China

Localisation of Base Erosion and Profit Shifting in China

The Organisation for Economic Cooperation and Development (OECD) released the final reports on all of the 15 action points of the Base Erosion and Profit Shifting (BEPS) Action Plan (BEPS package) on 5 October 2015. The G20 finance ministers endorsed the BEPS package in Lima, Peru on 8 October 2015.

China pays a very high level attention to the BEPS project. The State Administration of Taxation (SAT) has expressed its full support to the BEPS project in various occasions. The SAT also formed a BEPS task force when the BEPS project was launched back in 2013. Over the last couple of years, around 50 SAT officials participated in the BEPS project and China submitted over 1,000 comments or suggestions to the OECD, many of which are now reflected in the BEPS package.

The SAT has already been working very hard to localise the BEPS Action Plan through the revision of a series of domestic tax laws and tax treaties. Some of the most important developments include:

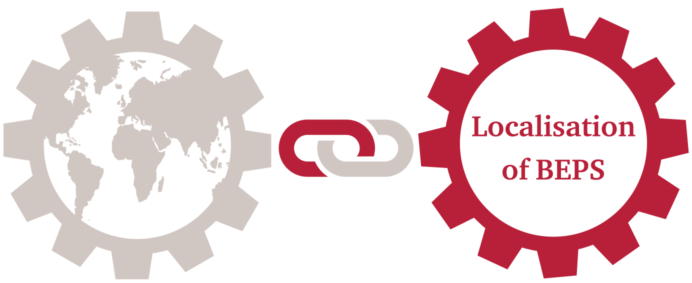
- SAT Public Notice [2015] No.16 which sets out SAT's position from a transfer pricing (TP) perspective in relation to the outbound payments of service fee and royalty fee to overseas related parties.
- SAT Public Notice [2015] No.7 which provides comprehensive guidance for the assessment of general anti-avoidance rule investigation for the indirect transfer of China taxable properties (for more details of SAT Public Notices [2015] Nos. 7 and 16, please see Asia Pacific Tax Notes 2015).
- Inclusion of the Limitation on Benefit clause (which is recommended in the final report of BEPS Action 6 on treaty abuse) in the recently negotiated double tax treaties with Chile.
- Ratification of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters signed by China in August 2013 and which has become effective in China from 1 February 2016. The signing of the Multilateral Competent Authority Agreement in December 2015 allows China to move forward with plans to activate automatic exchange of financial account information in tax matters and commence exchange with other countries in 2018.
- Signing of a Memorandum of Understanding between the SAT and OECD in December 2015 to implement a Multilateral Tax Programme at the OECD-SAT Multilateral Tax Centre in Yangzhou, China. The new Multilateral Tax Centre will deliver a programme open to interested country officials reflecting the OECD's current initiatives for the benefits of all participating countries.

The State Administration of Taxation's action plans in relation to the BEPS project in the near future

We can anticipate that the BEPS package will drive significant changes, over a reasonable time span, in China's TP standards, tax treaties, many parts of domestic tax laws and regulations, and even Chinese tax authorities' behaviours with an aim to counter tax avoidance and reinforce China's taxing rights to get a fairer share of multinational corporations (MNCs) taxation. MNCs need to get ready for the challenges of the new requirements on transparency and substance-tax alignment.

Some of the SAT's action plans are as follows:

- To revise the domestic tax laws and regulations. For example, to include the mandatory disclosure of aggressive tax planning schemes in the amended Tax Collection and Administration Law and to include the general anti-avoidance rules in the amended Individual Income Tax Law.
- To localise the BEPS package on an as-needed basis. The Implementation Measures of Special Tax Adjustment (Guoshuifa [2009] No. 2, Circular 2) was issued in early 2009 and is regarded as a master guide on the TP and anti-tax avoidance rules in China. The SAT issued a discussion draft of the revised Circular 2 in September 2015 which covers a wide range of issues discussed in the BEPS Action Plan including



The SAT is working hard to localise the BEPS Action Plan by revising domestic tax laws and tax treaties.

Action 3 (controlled foreign company), Action 4 (interest deduction), Actions 8 to 10 (intangibles and TP considerations) and Action 13 (TP documentation and reporting). Revised Circular 2 is one of the most important developments for China's localisation of the BEPS recommendations and the final version is expected to be released in 2016.

- To establish a national tax risk monitoring and response system on MNCs on a group basis. The local-level tax authorities in charge of a MNC's headquarter are responsible for monitoring the tax risks of the whole group.
- To use information technology to facilitate international tax administration.

The new self-assessment mechanism for non-tax residents to claim tax treaty benefits

According to Guoshuifa [2009] No. 124 (Circular 124) issued in 2009, non-tax resident taxpayers were required to obtain Chinese tax authorities' approval/record-filing acknowledgement before they could enjoy the tax treaty benefits under the double tax agreements (DTAs) entered into by China. In September 2015, the SAT issued the Administrative Measures on Non-resident Taxpayers Claiming Tax Treaty Benefits (SAT Public Notice [2015] No. 60, Public Notice 60) to replace Circular 124 and introduce a new mechanism of self-assessment on the eligibility for tax treaty benefits (reduced taxation or exemption under the relevant DTAs) by non-resident taxpayers.

New procedure

Public Notice 60 requires non-resident taxpayers and their withholding agents (if applicable) to go through the self-assessment procedure and file certain prescribed forms and other supporting documents when performing tax filing to justify their claims for the tax treaty benefits.

Reporting obligation

Non-resident taxpayers and withholding agents have the following obligations depending on different categories of reporting:

- Self-reporting by non-resident taxpayers: They shall perform self-assessment on their eligibility for tax treaty benefits while filing their tax returns.
- Circumstances where the payer of that income is legally obliged to be the withholding agent or appointed as such: The withholding agent shall check whether the tax treaty benefits should apply according to the forms and documents provided by the non-resident taxpayers. However, Public Notice 60 states that non-resident taxpayers shall still remain to be the party responsible for the authenticity of the information and documents submitted to the Chinese tax authorities.

Assessment of the eligibility to treaty benefits

Non-resident taxpayers and their withholding agents (if applicable) are required to provide a considerable amount of information in the prescribed forms and supporting documents to be submitted to the Chinese tax authorities in order to substantiate the tax residency, types of income and qualification (e.g. beneficial ownership) of the non-resident taxpayer for the tax treaty benefits.

Reporting frequency

Non-resident taxpayers and their withholding agents need to submit the prescribed forms together with the tax returns each time they perform tax filing. The requirement for submitting the supporting documents may be waived by the tax authorities for a certain period of time, depending on the category of income, in order to reduce repetitive submission.

Implementation

The role of the Chinese tax authorities has changed from pre-approver to post-tax filing examiner. The SAT issued Shuizongfa [2015] No.128 (Circular 128) to provide guidelines for local-level tax authorities on how to conduct assessment of the tax treaty benefit claims. Circular 128 sets forth the minimum percentage of treaty benefit claims to be selected for post-filing examination and the timeframe of such examination for the local-level tax authorities. The treaty benefit claims with the following characteristics are more likely to be examined:

- The non-resident taxpayer is from a jurisdiction with low effective tax rate.
- The non-resident taxpayer has a bad credit rating due to the refusal to pay back the taxes on time after an improper benefit claim was discovered, or having committed inappropriate actions such as the refusal to cooperate in previous examinations.
- A large amount of taxes are exempted or reduced.

This new mechanism would bring convenience and efficiency in granting tax treaty benefits and thus speed up the repatriation of funds, which should be welcomed by non-resident taxpayers. However, it would also bring uncertainties and challenges to non-resident taxpayers and their withholding agents. To mitigate the tax risks of being challenged on treaty shopping or treaty abuse, non-resident taxpayers and their withholding agents should ensure that proper documentation is in place and communicate early with their in-charge tax bureaus, where possible.

Completion of the Business Tax-to-Value Added Tax Reform

Business tax (BT) has been levied on the provision of services and the transfer of immovable properties and intangible assets since 1994. In order to mitigate the multiple taxation issues associated with goods and services and support the development of modern service industries, China firstly launched a pilot run of the BT to value added tax (VAT) reform (B2V Reform) in Shanghai in 2012 which covered transportation industry and certain modern service industries. It has been expanded nationwide to cover several additional industries through the recent years. In March 2016, the State Council announced that the remaining industries that are still subject to BT (i.e. construction, real estate, financial services, and consumer services industries) will be subject to VAT starting from 1 May 2016. This earmarks the completion of the B2V Reform and the official removal of BT from China's indirect tax system.

The applicable VAT rates for the four industries are as follows:

Industries	Applicable VAT rate
Construction and real estate	11%
Financial services and consumer services	6%

Tax policies to upgrade industrial structures and boost economy

The Chinese government has been supporting technology companies and encouraging research and development (R&D) activities via various policies, including tax incentive policies, to promote the structural adjustment of economy and industrial upgrading.

New administrative measures for new high-tech enterprises

China's prevailing Corporate Income Tax Law (CIT Law) provides a reduced income tax rate of 15% for qualified new high-tech enterprises (NHTEs). A company has to satisfy several conditions and go through specific assessment procedures as prescribed in a few circulars released in 2008 in order to enjoy the reduced CIT rate. In January 2016, several governmental authorities jointly released a new circular, Guokefahuo [2016] No.32 (Circular 32), to amend the assessment criteria and other administrative matters for NHTEs. The highlights of the amendment in Circular 32 include:

- expanding the high and new technology areas specifically supported by the State and removing certain technologies in the previous areas;
- adjusting certain assessment criteria and retaining the implicit requirement for enterprises to manage their NHTE qualifications systematically; and
- simplifying the assessment procedure to facilitate application processes and establishing an administrative mechanism of selective examination and key examination.

To summarise, starting from 1 January 2016, a company has to meet the following conditions simultaneously to qualify as a NHTE:

- The company has been incorporated for at least one year.
- The company has obtained the ownership of intellectual property rights that has made core technical contribution to its main product (service).
- The technology that makes a core technical contribution to its main product (service) of the company shall fall within the technology area of the 'Catalogue of High and New Technology Areas Specifically Supported by the State'.
- The ratio of the number of personnel participating in R&D to the total number of employees for the current year shall not be less than 10%.
- The minimum ratio of the total R&D expenditures to the total amount of sales revenue for the same year shall meet the following requirements for the last three accounting years:
  - 5% for a company whose sales revenue is less than RMB50 million (inclusive)
  - 4% for a company whose sales revenue is between RMB50 million and RMB200 million (inclusive)
  - 3% for a company whose sales revenue is above RMB200 million.

  In addition, the total R&D expenditures incurred within China shall not be less than 60% of the total R&D expenditures.

- The total amount of income generated from the sale of the new/high tech products (or services) shall not be less than 60% of the total annual income.
- The company shall satisfy the requirement for innovation capability evaluation.
- No serious security or quality accidents, or incidents seriously violating environmental laws or regulations shall happen to the company during the preceding year before application.

It is anticipated that Circular 32 will bring profound impact to NHTEs in China in terms of obtaining the NHTE qualification, retaining the eligible status, and the industry restructuring. Companies are advised to attend to the management of NHTE by enhancing their compliance level and mitigating the relevant risks.

Refined policies on start-ups and innovation

The Ministry of Finance and SAT jointly issued Caishui [2015] No.116 (Circular 116), extending certain income tax incentives implemented in the National Innovation Demonstration Zones nationwide, including:

- CIT preferential treatment for corporate partners of venture capital limited partnerships and for income derived from technology transfer; and
- individual income tax preferential treatment for shares distributed to individual shareholders and for equity awards plan.

The extending of these industry specific incentives nationwide will help to reduce tax policy differences among regions in China and promote a level playing field for enterprises. This will effectively and reasonably direct capitals to flow into innovative sectors and develop the innovative industry in China.

New guidance for research and development super deduction

According to the CIT Law, a company may claim an extra 50% tax deduction for qualified R&D expenses. In November 2015, several governmental authorities jointly released a circular, Caishui [2015] No.119 (Circular 119), to mainly expand the scope of activities and qualified R&D expenses eligible for the super deduction. Circular 119 also provides further clarification and refinement in relation to financial accounting and simplifying the tax administration. It resolves a large number of practical issues and will benefit various major industries with R&D activities.

Milestone reforms on tax administration

In late 2015, several authorities published a plan on deepening the reform of tax collection and administration system of state tax bureaus and local tax bureaus (the Reform Plan), unveiling the most important and comprehensive tax collection and administration reform in China since 1994. As the blueprint for the reform of China's tax administration, the Reform Plan proposed 31 initiatives with an aim to establish a modern tax collection and administration system by 2020. It is expected that the Reform Plan will be followed by a series of implementation regulations and have a profound influence on both tax authorities and taxpayers in the years to come.

One highlight of the Reform Plan is the new concept of tax risk-based administration on different categories of taxpayers (i.e. corporate taxpayers categorised by scale and industry and individual taxpayers categorised by revenue and assets), and centralising tax risk analysis and administration of 'large business enterprises' at the SAT or provincial level tax authorities. These new administration mechanisms will largely change the way tax authorities deploy their resources, tackle tax audits and communicate with taxpayers.

The improvement in tax services and the introduction of risk-based administration mode both rely on the support of information technologies (IT). The Reform Plan reiterates the 'Internet + Taxation' strategy set out in the SAT's 'Internet + Taxation Action Plan' back in September 2015, which requires tax authorities to tap into IT solutions to upgrade their tax administration systems. We observed that tax authorities all over China have already turned to IT solutions to facilitate their daily work, such as on-line tax filing and tax refund, e-invoices, webcast training, etc. In addition, traditional desktop tax audits have gradually been replaced by 'web crawler' technology and various other data collection and analysis systems. Taxpayers should consider upgrading their systems and changing their mindset of internal tax control to get adapted to the new 'Internet + Taxation' era.