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Leap Ahead: 2016 China Tax Policy Review and 2017 Outlook

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Foreword

China Tax Policy Review and Outlook is a series of annual publication designed to review key tax policy developments in China and discuss the trends from a forward-looking perspective. This *2016 China Tax Policy Review and 2017 Outlook* is the second issue in the series.

2016 was a year of transition for China. It was also the first year of the 13th Five-Year Plan. This year, China witnessed the weakest Gross Domestic Product (GDP) growth since 1990, only at 6.7%. In order to stimulate sustainable and quality economic growth, China has introduced a Supply-side Reform. At the same time, China is shifting from the role of a world factory to a more service-oriented economy. Building on the momentum of 2015, China's service sectors remain a major contributor to the GDP. The Global Innovation Index (GII) 2016[1] also remarkably placed China in the top 25 among 128 countries to become the first middle-income economy to get such a high ranking. Equally notable is the capital market, featured by the launch of Shenzhen-Hong Kong Stock Connect and China's IPO reaching a five-year high by the volume and capital raised. Cross-border investments are vigorous, too. China's outbound direct investment has overtaken inbound direct investment and hits 1,129.9bn yuan. China's contribution to the global economy growth has also been thriving through her trade, market and investment. In early 2017, the International Monetary Fund report[2] showed that China contributed 1.2% to global growth in 2016, remaining the single largest contributor, while the United States contributed 0.3% and Europe 0.2%. All these data indicate that, although the road is bumpy, China's economy is still running towards a steady growth model driven by service sectors, innovation and market vitality.

The State Administration of Taxation (SAT) has released a series of tax policies to support the transition of China's economy. Among them, the completion of the Business Tax (BT) to Value-added Tax (VAT) Transformation Pilot Program (B2V Reform) is the one of the most prominent reforms in 2016, which is expected to eliminate double or multiple taxation under the prior indirect tax regime and further support the growth of the service sectors. Other outstanding developments include a number of tax incentives to boost innovation, e.g. the introduction of the new *Administrative Measures for the Assessment of High/New Technology Enterprise (HNTE)* and its working guidelines, the extension of the Technology Advanced Service Enterprises (TASE) tax relief to more regions and more types of services, the relaxed procedures for Software and Integrated Circuit (IC) Enterprises to enjoy the Corporate Income Tax (CIT) preferential treatments, and the tax deferral treatments for equity incentive plans and investments with technology, etc. Besides, the SAT also fulfilled its green-growth commitment by promoting the Resource Tax Reform, taking in more natural resources (e.g. water) into the Resource Tax scope and transforming the traditionally volume-based tax to an ad-valorem tax. Another milepost green move is the enactment of the Environmental Protection Tax Law. The Law, which will take effect from 1 January 2018, will replace various pollutant discharge fees on water pollutant, solid waste, air pollutant, and noise pollution with a statutory tax.

Turning our eyes globally, China became the spotlight of international taxation in 2016. China hosted the G20 Summit and Forum on Tax Administration (FTA), voicing out her stance on international collaboration to foster growth, innovation and transparency, and her goal to establish a modern tax administrative system by 2020. Following the FTA, the SAT issued circulars to revise the requirements on transfer pricing (TP) documentation (i.e. Master File, Local File and Country-by-Country (CbC) Report) which was tailored upon the recommendations proposed in the Base Erosion and Profit Shifting (BEPS) project. A draft rule was also published to implement the Common Reporting Standard (CRS) proposed by the OECD (Organisation of Economic Cooperation and Development), which is aimed at facilitating the exchange of financial account information.

[1] Global Innovation Index (GII) 2016 rankings: https://www.globalinnovationindex.org/gii-2016-report#

[2] World Economic Outlook Reports: http://www.imf.org/external/ns/cs.aspx?id=29

These transparency initiatives were echoed by China's digital strategy, i.e. the "Internet+Taxation". The roll-out of the Third Phase of the Golden Tax System (Golden Tax III Project) nationwide and the formalisation of the "Thousand Groups Project" together earmarked a big data era for tax administration, where risk-based management becomes main stream and data analytics will guide the way tax authorities deploy their administrative resources to provide tax services and tackle tax evasion and avoidance.

The vision of tax modernisation is not only defined by enhanced transparency and advanced technology, but also a fairer and effective dispute resolution mechanism. Responding to Action 14 of the BEPS project, China amended her rules on Advance Pricing Arrangement (APA) to reflect her new thinking on TP administration and balance the dilemma of limited APA staffing and the burgeoning needs in this regard. The SAT also doubled its resources in handling Mutual Agreement Procedure (MAP) requests to better serve multinational companies (MNCs). Domestically, with the SAT's devotion to improve the efficiency of tax administrative appeal and court litigation, these are more than before seen as useful remedies to help taxpayers resolve tax controversies.

With China's increasing influence on the global economy and international taxation, we have more to expect in the years to come. As Mr. Wang Jun, the SAT Commissioner, commented, "The SAT will step up effort in 2017 to balance its focus on inbound and outbound taxation, and refine some of the existing rules to add more certainty and clarity." Policies in the 2017 pipeline may include revised anti-avoidance rules related to Controlled Foreign Corporations (CFC), Thin Capitalization, etc.; rules to further implement the BEPS project recommendations regarding anti-treaty abuse; landmark reforms in terms of Individual Income Tax (IIT), Property Tax; the elaboration on the implementation of the Environmental Protection Tax Law; further cut in non-tax government levies; and what taxpayers are most earnestly waiting for, the new look of the *Tax Collection and Administration Law*.

Final stage of the B2V Reform, finale or prelude?

VAT and BT have been levied on sales of goods and services respectively in China for decades. The fact that VAT is creditable while BT is not has given rise to double or even multiple taxation, which may have misdirected the way companies operate their business. To solve this issue and further promote economic upgrade, China launched the B2V Reform in 1 January 2012. After four years of industry-by-industry pilot implementation and regional pilot runs, the Ministry of Finance (MOF) and the SAT jointly released Caishui [2016] No.36 (Circular 36) on 24 March 2016 to roll out the B2V Reform to the remaining four major industry sectors, namely, construction sector, real estate sector, financial services sector and consumer services sector (collectively as the "Four Sectors") effective from 1 May 2016. This signifies the completion of the B2V Reform in China and the removal of BT from China's indirect tax regime. Going forward, the VAT chain is completed for largely all industries and taxpayers could claim VAT credit for the purchase of tangible goods, immovable properties, intangibles and most services.

Circular 36 and a bundle of subsequent circulars issued in 2016 provide the VAT policies for the Four Sectors which include:

- **Tax Rate:** VAT rate for the construction services and real estate sector (including immovable property leasing services, sales of immovable properties and transfer of land use rights) is 11%, and that for the financial services and consumer services sector is 6%. A noteworthy change brought by Circular 36 is that a "financial-sales-and-lease-back" transaction is re-categorised, from "leasing service" which is subject to 17% VAT, to "financial service" which is subject to 6% VAT.
- **VAT-input credit:** VAT incurred on the purchase of immovable properties can be credited over two years provided that valid VAT invoices are obtained. However, VAT on loan interest, passenger transportation services, catering services, resident daily services and entertainment services, etc. are not creditable.
- **Service export:** Certain cross-border services, like research and development (R&D) services, consulting services, are subject to zero-rated treatment or exemption. In principle, if a cross-border service is "consumed completely outside China", it will be eligible for zero-rated treatment or exemption.
- **Transitional policies:** Circular 36 also provides transitional policies for the construction and real estate sectors, primarily offering simplified VAT treatment (at the rate of 3% or 5%) for those projects started or properties purchased / developed before the effective date of 1 May 2016.
- MOF as well as SAT also clarified the VAT treatments of some **specific transactions and business models,** such as the disposal of restricted shares, commercial deposit card, inter-bank financial transactions, and labour dispatch arrangement.

Besides, with the completion of the B2V Reform, the revenue allocation ratio for VAT between the central and local governments has been adjusted to a 50%: 50% split[3] since 1 May 2016; any revenue shortfall of local governments as a result of the B2V Reform will be reimbursed by the central treasury. This adjustment not only ensures that there is sufficient financial capacity for the local governments but also helps standardise the VAT implementation across the country. Such revenue allocation ratio will be maintained for two or three years and then subject to further adjustment if necessary.

VAT is much more sophisticated in terms of its tax treatment and administration as compared with BT.

For new VAT payers borne in this round of the B2V Reform, they need to quickly master the complex VAT filing and invoice system, and conduct a comprehensive assessment on the VAT impact to their revenue, cost / expenses and profit, taking into account other taxes like CIT, IIT, Land Value-appreciation Tax, Deed Tax, Real Estate Tax, etc. Moreover, they are also suggested to review and adjust their pricing strategy to pass the VAT burden to downstream consumers, if possible. An in-depth study of the suppliers' tax profile is also vital to ensure they obtain sufficient input VAT credit.

The B2V Reform also has a profound impact on existing VAT payers. Apart from being able to claim input VAT credit on purchases from these Four Industries, they should pay attention to those non-creditable purchases as well as the new accounting treatment of VAT issued by the MOF following the B2V Reform and get ready for the transformation of accounting systems.

According to the State Council, the B2V Reform has boosted employment, improved the taxation regime, and upheld economic transformation. It is estimated that the indirect tax burden of taxpayers would be reduced by over 500bn yuan in 2016.

There are still a large number of policy uncertainties with respect to the B2V Reform, in particular relating to cross-border services and new business models, such as PPP (Public-Private Partnership) and digital economy. For these grey areas, inconsistent interpretation or administration at local levels could lead to tax risks for taxpayers. The MOF and SAT have been collecting feedbacks from taxpayers and industries to refine their VAT policies. We expect more regulations will be released in 2017 to clarify these issues.

The completion of the B2V Reform is just the beginning of the next phase of China's extensive VAT reform. Firstly, there are too many VAT rates in China which is not in line with international norm; secondly, the uncertainties in tax category reclassification have been confusing to certain new businesses; and thirdly, after the elimination of BT, VAT will become a major revenue contributor in China, but it has yet to be legislated as a law. Looking into the future, China will expand the use of electronic VAT invoices, and embark on the simplification of VAT rates and the formulation of the VAT Law. The road for VAT reform in China remains long.

[3] Before the B2V Reform, BT is a local revenue, while VAT is a shared revenue with 25% goes to local governments. During the B2V Reform, VAT collected in lieu of BT remained a local revenue till 1 May 2016.

More tax initiatives to boost innovation and green growth

Innovation has been a constant engine to drive economic growth all over the world. According to China's 13th Five-Year Plan, China has steadily increased investment in science, technology and innovation, with the expenditure on R&D reaching 2.1% of GDP in 2015 and projected to hit 2.5% by 2020. The 13th Five-Year Plan also sketches a set of targets and policies for 2016 – 2020 on enhancing scientific and technological strength, boosting high-tech service export, incentivising talents and the commercialisation of technological achievements, etc. At the same time, there is an increasing need for optimised utilisation of natural resources and better environmental protection to ensure a sustainable development. These macro-goals have been reflected in tax policy making in 2016.

A. New HNTE regime

The previous HNTE regime, introduced together with the new CIT Law in 2008, has proved effective in motivating Chinese enterprises to undertake R&D and innovative activities. Take Guangdong province as an example – HNTEs have saved 5.5bn yuan in CIT alone during 2011 – 2015 by claiming the 15% preferential CIT treatment, and an additional 4.8bn yuan of R&D expense super deduction (which is often related to the HNTE incentive) was enjoyed.

To keep abreast with the rapid advancement of the scientific and business environment and further enhance the development of core technology specifically supported by the State, the Ministry of Science and Technology (MST), MOF and SAT jointly released Guokefahuo [2016] No. 32 and Guokefahuo [2016] No. 195 in 2016 to revamp the HNTE regime, providing a new set of criteria, application procedures and administration model for HNTE assessment.

The new regime has put more emphasis on technology and innovation than the previous one. For instance, a technology-driven approach (instead of a product-driven approach in the past) is adopted to assess HNTEs; the HNTE Technology Catalogue is updated by adding more new technologies, which potentially broadens the pool of eligible companies; and Intellectual Property (IP) rights must be self-owned (meaning that the exclusive global license of IP rights will no longer help). Further, the evaluation mechanism of companies' innovation capability has also been upgraded to stress the quality of IP rights and the R&D capability, and commercialisation of technological achievements. Meanwhile, the R&D expense criteria for companies with an annual revenue below 50m yuan has been relaxed from 6% to 5%, facilitating middle-sized companies to enjoy the incentive.

In addition, it is worth noting that the post-administration on HNTEs is strengthened by requiring HNTEs to file an annual report online regarding its R&D performance and financial data. Random check and targeted examination mechanism have also been established to make sure the incentive is granted to deserved companies which heavily invest in R&D and innovation.

Overall, the new HNTE regime is more technology-focused, easier to apply but harder to maintain. While the new criteria and process provide opportunities for more companies to enjoy the incentive, IP ownership is a key consideration before they decide to go ahead with the application. Those which have obtained the HNTE incentive should also assess the impact of the new regime, enhance their daily management of the qualification by regularly reviewing their eligibility and making sure the relevant documentation is maintained.

B. Approval replaced by record-filing for Software and IC Enterprises

Since 2000, a series of tax incentives for Software and IC industries were released to accelerate the development of these industries and encourage technological innovation. They include "2+3" tax holiday[4], "5+5" tax holiday, 15% / 10% preferential CIT rate, etc. Previously, an approval was required for the assessment of Software and IC Enterprises. In May 2016, the SAT, MOF, National Development and Reform Commission (NDRC) and Ministry of Industry and Information Technology (MIIT) (collectively as the "Four Departments") jointly released Caishui [2016] No. 49 to replace the approval procedure with a record-filing procedure.

[4] "2+3"tax holiday refers to CIT exemption for a two-year period starting from the first profit-making year, followed by a 50% reduction of CIT payable for the subsequent three years. Similarly, "5+5"tax holiday refers to a five-year CIT exemption followed by another five-year 50% reduction.

In particular, Software and IC Enterprises which plan to enjoy relevant CIT incentives should self-assess their eligibility, and then perform a record-filing with in-charge tax authorities by submitting the required documents, which will be subject to the provincial-level NDRC and MIIT's examination within two months.

Similar to the HNTE regime, the post-administration of the Software and IC Enterprises is also enhanced requiring Four Departments to closely collaborate and monitor the implementation of this incentive.

The removal of the approval requirement is a typical trend in tax administration in recent years, which brings convenience but at the same time risk to the taxpayers. With tax authorities' attention shifting to post-administration, relevant companies should more proactively assess and monitor their eligibility to the tax incentives to mitigate any risk arising from inadvertent misapplication.

C. TASE incentives available to more regions and more services

Service sector is playing a more and more important role in China's economic restructuring. 2015 saw the record high of 50.5% contribution by the service sector to China's GDP, making it the largest economic sector in the country. In 2016, the State Council released the *Pilot Scheme for the Innovative Development of Service Trade*, calling for the nurture of innovative service models based on new technologies, such as big data, cloud computing and Internet of Things. Following this theme, the SAT has been constantly fine-tuning its policies to support the development of the service sector, in particular those high-tech services, during the past decade, e.g. the B2V Reform, the addition of modern services such as testing, logistics and cultural activities into the new HNTE's Catalogue, and the foremost 15% CIT preferential treatment offered to TASEs engaging in ITO (Information Technology Outsourcing), BPO (Business Process Outsourcing) and KPO (Knowledge Process Outsourcing) in 21 designated provinces / cities.

In 2016, the TASE regime has undergone two welcome expansions:

Geographical expansion

- Geographical expansion – 10 new "Service Outsourcing Demonstration Cities", including Shenyang (in Liaoning Province), Changchun (in Jilin Province), Nantong (in Jiangsu Province), etc. were added to allow qualified companies located there to apply for the TASE incentive. The valid period of this incentive is three years, starting from 1 January 2016.

Scope Expansion

- Scope Expansion – the other is a new pilot program effectively granting the TASE relief to companies engaging in four types of innovative services, e.g. computer and information services, R&D and technology services, cultural technology services and Chinese medical services in 15 "Pilot Areas to Boost the Innovative Development of Service Trade" (some of the areas coincide with the 31 "Service Outsourcing Demonstration Cities"). The valid period of this pilot program is two years, from 2016 to 2017.

Unlike other high-tech tax incentives, such as the HNTE and Software and IC tax regime, the TASE incentive is unique and more attractive as it does not require the company to own any IP right. The evolution of the TASE incentive shows the country's determination to encourage service trade and innovation. Service companies located in relevant areas should review their service scope and assess their chance to enjoy the TASE incentive.

D. "Super" tax benefits for equity incentive plans and investments with technology

In July 2016, China Securities Regulatory Commission (CSRC) released a new Administrative Measures for Equity Incentive Plans Granted by Listed Companies, encouraging public companies to incentivise technical talents and senior executives via share-based compensations. Soon after that in September, the MOF and SAT jointly released Caishui [2016] No.101 (Circular 101), providing "super" tax preferential treatments for eligible equity incentive plans and equity investments with technologies, including:

- For eligible equity incentive plans (defined as share options, restricted shares and share awards) granted by domestic **unlisted** companies, the **taxing point** of IIT for the employee is deferred to the time of the disposal of the relevant shares and at a flat **rate** of 20% on the realised gain. By contrast, employees of non-eligible plans shall be subject to a progressive rate of up to 45% and taxed as salary income at the time the shares are received / options are exercised; and then subject to a flat rate of 20% on the subsequent realised gain at the time of the share disposal.
- For employee who obtain qualified equity incentive plans granted by domestic **listed** companies, their IIT **payment deadline** is extended from up to six months after the shares are received / options are exercised, to up to 12 months.
- For **equity investments with technologies** made by corporate or individual investors, in addition to the current preferential instalment tax payment method, investors are now allowed to opt for **CIT / IIT deferral** treatment until the time of disposal of the relevant shares.

The above incentives resolve the typical cash flow issues suffered by relevant participants of equity incentive plans and investors, and will help companies attract, retain and motivate their talents and senior executives. The "super" tax benefits also place more compliance burden on companies, such as record-filing, documentation, withholding obligation and reporting of any subsequent changes. Companies which intend to leverage the benefit should take note of these additional compliance requirements and assess which treatment is proper to take.

E. Resource Tax (RT) Reform — save water and more

Since 2010, the Chinese government has accelerated the RT Reform, transforming the volume-based regime on crude oil, natural gas and coal to an ad-valorem regime, and eliminating various charges and levies associated with natural resources. Those rounds of reforms have pushed energy-consuming companies to upgrade their mining techniques and productivity.

In 2016, the MOF and the SAT jointly issued Caishui [2016] No.53-55, kicking off another round of landmark RT Reform:

- **Water RT pilot in Hebei:** This is the first time China subjects water to RT. The pilot run has been introduced in Hebei province starting from 1 July 2016 and will be rolled out to other regions in China in due course. For now, water RT is levied on a quantity basis, replacing the previous water charges.
- **More resources to be subject to RT:** Undoubtedly, water RT in Hebei is just a beginning. The country is to gradually expand the RT scope, bringing in more taxable resources, e.g. forest, meadow, mudflat, etc.
- **Ad-valorem taxation:** After this round of reform, most RT-able resources would be subject to RT on an ad-valorem basis. Volume-based taxation remains only for a small number of low-value resources like clay and gravel to ease administration.
- **Preferential policies:** Concessional tax treatments (i.e. 50% and 30% tax reduction) and tax exemption will be granted to environmental-friendly mining activities.
- **Local governments to decide the tax rates:** The provincial governments are delegated the authority to decide the RT rates for specific taxable items within a prescribed range, subject to the State Council's approval. This provides flexibility for each region depending on their own types of resources and financial situations.

Along with the RT Reform, previous resource-related charges and fees are also eliminated to ensure a neutral effect on the burden to most companies. Actually, as a prominent measure of the Supply-side Reform, the RT Reform has helped knock out unhealthy resource consumers and cut taxes for the relevant industries. According to the SAT's statistics, the amount of RT collected was reduced by 2.1bn yuan from July to September in 2016 as a result of the RT Reform. In addition, the excess exploitation of underground water in Hebei has also been largely under control.

The impact of RT Reform is not only critical for ore miners and manufacturers. Progressively, more natural resources will be subject to RT. A "green" strategy focusing on resource conservation, investment in innovation and R&D will eventually fuel the long-term development of businesses in China.

F. Environmental Protection Tax (EPT) Law — the sword to cut pollution

Smog and other pollution are becoming a very big social problem for China. As a strong response, China has introduced the Environmental Protection Law, effective from 1 January 2015. In that law, Environmental Protection Tax is mentioned as a means to prevent pollution. At the end of 2016, the long-awaited EPT Law was officially released.

Although EPT is a new type of tax, it is not created from scratch. It is to replace the current pollutant discharge fees levied by the local environmental authorities. The enactment of the EPT Law provides a legal framework for the collection of taxes (previously charges) by the tax authorities on the discharge of pollutants and will standardise the implementation nationwide. The scope of EPT is similar to that under the former pollutant discharge fee regime, including water pollutant, solid waste, air pollutant, and noise pollution. Companies emitting these pollutants directly into the environment in China will be subject to EPT which is calculated based on the volume of pollutants discharged. In general, taxpayer's EPT cost is aimed to be more or less the same as their previous pollutant discharge fees.

Like the RT Reform, the EPT Law also allows local governments to decide their own tax rates within a certain range. Certain sectors, such as agricultural production, transportation, sewage treatment plants, and those companies which comprehensively utilise the pollutants, are eligible for tax exemption. Concessional tax treatments (i.e. 25% or 50% tax reduction) are also available to those companies whose concentration level of pollutants discharged are lower than the prescribed pollutant disposal standard. These preferential treatments are designed to encourage companies to cut down pollution.

The EPT Law will be effective from 1 January 2018. This provides buffer time for companies to improve their capability in dealing with pollution and for governments to formulate the implementation rules. Also the collection of EPT could be meaningless without timely information exchange between tax and environmental authorities. It is expected that there would be more implementation and practical information about EPT in 2017.

Tax transparency in the era of big data

Exchange of Information (EOI) is a key form of international tax collaboration to promote transparency and crack down on tax evasion and avoidance arrangements. To enhance EOI, China has followed BEPS Action 13 and introduced CbC Reporting requirement into her domestic tax rules. China has also signed the *Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information* (CRS MCAA)[5] introduced by the OECD and released a discussion draft on the administrative measures on the due diligence procedures for implementing CRS in China for public consultation.

The advancement of information technology (IT) has helped strengthen Chinese tax authorities' data mining and analysis capacity in light of the vast volume of information being collected and exchanged. In line with the "Internet+Taxation" initiative launched in late 2015, Chinese tax authorities are seeking to deploy IT to their daily tax administration. Big data-driven approaches are being adopted in many aspects to integrate tax information, support data analysis, locate tax audit targets or even pinpoint common tax risks of certain industries. Outstanding developments in 2016 include the upgraded VAT Invoice System and Golden Tax III Project. These in turn have reshaped China's tax administration mode, including the "Thousand Groups Project" to enhance her capability and efficiency with respect to the administration of large businesses.

A. New TP documentation requirement – global view and China-unique features

On 29 June 2016, the SAT issued Public Notice [2016] No.42 (Public Notice 42) to set out new TP compliance requirements in China, including Master File, Local File, CbC Report recommended under the BEPS Action 13 and also Special Issue File for Thin Capitalisation issues and Cost Sharing Agreement (CSA):

Master File

Master File is focused on providing a global picture of MNCs' operation. If a Chinese company's annual related party transaction is over 1bn yuan, or it's group companies have prepared a master file, then the file should be prepared in China within 12 months after the close of the fiscal year of the group's ultimate holding company. The disclosure required is generally consistent with the BEPS standards, subject to a little Chinese variance, e.g. business restructuring and transfer of function, risk and assets within the group in the reporting year.

Local File

Local File requires significantly greater disclosure of China's local companies than before. The threshold for reporting is 200m yuan for related party transactions involving tangibles, 100m yuan for those involving financial assets or intangibles, and 40m yuan for others. Compared with the BEPS requirements, TP analysis of local-specific advantages, value chain analysis, etc. are China-unique features. The local file should be completed by 30 June of the following year, i.e. 30 June 2017 for the 2016 fiscal year.

Special Issue File

Special Issue File is required for any taxpayer signing a CSA or triggering the Thin Capitalisation rule. Though given a new name, it is mostly similar to the documents required for the two issues in the previous regime. The filing time is the same to that for the Local File.

CbC Report

CbC Report under the BEPS project is exactly adopted in China, as an integral part of the annual Related Party Transaction Reporting Forms. Principally, China's CbC Reporting is relevant to those Chinese MNCs making outbound investments. If the Chinese ultimate holding company's annual consolidated revenue is over 5.5bn yuan (almost equivalent to 750m euro required in BEPS Action 13), it should file the CbC Report alongside its annual CIT filing package, i.e. by 31 May 2017 for the 2016 fiscal year.

[5] For a list of signatories of the CRS MCAA, please prefer to this link: http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/MCAA-Signatories.pdf

The absence of cross-border related party transactions can exempt the relevant companies from the submission of Master File, Local File and Special Issue File.

Obviously, China is eager to align her TP practice with international standard and, to some extent, take a leading role among developing countries. By collecting the new TP documentation and enforcing those China-specific requirements, Chinese tax authorities can easily get a global view of MNCs' business and assess whether a fair share of tax has been paid in China. As of 7 December 2016, 50 jurisdictions (including China) have signed the *Multilateral Competent Authority Agreement for the Automatic Exchange of CbC Reports* (the CbC MCAA)[6]. 2017 will be the first year to exchange the CbC Report. Chinese MNCs should be mindful that they may be more than before exposed to overseas tax administrations.

For either Chinese MNCs or foreign-headquartered MNCs, the first-time preparation of the new TP documentation could be a tremendous challenge. Revisiting the group related party transactions against the new requirements and bridging the gap, starting preparation as early as possible, and creating a consistent and coordinated approach to handle the group's reporting is highly recommended.

[6] For a list of signatories of the CbC MCAA, please prefer to this link: http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/CbC-MCAA-Signatories.pdf

B. CRS around the corner for Chinese financial institutions

To localise the OECD-driven CRS in China, the SAT released the Discussion Draft of the Administrative Measures on the Due Diligence Procedures for Non-resident's Financial Account Information in Tax Matters (Discussion Draft) in October 2016 for public consultation.

The framework and basic requirements of China CRS generally follow the OECD standard, with more implementation details tailored to China's circumstances. Specifically,

What

China's reporting financial institutions are required to conduct due diligence on financial accounts held by foreign individuals and companies and identify reportable information of relevant accounts, including account name, tax residency status and tax identification number of the account holders, account balance, etc.

When

According to the Discussion Draft, all new accounts opened after 1 January 2017 will be subject to due diligence; for pre-existing accounts, due diligence of accounts held by foreign individuals with a balance over 6m yuan (which is slightly lower than the OECD standard of 1m USD) will be prioritised to complete by the end of 2017; whereas other accounts need to be scrutinised by the end of 2018.

High-value entity accounts with passive income

Notable is that for certain high-value entity accounts with passive income (e.g. dividends, interests) accounting for over 50% of the total receipts of the current year, the financial institution is obligated to identify their controlling person and its tax residency status. This reflects the anti-tax avoidance nature of the CRS.

The information collection requirement serves the ultimate goal of CRS, which is to enable tax authorities to get a clearer understanding of the financial assets held abroad by their residents and tackle tax evasion and avoidance via automatic EOI. As of 2 November 2016, 87 jurisdictions, including China, have signed the CRS MCAA. Signatories include non-tax jurisdictions such as Cayman Islands, British Virgin Islands, Cyprus, etc. The information exchanged to China, facilitated by various data analytics, will greatly enlarge Chinese authorities' radar to combat offshore tax evasion and avoidance. Meanwhile, China is also committed to exchange the first batch of information by September 2018. Though the official rule has not yet come out, given the tight schedule, a lot of Chinese financial institutions have already taken actions to upgrade their IT systems, procedure and training courses to get ready for the implementation. But as China has strict foreign exchange administration and legal regimes, it is not common for foreign residents to open offshore accounts in China for tax evasion and avoidance.

C. Upgraded VAT Invoice System to enhance VAT administration

2016 not only marked China's achievement in tax transparency, but also witnessed her digital transformation of tax administration systems.

In 2016, the deployment of an upgraded version of the VAT Invoice System has been completed. The effort standardises the issuance of VAT invoices by taxpayers and strengthens tax authorities' control on input VAT credit, paving the ground for digitalisation of VAT administration.

From the suppliers' perspective, after the upgrade, all special and ordinary VAT invoices have to be issued via one single online platform and uploaded immediately through the new VAT Invoice System. More importantly, from 1 May 2016, taxpayers are required to select a code from the *Catalogue and Code of Taxable Goods and Services* (the "Catalogue") when issuing VAT invoices. This Catalogue covers more than four thousands of goods and services. The consistent codification and e-record would help tax authorities analyse and compare the VAT burdens of different goods for multiple purposes.

From the purchasers' perspective, the upgraded System has replaced the previously time-consuming paper invoice verification process for taxpayers with a better tax credit rating (i.e. rating of A, B or C)[7]. Those taxpayers can now log directly onto a designated tax website enquiring and selecting the relevant VAT invoice information to claim input VAT credit, which speeds up the verification process.

The upgrade of the VAT Invoice System is not solely for convenience purpose for the interest of taxpayers. With the new functions embedded in the upgraded System, it is expected VAT short payment and fake invoices can be detected automatically and more efficiently, which also provides a solid database for tax risk administration for the interest of Chinese tax authorities.

D. Golden Tax III Project – fly to digital taxation with golden wings

After years of pilot runs, the SAT rolled out Golden Tax III Project nationwide in 2016. It integrated the previous systems used by various tax authorities and taxpayers, covering all tax categories and major tax-related work to create a unified paperless tax administration.

Golden Tax III Project is not merely a tool to facilitate taxpayers' filing. It is also able to link filing information with data collected from other government bodies (e.g. Customs, SAFE, etc.) to conduct cross-check and real-time analysis. Moreover, it is inter-connected with the case selection system of the tax investigation bureaus to facilitate tax risk identification and audit case selection process via its strong analytical capacity and capability. It also standardises the tax law enforcement by incorporating the prevailing tax laws and regulations to closely monitor taxpayers' compliance with procedural provisions, particularly those timeline requirements which were not easily administered in the past. For instance, it will automatically levy penalty on the withholding agent who fails to conduct service import contract registration within 30 days.

[7] The tax credit rating system assesses the taxpayers' compliance level generally based on reviewing a series of internal and external information, such as tax filing, tax payments, bookkeeping, tax inspection / audit results, etc. and other factors that affects the taxpayers' credit. Rating ranges from grade A to D will be awarded to the taxpayers after the assessment. Grade A indicates the best credit rating, whereas grade D the worst. Under certain circumstances, a taxpayer may directly be rated grade D if it commits tax violations, such as tax evasion, tax fraud, claiming false tax incentives.

Mr. Wang Jun, the SAT Commissioner, has said in various occasions that, “Tax big data is a treasure island”. The Golden Tax III Project has centralised the previous scattered tax collection and administration data and is able to help Chinese tax authorities gain additional insights into the economy and tax revenue generation process via data mining and analysis. Such capacity and capability can therefore support the transformation of tax administration mode. In parallel, while enjoying the convenience brought by the highly automated tax system, taxpayers should also beware of the more rigid tax enforcement measures and environment. A robust internal tax control framework and a regular review of the pitfalls in tax process may be crucial to prevent tax risks in the cradle.

E. New landscape of risk-based tax administration

As envisaged in last year’s *China Tax Policy Review and Outlook*, China is transforming from a historically comprehensive tax administration facility to a new risk-based and data-driven tax administration mechanism. While the goal has been set in the Plan on *Deepening the Reform of Tax Collection and Administration System of State Tax Bureaus and Local Tax Bureaus* issued in 2015, the SAT has put it into action in 2016. The advancement in EOI, the deployment of the upgraded VAT Invoice System and Golden Tax III Project has certainly facilitated the implementation of the new administration mechanism. And a number of new administrative measures introduced in 2016 has made the mechanism far better, such as inviting more than 20 government bodies to impose collective punishment on taxpayers in severe tax violation cases, sharing tax credit rating with banks to facilitate / scrutinise taxpayers’ financing activities.

Under the new tax administration mechanism, tax risk analysis of large businesses is centralised at the provincial-level tax authorities or even at the Large Enterprise Administration Department (LEAD) of the SAT, supported by big data analytics. Based on the outcome of the risk analysis, taxpayers are categorised according to their size and industry, and subjected to different levels of tax risk management and tax services. In the meantime, taxpayers’ behaviours and responses to risk management will also be reflected in their tax credit rating, which may be linked to the entitlement of certain preferential tax treatments and non-tax benefits. This risk-based administration cycle will continually affect the way that Chinese tax authorities deploy their resources and their relations with taxpayers.

For instance, companies with a higher risk would more likely be subject to more comprehensive and frequent tax audits. Tax short payment identified may result in a demerit point in the tax credit rating, which would be relevant in VAT invoice administration, credit rating for export tax refund, availability of bank loans and many other operating affairs. It is expected that taxpayers should be motivated to be tax-compliant under such administration mode.

F. "Thousand Groups Project" — unlock the power of data

Taking a closer look at the progress of risk-based tax administration in 2016, one of the core accomplishments is the "Thousand Groups Project" in the opinion of the SAT. The SAT kick-started the Project in a low-key manner in late 2015, requesting more than one thousand large groups operating in different regions of China (including foreign-invested MNCs, state-owned companies and domestic private companies) to provide their business, financial, tax and accounting data in electronic format. The originally "mysterious" project has finally floated above the water through Public Notice [2016] No. 67 (Public Notice 67), unveiling the details of the "Thousand Groups Project" and making this Project a routine (i.e. quarterly and annually) digital reporting obligation for the selected business groups.

The data collected under the Project has become a rich source for the SAT's data pool and analysis. For tax purposes, such analysis can help the Chinese tax authorities predict tax collection, pinpoint common tax risk areas or certain industries or specific risks of certain companies and provide customised services to large taxpayers. From a macro-economic perspective, the data can also be used to optimise the deployment of tax administration resources, analyse major economic trends and facilitate policy making.

In 2016, the "Thousand Groups Project" has generated fruitful results according to a public report[8] of the LEAD. It has performed analysis over 547 groups of the 1,354 groups under the Project and identified 2,880 tax risk areas, which directly contributed additional tax revenue of 20.2bn yuan. Besides, the SAT also reaffirmed that it will explore more diversified channels to collect data and establish information sharing platform with other government bodies (e.g. MOF, NDRC). In 2017, as suggested at the National Conference of Tax Administration on Large Enterprises, the administration on large businesses will be "put on full speed", such as developing more sophisticated risk alert indices, increasing IT capacity and staffing for relevant tax authorities, etc. A new age of tax administration on large businesses has set off from now on.

[8] Data source: a news clipping on China Taxation News about *"Achievements of China's Tax Administration on Large Enterprises in 2016"*. See this link: http://mp.weixin.qq.com/s/75ghU4LZDGmuDBWgVN39sQ

Dispute resolution in China – face it and embrace it gracefully

China's tax regime has become more sophisticated in the past decade. The risk-based tax administration supported by advanced IT and increased transparency has also availed tax authorities with more resources and capability to conduct tax audits. This is not just the trend in China. Tax administrations across the world are also undergoing such transformation fuelled by the implementation of the BEPS project recommendations. Tax disputes are expected to be soaring all around the world.

Traditionally, taxpayers often resorted to informal consultation and compromise to settle tax disputes in China. Recently, with the development of the legal environment and change in mind set, taxpayers – citizens and businesses – are more open to formal ways to cope with controversies, such as tax administrative appeal and court litigation for domestic tax issues, APA, and MAP for cross-border cases. Meanwhile, the SAT is also making efforts to improve its dispute resolution system to make it fairer, more transparent and efficient.

A. Trend of tax administration appeal and court litigation

With the steady development of China's tax administration environment, statistics show that taxpayers are more willing to solve tax disputes via tax administrative appeal and court litigation.

According to the SAT and Legislative Affairs Office of the State Council[9], the numbers of tax administrative appeals and court litigations have been constantly surging. In 2015, 688 tax administrative appeal cases and 549 court litigation cases were initiated, almost doubling and tripling the respective number of cases in 2011. The issues in dispute are diverse, including straight-forward tax issues such as tax collection and tax penalty, and more complicated issues such as the challenge of procedures and substantive laws. We also observe that more and more tax administrative appeal cases are handled by provincial-level tax bureaus and SAT. The involvement of senior-level tax officials, to a certain extent, suggests Chinese tax authorities' respect and proactive attitude towards such dispute resolutions.

The strides being made are inseparable from China's persistent effort to refine the guidance on tax appeals and enforcement.

- The revised *Rules for Tax Administrative Appeal*, which took effect from February 2016, has recognised electronic evidence as a valid document in tax administrative appeals, which effectively adds in flexibility for both taxpayers and tax authorities in providing evidences.
- The *Guidelines on the Discretion in Tax Administrative Penalty* released in November 2016 sets forth the principles in exercising discretion in tax administrative penalty and formulating the consistent discretion benchmark in each province. Such principles include legitimacy, reasonableness, equity, legitimate expectation, combination of punishment and education, etc. The standardised penalty discretion is seen as a practical means to prevent confrontations between tax authorities and taxpayers from the very beginning.
- In December 2016, the SAT announced its work plan and timeframe to promote "tax legality" theme during the 13th Five-Year period. Amongst others, the plan for tax administrative appeals is eye-catching, including amending the current *Working Guidelines for Responding to Tax Court Litigation*, requesting relevant government officials who work on administrative appeal to hold a legal professional qualification by 2017, streamlining the collaboration of government departments in tax administrative appeal by 2018, and creating a new office specialised in handling tax administrative appeal within the SAT and each provincial-level state tax bureau by 2019.

In the years ahead, the evolving legal environment in China would further encourage taxpayers to use tax administrative appeals and court litigation to settle tax disputes and protect their legal rights.

[9] Data source: the Legislative Affairs Office of the State Council. See this link: http://www.chinalaw.gov.cn/article/xzfy/

B. New APA rules reflect new thinking on TP administration

The BEPS project has changed the international tax landscape and intensified TP enforcement in many countries including China. The unprecedented rise of uncertainties faced by MNCs on their TP arrangement, has resulted in an ever-greater demand for APA, particularly bilateral APA (BAPA), which is regarded as an effective tool to prevent and mitigate controversies on related-party transactions in advance.

Over the past 8 years of APA practice in China, the SAT has developed some priority criteria and internal procedures to balance the rising requests and the problem of short staffing. Against that background, the SAT issued Public Notice [2016] No. 64 (Public Notice 64) to replace the previous APA regime. Public Notice 64 reflects SAT's new thinking and positions on TP in the administration of APAs. It revises the conditions for APA applications and the relevant procedures, and intensifies the follow-up monitoring on implementation. Notable points include:

- **Conditions:** For a company to be eligible to apply for an APA, it should have related-party transactions over 40m yuan in each of the past three consecutive years.
- **Covering period:** An APA may cover three to five years prospectively and up to ten years retrospectively.
- **Criteria for prioritised processing** include, for example, the fact that the company has closed a TP audit; the company has a top tax credit rating; the application is for a renewal with no substantial change to the fact pattern; the documents submitted are adequate with value chain analysis and reasonable proposal on TP methods, etc.
- **The application package requirement** has been updated, with additional analysis on location-specific advantages, such as location savings, market premiums, and the value chain analysis or supply chain analysis.
- **Additional steps:** Unlike the previous regime, the new rules require the taxpayer to go through pre-filing and analysis / evaluation stages and get an approval from tax authorities before lodging the letter of intent and formal APA application.
- **More stringent requirements on monitoring of APA implementation:** Where a taxpayer adopts the interquartile range to determine its profit level in the APA, if its actual operating results during the APA period fall below and are not adjusted to the median, the tax authorities shall reject a renewal application.

Public Notice 64 strengthens tax authorities' control over the APA process, and puts stricter requirements on taxpayers' compliance, cooperation attitude, and information disclosure during the APA application process. As SAT's capacity to handle APA cases is limited and the process may be tedious, it is imperative for taxpayers to evaluate the prospect and benefit of obtaining an APA against the new requirements ahead of the application. When preparing the application package, they are recommended to pay special attention to analyses of value chain and location specific factors. Timely response to tax authorities' queries is also crucial in order for their applications to receive prioritised processing.

C. MAP to be an effective mechanism to resolve cross-border double taxation

While BAPA is often treated as a channel to pre-empt TP-related cross-border dispute, MAP is more frequently used to resolve other international tax issues and eliminate double taxation.

Since 2015, China, as one of the five partner economies to the OECD, has started publishing MAP statistics on OECD's website. China's MAP statistics for 2013, 2014 and 2015 are available in public domains. The statistics include all MAP requests made pursuant to the MAP provision of double tax treaties, such as determination of residency, permanent establishment and TP cross-border corresponding adjustment, but exclude BAPA[10].

For 2015[11], five MAP cases were closed in China. The processing time to close these cases was volatile, ranging from 1 month to more than 30 months, depending on the complexity of specific cases and the process of negotiation with treaty parties. Far more than cases closed, 25 new cases were initiated in 2015, making the cases in the queue surge to 99. While these numbers demonstrate China's effort to make her dispute resolution mechanism more transparent, it also shows SAT's massive pressure in MAP staffing and the challenge to attain a successful close of the MAP cases.

The situation, however, should be expected to gradually improve in 2017. With all G20 countries' commitment to the minimum MAP standard under the BEPS project, China will be subject to a peer review on her MAP capability by 2018. More resources are expected to be put in place to escalate the MAP processing period and support the country's "Belt and Road" strategy as well. The process may become more appealing to Chinese companies investing abroad to resolve cross-border tax disputes with foreign tax authorities. For MNCs operating in China, MAP also offers them an alternative way to settle disputes apart from the domestic measures of tax administrative appeals and court litigation.

Looking to the future, with tax dispute resolution in China turning more formal, taxpayers should decide which approach to take by considering the complexity of the issues, the time cost for dispute settlement, the tax systems of the other country, etc.

[10] China's APA status is disclosed via China APA Annual Report. For the latest report (2015), see this link: http://www.chinatax.gov.cn/n810214/n810606/c2420314/content.html

[11] Data source: OECD. See this link: http://www.oecd.org/tax/dispute/map-statistics-2015.htm

Outlook for 2017

2017 will not be a quiet year for both international and China's tax communities. Globally, the US tax reform as proposed by the President Trump aims to significantly lower individual and corporate tax rates and impose a "deemed" repatriation tax on the foreign earnings of US-based companies and so on, to revitalise US markets. The UK's referendum to leave the European Union (EU) may trigger market volatility and result in tax policy changes over the years ahead. In addition, certain countries including Luxembourg, the Netherlands and Ireland are being challenged to have unfairly favoured MNCs through special tax rulings (i.e. the State Aid) and thus may have to revisit their ruling systems to stop the "illegal" State Aid.

Against this backdrop, China is also constantly examining her existing tax regime against the global trend to improve her tax competitiveness, such as the possible refined foreign tax credit regime to support the "Belt and Road Initiative", the R&D incentives accessible to foreign branches of China's companies, and tax policies to promote the development of digital economy and avoid tax leakage simultaneously, etc. This is in line with the national strategy stated in the 13th Five-Year Plan.

In addition to the unilaterally-proposed policy changes, tackling cross-border tax avoidance will remain to be the top agenda of the international tax arena. China will make continuous effort to implement G20 tax reform. For example, apart from Public Notice 42 on TP documentation and Public Notice 64 on APA released in 2016, China has been revisiting the other special tax adjustment rules such as CFC, Thin Capitalisation. Some of the recommendations under the BEPS project may be taken into consideration in the revision but need to be tailored to China's own circumstances. At the same time, China will issue her final CRS compliance administrative measures soon to fulfil her commitment in the exchange of financial accounts information in 2018. Enforcement on non-tax resident enterprises (non-TREs) will also likely be strengthened. A new guideline on tax withholding obligation on passive income is under draft to replace the existing one released in 2009 (Guoshuifa [2009] No. 3). This may affect both the withholding agents and non-TRE income recipients on their business arrangements.

Moreover, with the signing of the Multilateral Instrument for implementing the tax treaty related BEPS Actions, a new landscape of tax treaties will be unfolded. China is also considering adopting certain treaty related BEPS Action recommendations into her new treaties and assessing their implications to her domestic regulations. For instance, in order to prevent treaty shopping, China may follow the recommendations in BEPS Action 6 and incorporate the proposed anti-avoidance measures, Limitation of Benefits and/or, Principle Purpose Test into her treaties.

The transformation of tax administration mode, especially the "Thousand Groups Project", will be given even more emphasis in 2017. More circulars may come out on how to leverage big data to enhance the tax administration of large businesses.

In the longer run, more tax reforms in China are ready to go. The IIT Reform, which has been hotly discussed over the past few years, may reach the stage of a Discussion Draft being released for public consultation within 2017. As for the Property Tax Reform, more time may be needed for deliberation. According to some discussions in public domains, Property Tax may be levied on owners during the holding period, with the aim to curb speculation in the real-estate markets.

The above-mentioned two Reforms cannot be done without an improved administration system. A tax identification number system was introduced in the 2015 Discussion Draft of the *Tax Collection and Administration Law (TCAL)* to record tax data of a company / natural person in one single account, including the registration of real-estates. The TCAL has been marked as one of the "prioritised items for comprehensive reform" on the government's 2016 Legislative Agenda. Although there were not too much public news on the topic since the release of the 2015 Discussion Draft, this does not mean that the Chinese authorities have not been working diligently on it behind the scene. Let's see whether the amendment to TCAL would draw to a close in 2017?

The takeaway

Towards the end of 2016, there was a wave of discussions and debates among private business entrepreneurs, scholars, tax experts, sociologists and SAT / MOF officials on the tax burdens of Chinese taxpayers. The triggering event is the *Paying Taxes 2017* report published by the World Bank Group and PwC Global which ranked "China's total tax rate" as the 12th heaviest among 190 economies in 2015. Many of them are of the view that the methodology used in the report is subject to a lot of artificial assumptions which may not clearly and accurately reflect the true Chinese tax burdens and some even pointed out that there is yet to have a globally accepted standard or measurement in such area. Moreover, the cry for lessening tax burdens (including non-tax government levies) is getting louder and louder. The Chinese government has reacted quickly and announced several immediate actions, including the further cut in non-tax government levies and relaxation of administrative control on the markets, which are seen as positive signs.

It is generally believed that the global tax policy landscapes would be exiting in 2017, and China will not be left behind. China's taxation is dynamic and serves multiple purposes, as a key pillar of fiscal revenue, as an important tool to stimulate inclusive growth of the country's macro-economy, as a contributor to ensure social equity, as a fund to expand public services, as a catalyst to encourage innovation, as a deterrent to unsustainable business activities, and more. To achieve these purposes, China has embarked on a string of reforms, aiming to optimise her taxation regime and modernise her tax administration system by 2020.

Meanwhile, the vibrant international tax developments, in particular BEPS project, and domestic taxation reforms over the past years have also raised the tax awareness of Chinese taxpayers in general. Businesses may have to do more than just duly filing their tax returns. Internally, they may have to put more effort into building their tax control framework and upgrading their IT capacities to manage tax risks. Externally, they may have to be more proactive in participating in the development towards a better tax system — by voicing out their opinions on important tax policies, sharing their business concerns with tax collectors, seeking clarification on tax uncertainties, recognising and using formal remedies to settle tax disputes…

As we mentioned above, 2017 will keep to be a thriving year for tax. Businesses should stay alert for both international and domestic tax reforms and development, and prepare and adapt accordingly.

List of China Tax/Business News Flashes published in 2016

Jan 2016, Issue 1 – Hong Kong issued a draft tax legislation to promote it as a location for setting up a corporate treasury centre
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Jul 2016, Issue 1 – Entry ban lifted for wholly foreign-owned enterprises (WFOEs) and joint ventures (JVs) engaging in private securities investment fund management business in China
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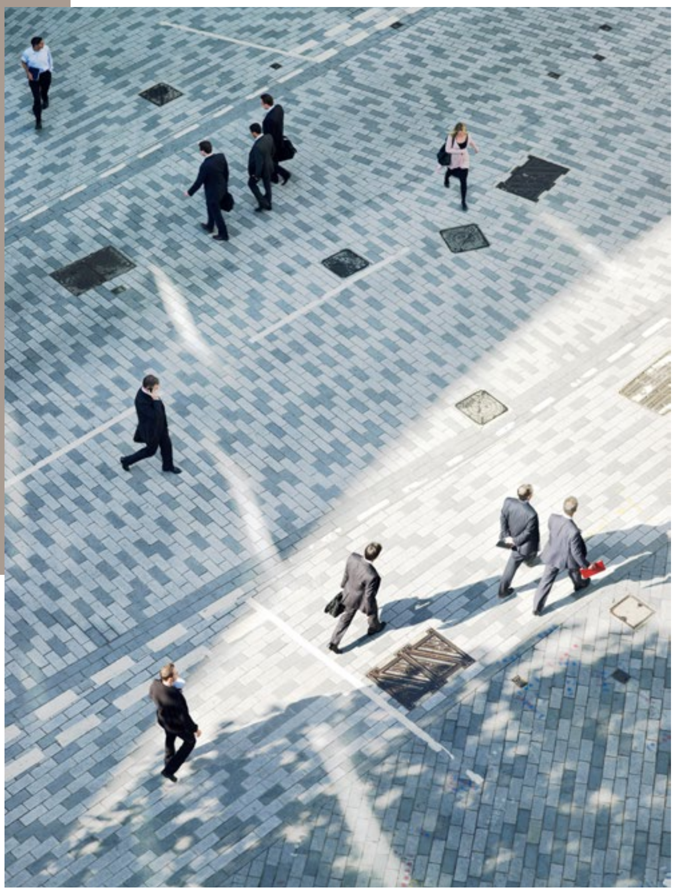

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