income reported by the withholding agent/taxpayer;
- exchange of information with immigration authorities;
- making comprehensive assessments based on the filing documentation submitted by the withholding agent/taxpayer to identify targets with high risk of tax issues;
- interviewing the withholding agent and/or taxpayer to identify potential tax issues;
- pre-select companies with poor tax credit ratings to conduct self-assessment on potential tax underpayments; and
- conducting tax audits on selected companies which are perceived as high risk companies

Enforcement of worldwide income taxation on expatriate employees

China is one of the few countries in the world that subject its citizens to worldwide income taxation irrespective of their residence. However, this appears to be less than fully effective for many of its citizens residing overseas, though the rule has been around for more than two decades. In recent years, we have seen the PRC tax authorities begin with efforts to properly enforce tax collection in this regard.

Notably, Chinese local tax authorities have begun dialogues with multinational companies headquartered in the

PRC to enquire about the tax compliance status of outbound assignees. This is to ensure that regular monthly tax withholding continues for those staff staying on the PRC payroll and to ensure that year-end reconciliation tax returns are lodged to report offshore payroll.

For foreign expatriates working in China, tax authorities are now assessing their tax residency status to determine whether they are taxable on worldwide income in China, not only based on their cumulative period of physical residency in the PRC, but also relying on factors, such as availability of a permanent home in the PRC, place of vital interests and habitual abode.

In-depth review of application of preferential tax treatment to equity compensation

Certain equity-based compensation derived by employees of publicly listed companies enjoys a preferential tax treatment. This may apply where the corresponding equity-based compensation plan has been registered with the respective local tax bureau. The preferential treatment allows the equity compensation derived to be taxed as a separate source of employment income from the employee's regular monthly salary and wages derived in the same month, and subject to a lower marginal tax rate, which is determined solely based on the equity compensation. By applying this tax treatment the employee could lower his IIT liability on the equity compensation.

The aforementioned tax registration formalities are generally required at both the plan implementation stage and throughout the lifecycle of the plan. In this regard, companies not only need to fulfill the registration requirements at the time of implementation of the equity plan, but theoretically there are also subsequent tax registration requirements, that is, at the time of each new grant and each vesting/exercise after the equity plan is initially registered with the local tax bureau. Until recently, the subsequent tax registration requirements for equity-based compensation plans were not strictly enforced by the local tax bureaus in the PRC, and in certain cases, companies were applying the preferential tax treatment when withholding IIT from the equity compensation for its employees. We are, however, now observing that local tax bureaus in the PRC are catching up on this and requiring registration to be completed for all the events, and there have also been instances where application of preferential tax treatment was denied due to subsequent registrations not being completed. Companies are advised to review the tax registration status of their existing equity compensation plans to ensure that employees remain eligible for the preferential tax treatment.

Outlook

The key theme in IIT practice that is expected to continue for some years to come is the enforcement focus on high income earners. With the wider net which the PRC tax authorities are beginning to use to collect and exchange information for tax enforcement, it is imperative for companies to conduct regular reviews of the IIT and visa compliance status of their employees. Companies should also seek periodic advice on regulatory and practice developments with respect to staff reward or incentive programmes in place,to effectively managing IIT exposures.

Moving up the value chain – greater access to R&D incentives

This article by Alan Garcia, Yang Bin, Dylan Jeng and State Shi reviews global R&D Super Deduction policy trends and how these might apply to China in the context of its economic growth trajectory. The first section of this paper sets the scene of innovation and inclusive economic growth. The latter section describes how China compares to other jurisdictions that offer R&D incentives

The superior man, when resting in safety, does not forget that danger may come. When in a state of security he does not forget the possibility of ruin. When all is orderly, he does not forget that disorder may come. Thus his person is not endangered, and his States and all their clans are preserved.

Confucius

When one considers the efficacy of R&D tax incentives in the context of a sluggish and slowing Chinese economy (at least in comparison to China's stellar growth over the past two decades), it is important that such incentives generate benefits greater than the outgoing cost to tax revenue. In this way R&D policy outcomes may help to preserve the State to minimise the impact of a potentially more severe economic downturn in China.

The innovation and economic growth nexus

Thinking and planning ahead to minimise disorder and enhance China's economy is obviously both fundamental and critical in this 21st century age of disruption, and innovation is widely considered to be a dominant factor in stimulating economic growth. The Economist Intelligence Unit identified a number of key innovation indicators:

- innovation is beneficial to both national economies and corporate performance;
- innovative companies tend to outperform their peers;
- firms connected to high-tech clusters tend to outperform their peers;
- technical skills of the workforce and IT/telecommunications infrastructure are critical to innovation;
- small countries have an advantage; and
- return on investment (ROI) is higher in middle-income countries than in rich countries.

(*Innovation: Transforming the way business creates" Report: Sponsored by Cisco, 2009*)

A major factor concerning a country's ability to drive innovation is its capability and opportunity to actually undertake the work. When R&D investment by companies is encouraged and rewarded, this 'innovation capability' and opportunity is thought to increase exponentially. Technical capability is a strong attraction for local Chinese and foreign companies looking to establish or expand operations in China, and, when combined with effective R&D incentives, such a combination may lead to stronger economic growth and innovative technologies and outcomes.

Inclusive economic growth and the impact of technology and education

The World Economic Forum (WEF) in *The Inclusive Growth and Development Report 2015* highlighted friction around economic growth and the need to ensure such growth reaps benefits for a broad spectrum of society, including the unskilled and uneducated (and not just the Hurun Rich List (The Hurun Research Institute: Hurun Rich List 2015, October 15 2015, Shanghai)). In this context, the WEF reported that:

> Technological change can be an important driver of economic growth: in developing countries, a 10% increase in high-speed internet connections is associated with an increase in growth by an average of 1.4%. Yet, whether it tends to create inclusive growth in the absence of supportive public policies is hotly debated…
>
> *World Economic Forum: The Inclusive Growth and Development Report 2015 – Box 5: Technology and Inclusive Growth*

The WEF noted that technological progress may be linked to unequal global distribution of income by increasing the premium paid to high skilled workers while potentially shifting medium skilled activities to lower skilled workers or moving such work offshore at reduced cost. The question is often raised as to whether redundancies resulting from technological advancement will be offset by opportunities in the modern technological realm of artificial intelligence and robotics.

So the challenge for China is how to manage its transition from a 'manufacturer for the world' to a capable and technologically advanced and inclusive global economic leader. Geographic regions and individuals with access to knowledge delivered via the internet and technological innovations will more likely prosper economically than those without. Indeed, modern technologies can encourage successful establishment of small businesses and entrepreneurs:

> One study in Niger found that farmers increased their income by 29% when technology gave them better access to information. Online work offers opportunities for people who face barriers to working outside the home, whether due to geographical remoteness, physical disability, or cultural barriers (such as those against women's work in patriarchal cultures).
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> *World Economic Forum, Ibid*

It is encouraging to note that the Chinese government's Internet Plus national strategy seeks to integrate internet and mobile technology efficiencies into the country's retail, transport, health, finance and housing sectors. Given that access to start-up finance is absolutely critical to a growing economy, it is clear that advancements in mobile payment systems and online lending platforms that provide access to transparent financial services (including reputable loan products and other forms of funding such as crowd sourcing) will play a fundamental role in the success of budding start-ups and small to medium sized enterprises in China. This is particularly important to the Chinese economy in the context of the government's crackdown on underground banking and illegal foreign exchange trading.

Another key metric for inclusive economic growth is community access to education. Once again, technological advancement and capability is key to enhancing the accessibility of quality education to a broad spectrum of society–this is now possible through the provision of educational courses and qualifications via so-called open education universities and online technical courses across the world.

Innovation capability and knowledge based capital – a shift in focus

But the OECD notes that "where innovation comes from is changing… Strong knowledge based companies invest in a wider range of intangible assets, such as data, software, patents, designs, new organisational processes and firm specific skills. Together these non physical assets make up knowledge based capital."(OECD Multilingual Summaries: *Supporting Investment in Knowledge Capital, Growth and Innovation: Beyond R&D – considering 'knowledge capital' and its ability to drive growth and innovation*?) In many countries, business investment in knowledge based capital has been increasing faster than investment in physical capital such as equipment, buildings and hard assets.

Moreover, McKinsey & Co in its report: *Playing to Win: The New Global Competition for Corporate Profits*, highlights that for the past three decades many companies have enjoyed reduced input costs, significant profit growth and new market opportunities. But these historical market growth highs have mostly ended, especially for those in mature economies and markets – and new rivals are putting traditional leaders at risk. Consistent with the OECD perspective, McKinsey & Co highlight that companies with an asset-light footprint can avoid stagnation and disruption and, should plan ahead for resilience (as Confucius would also recommend). McKinsey stress the need for companies to focus on intangibles and new business armaments such as software, data and R&D.

Indeed this is playing out in the marketplace, as the 2015 KPMG M&A Outlook survey of 738 US based finance and M&A professionals found that nearly half of respondents said technology will be the most active industry for M&Ain 2015. This is followed by pharmaceuticals / biotechnology (33%). The primary motivators for technology deals are access to intellectual property and/or talent (50%), bolt-on acquisitions to enhance new products (42%), the acquisition of innovative technologies or products (41%), the desire to enter into markets (41%), and the desire to expand existing technology platforms (40%) (KPMG LLP Four Hot Trends Driving Technology M&A Growth In 2015: KPMG Survey).

It is clear that innovation capability and knowledge-based capital will drive a company's ability to succeed across many industries and countries.

Knowledge based capital: services sector in China

The services sector is a key component of knowledge-based capital innovation. However, until recently, China's prevailing focus on manufactured exports (combined with barriers to trade and investment in the services sector) has limited development of the services sector in China: "The Services Sector in China still accounts for a smaller percentage of GDP than the global average for developing countries… The sector has grown strongly in China in recent years, but it is arguably still smaller than it should be for an economy at China's stage of economic development." (Intracen.org: China Services Sector Analysis: page 2)

It is anticipated that a cut in GDP growth (potentially to 6.5% from 7% (*China Daily*, November 3 2015, GDP Growth targeted at 6.5% to 7% through 2020, Chen Jia)) for China's 13th Five-Year Plan (2016 to 2020) may facilitate reform and the switch to a services-driven economy. Indeed, Yu Bin, an economist with the State Council Development Research Centre (government think-tank) believes a slowdown is logical because the "service industry is comprising an increasing share of the economy. The service industry generally has a lower demand for capital investment than manufacturing industry, and inevitably when translated in terms of GDP growth, you get a smaller figure".(*China Daily* October 21 2015 Business Economists favor reducing GDP target to 6.5%, Chen Jia)

Importantly, in China's 12th Five-Year Plan (2011to 2015) the government highlighted services, and specifically Trade in Services (TIS), as strategic focal points. As such, China is opening-up commerce in sub-sectors such as logistics, finance, tourism, healthcare and education. This includes supporting activities in a broad range of service areas such as renewable energy, online trading and financial technology products, and high technology services (including software development and information systems improvement).

Not inconsistent with such forecasts is the 2015 Hurun Rich List which indicates that many billionaires were made in emerging service oriented industries. The list shows that technology was the fastest-growing source of significant wealth, and that almost all self-made individuals under 40 years of age made their fortune in the information technology sector.

Knowledge based capital: value-added manufacturing, agricultural modernisation and green technology in China

Nonetheless, traditional sectors such as manufacturing and agriculture comprise a significant portion of China's GDP. As a result, the Chinese government proposed the Made in China 10 year action plan earlier this year and policy makers are keen to emphasise value-added production and intelligent manufacturing. The aim is to upgrade the industrial sector and set targets for innovation, green and smart manufacturing. An important policy initiative within the Made in China plan is for R&D expenses in the manufacturing sector to double, with 40 manufacturing innovation centres to be created and carbon dioxide emissions to be reduced by 40%. President Xi in a written interview with Reuters on Sunday October 18 2015 stated: "The new type of industrialisation, urbanisation and agricultural modernisation and IT application that is in full swing has generated strong domestic demand and great potential for future growth."

Maintaining economic growth is a key policy consideration for the Central Committee of the Communist Part of China and its 13th Five Year Plan (2016 to 2020), and economists believe that key goals of the next plan will include promoting innovation and rapidly improving the environment across China. This will include a focus on new green technologies and the allocation of special funds to tackle pollution on a coordinated basis. Sectors where China plays a global lead include solar photovoltaic manufacturing and deployment of wind turbines. One would expect the focus for the next plan would be toward reducing the cost of solar and wind energy, linking energy to IT (for example, the internet of things), electric transportation, and increased investment in smart grid and energy storage.

The link between traditional industries' modernisation, technology and China's knowledge and capability to execute transformative projects of this nature could not be clearer.

How innovation and knowledge based capital drive growth

The World Bank suggests that technological innovation can help drive industrial growth and raise living standards, and China is a major driver of global R&D, doubling spending on R&D over 2008 to 2012, despite an economic slowdown in growth compared to 2001to 2008 (OECD Multilingual Series: OECD Science, Technology and Industry Outlook, 2014, p1). China's National Bureau of Statistics: Economic and Social Development Report 2014 states "that expenditures on R&D activities was worth Rmb 1,331.2 billion in 2014, up 12.4% over 2013, accounting for 2.09% of GDP" (Statistical Communiqué of the People's Republic of China on the 2014 National Economic and Social Development, National Bureau of Statistics of China, February 26, 2015). This statistical information supports recent comments by China's Vice–Premier Zhang Gaoli on November 1 2015 that innovation was the key to driving development (*China Daily*, November 3 2015, GDP Growth targeted at 6.5% to 7% through 2020, Chen Jia) and the Minister of Finance, Lou Jiwei's, statement that China is making innovation a focus for economic growth and is increasing its capacity to innovate (*China Daily*, October 22 2013).

The OECD knowledge capital report also provides evidence of the economic value of knowledge based capital and how it can boost economic growth and productivity in technology and manufacturing process improvement. For example, studies for the EU and the US show that "business investment in knowledge based capital contributed 20% to 34% of average labour productivity growth" (OECD Multilingual Summaries: *Supporting Investment in Knowledge Capital, Growth and Innovation: Beyond R&D – considering 'knowledge capital' and its ability to drive growth and innovation?*). It stands to reason that the services sector and value-added manufacturing / agricultural modernisation in China have tremendous potential to increase employment prospects for a fast-growing labour force, increase trade and exports and generally help achieve economic growth in China. And despite the slowdown in China's growth, the government's goal for jobs creation in urban areas remains at 10 million a year. Dr Dollar from the Brookings Institute states that job creation is important in boosting China's service sector and overhauling the economy: "Service sectors are going well. That is where most of the job creation is. So I think it makes sense to the government to focus on job creation that means paying more attention to the service sector." *China's 2015 GDP Target Means Healthier Growth: Experts 2015-03-05*; Crienglish.com)

R&D tax incentive policy rationale and characteristics

If one accepts the nexus between innovation – R&D – and a country's ability to achieve inclusive and sustainable economic growth, it seems logical that tax incentives to encourage R&D spending will help achieve this aim. In some countries and regions, such as the EU, a key priority for governments is that business investment in R&D should reach at least 3% of gross domestic production by 2020.

It is thought that government intervention to stimulate R&D is justified because R&D activity generates spillover benefits for society that outweigh the cost of the R&D subsidy. From a policy perspective it is commonly held that R&D incentives can:

- promote R&D activities that would not be performed in the absence of incentives;
- stimulate the creation and direct use of intangible assets in the production of goods and delivery of services, which may in turn induce spill-over benefits; and
- attract highly mobile capital by reducing the effective tax rates applicable to the income stemming from such capital.

Source: Innovation through R&D Tax Incentives: Some Ideas for a Fair and Transparent Tax Policy; Paolo Arginelli, World Tax Journal February 2015

Therefore, R&D incentives are considered to enhance innovation and decrease the cost of domestic R&D. This helps to retain R&D activities onshore where they will be undertaken in a tax effective location. A major factor in this equation is also capability to undertake the work.

An increasing number of countries favour tax incentives as opposed to direct grants or subsidies to support R&D. This is because tax incentives are usually broad brushed and do not attempt to pick winners. Across the world, the rate of R&D tax benefits (that is, the net tax benefit accruing to the applicant company resulting from the R&D incentive) is rising, especially within the EU and parts of Asia. For example, Thailand is in the process of increasing the R&D incentive from 200% to 300%.

R&D incentives are generally grouped into two categories. The first category refers to input incentives, which include expenses incurred in conducting the R&D activities. These incentives are often in the form of tax credits, super-deductions, offsets, and accelerated depreciation for R&Drelated activities. Output incentives include benefits related to income generated from eligible intangible assets – these are often referred to as patent boxes.

Including within industry and academia, R&D is undertaken at various levels. For R&D tax incentive purposes, the focus is mainly on business expenditure on R&D as opposed to academic research. As such, definitions of R&D for tax purposes generally include references to process improvement, product development, new knowledge and innovation. Tax systems for R&D are geared toward facilitating industrial / applied R&D as well as pure research. This is, by definition, iterative and evolutionary in nature, where businesses discover and develop new and improved processes, technologies, services and methodologies, having accumulated know-how and expertise over the years. Such a definition of eligible R&D is broader than the traditional laboratory or academic concept of blue sky R&D. Of course, R&D activities inclined towards revolutionary development (that is, where a breakthrough in technology and knowledge occur) is also clearly applicable to R&D tax incentives across the world.

Global R&D tax incentives landscape – a snapshot

If one concludes that innovation, knowledge-based capital and technological advancement intertwine to generate and support inclusive economic growth, what R&D tax incentives exist and how do such R&D tax incentives support economic objectives?

First, it is important to understand the R&D tax incentive landscape. KPMG has issued regional R&D incentive reports (KPMG: *R&D Incentive Guides: Asia Pacific 2015*; Europe Middle-East and Africa 2013; Americas 2014),which provide an update on available R&D tax incentive schemes around the world. Specifically, these reports contain country by country information on the design, scope and benefits associated with R&D tax incentive support. Generally, KPMG has found that many countries are introducing or reforming their R&D incentives; some are enhancing R&D benefits while others are tightening audit protocols to manage revenue leakage.

A 2014 OECD R&D report(OECD: *Measuring R&D Tax Incentives: Summary description of R&D tax incentive schemes for OECD and selected economies*, 2013, which wasbased on the results of a 2013 questionnaire conducted by the OECD Working Party of National Experts on Science and Technology Indicators) provides R&D tax incentive details for relevant jurisdictions. Key OECD data, trends and issues in a number of different areas related to R&D incentives include:

- as of 2015, 28 of the OECD's 34 countries offer R&D incentives for eligible R&D expenses – more than double the number in 1995.
- Some countries are making their incentives more generous (for example, UK, France, Thailand, Singapore, www.oecd.org/sti/rd-tax-stats.htm. OECD *Report: Measuring R&D Tax Incentives; & OECD Science Technology and Industry Scoreboard 2015*) while others are increasing R&D incentives but expanding audit activities to better manage compliance.
- Between the years 2006 and 2011, the OECD data indicates that direct support from R&D incentives increased for about 12 of 23 countries. However, direct R&D funding support dropped in some countries due to difficult economic conditions. Lower profitability during the global financial crisis limited some companies' opportunity to access various R&D incentives, especially incentives linked to profit.
- Australia, UK, Norway, Austria, France and some other countries allow companies to cash out R&D deductions if in a tax loss position. This tends to be available for SMEs but UK has extended this to large companies too.
- Australia, Singapore, Canada, France, Korea, the Netherlands and Portugal offer more generous tax savings to SMEs as compared to large companies.
- Some countries allow tax deductions to be carried-forward to allow companies to benefit from tax incentives when they are not profitable.

Large companies and R&D activities

Large companies traditionally undertake large-scale transformational or nation-building projects, with elements of R&D. They are linked to broader supply chains and create spin-off benefits, such as employment. The Dyson Report in the UK (Dyson, J, *Ingenious Britain: Making the UK the leading high tech exporter in Europe*, March 2010), found that large companies are likely to engage with universities and smaller companies to work together to undertake R&D and support innovation.

Large companies also have the resources to undertake significant, high risk R&D projects which other smaller companies may be unable to execute. Large companies employ a significant number of people involved in R&D, both directly and through contracts with companies and research entities. As these companies may typically have a global presence, decisions as to where to undertake R&D activities may be considered with every project.

As a consequence of the intrinsic direct and indirect value attributed to large companies' R&D activities, many jurisdictions around the world offer enhanced R&D tax benefits to large companies.

Small and medium sized enterprises (SME) and R&D activities

The SME company lifecycle often begins with (1) early stage innovation, and moves to (2) implementation/ applied development, and onto (3) incremental innovation, potentially building on the original core innovation. As the company matures it may (4) expand its technical capability and increase its core technology and products or platforms for further growth.

The empirical evidence suggests SMEs have revolutionised entire industries (*Business R&D in SMEs*; Raquel Ortega-Argilés Peter Voigt 2009 IPTS, IPTS working paper on corporate R&D and innovation 07/2009). Early-stage startups, entrepreneurs,and university spinoffs have produced major technological break throughs that have collectively changed society. Such companies also generate spill-over benefits since their technology and know-how is often purchased or relied upon by larger corporations (KPMG M&A report). This is despite the fact the small companies have limited capabilities, resources and income. They often incur tax losses and derive no benefit from R&D incentives that cannot be cashed out if the company has tax losses.

It is thought that smaller companies may therefore be at a competitive disadvantage (relative to MNEs) in undertaking and exploiting R&D. On this basis, improved design of R&D tax incentives, such as greater targeting of benefits to SMEs, is often implemented.

> SMEs and entrepreneurship continue to be a key source of dynamism, innovation and flexibility in advanced industrialised countries, as well as in emerging and developing economies. Therefore it is crucial to consider SMEs, and in particular their attitude to both R&D, and common trends (growth patterns, sector composition/trends), and the problems they face, in order to achieve an understanding of the EU economy's positioning in terms of business R&D.
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> *Business R&D in SMEs; Raquel Ortega-Argilés Peter Voigt 2009 IPTS working paper on corporate R&D and innovation 07/2009*

As such, policy makers may be willing to stimulate small business R&D spending by introducing tax incentives specifically targeting those companies. This may reduce financing constraints faced by SMEs and stimulate inbound M&A of small R&D companies (KPMG LLP *Four Hot Trends Driving Technology M&A Growth In 2015: KPMG Survey)*. This M&A activity is thought to generate spill-over advantages resulting from R&D performed elsewhere around the world, and attract foreign investment and improved products and processes for the local market.

As a consequence, some jurisdictions have implemented higher R&D tax benefits for SMEs as compared to large companies, also allowing SMEs to cash out benefits if the SME has tax losses.

UK

Since introducing its R&D assistance regime, the UK has increased support for small companies; extended the programme to large companies; enabled all large companies to report R&D assistance as an above the line benefit; and provided refundable benefits to both large and small companies.

Interestingly, a 2010 to 2012 review of the UK R&D regimes resulted in a change to the large company regime from a super-deduction to a credit. The above the line credit can provide increased visibility for technical teams undertaking R&D activity to drive investment decisions since the benefit is accounted for as income and can be owned by the engineering/science department rather than the tax function, since it is not technically a tax deduction.

The definition of an SME for UK R&D purposes is wider than the normal EU definition and is a company, organisation or group of linked or partnered companies with fewer than 500 employees and either of the following:

- an annual turnover of not more than €100 million ($107 million); or
- gross assets on the balance sheet not more than €86 million.

In the UK, SMEs access a higher R&D rate of 225% (230% after April 1 2015), which can be surrendered for a cash credit if in tax losses (at a rate of 14.5% by 225%). This amounts to a cash refund of £32.63 cash back for every £100 of qualifying expenditure incurred on or after April 1 2014 (increasing slightly after April 1 2015). However, a company may not be considered to be an SME if it is part of a larger enterprise that taken as a whole would fail these tests.

This expansion of its R&D programme has occurred during a tough economic period for the UK, however the promotion of R&D assistance across all sectors is considered as beneficial to the economy.

Singapore

Singapore introduced its R&D regime in 2009 and has since increased the level of benefit to all companies in a bid to encourage further investment in Singapore by multinationals and local operations. The programme was built upon the framework of existing, well established programmes already available throughout the world. In particular, the Singapore R&D incentive has a number of similarities to the requirements of the Australian R&D tax system.

A tax deduction of 400% of qualifying expenditure on the first SG$400,000 ($283,000) is available for R&D carried out in Singapore or overseas. A tax deduction of 150% of qualifying expenditure applies to the remainder for R&D carried out in Singapore only.

As an added tool to support SMEs in Singapore, a tax deduction of 400% of qualifying expenditure on the first $600,000 instead of $400,000 (that is, additional $200,000) is available to SMEs for R&D carried out locally or overseas.

Unused deductions may be carried forward indefinitely subject to the satisfaction of the shareholder continuity test or transferred to other related entities under the group relief system

Australia

In response to concerns over funding business as usual activities, the Australian R&D tax incentive scheme replaced the long-standing R&D tax concession in 2011. The R&D tax incentive includes a modified definition of eligible activities, narrows the scope of supporting activities; but raises the benefits for small companies in particular.

A tax offset of 45% (equivalent to a 150% deduction for comparison purposes) applies to SMEs with a turnover under A$20 million ($14 million) (this is much lower than the SME threshold in the UK). It equates to 15% net benefit for every eligible dollar, and 45% cash refund if the company has tax losses.

A tax offset of 40% (equivalent to a 133% deduction for comparison purposes) applies to larger companies. This equates to 10% net benefit per eligible dollar. With effect from July 1 2014, a $100 million threshold applies to R&D expenses. Clearly this cap will limit the benefit for some large local and global companies.

The tax deductions may be carried forward indefinitely.

Research indicates that the R&D tax incentive has had a positive impact on business expenditure on R&D (BERD) in Australia, with BERD as a percentage of GDP generally increasing over time. This can be attributed to more companies taking advantage of the tax benefits provided by the R&D incentive. (Australian data comes from ABS cat. no. 8104.0 (various issues) and OECD data from MSTI 2013/1.)

Asia Pacific region

Table 1 (KPMG ASPAC R&D Incentives Guide 2015) highlights the nature and value of R&D tax incentives available to small and large companies in the Asia Pacific region.

We note that Thailand, Malaysia and Sri Lanka offer the highest net benefits per eligible R&D spend across Asia.

Table 1

Jurisdiction	Enhanced Tax Benefit	
	Typical SME benefits	Typical large company benefits
Australia	Corporate tax rate: 30% Benefit: 45% refundable offset	Corporate tax rate: 30% Benefit: 40% non-refundable offset
China	Corporate tax rate: 25% Benefit: 150% deduction	Corporate tax rate: 25% Benefit: 150% deduction
India	Corporate tax rate: 33.99% Benefit: 200% deduction	Corporate tax rate: 33.99% Benefit: 200% deduction
Japan	Corporate tax rate: Benefit: 12% credit	Corporate tax rate: Benefit: 8% credit
Malaysia	Corporate tax rate: 25% Benefit: 200% deduction	Corporate tax rate: 25% Benefit: 200% deduction
Singapore	Corporate tax rate: 17% Benefit: 400% deduction on first SGD 600,000 then 100% deduction on remainder	Corporate tax rate: 17% Benefit: 400% deduction on first SGD 400,000 then 100% deduction on remainder
South Korea	Corporate tax rate: 24.2% Benefit: 25% credit	Corporate tax rate: 24.2% Benefit: 4% credit
Sri Lanka	Corporate tax rate: 28% Benefit: 200% deduction	Corporate tax rate: 28% 200% deduction
Taiwan	Corporate tax rate: 17% Benefit: 15% credit up to 30% of tax due	Corporate tax rate: 17% Benefit: 15% credit up to 30% of tax due
Thailand	Corporate tax rate: 20% Benefit: 200% deduction	Corporate tax rate: 20% Benefit: 200% deduction

Patent box

Patent box regimes offer enhanced income tax treatment for profits derived from eligible intangible assets. These are usually in the form of tax relief on royalty and licence income. The tax incentive/benefit is often extended to capital gains realised on the disposal of eligible IP assets. Patent box regimes take the form of a partial exemption or a notional deduction of the relevant eligible income.

Patent boxes are therefore output based in the sense that the tax incentive usually applies after the core R&D activities have ceased, when income is derived. As a consequence, patent boxes are sometimes considered to be less effective at promoting R&D activities than input-based R&D incentives.

Patent boxes have sprung up in many EU member states in an attempt to protect their tax base since some companies were moving their IP offshore notwithstanding that the R&D activity originally occurred onshore.

Commentators therefore contend that some patent boxes can generate unintended tax leakage because multinational groups may seek to locate the IP in jurisdictions with lower effective tax rates for related royalty, profits and capital gains. It is possible, if the patent box is not carefully designed, that the substance and economic value of the R&D activity may occur in one country (where tax deductions and incentives may be derived) but that the income to be gained from the R&D results is transferred to a lower tax jurisdiction with an attractive patent box regime. Such preferential tax rates on royalties and licence fees can be between 15% and 0% in certain countries.

China's R&D Super Deduction and recent changes

In China, the R&D super deduction is an input incentive that offers companies a 150% tax deduction for eligible activities. This provides companies with a net tax saving of 12.5% for every eligible expense. To be eligible, a company's technological activity must itself involve, new knowledge applied in a creative way, and result in an improved product or process. For example, if a company spends Rmb10 million on eligible R&D expenses that involve new knowledge, improved products and/or processes and achieve an advancement in science and technology, such expenditure will generate a tax saving of Rmb1.25 million. This definition is very broad and can include improvements to products and technologies in many industry sectors such as financial services (usually software development), IT, logistics, agribusiness, manufacturing, engineering and mining – as well as more typical R&D industries such as pharmaceuticals and automotive.

China's net saving of 12.5% is on the low-side in comparison to some other Asian countries such as Thailand and Malaysia. However, it is also important to consider a company's ease of access to the relevant R&D programme. It's fair to say that some countries, while offering healthy R&D tax savings on paper, may make such savings difficult to access in reality. On the ease of access metric, China's R&D Super Deduction application process is reasonably competitive – perhaps not as transparent or consistent as some Western countries, but better than some Asian neighbours.

R&D Super Deduction: Improvements issued on November 2 2015

On November 2 2015 the Chinese government released Notice on Policy Improvement of Research and Development Expenses Super Deduction Cai Shui [2015] No. 119, which includes the following key changes:

From January 1 2016:

The scope of eligible R&D activities and R&D expenditures will expand. The adjusted policy will apply a Negative List method. This means that companies will need to satisfy the definition of R&D activities but will no longer need to match the activity to one of eight High New Technology categories. This is a significant policy change and consistent with global benchmarks. It suggests that all R&D activities shall be eligible for the R&D Super Deduction, unless specifically listed as ineligible.

In the future, companies will be able to deduct previously unclaimed R&D expenses for the preceding three year period. In the global landscape for R&D incentives, this is curious policy that rewards prior R&D activity. Some economists and academics may prefer to see additional funds allocated to current or future projects in the form of higher net benefits (for example at 200% rate) rather than reward companies for R&D previously undertaken.

The allocation and accounting of R&D expenses will be simplified. According to the original policy, special account management for R&D expenses was required. The new policy will allow companies to use auxiliary or supplementary accounts to support the relevant R&D expenses. This initiative should be applauded and it is consistent with other jurisdictions where a separate R&D account to track expenses is not required. For example, in the UK and Australia, activities that constitute R&D for tax purposes are those which meet the definition of R&D activities, even where the project itself may not be separately treated as R&D in the company's accounts.

Companies will experience streamlined R&D validation procedures, adopt post-filing management for the R&D Super Deduction, and may apply updated accounting methods regarding deductible R&D expenses. This is another significant improvement as the Chinese compliance process

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In China, Alan focuses on the R&D Super Deduction and HNTE / ATSE. He deals with State Administration of Taxation (SAT) / Ministry of Finance (MOF) regulators regarding interpretation of R&D incentive rules and regulations, and liaises with government regarding issues such as incentive policies and audit defence. Alan specialises in identifying all material R&D activities and associated R&D expenditure. This includes the provision of tailored knowledge transfer workshops and extensive analyses and processing of financial data – including understanding IP location issues, cross-charge/reimbursement across jurisdictions and associated financial risk.

Across ASPAC, he has extensive experience in undertaking R&D reviews for global and local companies. In particular, Alan manages high value R&D audits and inland revenue reviews and appeals and provides advice on legal R&D issues, including strategy and R&D planning.

Key areas of experience include the following: automotive, process and materials engineering; chemical engineering; banking and finance; information technology; energy and natural resources; manufacturing process, including automation; recycling process development; environmental sustainability projects; pharmaceuticals, and food and beverage development and processing efficiency.

Alan also assists companies to identify potential government grant opportunities and preparation of competitive grant and subsidy applications. He has extensive experience in tracking the changing funding priorities of governments across Asia and assists companies to access appropriate funding opportunities, particularly for the innovation or commercialisation of new technologies and/or for projects that deliver environmental benefits.

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Bin also has in-depth knowledge of R&D incentives in China and has been actively assisting multinational companies as well as China domestic enterprises in R&D planning, R&D incentive application and R&D audits.

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can be unduly complex. It suggests a move toward self-assessment which is consistent with many other R&D incentive programmes globally. However, contemporaneous and post-filing recordkeeping will be a critical step to managing tax compliance as the tax authorities aim to audit 20% of R&D applications and may retrospectively undertake audits of prior year R&D claims.

In addition to expenses listed in the previous *Guo Shui Fa* [2008] No116 and *Cai Shui* (2013) No70, additional expenses such as trial product testing and inspection fees, consulting fees, cooperative or contract R&D related costswill be eligible R&D Super Deduction expenses. Once again, such changes should be applauded and are consistent with global benchmarks.

However, the government has listed a number of ineligible industry categories:

1) Tobacco manufacturing
2) Accommodation and catering industry
3) Wholesale and retail business
4) Real estate
5) Leasing and business services
6) Entertainment businesses
7) Other industries as prescribed by the Ministry of Finance and State Administration of Taxation

So even if a company in these sectors is undertaking highly innovative activities, it is possible such companies will not be eligible to claim the Super Deduction. Of the regulation changes issued on November 2, this particular provision is at odds with the general move in China, and globally, toward a services-consumption driven economy.

Otherwise, the R&D Super Deduction in China should, in principle, be applauded. We are expecting more detailed R&D Super Deduction guidance materials to be released to clarify specifically how the above initiatives will work in practice, and, as usual, the devil is often in the detail.

A key success factor to consider is how the many local Chinese tax bureaus will actually implement and interpret the abovementioned policy improvements.

Recommended enhancements to China's R&D Super Deduction

In the context of the global R&D tax incentive and economic landscape mentioned in this paper, we consider that the following enhancements to the R&D Super Deduction regulations may help achieve government innovation policy objectives:

'Rule of law' interpretation of the R&D regulations and creation of specialist national R&D audit teams to review selected R&D Super Deduction applications

It is important to attempt to ensure that government officials follow a 'rule of law' interpretation of R&D Super Deduction regulations. In this regard, regulatory guidelines should be clearly drafted and both companies and tax authorities must adhere to them. It is also important that the various local tax authorities across China apply a consistent interpretation of the R&D regulations. This can be difficult considering the decentralised nature of the SAT and various science and technology bureaus. In this vein, the government should consider creating: a national R&D sub-group within the SAT to conduct any applicable R&D tax expense audits; and a national R&D sub-group within the Science and Technology Bureau to conduct any applicable R&D technical audits across China.

'Cash out' and higher R&D benefit rate for SMEs in tax losses

The global trend in R&D incentives is to encourage and reward SMEs for undertaking R&D activities. This has taken the form of cash out benefits (usually at a higher rate than those available to large companies) to the extent that the company has tax losses, that is, the R&D benefit can be crystallised in the current year rather than carried forward.

We would recommend that the Chinese authorities investigate how this cash out policy might apply in the context of the Chinese economy. Policy makers might also consider whether a similar scheme should apply to large companies, such as the UK R&D relief scheme.

'Above the line' treatment of the R&D benefit

As mentioned above (refer UK section), the Chinese R&D regulations should be amended to allow the R&D Super Deduction benefit to be reflected above the line in corporate accounts, that is, the benefit may be booked as income in the profit and loss statement of the company. This would result in minimal loss to tax revenue but encourage greater participation in R&D.

Higher R&D Super Deduction rate to encourage business collaboration with universities

Countries such as Australia are examining how to encourage greater collaboration between business and universities (*Australian Financial Review*: Christopher Pyne seeks to fortify business science bonds with tax breaks, October 26 2015). This may take the form of R&D incentives directly linked to collaboration with universities to commercialise ideas successfully and traverse the technology/innovation valley of death, that is, help bridge the gap between an innovative product or process and full-scale implementation. As highlighted by the WEF:

> Technological change is the result of conscious decisions taken by scientists, investors, governments, and consumers, and its nature and direction can be influenced by public policies and market incentives. There is a role for public-private collaboration in mitigating the social and economic risks presented by technological change, and for maximizing benefits to produce more widespread stability and prosperity.
>
> World Economic Forum: *The Inclusive Growth and Development Report 2015 – Box 5: Technology and Inclusive Growth*

This policy initiative appears to have merit given that science, technology and access to education are fundamental to innovation.

Charge to expense of R&D costs usually capitalised for accounting purposes

Some countries provide that costs incurred in intangible asset creation can be expensed through the profit and loss statement, notwithstanding that accounting principles may require capitalisation of such costs. This tax treatment provides a cash flow benefit by "creating a mismatch (only for tax, not accounting purposes) between the accrual of revenues and the accrual of related costs" (P. Palazzi, *Taxation and Innovation*, OECD Taxation Working Papers, no 9, OECD Publishing (2011), p10). If the R&D Super Deduction rate of 150% could also be applied to the relevant expense in China, then a permanent tax benefit of 12.5% would be derived by the eligible entity. In terms of increasing investment in innovation, from a policy perspective this makes sense for China and may enhance China's existing R&D incentive programme since intangibles are increasingly relevant to expanding knowledge based capital.

R&D expenses charged to cost of goods sold

An approach by some Chinese tax authorities is that expenses allocated to Cost of Goods Sold (COGS) are considered routine in nature and ineligible for the R&D Super Deduction. While the R&D regulations do not prohibit such expenses, the COGS treatment is occasionally used by some Chinese tax

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State was seconded to KPMG Australia in October 2010. He focused on advising Chinese clients on their investment and operational activities in Australia as well as Australia clients investing to China. Over five years in Australia, State has been involved in a number of high-profile transactions between China and Australia and is well recognised by the market as the tax man in the corridor.

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authorities to limit the scope of eligible expenses. It is hoped that the new updated R&D regulations (refer above) clarify this issue to ensure that R&D COGS expenses are no longer deemed ineligible. This would be consistent with R&D incentive programs globally.

Accelerated depreciation/amortisation

Accelerated depreciation/amortisation of assets used in R&D input activities is encouraged in certain countries. This provides a cash flow benefit by increasing the present net value of depreciation/amortisation deductions. The regulations suggest that Chinese entities may deduct such costs but accelerated depreciation/amortization is not permitted since the depreciation rate for R&D assets is the standard 10 years.

In terms of increasing investment in innovation, from a policy perspective it is logical for China to modify the regulations to allow accelerated depreciation and amortisation for R&D related assets since asset acquisition and construction is inherently relevant to expanding R&D capability.

It would also be prudent to clarify the Chinese regulations to confirm that companies can pro-rate the deduction for the asset to the extent it is used for R&D purposes rather than to require exclusive use of the asset for R&D purposes.

Indefinite carry forward of R&D deductions

Indefinite carry forward of R&D deductions for companies with losses is regarded as best practice. In China, carry forward deductions expire after five years. We recommend that the regulations in China be amended to allow indefinite carry forward.

Outsourcing R&D activities

Whenever there is more than one entity undertaking an R&D project (for example, where R&D activities are contracted out to another party), a key issue to resolve is which entity should claim the R&D incentive for the cost incurred.

MNE cost-plus or contract R&D expenses

In recent years, countries such as Australia have modified the R&D regulations to allow resident companies within a multinational group to obtain R&D incentive relief even though the R&D expenses are reimbursed by a related offshore entity and where the IP is owned by the offshore entity. In this situation the policy objective is clearly to attract actual performance of the activity to Australia.

In China it is very common for MNEs to engage local Chinese subsidiaries on a cost-plus basis to undertake R&D on behalf of the global group. If the policy intent behind the R&D Super Deduction is to encourage greater R&D activity in China, then it is appropriate for policy makers to consider the Australian precedent and allow cost-plus R&D expenses to be deductible under the R&D Super Deduction.

R&D activities contracted out to other local unrelated companies

Where all the R&D activity for a project occurs within the one country, and is contracted to one or more unrelated entities, then R&D incentive policy must determine which entity should claim the deduction. The purpose of legislative provisions in this regard is to ensure that the same R&D expense is not claimed by multiple entities. In this context some jurisdictions apply an 'on own behalf test' which involves awarding the R&D benefit to the entity that (1) owns the IP, (2) controls the activity, and (3) bears the financial risk. Other jurisdictions deem that the entity that pays for the work is entitled to the deduction.

In China the recent *Cai Shui* (Notice on Policy Improvement of Research and Development Expenses Super

Deduction Cai Shui [2015] No. 119 'Entrusting party allowed deduction') states the latter approach applies, but in practice the authorities may require that the IP is also owned by the claimant company. This is a point of uncertainty for Chinese taxpayers and requires clarification.

Patent box

Given the global focus on base erosion and profit shifting it may be prudent to defer implementation of any potential patent-box-type incentive in China.

Some countries are currently reviewing patent efficacy, and considering patent box systems which more effectively link the R&D activities to downstream income benefits.

Innovation-rich

This paper suggests that knowledge based capital and innovation are dominant factors in generating inclusive economic growth and influencing patterns of world trade. In China the R&D Super Deduction(and other incentive programmes such as High New Technology Enterprise Status and Advanced New Technology Enterprise Status) encourages and rewards investment by Chinese companies and MNEs to create new or improved products or processes. The R&D Super Deduction may be seen as a tool to grow China's knowledge capability and increase business expenditure on R&D. This increased technical capability itself is a strong motivating factor to drive foreign and local investment into China.

The various initiatives undertaken by the PRC government (including those described in this paper such as the 12th Five Year plan, Internet Plus national strategy, Made in China 10-year action plan, and R&D Super Deduction) – combined with broader structural economic reforms – may coalesce to achieve steady and stable growth for China in the midst of technological change and disruption.

Klaus Schwab, founder and executive chairman of the WEF, recently stated that countries will soon no longer be described as "emerging" or "advanced" but rather "innovation-rich" or "innovation-poor" and China is well on the way to being an "innovation-rich" country. With careful government planning and collaboration with key community stakeholders, this may be achieved and sustained in the context of a potential structural slowdown in the economy.

New customs opportunities and risks in China

In this chapter Eric Zhou, Helen Han, Dong Cheng, Philip Xia and Melsson Yang discuss the changing customs duty implications for e-commerce enterprises, the impact of the new free trade zones and China's growing network of free trade agreements

In 2015 China's General Administration of Customs (GAC) has shown its commitment to updating relevant legislation and improving customs clearance and supervision policies and processes. Import tariff rates are being effectively reduced, bilateral & multilateral negotiations to facilitate international trade are making progress, customs efficiency is increasing, reforms in customs clearance and trade facilitation are constantly being deepened, the integration and optimisation of various types of Special Customs Zones (SCZs) is speeding up, and enterprise management and self-discipline systems in line with international practice are taking shape.

China's import and export tax rates may face more frequent adjustment in the future

In 2015, China made adjustments to consumption tax and import duty rates with a view to encouraging increased importation of consumer goods, to promote expanded domestic consumption levels, and better environmental governance, including energy saving and emission reduction. The adjustments were also aimed at easing the tax burden on enterprises to assist them in improving their competitiveness in international markets and encouraging industry transformation and upgrading in a harsh global economic environment.

To this end, in 2015 consumption tax rates were increased for the importation of refined oil products, import duty rates for consumer goods such as garments, footwear, skin care products, and disposable diapers were reduced by an average of more than 50% from June 2015, and export VAT refund rates for some high value-added products, core milling products, textile and garments were increased with effect from January 2015.

Since the overall economic outlook globally remains clouded, China may adjust import and export tax rates more frequently in the future than in the past. Enterprises should keep an eye on the change and properly plan and adjust their operating strategies.

Enterprises should pay close attention to administrative rulings on Customs Tariff Number (HS code) classifications

From July 1 2015, the GAC empowered Shanghai Classification Sub-centre (上海归类分中心) to issue administrative rulings on classification of merchandise (Chapter 84 to Chapter 90 of the Harmonised System rules) upon the application of business operators registered in the Shanghai Pilot Free Trade Zone (Shanghai PFTZ). According to a related notice issued by Shanghai Customs, importers and exporters may submit an application to

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Helen worked as a project leader in the Customs authority and a trainer for nationwide Customs officials. She was sent by GAC to study post-clearance audit, price valuation, risk management and customs management abroad, and also attended a few international customs academic seminars to discuss with World Customs Organisation experts on behalf of the PRC Customs. She was involved in writing and designing regulations, and used to organise, and was responsible for, some important cases.

Since joining KPMG, Helen has been integrally involved in a wide range of customs projects such as consulting, compliance and defence, including customs valuation, processing trade, internal control implementation and related-party pricing. She provides services to many multinational corporations in various industries. She has also been a guest speaker at various customs seminars and training courses hosted by Customs authority.

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the responsible customs authority for an administrative ruling or engage a third party to submit the application on their behalf. The application will be escalated to the Shanghai Classification Sub-centre, which shall issue administrative rulings within 60 days upon acceptance of related application material. The rulings should be sent to the applicant in writing and be published in the public domain and are applicable to all customs authorities within the territory of China beginning on the publication date. Goods imported or exported under the same conditions shall be subject to the same administrative rulings.

For enterprises, the administrative ruling on the classification of goods has three benefits: it solves difficult classification issues and increases the customs clearance efficiency; it is equally binding on both the enterprises and Customs; it helps enterprises estimate the cost for customs clearance and increases the predictability of cross-border trade business by allowing applications before import and export.

Considering the general binding force of the rulings, enterprises should pay close attention to the administrative rulings on classification of goods published by Customs to see whether the classified goods are the same as their own import or export goods. If they are the same, enterprises shall declare the same HS code to Customs accordingly. Failure by enterprises to adopt administrative rulings on classification of goods in time could affect customs clearance efficiency and the enterprise may face punishment by Customs for not correctly declaring the HS code of the goods. Since the classification of goods is highly technical, enterprises should seek assistance from professional advisers.

Import & export by cross-border e-commerce enterprises faces opportunities and challenges

The development of the internet has led to an explosion of cross-border online shopping and e-commerce imports and exports. Pilot cities for special cross-border e-commerce import regulations only include Shanghai, Chongqing, Hangzhou, Ningbo, Zhengzhou, Guangzhou, Shenzhen and Tianjin. Where an individual living anywhere in China imports goods via a pilot city the customs authorities of that city will impose solely the Personal Postal Articles Tax (PPAT) on the imported goods rather than the full range of taxes which would normally apply. For most consumer merchandise, an importer needs to pay duty (generally more than 9.8%) and import VAT (generally 17%) if goods are imported in general trade. Goods produced and sold purely

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Before joining KPMG in January 2004, Dong Cheng served as the director of policy research in the Shanghai Customs from September 1991 to December 2003. During his tenure, his role was to research complex customs issues from the various local customs units in the Shanghai region and advise them on the appropriate treatment. In addition, he was involved in the drafting of a number of PRC customs regulations. Over the years, Dong Cheng has developed excellent relationships with senior customs officials throughout the PRC.

Since joining KPMG, Dong Cheng has been integrally involved in the analysis and development of resolution strategies for multiple trade and customs issues, including customs valuation, import tariff classification and related-party pricing.

Dong Cheng gained extensive knowledge and experience in all major areas of customs duty activities, such as valuation, duty reduction and exemption, duty collection methodology and customs policy implementation study, through providing services to many multinational corporations in various industries, including automobile, chemical and luxury goods. These services comprise strategic planning, duty saving and industry-specific analysis. He has also assisted many multinational companies to cooperate with Customs audits on various issues, such as smuggling and the false declaration of import goods.

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In KPMG, he has been actively involved in a wide range of customs projects such as customs valuation, compliance review and internal control improvement. He has advised multinational clients on various customs cost-saving opportunities, such as duty-free equipment and processing trade practice. He has also assisted his clients in audit defence and customs operation setup issues.

His clients include manufacturing, logistics and trading companies. Industries involved include electronics, chemicals, machinery, aeroplane repairing, luxury consumables and foods.

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domestically within China would be subject to tax at 17%. However, where PPAT applies under the pilot e-commerce scheme, a combined import tax of as low as 10% applies.

This pilot e-commerce tax scheme is consequently leading to market distortion issues as well as potentially eroding the tax base (tariff, VAT and income tax). Customers may be inclined to purchase from pilot cross-border e-retailers rather than domestically, given the 7% tax saving, and businesses selling into China are incentivised to alter their traditional B2B2C selling mode to B2C. Therefore, future adjustments of the tax mechanisms related to cross-border e-commerce are becoming the focus of attention of the industry.

To gain market opportunities, enterprises need to make proper business decisions in an unclear, uncertain environment. E-commerce enterprises should consider the following issues: the location selection of the project, product scope, tax and other costs, business modes, marketing, as well as potential tax scheme adjustment and related regulatory environment change.

Construction of Pilot Free Trade Zones and integration of special customs zones is accelerating

By 2015, China announced four PFTZs in Shanghai, Guangdong, Tianjin and Fujian. The top-level structure of the four PFTZs is basically the same but the strategic positioning is different. The Shanghai PFTZ is the first PFTZ in China and was aimed at playing an exploratory role in reforming and facilitating trade and investment. The Tianjin PFTZ is aimed at promoting the synergistic development of Beijing, and Tianjin and Hebei provinces, developing the full potential of financial leasing. Guangdong PFTZ's mission is to support cooperation between Guangdong, Hong Kong and Macau. The Fujian PFTZ is positioned to open and cooperate with Taiwan.

Since there are the above established free trade zones and more waiting to be approved, enterprises may have difficulties in understanding each zone's pros and cons, and in selecting the best investment and operating locations, particularly when the detailed policies of the established zones are still not clear. Enterprises can cooperate with related government bodies and professional research institutions to study and consider the PFTZs from perspectives such as business

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Melsson started his career as an officer with China Customs, after graduating from a top customs school, then he moved to the private field, and was responsible for customs and logistics operations of a well-known telecommunications manufacturer. He also served at leading logistics and supply chain management companies as the regional customs & solution manager for southern China. Melsson is a member of the expert panel for the Guangzhou government and a licensed customs broker.

entrance, tax, customs, foreign exchange, inspection and quarantine, business and operations.

The exploratory implementation of related policies and an innovative supervision mode for PFTZs bring development opportunities for SCZs . On August 28 2015, the State Council published the Notice on Distributing the Plan on Speeding up the Integration and Optimisation of Areas under Special Customs Supervision (the Plan). The Plan stipulates that:

- qualified SCZs shall be integrated and upgraded to comprehensive bonded zones;
- different types of zones under special customs supervision shall be integrated and their functions expanded to cater for the regulations conducive to economic development; and
- tax policies for SCZs shall be adjusted, especially policies on export VAT refund and enterprises' status as VAT general taxpayer.

This document may not only affect bonded processing, modern logistics and traditional trading businesses, but also facilitate cross-border leasing, cross-border e-commerce, maintenance and test, and reproducing industries. Enterprises operating in related sectors in China should pay close attention to this document and the specific implementation progress to provide reference for their decision-making and daily operations.

Bilateral and multilateral international free trade agreements may bring tax savings

While building free trade zones, China is also actively participating in bilateral and multilateral international free trade agreement (FTA) negotiations. There are 19 FTAs under negotiation by China, involving 32 countries and regions. Tariff concessions (or zero tariffs) are some of the main advantages of FTAs.

However, due to a limited understanding of FTAs, Chinese enterprises do not take full advantage of regional preferential certificates of origin. A few enterprises which have already applied for preferential duty rates under FTAs do not pay enough attention to the compliance management of certificates of origin either, exposing them to compliance risk that should not be ignored.

Enterprises need to pay attention to the negotiation progress and implementation of related FTAs, and evaluate, plan and adjust supply chain arrangements accordingly. In terms of operating, enterprises should sort import and export goods lists, examine related contract arrangements, and enhance employee training to better adapt to the rules of origin under new free trade agreements and enjoy preferential duty rates. For internal system controls, enterprises should ensure that there are procedures and policies in place, verify the existence of credible supporting data and commercial substance for the application of country of origin status, and make the information and data chain for country of origin traceable and reviewable.

China enterprise internal control and compliance management for customs may converge towards international best practice

Customs in China published Provisional Measures of the Customs of the People's Republic of China on Administration of Enterprise Creditworthiness and Customs Standards for Certified Enterprises in 2014 to adjust the compliance management regulations on enterprises; it also laid the legal foundations for mutual recognition of AEO (Authorised Economic Operator) and C-TPAT (Customs-Trade Partnership Against Terrorism). China Customs is also actively negotiating with customs authorities in other countries on mutual recognition. China has so far signed AEO Mutual Recognition Decisions with Singapore, South Korea, Hong Kong and the EU, and is negotiations with the US, Taiwan and other countries or regions. Enterprises that are AEO can enjoy related effective and practical customs clearance benefits such as reduced physical goods inspection rates and the speeding up of clearance through simplified document checks.

China Customs is also introducing and establishing an enterprise self-discipline system, and regulations on a Voluntary Disclosure Program (VDP). China has no such customs regulations in place and China Customs is discussing and exploring related measures, such as mitigating or exempting from punishment enterprises that voluntarily identify and report non-compliance in operations, or reducing or eliminating overdue fines. Such regulations will serve as a policy protection for enterprises that promptly identify and resolve operating problems in the future.

This poses higher requirements on enterprises' operations related to customs and internal control. Therefore, enterprises should make comprehensive evaluations, standardise import and export processes, improve internal control policies, and enhance compliance and self-discipline to realise self-discipline in import and export activities.

More to come

As well as the above mentioned customs reforms and changes in the past year, 2016 is bound to be a year full of opportunities and challenges — also a year worth attention and expectation. Enterprises should conduct deep studies of the main customs policies and measures stated above, track the implementation progress of related reforms, evaluate the implications of the reforms and make business adjustments. Enterprises that should pay special attention include enterprises engaging in bonded processing, traditional trade, e-commerce and logistics.

Hong Kong looks to the future

The roll out of enhanced tax exemptions for offshore private equity funds, the improvement of intellectual property and treasury centre incentives, the expansion of Hong Kong's tax treaty network and the putting in place of arrangements for automatic exchanges of information are the focus areas of this article by Ayesha Macpherson Lau, Darren Bowdern, Michael Olesnicky, and Curtis Ng

When the Financial Secretary presented his 2015/2016 budget in February 2015 he announced a number of measures designed to increase Hong Kong's competitiveness and position Hong Kong as an international hub for financial services.

These measures included allowing private-equity funds to enjoy the same profits tax exemption available to offshore funds and providing a legal framework for introducing an open-ended fund company structure. More information regarding plans announced the previous year to develop Hong Kong as a treasury hub were also announced which should attract more multinational enterprises to set up their corporate treasury services for their group companies in Hong Kong.

A further positive proposal contained in the budget was to promote Hong Kong as an intellectual property (IP) trading hub providing high value-added IP services in the region.

The Hong Kong government has continued to prioritise the growth of Hong Kong's network of double tax agreements (DTAs) with its major trading and investment partners. Hong Kong has now concluded 32 DTAs, 11 with its top 20 trading partners, and negotiations are ongoing with a number of others including Germany and India. The government has also fully supported the OECD initiatives regarding a global standard on tax transparency.

Offshore funds exemption changes

Legislative changes were finalised in July 2015 and extended the profits tax exemption for offshore funds to private equity (PE) funds.

The changes were warmly welcomed by the Hong Kong PE industry and included the following key features:

- Extending the scope of transactions covered by the exemption to include investments in private companies incorporated outside of Hong Kong. This is a key feature of a PE fund's business so this is ultimately a crucial change.
- Exempting special purpose vehicles (SPVs), including Hong Kong SPVs, from Hong Kong profits tax on gains on disposal of a qualifying offshore portfolio company (this also includes gains by one SPV from the disposal of another SPV which holds a qualifying offshore portfolio company).
- Loosening an existing requirement that qualifying transactions be arranged through a person with a Securities and Futures Commission (SFC) licence to rely on the exemption. For offshore PE funds, the SFC

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Ayesha has extensive experience advising multinational clients in various industries on the local and regional tax implications of international group transactions and structures. She also has extensive experience in tax audit cases where she takes the lead during discussions and negotiations of compromise settlements with the Inland Revenue Department (IRD) in Hong Kong with the aim of minimising the additional taxes and/ or potential penalties, if any, which may be imposed by the IRD.

Ayesha is a regular speaker and writer on tax matters and is the co-author of *Hong Kong Taxation: Law and Practice* (Chinese University Press), a leading textbook on Hong Kong taxation.

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Ayesha is passionate about community service and has been appointed by the Hong Kong SAR government as a member of various advisory bodies. She is a member of the Council of the Hong Kong University, the Independent Commission Against Corruption Advisory Committee on Corruption, the Hong Kong Trade Development Council, the Standing Committee on Judicial Salaries and Conditions of Service, the Policy Research Committee of the Financial Services Development Council, and the Financial Infrastructure Sub-Committee of the Exchange Fund advisory committee.

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licence requirement has been removed where the fund has at least five investors at its final close which have collectively committed more than 90% of the capital of the fund

The amending legislation provides scope for PE funds operating in Hong Kong to benefit from the offshore funds exemption, although this may require, in some instances, some operational changes to ensure that they benefit fully from the concessions.

Developing Hong Kong as an IP hub and Treasury centre

Measures have been proposed to assist the development of Hong Kong as an IP hub and corporate treasury centre:

- With regard to IP, consideration is being given to extending the scope of tax deduction for capital expenditure incurred on the purchase of IP rights to appropriately cover more types of IP rights.
- The government has proposed amending existing tax laws to allow, under certain conditions, interest deductions under profits tax for corporate treasury centres and reduce profits tax for specified treasury activities by 50%, in other words a concessionary tax rate of 8.25%.

Stamp duty exemption for exchange traded fund transactions

The Stamp Duty (Amendment) Ordinance 2015 became effective on February 13 2015 and amended the law to waive stamp duty payable on the transfer of shares or units of all exchange trade funds listed in Hong Kong. This stamp duty exemption put Hong Kong on an equal footing with other major financial markets and is another initiative to enhance Hong Kong's role as an international financial and asset management centre.

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Curtis is well versed in the complexities of delivering compliance and advisory services to multinational clients in various sectors. His experience includes a depth of experience in cross-border business activities, and coordination and liaison with specialists to provide the most efficient and effective services.

Curtis received his BSSc degree in economics. He is an associate member of the Hong Kong Institute of Certified Public Accountants (HKICPA) and Taxation Institute of Hong Kong. He is an executive committee member of the Taxation Faculty and a member of the tax specialisation development committee of the HKICPA. Curtis is also a certified tax adviser (Hong Kong).

DTA developments

Since the last edition of this publication, Hong Kong has concluded new DTAs with South Africa and the United Arab Emirates. Neither have entered into force yet as they are still awaiting final ratification.

Hong Kong and China also signed the Fourth Protocol to the existing DTA between the two territories on April 1 2015 which amends the existing DTA in the following manner:

- Firstly, it reduces the withholding tax rate on lease rentals from aircraft leasing and ship chartering from 7% to 5%. Lease rentals from aircraft and ship leasing business (excluding the interest portion under a finance lease arrangement) are regarded as royalty payments for the purposes of the DTA and are dealt with by the royalties article. Under the current DTA, the withholding tax rate on royalties is 7%.
- The Protocol reduces the withholding tax rate on royalties from 7% to 5%. Once the Protocol becomes effective, Hong Kong will benefit from having the lowest withholding tax rate relating to lease rentals from aircraft and ship leasing businesses among the tax treaties that China has concluded in Asia and Europe. The reduction of the withholding rate to 5% and a clarification on the VAT position will enhance Hong Kong's competitiveness as a leasing hub serving the China market and removes a major impediment to Hong Kong becoming a major player in the leasing of aircraft into China.
- The protocol provides a tax exemption in China, provided a number of conditions are met, for gains derived by Hong Kong tax residents (including "Hong Kong resident investment funds" as defined in the protocol) from the disposal of shares of Chinese tax resident enterprises listed on recognised Chinese stock exchanges. This provides certainty on the China tax position for gains derived by a Hong Kong resident from the sale and purchase of shares listed on the Shanghai Stock Exchange under the Hong Kong-Shanghai Stock Connect.
- The Protocol also introduces a "main purpose test" to the DTA whereby benefits under the DTA will not be available if the main purpose for entering into the transaction or arrangement was to secure a more favourable tax position. This is in accordance with global trends and is similar to that proposed by the OECD in its final report on BEPS (Base Erosion and Profit Shifting) Action 6.
- Finally, the Protocol extends the definition of China's taxes subject to the exchange of information article under the DTA to include VAT, Consumption Tax, Business Tax, Land Appreciation Tax and Real Estate Tax.
- This protocol will enter into force after the completion of the ratification procedures and formal exchange of notification by both contracting parties.

Automatic exchange of information

The Hong Kong government announced in October 2015 that, subsequent to a public consultation process, it will put forward legislative proposals for implementing the new international standard on automatic exchange of financial account anformation in tax matters (AEOI).

In September 2014, the Hong Kong government indicated its support for the new OECD standard on AEOI and targeted a commencement date for information exchanges with appropriate partners by the end of 2018. The abovementioned consultation was a precursor to drafting legislation to put before the Legislative Council in early 2016.

In the response, the Hong Kong government reiterated that they will adhere to the OECD AEOI standard, including the broad definitions of financial institutions (FI), the scope of reporting FIs and reportable accounts, and the due diligence requirements, all of which form the building blocks of the proposed legislative framework in Hong Kong. To ensure certainty, the Hong Kong government intends making appropriate adaptations to some of the generic terms and requirements for enforcement with specific reference to Hong Kong local legislation where necessary.

The government will now focus on the drafting of the AEOI legislation, which it intends to introduce in the Legislative Council in early 2016. Should the legislation be enacted in 2016, then FIs will need to commence their due diligence procedures in 2017, with the first AEOIs taking place before the end of 2018.

Maintaining competitiveness

Hong Kong's simple and low tax system provides key competitive advantages in attracting foreign investment. However, the recent global trend for reducing corporate tax rates and the growing use of tax incentives to attract targeted investments and business activities ensures that Hong Kong needs to remain on its toes with regard to competitiveness. Over the past two years, the government has introduced a number of initiatives with a view to attracting the targeted investments and business activities to Hong Kong. This trend is likely to remain although it is expected that the OECD's BEPS initiative and its eventual implementation may have a significant impact on Hong Kong's future policies.

Taiwan: an innovative centre with attractive investment options

Taiwan's attractions as an investment location and the benefits of the new Cross-straits Agreement between Taiwan and the People's Republic of China are the focus of this chapter by Jessie Ho, Hazel Chen, Betty Lee and Stephen Hsu

Advantageous geographic location

Taiwan offers investors a unique opportunity to invest in a modern economy and benefit from its strategic proximity to China and Southeast Asia. Its location makes it a perfect place for international corporations to establish their headquarters in the Asia Pacific region. Together with Hong Kong and Singapore, Taiwan is also one of the low tax rate jurisdictions in Asia.

Located in the heart of the Asia-Pacific region, Taiwan is in an advantageous position to capitalise on the centrality of Asia-Pacific to global value chains and serve the global marketplace. This geographic location enables Taiwan to be a premier hub for Asian transportation and a key logistics centre for the East-Asian region.

Global operations headquarters and global innovation centre

Taiwan's location makes it a perfect place for international corporations to establish their headquarters in the Asia Pacific region. As the hub that connects Europe, the US, Japan and the emerging Asian markets, Taiwan is very crucial in terms of its high economic and strategic value. Aspiring to integrate manufacturing and service industries, Taiwanese enterprises have successfully fostered good collaborative relationships with several well-known and well-respected European and American enterprises.

A superior innovator with an impressive R&D base, Taiwan is very active in the global R&D and product innovation scene. Not only is it a key centre for product R&D, it has also become an important centre for high-tech original equipment manufacturing (OEM)/ODM. Taiwan provides quality products and services, which in turn, enables the development of international brands. Moreover, Taiwan's easy access to mainland China's production resources allows for mass production. Its wealth of production experience, capability to commercialise innovative products rapidly, and global deployment are factors that help Taiwan contribute value-add to global production chains.

According to the world competitiveness reports released in recent years, Taiwan is highly competitive and has great potential for even further development. The high competitiveness and innovation ability stem from the excellent technological infrastructure and talented human resources.

Technological products throughout the world

Taiwan has consistently been the top global market for semiconductor manufacturing equipment in recent years, representing more than 25% of the total worldwide market.

Table 1: Comparison with neighbouring countries/jurisdictions

Item	Taiwan	China	Hong Kong	Singapore	South Korea
Corporate income tax	17%	25%	16.5%	17%	22%
Individual income tax	5% - 40%	3% - 45%	15%	2% - 20%	8% - 35%
Value-added business tax	5%	17%	0%	7%	10%
Tax incentive policy	R&D investment	R&D investment, high & new technology	-	R&D investment, emerging industries, operations headquarters	R&D investment, foreign investment

Source: Department of Investment Services, Ministry of Economic Affairs, Republic of China (ROC)

Taiwan has competitive advantages in the IT manufacturing industry; Taiwan's semiconductor, optoelectronic, information, and communication products account for more than 70% of global production. The production value of silicon wafer OEM remains as the largest at around 70% of the world total.

These sectors and the assembly and testing sector are all ranked number one in the world. The production value of Taiwan's integrated circuit (IC) design accounts for 22.2% of the world total, and that of thin-film transistor-liquid-crystal display (TFT-LCD) is in second place. Its light-emitting diode (LED) production value is third.

International ranking reports demonstrate that Taiwan's business environment will remain as excellent as it is now. According to the *2015 Index of Economic Freedom* published by the Heritage Foundation (a US think tank) and the *Wall Street Journal*, Taiwan was ranked 14th among the 186 countries/jurisdictions, up three places from last year's ranking at 17th in the world. This ranking was Taiwan's best performance in the index to date. Taiwan was ranked 5th in the Asia-Pacific region, only behind Hong Kong, Singapore, Australia, and New Zealand, ahead of Japan (20th) and South Korea (29th) (Source: http://investtaiwan.nat.gov.tw/eng/show.jsp?ID=413).

Low taxation investment environment

Taiwan provides a low taxation investment environment. The ratio of government tax revenue to GNP is lower than 13%, which is lower than in Japan, South Korea, and most of the developed countries in Europe and the Americas. In recent years, Taiwan has launched taxation reforms to lower domestic tax rates and to simplify the taxation system. Beginning from 2010, the tax rate for profit-seeking enterprise income has been reduced to 17% from 25%, making Taiwan, together with Hong Kong and Singapore, one of the lowest tax rate jurisdictions in Asia (Table 1).

The R&D tax incentive regime allows up to 15% of the R&D expenditure incurred by a company in a specific tax year to be claimed by the company as a tax credit. The amount of the tax credit is limited to 30% of the income tax payable for the current year. There are various R&D tax incentives applicable to specific industries.

Furthermore, there are also special regimes for specific industries or sectors, such as:

- The biotechnology and new pharmaceuticals industry.
- Private participation in Transportation and Communication Infrastructure Projects.
- Foreign profit-seeking enterprises conducting goods storage in the Taiwan Free Trade Zone.
- Simple processing operations in the Taiwan Free Trade Zone.

Treaty network

As of March 31 2015, Taiwan has signed tax treaties with 28 countries including Germany, France, and Luxembourg, as well as 14 treaties on air and sea transportation income tax exemption.

New double tax agreement between Taiwan and China expected to promote trade and direct investments

After several years of negotiation and discussions, the Cross-straits Agreement for the Avoidance of Double Taxation and the Cooperation of Tax Matters (the Agreement) between Taiwan and the People's Republic of China (PRC) was signed on August 25 2015. The Agreement will officially take effect from January 1 of the year after the year of approval and ratification process from both jurisdictions.

Both the OECD's Model Tax Convention and the UN's Model Double Tax Convention served as blueprints for the Agreement. The domestic tax regulations, economic and trade conditions, various income-generating cross-border activities and existing double taxation eliminating relief measures for each jurisdiction were taken into consideration in finalising the Agreement, which also seeks to protect Taiwanese investors' right to fair taxation and competition. The Agreement addresses methods to resolve tax disputes and enhance bilateral economic and investment relations. A few key features of the Agreement are as follows:

Permanent establishment and business profits

Typical to treaties, there is a provision within the Agreement governing PE profit attribution which draws on the UN Model in providing that, profits from an enterprise of one jurisdiction will not be taxed by the other jurisdiction if the enterprise does not carry on business through a permanent establishment (PE) in that other jurisdiction. In addition to the general definitions of a PE, the Agreement also stipulates that companies providing services, including consultancy services, will create a PE in the other jurisdiction only if the enterprise, through employees or other personnel engaged for the same or a connected project, provide services for a period or periods of more than six months in the aggregate within any 12-month period. This services PE article provides an opportunity for companies in either jurisdiction to benefit from the exemption under the business profits article.

Reduced withholding tax rates

- Dividends: this is reduced to 5% where the beneficial owner is a company directly owning at least 25% of the capital of the company which pays the dividends, otherwise 10% of the gross amount of the dividend.
- Interest: if the beneficial owner of the interest is a resident of one state, the tax charged in the other state shall not be more than 7% of the gross amount of the interest.
- Royalties: if the beneficial owner of the royalty is a resident of one other state, the tax charged in the other state shall not be more than 7% of the gross amount of the royalty.
- Capital Gains: The capital gains article within the Agreement includes a special feature for share disposal gains not typically found in the agreements or treaties signed with other nations. Source jurisdiction taxing rights are preserved for gains derived from the disposal of 1) PE assets; 2) immovable property; 3) equity in land rich companies; and 4) equity in non-land rich companies in which the transferor holds at least 25% of the shares (but only where the other jurisdiction exempts such gains). In view of the latter, as Taiwan generally taxes share disposal gains, effectively, all non-land-rich share disposal gains would be tax exempt in the PRC. The same would also apply in the reverse for a Chinese investor investing in Taiwan. This treatment makes the PRC-Taiwan Agreement one of the best for capital gains of any tax agreement signed by either side. Other gains are exclusively taxable in the residence jurisdiction, saving the disposer WHT of 10% in the PRC and 20% in Taiwan.

Exchange of information

Any information received by one jurisdiction shall be treated as confidential and shall be disclosed only to persons or authorities concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Agreement. Such persons or authorities shall use the information only for prior mentioned purposes and shall not use the information on any criminal cases.

Other notable features of the new DTA

- Specific measures on treatment of third-jurisdiction intermediate holdings – To address Taiwanese companies' concerns on their existing indirect investment structures into the PRC, there are specific measures addressing the treatment of third-jurisdiction intermediate holding companies as tax residents of one of either the mainland China or Taiwan.
- Shipping and air transport – There are mutual tax exemption stipulations of relevant businesses operating out of each jurisdiction.
- Individual services – There are articles covering personal tax matters such as employment income that are in line with the OECD Model which should benefit many Taiwanese nationals working in the PRC.

Lowering the risks of double taxation

Taiwan's Ministry of Finance (MOF) has been studying the relevant deliverables under OECD's base erosion and profit shifting (BEPS) actions and devising possible implementing measures. It may be anticipated that the increased transparency and reporting of tax structures and transfer pricing practices

Table 2: Applicable WHT rates under the Agreement

	PRC domestic	Taiwan domestic	Rates under the agreement
Dividends	10%	20%	5%[1] /10%
Interest	10%	15%/20%	7%
Royalties	10%	20%	0[2] /7%
Capital gains	10%	20%	0[3] /10%

[1] 5% dividend rate applies where the shareholding exceeds 25% of equity capital

[2] 0% rate for leasing dependant on precise interpretation of the tax agreement

[3] 0% capital gains rate applied for non-land rich shareholdings of less than 25% of capital

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Jessie has been providing tax consultation services and tax compliance services such as the provision of corporate income tax return certifications for multinational clients. Jessie also provides tax advisory and compliance services to foreign institutional investors and qualified domestic institutional investors (FINIs & QDIIs).

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Hazel has been involved in numbers of tax field audit projects for merger transactions conducted by multinational and large local companies. She also has extensive experience in corporation with many foreign KPMG teams through co-execution of varies transfer pricing analyses.

Hazel is a frequent speaker at tax and transfer pricing seminars, and workshops for clients and the public.

of multinational enterprises (MNEs) in each tax jurisdiction will better equip the Taiwan tax authority for future audits. The following two provisions in the Agreement will certainly help mitigate future potential double taxation issues.

Mutual agreement procedures

Under the Agreement, should the conduct of businesses between a Taiwanese company and a related Chinese company lead to issues with respect to transfer pricing adjustments in the PRC which increase the Chinese company's taxable income, the companies are entitled to access a tax dispute resolution mechanism. They may request the initiation of a mutual agreement procedure with the Taiwanese tax authorities concerning the right of taxation, effectively eliminating double taxation.

Bilateral advanced pricing agreement

Apart from the mutual agreement procedure, the Taiwanese company and Chinese company may approach the respective tax authorities to apply for a bilateral advanced pricing agreement. Once a consensus is reached and approved, this will not only comprehensively address and resolve any potential transfer pricing disputes for the relevant years, but also minimise scrutiny from the tax authorities from either contracting jurisdictions in reviewing or making post-transactional adjustments.

Opening doors for potential tax efficiencies

Overall, the Agreement is a very positive development, providing more attractive investment options in terms of taxation and opening doors for potential tax efficiencies. Moreover, it eliminates investors' tax concerns about the uncertainty of the cross-strait relationship. Investors can now enjoy lower withholding taxes on dividends, interests, and royalties; and gains from property transactions may be taxed in one jurisdiction only (subject to certain conditions). The Agreement also provides a clearer definition for determining what constitutes a PE. In the case where a corporation is not considered to have a PE in one jurisdiction, such as a Taiwanese company providing services (for example, management, data processing, technology, and R&D services) to a Chinese company outside of

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Stephen specialises in the provision of financial services. He has assisted multinational companies in the tax evaluation of M&A, international tax planning and tax planning services for corporate investment and operation structures. He has also been actively providing global transfer pricing services to both foreign and domestic companies and assistance in tax appeal consultation and filings.

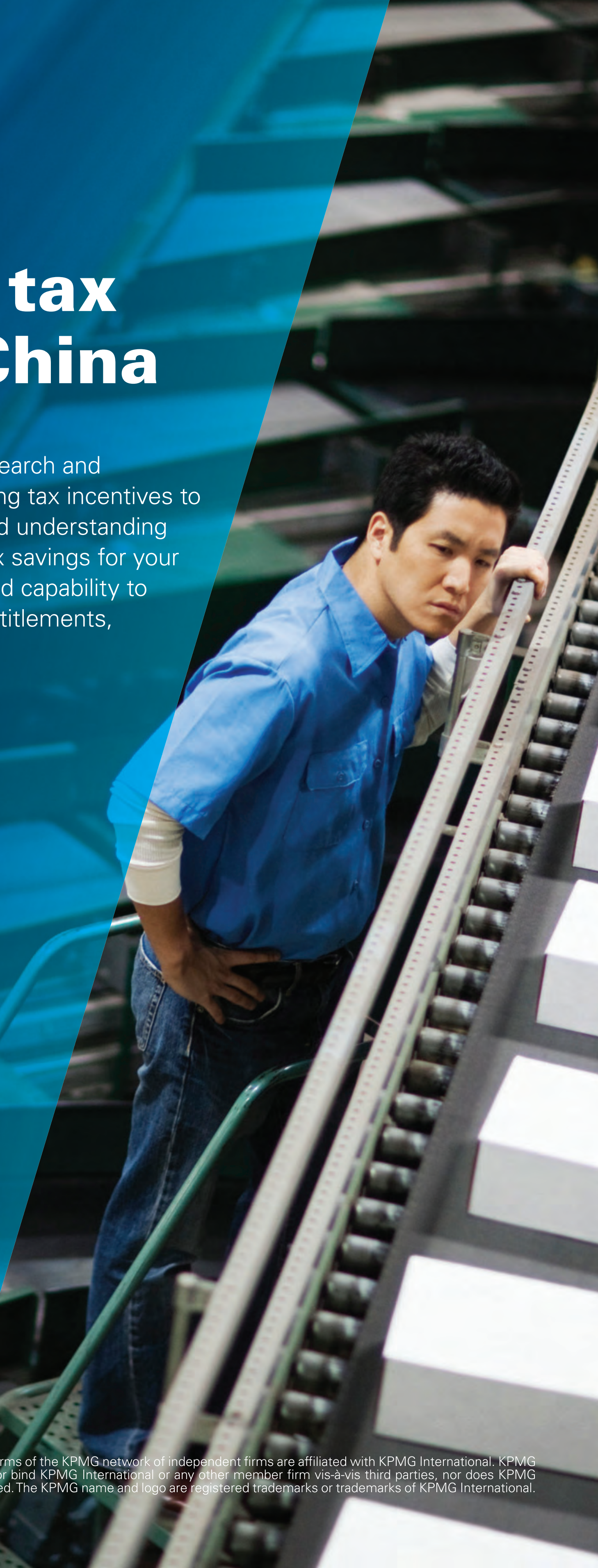
Stephen is an instructor both internally at KPMG in Taiwan, and externally at National Taiwan University's College of Management, and a lecturer at the training institute of the Ministry of Finance, ROC. Stephen serves as an adviser of the Taiwan Insurance Institute. He is also a member of the Taipei City CPA Association, a member of the Taxation Agency, Ministry of Finance, ROC, and a member of the Government Information Office, ROC.

China, the profit or income received may be exempt from China's corporate income tax.

More opportunities are also offered to shipping and air transport businesses under the Agreement to enhance their operational efficiency. Dual-resident individuals (such as individuals with a household registered in Taiwan under the Household Registration Act, but who have worked in the PRC for more than five years consecutively and have become a Chinese tax resident), and corporations will be taxed based on a tie-breaker that allocates taxing rights to one jurisdiction, and effectively prevents taxation in both jurisdictions. This is especially favourable to the large number of Taiwanese nationals working in the PRC.

An opportunity to invest in a modern economy

All in all, this landmark Agreement further strengthens Taiwan's attractiveness. Taiwan offers investors a unique opportunity to invest in a modern economy and benefit from its strategic proximity to China and Southeast Asia. Multinational companies may now consider Taiwan as an alternative holding company jurisdiction for China. Taiwanese companies are recommended to evaluate their investment structures and to consider ways to improve tax efficiencies. Companies should consider the benefits that may arise from direct investment after the implementation of the signed Cross Straits Agreement, particularly where offshore holding companies that have their effective management located in Taiwan have been used, given the consequent potential tax risks. Companies are also encouraged to consider the PRC and Hong Kong tax agreement (Hong Kong being the holding company location of choice for many existing Taiwanese indirect holding structures into China) and Taiwan's potential implementation of controlled foreign corporation (CFC) rules and other related tax-avoidance provisions. In cases where Taiwanese companies has no substance in their Hong Kong holding companies then indirect structures may not have worked given China's tighter treaty relief criteria. Consequently, moving to a direct Taiwan-China holding arrangement may be beneficial from the perspective of securing treaty benefits. In general, MNEs should measure the overall impact of tax after adjusting the investment and operational structures.



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