

China announced her stance on BEPS and her localisation plans

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In brief

On 5 October 2015, the Organisation for Economic Co-operation and Development (OECD) released the final reports on all of the 15 action points of the Base Erosion and Profit Shifting (BEPS) Action Plan (the BEPS Package)¹. Soon after that, all the G20 finance ministers endorsed the BEPS Package in Lima, Peru on 8 October.

With an amazingly response time, China's State Administration of Taxation (SAT) held a propaganda conference in Beijing on 10 October 2015 to present its stance on the BEPS Package and future action plans to localise the recommendations on an as-needed basis. At the same time, the SAT also published the Chinese translation of all of the BEPS reports on its official website².

We anticipate that the BEPS Package will bring along significant changes, over a reasonable time span, in China's transfer pricing (TP) standards, tax treaties, many parts of her domestic tax laws and regulations, and even Chinese tax authorities' behaviours, with an aim to counter tax avoidance as well as reinforcing her taxing rights to get a fairer share of MNC's taxation.

Multinational companies (MNCs), be they foreign-based doing business in China or Chinese-based doing business overseas, need to get ready for the challenge of new requirements on transparency and substance-tax alignment. They are suggested to assess the impact of the BEPS recommendations and SAT's action plans on their business and tax strategies as soon as possible in light of the BEPS Package and the BEPS-driven changes of China's tax laws and regulations.

In detail

More than 300 participants joined the SAT's propaganda conference on BEPS, including representatives from mass media, foreign MNCs, Chinese MNCs (both large state-owned enterprises and private enterprises), tax consulting firms, and law firms. OECD's Head of the BEPS Project, Mr. Raffaele Russo, and core members of the SAT's BEPS task force, headed by Mr. Liao Tizhong, Director General of International Tax Division (ITD) and Ms. Wang Xiaoyue, Deputy Director General of ITD, presented at the conference.

The SAT's BEPS task force addressed the audience with the overall strategy and detailed action plans for the localisation of the BEPS Package. Key messages are summarised as below.

SAT's general observations on BEPS

The SAT has expressed full supports to the BEPS Project in various occasions and formed a BEPS task force headed by its Deputy Commissioner Mr. Zhang Zhiyong when the BEPS Project was launched back in 2013. As disclosed at the propaganda conference, 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 final BEPS reports.

Ms. Wang Xiaoyue highlighted the importance of China's participation in the BEPS Project and the influences it will bring to China, namely:

- China fully participated in the formulation of the new international tax rules;
- the BEPS Project is helpful for China in upgrading her tax regimes, as well as improving her tax legislations and tax administration system;
- the BEPS Project is a good opportunity for China to expand her cooperation with other jurisdictions, both bilaterally and multilaterally.

- the BEPS Project will help to protect China's tax base and allow her to get a fairer share of the MNCs taxation. With the improvement of China's tax laws and regulations, it is expected that it is easier for MNCs / taxpayers to better comply with them. All these efforts are aimed to provide a stable and transparent tax environment in China for MNCs engaging in cross-border businesses.

Three principles for localising BEPS recommendations in China

Ms. Wang Xiaoyue put forth three principles with respect to the localisation of BEPS recommendations in China:

Principle 1. Combination of implementing BEPS recommendations and addressing China's specific circumstances

While some BEPS recommendations will be introduced into the China's domestic tax laws and regulations, not all of them will be copied directly. Instead, China will adapt BEPS recommendations based on its own circumstances on an as-needed basis, and may also develop some tax rules to address China-specific issues.

Principle 2. Combination of protecting tax interest and boosting economic development

On one hand, China will improve tax laws and regulations to plug BEPS loopholes, especially by developing rules to prevent profits from being shifted to low or no tax jurisdictions. But on the other hand, China will also protect the interest of cross-border business activities that are full of substance, give enough certainty to MNCs and remove tax barriers in their cross-border businesses.

Principle 3. Combination of reinforcing tax administration and promoting tax compliance

China will enhance its international tax administration capacity and capability through strengthening exchange of information, improving its tax administration system, as well as further collaborating with international counterparts. But all in all, the main purpose of a strengthened tax administration is to encourage taxpayers' compliance. China expects that the new

international tax regime will not only allocate tax revenue among different countries in a fairer way, but also protect the interest of MNCs on cross-border businesses.

Observations of the SAT's BEPS task force on specific BEPS Action Plans

At the propaganda conference, although the SAT's BEPS task force members were focusing primarily on introducing the contents of the newly published reports in the BEPS Package, they also provided China's stance on BEPS and the localisation plans.

Action 3 – Controlled Foreign Corporation (CFC) rules

As the amount of capital exported from China has exceeded the amount of capital imported into China in 2014, it is very important for the SAT to carefully consider the design and enforcement of the CFC rules. However, the SAT will ensure that China's CFC rules will not be an obstacle for Chinese MNCs with outbound investments to participate competitively in international investments and businesses.

The BEPS Package has provided a good reference for China to improve its CFC rules. In particular, the SAT will elaborate the definition of 'control' and clarify how to determine the attributable income by making reference to Action 3 report. These proposed changes have already been reflected in the recently released Discussion Draft of the revised *Implementation Measures of Special Tax Adjustment* (Guoshuifa [2009] No. 2, Circular 2) (Discussion Draft)³.

In addition, the SAT task force member also disclosed that the current overseas investment information reported by the Chinese MNCs is not of good quality. The SAT has established the Offshore Taxation Division (OTD) in early 2015 to provide more services and administer the Chinese companies with outbound investments. It is expected that the OTD would enhance its information collection capability on Chinese outbound investments going forward.

Action 4 – Limitation of interest deduction

While BEPS Action 4 recommends a limitation on interest deduction of both related party loans and non-related party loans, the thin capitalisation rule in China only

applies to related party loans according to the Corporate Income Tax (CIT) Law. So, it may be difficult to localise all BEPS recommendations fully at this stage. However, the SAT may do it when there is an opportunity to revise the CIT Law in the future.

Currently, China plans to refer to Action 4 report to improve its thin capitalisation rule in the following aspects:

- clarifying the scope of interest expenses,
- setting out a more reasonable debt/ equity ratio and consider the specific features of certain industries, and
- exploring the possibility to carry forward, or even carry back the non-deductible interest expenses.

At the same time, the SAT also reminded Chinese MNCs with outbound investments to watch out for the implementation of Action 4 in other countries since it may have an impact on their cross-border financing arrangements.

Action 5 – Harmful tax practices

Action 5 report was released in 2014. As the audience of the propaganda conference were interested in China's CIT incentives provided to New/ High Technology Enterprises (NHTE), the SAT task force member explained that although China's assessment on NHTE was not exactly the same as the recommended 'nexus approach', the domestic application requirements are even more stringent than the nexus approach under most circumstances. Therefore, China and other BEPS participating countries do not consider that China's NHTE incentive is a harmful tax practice and the report will not lead China to suspend the NHTE incentive.

Action 7 – Permanent establishment (PE)

The SAT believes that China's domestic treaty interpretation rules in Circular Guoshuifa [2010] No. 75 (Circular 75) has already addressed a lot of issues mentioned in Action 7 report. For example, Circular 75 requires the preparatory and auxiliary test to apply to all activities included in Article 5(4) of the standard double tax treaties. It also provides that dependant agent provision may also apply to the situation where contracts are not concluded in the name of the foreign enterprise.

Besides, the SAT task force member indicated that the SAT will consider inclusion of the recommendations in Action 7 report during negotiation of double tax treaties in the future. The SAT's work plan in relation to PE will focus on improving PE administrative rules and strengthening the administrative practice. To achieve this, the SAT will also establish a PE information sharing system between local-level state tax bureaus and local tax bureaus and enhance information sharing with exit and entrance (immigration) administrations.

Action 8-10 – Aligning TP outcomes with value creation

TP is one of the key focuses in China's localisation of the BEPS Package. The SAT's positions on TP have already been fully reflected in the Discussion Draft. Ms. Wang Xiaoyue highlighted the following views:

- It is necessary to analyse the contributions (i.e. development, enhancement, maintenance, protection and exploitation) made by local Chinese enterprises to intangibles so as to ensure that these contributions are reasonably compensated by foreign related parties, especially where the legal owner of the intangibles resides outside China.
- Similar to intangibles, location specific advantages (LSA) also create values, and LSA has been well recognised in comparability analysis, contribution analysis and profit split consideration.
- Risk is rather difficult to identify but is easy to transfer. Consequently, in TP analysis, risk should not be assessed alone without considering the functions.
- Once a service is identified as low value-adding, the benefit test may be oversimplified and has the risk of being abused. The recommendation on safe harbour rules regarding low value-adding services are optional in the BEPS Package and it is up to each country to decide whether to introduce such rule. It should be noted that Discussion Draft does not provide safe harbour rules on low value-adding services.

Ms. Wang Xiaoyue also explained the rationale for the value contribution attribution method

newly added in the Discussion Draft. She agreed that the arm's length principle (ALP) shall be respected as an internationally recognised TP principle. However, based on China's experiences in TP practice over years, ALP could not be perfectly applied in many cases due to various reasons. This dilemma inspired the SAT to explore other practical methods. Meanwhile, the use of value contribution attribution method could also refer to the ALP, e.g. by analysing how unrelated companies make value contribution under similar circumstances.

Action 12 – Mandatory disclosure of aggressive tax planning schemes

The SAT task force member disclosed that in the revision of the *Tax Collection and Administration Law* (TCAL), the SAT plans to bring in the mandatory disclosure regime under which taxpayers or scheme promoters are obliged to disclose their aggressive tax planning information to the tax authorities. However, the SAT is also aware that in designing the regime, it has to balance compliance burden of taxpayers and relevant parties and the benefits of the transparency potentially brought to the tax authorities.

Action 13 – TP documentation

The SAT has introduced the new TP documentation requirements in the Discussion Draft. The SAT task force member further explained that most of the requirements are the same as those recommended in the BEPS Package. However, there are indeed additional requirements which are not found in the BEPS recommendations, for example, the addition of the value chain analysis in China's TP documentation requirements. The SAT believes it is important for tax authorities to understand the value creation of a corporate group, which is in fact in line with the general principle of the BEPS Project. The SAT task member clarified that the SAT has considered the balance between the collection of more information by tax authorities and compliance burden of taxpayers. As the Discussion Draft is still open for public consultation, taxpayers can express their views and concerns to the SAT freely and the SAT will consider them seriously.

Action 14 – Dispute resolution

The SAT does not accept the mandatory binding arbitration under Mutual Agreement Procedure (MAP) proposed in Action 14 report. Nevertheless, the SAT still supports other recommendations in Action 14 and will try its best to improve the efficiency of the MAP process in China.

SAT's action plans in near future

In the concluding remarks, Mr. Liao Tizhong described the release of the BEPS Package as a remarkable success of the BEPS Project. He reiterated China's action plans in relation to the BEPS Project in the near future, including:

- revision of the domestic tax laws and regulations (e.g. *TCAL*, *Individual Income Tax Law*);
- localisation of the BEPS Package on an as-needed basis (e.g. revision of Circular 2);
- adjustment of the tax authorities' international tax administration divisions (completed at the SAT level with a new OTD responsible for offshore tax administration and an additional TP division);
- establishment of the national tax risk monitoring and response system on MNC's on a group basis by the end of this year, which means that the local-level tax authorities in charge of a MNC's headquarter will be responsible for monitoring the tax risks of the whole group; and
- use of information technology to facilitate international tax administration

The takeaway

China is among a few in developing countries paying such high level attention to the BEPS Project. And the SAT is presenting its response to the BEPS final recommendations and its localisation plans in amazing speed, just within 5 days of the release of the final reports by OECD.

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 her domestic tax laws and regulations, and even Chinese tax authorities' behaviours with an aim to counter tax avoidance as well as reinforcing her taxing rights to get a fairer share of

MNCs taxation. More directions can be found in the Discussion Draft and the 10 October propaganda conference, though not completely clear.

In the short to medium run, we believe that the most significant and imminent impacts for MNCs, be they foreign-based doing business in China or Chinese-based doing business overseas, are likely to occur in the following areas in China:

- heavy system requirements for TP documentation;
- an increased focus on conduct / activity as an important test in assessing TP compliance;
- tax treaty access being constrained and in some situations uncertain;

- a wider transparency agenda, including introduction of mandatory disclosure regimes; and
- substance-tax alignment.

Overall, in the post-BEPS environment, almost all MNCs' tax profiles would be affected in one way or another by the BEPS Package and the localisation by each country. These MNCs should revisit their business and tax strategies, including but not limited to their business arrangements, financing models, investment holding structure and tax compliance requirements. They may even need to ensure they are equipped to deal with the expected uptick in levels of tax controversy and dispute in their cross-border businesses where the other tax

jurisdictions are not taking the same stance as China in some aspects.

Endnote

1. Please refer to OECD's official website for the BEPS Package:
<http://www.oecd.org/tax/beps-2015-final-reports.htm>
2. Please refer to SAT's official website for the Chinese translation of all the BEPS reports:
<http://www.chinatax.gov.cn/n810219/n810724/c1836574/content.html>
3. For our analysis on the Discussion Draft, please refer to *China Tax News Flash [2015] Issue 38 and 39*.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact a member of **PwC's China Transfer Pricing Service**:

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