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Tax Developments in China

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1. Introduction

This paper summarizes the major tax developments in China during 2016.

Over the past year, multinational companies (MNCs) have experienced increasingly aggressive tax enforcement and collection from the Chinese tax authorities. According to the State Administration of Taxation (SAT), the Chinese tax authorities collected RMB58 billion in taxes from anti-avoidance investigations in 2015, representing an 11 percent increase over 2014. As illustrated in Sections 2 and 3 of this paper, the tax audits during the past year mainly focused on transfer pricing issues, outbound service fee or royalty payments, indirect share transfers, entitlement to treaty benefits and permanent establishments (PEs).

The PRC tax authorities have been shining a spotlight on transfer pricing over the past years. This scrutiny has intensified in response to the Base Erosion and Profit Shifting (BEPS) Project. In June 2016, China revised its transfer pricing documentation rules to introduce new concepts and requirements such as country-by-country reporting, value chain analysis, and location specific advantages (LSAs). As a result, MNCs today face significantly greater transfer pricing audit risks in China.

At the same time, taxpayers are becoming more confident about standing firm in their legal positions and advancing strong arguments in negotiations with tax bureaus during tax audits and disputes. This year, like the year before it, has seen more formal controversies, even with some litigation cases against the tax authorities by MNCs. Practice indicates that tax authorities are more motivated to make a compromise if taxpayers are willing to go the distance by pursuing formal dispute resolutions forums up to and including litigating the matter in a court of law.

Other major Chinese tax developments over the past year include the expansion of the value-added tax (VAT) pilot program to cover all industries, the revisions to the R&D super deduction rules and high and new technology enterprises (HNTE) rules, and the improvement of information exchange network.

2. Transfer Pricing

2.1 New Transfer Pricing Documentation Rules Introduced to Implement BEPS Country-by-Country Reporting

On 29 June 2016, the SAT finally issued the long-awaited Bulletin 42[1] to revise the transfer pricing documentation requirements under Circular 2[2]. By introducing the key recommendations under Action Plan 13 of the BEPS Project, Bulletin 42 will have a far-reaching impact on taxpayers.

In this section, we will first look at who is affected by Bulletin 42. We will then discuss key provisions introduced under this bulletin and their implications on

[1] *State Administration of Taxation's Bulletin on Issues Relating to the Enhancement of the Declaration of Related Party Transactions and Administration of Contemporaneous Documentation*, SAT Bulletin [2016] No. 42, dated 29 June 2016, retroactively effective from 1 January 2016.

[2] *Circular of the State Administration of Taxation on Printing and Distributing the Implementing Measures for Special Tax Adjustments (for Trial Implementation)*, Guo Shui Fa [2009] No. 2, dated 8 January 2009, retrospectively effective from 1 January 2008.

MNCs. Finally, we will provide some recommendations to MNCs on how to ensure compliance with the new transfer pricing documentation requirements and how to develop appropriate strategies to safeguard their tax interests in China.

2.1.1 Who is affected?

Any MNC engaged in a cross-border, related-party transaction can expect to be significantly affected by the transfer pricing documentation requirements in Bulletin 42. MNCs engaged in purely domestic related-party transactions are expressly excluded from these requirements.

Bulletin 42 requires MNCs to prepare transfer pricing documentation for related-party transactions occurring in or after 2016. Non-compliance may lead to a punitive interest penalty equal to the RMB loan benchmark rate published by the People's Bank of China plus 5 percentage points if and when the PRC tax authorities make a final transfer pricing adjustment.

2.1.2 What does the bulletin require?

Consistent with the OECD proposals under the BEPS Action Plan 13, Bulletin 42 requires the taxpayer, subject to certain conditions as illustrated below, to provide a three-tier transfer pricing documentation[3]: (i) a master file containing general information about the MNC group's global business operations; (ii) a local file containing detailed information about the related-party transactions of the Chinese enterprise in the group; and (iii) a country-by-country report containing information about the global allocation of the MNC group's income and taxes ("**CbC Report**"). In addition, Bulletin 42 requires the taxpayer to prepare a special file for cost sharing agreements and thin-capitalisation.

(i) Master file

An enterprise must prepare a master file within 12 months from when the fiscal year ends for the MNC group's ultimate holding company if (i) the enterprise's total related-party transactions exceed RMB1 billion, or (ii) the enterprise has cross-border related party transactions and the MNC group has already prepared a master file.

The master file provides a "blueprint" of the MNC group and contains:

- the MNC group's organizational chart;
- a description of the MNC's business, including profit drivers, supply chain and main geographic markets of major products/services, intercompany service agreements, brief functional and value creation analysis for group entities, and recent restructurings;
- information on the MNC's intangibles, e.g., a list of intangibles important for transfer pricing with legal owners and a general description of the MNC group's transfer pricing policies for R&D and intangibles;

[3] Transfer pricing documentation used in this section include (i) the Annual Statement of Related Party Business Transactions, which consists of 22 standard forms (including six forms on CbC reporting), and (ii) contemporaneous documentation, including a master file, a local file and special documentation.

- a description of the MNC's financial arrangements, including related and unrelated financing; and
- documents containing the MNC's financial and tax positions, e.g., the latest consolidated financial statements of the MNC group, a list and a brief introduction of advance pricing agreements (APAs) and tax rulings on income allocation, and the reporting entity for the CbC Report.

Normally, a Chinese affiliate does not have direct access to most (or any) of this information. Therefore, it would be burdensome if not impossible for the Chinese affiliate to prepare the master file by itself.

Fortunately, most Chinese affiliates will not have to prepare the master file from scratch. Since the information required for the master file under Bulletin 42 is basically the same as the information required under the BEPS proposals[4], the Chinese affiliate can modify the master file that has been prepared by the MNC group to satisfy the BEPS requirements and submit that modified file to satisfy the Bulletin 42 requirements. As such, we recommend Chinese affiliates ask the MNC group's parent company to share the most recent BEPS master file whenever the Chinese affiliate prepares the Bulletin 42 master file.

(ii) Local file

An enterprise must prepare a local file for its annual related-party transactions (excluding transactions covered by APAs) by 30 June of the following year if:

- its annual amount of related-party transfers of tangible assets exceeds RMB200 million;
- its annual amount of related-party transfers of financial assets exceeds RMB100 million;
- its annual amount of related-party transfers of intangible assets exceeds RMB100 million; or
- its annual amount of other related-party transactions exceeds RMB40 million.

Although most of the information required for the local file has already been required under Circular 2, Bulletin 42 does require some new information, such as information on value chain analysis, LSAs, the enterprise's contribution to the MNC group's overall or residual profits, related-party equity transfers[5], intragroup services, APAs and tax rulings related to the transactions conducted by the enterprise.

Even though Bulletin 42 marks the first time that any regulation will expressly require value chain analysis to be included in transfer pricing documentation, the SAT has consistently instructed local tax authorities to conduct a value chain analysis when making transfer pricing adjustments because the SAT enthusiastically insists that "value chain analysis" is consistent with the BEPS Project's principal objective, i.e., to ensure that "profits [are] taxed in the jurisdiction where economic activities occur and value is created." Notably,

[4] Except, Bulletin 42 requires the reporting entity for the CbC Report to be specified in the master file.
[5] For the first time, Bulletin 42 codifies the tax authority's practical approach in requiring a valuation report to evidence a related-party equity transfer is conducted at arm's length.

the financials of all the related parties along the value chain will have to be provided to the Chinese tax authorities under the value chain analysis. We expect the value chain analysis as part of the local file to encourage the PRC tax authorities to use the profit split method more frequently when determining a Chinese affiliate's proper returns.

(iii) CbC Report

A Chinese resident enterprise must submit a CbC Report when filing its annual tax return if:

- it is the ultimate holding company in an MNC group with a consolidated revenue for the last fiscal year in excess of RMB5.5 billion; or
- it is designated by the MNC group as a reporting entity for the CbC Report.

Consistent with the BEPS recommendations, the CbC Report under Bulletin 42 requires aggregate country-by-country data about entities (and permanent establishments) in every country, including information about revenue, profits (and losses) before income tax, income tax paid (on cash basis), income tax incurred, stated capital and accumulated earnings, number of employees, and tangible assets other than cash and cash equivalents.

In addition, the PRC tax authorities may request an enterprise under audit to submit a CbC Report if: (i) the MNC group to which the audited enterprise belongs is required to prepare a CbC Report under any jurisdiction's law; and (ii) the PRC tax authorities cannot obtain that CbC Report through an information exchange program [6].

On 30 June 2016, the US Treasury and the Internal Revenue Service released the final regulations implementing CbC reporting[7] ("US CbC Regulations"). The US CbC Regulations require every US-parented MNC with an annual group income of US$850 million or more to prepare a CbC Report for reporting periods that begin on or after 30 June 2016. Notably, the US has said it will not participate in the CbC MCAA. Instead, it would enter into bilateral agreements for exchange of CbC Reports to conform with US government's practice on international agreements. Thus, before China enters into a bilateral arrangement with the US on the exchange of CbC Reports, a US MNC's CbC Report will not be exchanged to the PRC tax authorities. That being said, with US domestic law requiring a US MNC to prepare a CbC Report, the PRC tax authorities can now request an MNC's Chinese subsidiary(ies) to provide the MNC's CbC Report during a transfer pricing audit.

In addition to increasing the compliance burden on MNCs, CbC reporting could pose a risk for MNCs because the PRC tax authorities may attempt to claim a larger share of the MNC's global profits.

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[6] On 12 May 2016, China signed the Multilateral Competent Authority Agreement on the Automatic Exchange of Information of Country-by-Country Reports ("**CbC MCAA**").
[7] The full text of the legislation is available at https://www.federalregister.gov/documents/2016/06/30/2016-15482/country-by-country-reporting.

(iv) Special file

Although the term "special file" is being used for the first time, the information required for the special file was already required under Circular 2. The new terminology will not have any substantial impact on MNCs.

2.1.3 What are the impacts on MNCs?

The PRC Enterprise Income Tax Law (EITL) and its implementing regulations only require taxpayers to provide information relevant to the related-party transactions. Whereas, Bulletin 42 requires information beyond the scope of the taxpayer’s related-party transactions, for example, the CbC Report. Technically speaking, the EITL and its implementing regulations should prevail over Bulletin 42 in case of conflict. In practice, however, it would be difficult for taxpayers to challenge Bulletin 42 based on the said conflict.

With more transfer pricing documentation information being required under Bulletin 42 and being disclosed to the PRC tax authorities, we expect more transfer pricing audits and more tax disputes to follow in China. In particular, the SAT may introduce new transfer pricing legislation in the future as weapons to bring more profits to China.

However, as concerning as it may sound, Bulletin 42 and potential transfer pricing regulations to follow, are by no means the end of tax planning in China. After all, China's transfer pricing rules still follow the arm's length principle. Therefore, amid the heightened scrutiny, taxpayers should remain confident in being able to defend their related party transactions before the tax authorities as long as their positions are based on a sound application of the arm's length principle and are supported by high-quality comparable data. In addition, taxpayers can still expect assistance and relief from other involved jurisdictions. Action Plan 14 under the BEPS Project requires jurisdictions to settle disputes within 24 months. In response to this requirement, the SAT has invested vastly in its mutual agreement procedure program. Even if a taxpayer on its own is not able to settle with the SAT, the competent authority of the taxpayer's jurisdiction could always intervene to negotiate with the SAT on the taxpayer's behalf or provide a corresponding adjustment to alleviate double taxation.

Last but not the least, the tax administration environment is improving in China. Previously, administrative review and administrative litigation were not used by foreign companies and foreign-invested companies. The past two years have seen more formal controversies, even with some litigation cases against the tax authorities by MNCs. Practice indicates that tax authorities are more motivated to make a compromise if taxpayers are willing to go the distance by pursuing formal dispute resolutions forums up to and including litigating the matter in a court of law. In short, MNCs with a solid legal basis for their structure must be ready, willing and able to vigorously defend their positions.

2.1.4 What should MNCs do?

With Bulletin 42 taking effect from 1 January 2016, MNCs will be required to comply with the new transfer pricing documentation requirements. Coupled with the PRC tax authorities' increasing scrutiny on cross-border related-party transactions in a post-BEPS environment, every MNC should consider the following actions to safeguard its tax interests in China:

- invest in human resources and accounting systems to comply with new transfer pricing documentation requirements;
- review and assess existing legal structures and the economic substance of income receiving entities to determine whether these arrangements are defensible;
- manage the tax risks from BEPS by obtaining certainty through APAs where appropriate;
- prepare to challenge tax authority decisions through administrative review processes, litigation, mutual agreement procedures or other procedures when a sound legal basis exists and it is commercially necessary and feasible to do so.

2.2 New Rules on APA Administration: Signs of Hope or Greater Challenges Ahead?

Many MNCs have expressed frustration with China's APA program. For a country with the economy size and importance of China, the program has historically been understaffed and has never received the attention and resources that most believe it deserves.

On 18 October 2016, the SAT released Bulletin 64[8], which introduces new rules on the administration of APAs. Bulletin 64 has superseded the previous APA administrative rules, which are found in Chapter 6 of Circular 2, starting 1 December 2016. The SAT issued Bulletin 64 in response to the key recommendations under Actions 5 and 14 of the BEPS Project. Those recommendations were to include unilateral APAs (UAPAs) in the information exchange network and to provide guidance on the APA program. More generally, Bulletin 64 aims to provide comprehensive and practical guidance to enterprises and tax bureaus seeking to reach an APA. Bulletin 64 is the second bulletin released this year as part of the SAT's ongoing plan to revise parts of Circular 2. The first was Bulletin 42, which was released in July (see Section 2.1 above).

The key question now is whether Bulletin 64 will help to address the logjam in this process and how changes in China's administration of APAs will be a net win or loss for MNCs seeking the certainty an APA should provide in what is now one of, if not the most, important market(s) for their business globally. There is little doubt that Bulletin 64 constricts the availability of APAs as a technical matter, but given that the key barriers to access to APAs in China have historically been more practical in nature, there is hope here.

2.2.1 Who is affected?

The tax authorities in China have been shining an increasingly bright spotlight on transfer pricing over the past several years. The BEPS Project has certainly added to that focus, and MNCs today are faced with significantly greater transfer pricing audit risk. An APA is one way of effectively managing this risk. Therefore, any MNC that seeks to manage the uncertainties associated with transfer pricing issues via an APA will be significantly affected by the new APA administration rules under Bulletin 64.

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[8] *Bulletin of the State Administration of Taxation on Issues Concerning Improving the Administration of Advance Pricing Arrangements*, SAT Bulletin [2016] No. 64, dated 11 October 2016, effective from 1 December 2016.

The APA program in China has suffered from a lack of resources. Many APA applications have stalled at either the APA letter of intent stage or the examination and evaluation stage. According to China's 2014 Annual APA Report dated 18 December 2015, 90 applications were stuck at the letter of intent stage and 39 applications at the examination and evaluation stage by the end of 2014. Overall, China has concluded a relatively modest number of bilateral APAs (BAPAs) (with only eight BAPAs signed in 2013, and six in 2014). Given the backlog of APAs in China, MNCs have long been hoping for greater resources and attention being paid to China's APA program. Bulletin 64 impacts the administration of APAs by tightening the scope of availability for potential APAs, but a key question is whether these changes may be paired with greater access for those who qualify.

2.2.2 What does Bulletin 64 say?

(i) In-charge tax authority for APAs

Bulletin 64 specifies different in-charge tax authorities depending on the type of APA involved: a UAPA, a BAPA or a multilateral APA (MAPA). A UAPA will normally be handled by an enterprise's in-charge tax authority, whereas, a BAPA or an MAPA will normally be jointly handled by the SAT and the enterprise's in-charge tax authority. Bulletin 64 further defines "the in-charge tax authority" as the tax authority that is responsible for an enterprise's special tax adjustment.

From a technical reading, "the in-charge tax authority" appears to include a tax bureau at the district level. This would be a change from Circular 2, under which only a tax authority at or above the level of a municipality divided into districts or an autonomous prefecture can handle APA procedures. However, this part of Bulletin 64 has to be understood in conjunction with what has actually happened in practice across China. Given that most provinces have centralized the special tax adjustment function, the in-charge tax authority for an APA has been de facto elevated to the provincial level tax bureaus.

The situation is more complicated where an APA involves:

- tax authorities from two or more provincial-level administrative regions; or
- a state tax bureau and a local tax bureau.

Bulletin 64 does not change the previous rule that the APA procedure should be coordinated by the SAT in both of these situations, but Bulletin 64 moves a step further by clarifying that the enterprise should submit the APA application to the SAT and its designated tax authority when seeking a UAPA. Thereafter, the SAT or its designated tax authority may sign a consolidated UAPA with the enterprise; or each in-charge tax authority involved may sign a separate UAPA with the enterprise.

(ii) APA procedure

Bulletin 64 divides the APA procedure into six stages: (i) pre-filing meeting; (ii) letter of intent to seek an APA; (iii) analysis and evaluation; (iv) formal application; (v) negotiation and execution; and (vi) implementation and monitoring. The detailed APA procedure is set out in Diagram One:

Diagram One:

The most significant procedural change is that Bulletin 64 officially moves the analysis and evaluation stage (called the examination and evaluation stage under Circular 2) ahead of the formal application process. This change formalizes a longstanding practice of conducting examination and evaluation before formally accepting an enterprise's APA application. From the SAT's perspective, this practice helps to prevent a backlog of formal APA applications and also gives the SAT greater discretion to remove an APA from the pipeline much later in the process, even after the analysis and evaluation has been completed.

Bulletin 64's other notable changes include:

- *Increased focus on value/supply chain analysis and LSAs.* At the pre-filing meeting stage, the enterprise is required to provide a concise explanation of whether there exist any LSAs. Next, at the letter of

intent stage, the enterprise should include analysis of LSAs and of the group's value/supply chain. Then, at the analysis and evaluation stage, the tax authority will assess whether the analysis on value/supply chain is complete and accurate and whether full consideration has been given to LSAs. This increased focus on assessing value/supply chain analysis and LSAs is consistent with new transfer pricing documentation requirements under Bulletin 42, which requires analysis of value chain and LSAs in the local file. But Bulletin 64, like Bulletin 42, fails to provide any clear guidance on how to conduct the value chain and LSA analysis.

- *Frees the tax authority from application response deadlines.* Bulletin 64 sets no deadlines for the tax authority to respond to the entepise's application at each stage. This represents a departure from Circular 2, which contained time limits for the tax authority to respond at each stage. For example, under Circular 2, the tax authority had to issue a written notice to the enterprise within 15 days from the date on which an agreement was reached at the pre-filing meeting stage. By removing these time limits, the tax authority will have full discretion and control over the timing of the APA procedure. Thus, enterprises will face increased uncertainty in the expected timeline of the APA process.
- *Increases monitoring of the enterprise's profitability.* The tax authortity may adjust the enterprise's profit rate in the current year up to the median of the agreed profitability range if the enterprise's acutal profit rate falls outside of the agreed profitability range during the APA application period. Upon the expiration the APA, an enterprise with a weighted-average annual profit rate in the APA application period lower than the the median of the agreed profitability range will not be eligible to renew the APA unless it adjusts its profit rate to the median for the expired APA period. This represents a significant departure from Circular 2, which only provided for a profit rate adjustment to reach the agreed profitability range. That said, some tax authorities have imposed this profit adjustment mechanism now expressed in Bulletin 64 for years despite the lack of solid legal authority.

(iii) Prioritized list and blacklist

Bulletin 64 permits the tax authority to prioritize an enterprise's APA application if:

- The enterprise has duly declared its related party transactions and prepared contemporaneous documentation;
- The enterprise has an A-level tax payment credit rating;
- The tax authority has already imposed a special tax adjustment on the enterprise and the case has been closed;
- The enterprise has not undergone any substantial change when an application is filed to renew an APA;
- The enterprise has submitted complete documents, which contain complete and accurate analysis on value/supply chain and LSAs and use reasonable transfer pricing principles and calculation methods;
- The enterprise proactively cooperates with the tax authority;
- The BAPA/MAPA partner country is willing to conclude the APA; or

- Other factors exist that may faciliate the conclusion of the APA.

The tax authority may reject an enterprise's APA letter of intent if:

- The enterprise is under a tax audit (including a transfer pricing audit);
- The enterprise has not duly declared its related-party transactions;
- The enterprise has not duly prepared, kept and provided contemporaneous documentation; or
- The tax authority and the enterprise do not reach an agreement during the pre-filing meeting stage.

In addition, Bulletin 64 provides that the tax authority may reject an enterprise's formal APA application if:

- The enterprise refuses to change inappropriate pricing principles and calculation methods used in the draft APA application report;
- The enterprise refuses to provide required documents or to correct insufficient documentation on a timely basis;
- The enterprise refuses to cooperate with the tax authority during the onsite interviews; or
- Other factors exist that obstruct the conclusion of the APA.

(iv) Roll-back of APA

According to Bulletin 64, an enterprise may apply and the tax authority may agree to retrospectively apply the pricing principles and calculation methods under an APA to identical or similar related-party transactions during the previous 10 years.

Furthermore, Bulletin 64 provides that the tax authority will collect the additional tax or grant a tax refund accordingly where an APA is applied to previous transactions. This provision is the first time that an established rule has provided legal authority for tax refunds in transfer pricing situations. However, it remains to be seen how the tax refund mechanism will work in practice.

(v) Information exchange

In response to the recommendations under Action 5 of the BEPS Project, Bulletin 64 introduces a new rule that the SAT may conduct information exchange with the competent tax authorities in other jurisdictions about UAPAs signed after 1 April 2016, unless national security information is involved.

2.2.3 What should MNCs do?

As mentioned before, the APA program in China has suffered from a lack of resources. As such, MNCs have found it difficult to have their applications formally accepted by the SAT. The hope is that while Bulletin 64 narrows the availability of APAs and seems to erect additional roadblocks for MNCs seeking an APA, given how difficult access has been due to insufficient resources, the hope is that these changes will focus the SAT on what they consider as higher value APAs and provide greater clarity for taxpayers on whether the pursuit of an APA has sufficient merit. Of course, for this to be

true, the SAT will need to make additional resource commitments to the program.

Faced with the APA procedural changes in Bulletin 64, every MNC trying to manage potential transfer pricing risks through any of the three types of APAs should consider the following:

- Evaluate the prioritized list and the blacklist under Bulletin 64 to identify and satisfy as many prioritized conditions as possible and to minimize the risk of being blacklisted;
- Develop a complete and appropriate analysis on the value/supply chain and the LSAs;
- Within the bounds of reasonableness, demonstrate an attitude of proactive cooperation with the tax authorities; and
- Understand the incentives that the local tax bureau, as well as the local government more generally, has to reach an APA and align your APA strategy with these incentives.

2.3 New Internal Government Procedural Rules on Transfer Pricing Audits

On 14 September 2016, the SAT issued Shui Zong Fa [2016] No. 137[9] ("**Notice 137**"), which superseded Guo Shui Fa [2012] No. 13 to become the government's internal procedural rules for transfer pricing audits. Although not officially released to the public, Notice 137 became available online in late November.

Notice 137 provides the tax authorities with key provisions on assigning audit responsibilities within the government as well as on following proper working procedures at each stage of transfer pricing audits. Among these key provisions, MNCs should particularly note the guidance on initiating transfer pricing audits and on approving final transfer pricing adjustments.

Initiating transfer pricing audits

In order to initiate a transfer pricing audit, the in-charge tax authority needs approval from the upper-level tax authorities. Notice 137 lowers the level of final approval authority for most cases from the SAT to the provincial-level tax authority. Previously, the initiation of a transfer pricing audit had to be approved by the SAT. Now under Notice 137, the provincial-level tax authority serves as the final approval authority for initiating a transfer pricing audit unless the case concerns a nationally coordinated transfer pricing audit, for which the SAT approval is still needed.

Approving final transfer pricing adjustments

Previously, a final transfer pricing adjustment always had to be approved first by the provincial-level tax authority and then by the SAT. Notice 137 does not change this approval process in major audits[10]. As an exception, for

[9] *Notice of the State Administration of Taxation on Printing and Distributing the Internal Guideline on Special Tax Adjustment*, Shui Zong Fa [2016] No. 137, dated 14 September 2016, effective as of the same date.
[10] Major audits include: (i) nationally coordinated audits; (ii) audits with the preliminary adjustment amount in excess of RMB10 million; (iii) audits involving cost sharing agreements,

nationally coordinated audits, the SAT reviews and approves the final transfer pricing adjustment directly without it first going to the provincial-level tax authority. However, for non-major transfer pricing audits, now the provincial-level tax authority is the final approval authority.

Observations

With the approval level for initiating most transfer pricing audits lowered to the provincial-level tax authority, the local tax authorities will have more discretion on whether to start a transfer pricing audit. Thus, MNCs could face greater transfer pricing audit risks. Although approval for the final transfer pricing adjustment in most audits will remain with the SAT, our experience is that the SAT tends to not intervene with the local tax bureau's decisions. As such, it is important for MNCs to formulate good strategy from the beginning and actively manage the audit from its outset.

2.4 Updated China Chapter of the UN Practical Manual on Transfer Pricing for Developing Countries

In October 2016, China submitted an updated China Chapter of *the United Nations Practical Manual on Transfer Pricing for Developing Countries*[11] ("**Updated China Chapter**") to the Committee of Experts on International Cooperation in Tax Matters. The Updated China Chapter introduces China's most recent transfer pricing regime and practices and sets out tax authority positions on key transfer pricing issues. MNCs should particularly note the following issues.

China affirms its adherence to the arm's length principle

The Updated China Chapter clearly states that the core of China's transfer pricing regime is the arm's length principle. A transfer pricing audit will be initiated only if a taxpayer fails to conform with the arm's length principle.

China intends to build a more professional transfer pricing team

The SAT has always prioritized building a dedicated transfer pricing team. In 2016, the SAT established the Anti-avoidance Division III, which has joined two other anti-avoidance divisions in administering transfer pricing issues. According to the Updated China Chapter, China aims to dedicate 50 people at the SAT and around 500 people across the country to administering transfer pricing. The transfer pricing team will include economists to focus on the quantification of technological intangibles, marketing intangibles, market premiums, location savings, etc.

China emphasizes location specific advantages and intangibles

In the Updated China Chapter, China emphasizes the role of location savings and marketing premiums (collectively known as location specific advantages or LSAs) on the determination of profits in China. According to the Updated China Chapter, the Chinese tax authorities view additional profits as taxable in China if derived from the Chinese market's unique characteristics. In

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controlled foreign enterprises and thin capitalization; (iv) general anti-avoidance audits; and (v) any other case as decided by the SAT.

[11] See http://www.un.org/esa/ffd/wp-content/uploads/2016/10/12STM_CRP2_Att12_ChinaCountryPractice.pdf

addition, the Chinese tax authorities strongly believe that any Chinese entity contributing to the development of intangibles should be compensated.

Tax authorities conduct holistic evaluation of functions and risks

If an MNC has multiple Chinese entities and each entity performs only a single function, such as manufacturing, distribution or R&D, the Chinese tax authorities will consider these entities and their functions as a whole to determine the returns each entity should earn in China. Similarly, multiple functions performed by an entity should be considered as a whole in order to properly determine the entity's returns.

Tax authorities propose alternatives to the transactional net margin method

The Updated China Chapter uses a hypothetical case to illustrate the selection of transfer pricing methods. The hypothetical case involves an MNC engaged in electronic manufacturing services. All or nearly all of the MNC's manufacturing activities are outsourced by its foreign headquarters to its Chinese subsidiary. This Chinese subsidiary earns only a limited return as a contract or toll manufacturer even though the majority of the MNC's work force (including many high-level operational staff) and tangible assets are located in China.

Under this hypothetical case, the Chinese tax authorities view a risk-based approach (e.g., the transactional net margin method) as generating insufficient compensation for the Chinese subsidiary. Instead, they would consider one of the following three approaches: (i) applying a global formulary approach based on the value chain analysis; (ii) determining the property return for the headquarters and allocating the residual profits to the Chinese subsidiary; or (iii) evaluating the Chinese subsidiary's return on its assets or capital employed using the MNC's overall profitability as a comparable.

Observations

With the Chinese tax authorities devoting more resources to transfer pricing audits, MNCs will face increased audit risks in China. During these audits, MNCs will face tough battles when it comes to LSAs, intangibles, value chain analysis, etc.

Many of the principles illustrated in the Updated China Chapter are methods the Chinese tax authorities have already been employing in TP audits in the last couple of years. The Chinese tax authorities have become more aggressive in trying to allocate a higher percentage of global profit to China based on these principles. MNCs should be wary of compromise. We have seen cases where taxpayers compromised on key transfer pricing issues, such as intangibles and transfer pricing methods, in the hope the tax bureau would grant a lower transfer pricing adjustment. Unfortunately, many of these taxpayers were rewarded with huge adjustments and additional taxes payable. Instead, MNCs should stand their ground by relying on China’s commitment to the arm's length principle in its transfer pricing rules. MNCs under a transfer pricing audit should develop a sophisticated plan at the outset of negotiations with the tax authorities and hold firm to their positons based on the arm's length principle.

2.5 Transfer Pricing Audit Cases

2.5.1 Qingdao Case: Transfer Pricing Adjustments to Outbound Royalty Payments

On 28 June 2016, China Taxation News reported that the Qingdao State Tax Bureau made a transfer pricing adjustment to outbound royalty payments and collected RMB14.95 million in EIT and interest from an equity joint venture (EJV). [12]

Facts

According to the news report, the EJV was investigated because it had stable sales revenue but fluctuating profits in the past ten years. In particular, from 2004 to 2007 when the EJV was entitled to tax incentives, it had positive profits. Whereas, it incurred loss in those years when the tax incentives were not available.

During the investigation, the tax bureau identified two abnormal royalty payments from the EJV. The first payment related to a technology, which was announced to be outdated by the Ministry of Commerce in 2003. However, the EJV kept paying royalties for this technology until 2009. The other payment related to a long-term license of a patented technology. The royalty payment was calculated at a fixed rate, which remained the same for 20 years. However, the tax bureau expected such royalty payment to reduce by year because the technology would normally become less advanced as time goes by.

The tax bureau determined that these two royalty payments were not at arm's length, and decided to make a transfer pricing adjustment using the net margin method. As a result, the EJV recognized an additional taxable income of RMB95 million, and paid RMB14.95 million in EIT and interest.

Observations

The PRC tax authorities have started to focus more on cross-border intercompany payments such as royalties and service fees. Unreasonable royalties paid by Chinese subsidiaries to offshore affiliates are subject to increasing scrutiny. MNCs should conduct a thorough review of its existing and future transfer pricing policy on IP related transactions.

2.5.2 Anshan Case: Transfer Pricing Adjustment on Service Fees

On 22 December 2015, China Taxation News reported that the Anshan State Tax Bureau of Liaoning province made a transfer pricing adjustment to outbound service payments and collected RMB11.34 million in EIT and interest from a foreign invested enterprise (FIE).[13]

Case Facts

According to the news report, the FIE was investigated because it paid unusually large service fees to its overseas parent company. The tax authority's investigation found that the FIE's service payments had increased

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[12] See http://www.ctaxnews.net.cn/html/2016-06/28/nw.D340100zgswb_20160628_3-07.htm?div=-1(China Taxation News is a newspaper indirectly owned by the SAT).
[13] See http://www.ctaxnews.net.cn/html/2015-12/22/nw.D340100zgswb_20151222_1-05.htm?div=-1.

significantly: in 2006, the FIE paid RMB180,000 for five service items; and in 2013, it paid RMB19.85 million for 24 service items. The FIE's previous annual profit rates of 20 to 35 percent dropped to 13.71 percent in 2013. By the end of 2013, the FIE had cumulatively deducted RMB49.9 million in service fees when calculating EIT.

On this basis, the tax authority reached a preliminary conclusion that the FIE was likely to be involved in tax avoidance. Their preliminary conclusion led them to conduct a functional analysis on the FIE. According to their functional analysis, the FIE was not a full-function enterprise because it did not have sales functions (the FIE did perform all production and had some procurement, management and contract R&D functions).

The tax authority required the FIE to provide a breakdown of the service items. It applied Bulletin 16's six tests[14] to analyze the authenticity and reasonableness of the service items. The tax authority then provided opinions on the service items:

- *Financial and human resource (H&R) service.* The FIE could have operated normally without the parent company's services; therefore, the financial and H&R services were not provided due to the FIE's operational needs.
- *Information dissemination service.* The FIE neither owned its own brand nor sold products to third parties; therefore, it could not have benefitted from the information dissemination service.
- *Planning service for product development.* The FIE did not own the patent produced from product development; therefore, it could not have benefitted from the planning service for product development.
- *Enterprise resource planning service.* The parent company had been compensated by previous royalties; therefore, the parent company should not charge a separate fee here.
- *Market research service.* The FIE did not sell products to third parties; therefore, it could not have benefitted from the market research service.
- *Production process support and technical service.* The service content was identical to other services – consulting service and production efficiency planning service; therefore, the parent company should not charge a separate fee here.
- *Product application supporting service.* This service should be provided by a sales company to third-party customers; therefore, it should not be borne by the FIE as a non-sales company.
- *Technical support service for product development.* The parent company controlled and implemented the whole process of product development while the FIE did not have any product development function; therefore, the service was never provided to the FIE.

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[14] Six service categories are not deductible for EIT purposes, including: (i) services irrelevant to the enterprise' functions, risks or operations; (ii) shareholder activities; (iii) duplicative services; (iv) incidental benefits; (v) services that have been compensated in other related-party transactions; and (vi) other services that cannot bring economic benefits to the enterprise. *State Administration of Taxation's Bulletin on Enterprise Income Tax Issues Related to Outbound Payments by Enterprises to Overseas Related Parties*, SAT Bulletin [2015] No. 16, dated 18 March 2015, effective as of the same date.

After nearly 10 rounds of negotiations, the FIE finally agreed to pay the additional tax and interest.

Observations

This case shows that the PRC tax authorities have become highly sophisticated in conducting transfer pricing analysis on intercompany services. Coupling this development with the tax authorities' aggressive auditing of intercompany service payments in response to the BEPS Project, MNCs may face greater challenges in their intercompany service payments. To meet these challenges, MNCs should conduct a thorough review of whether their intercompany services fall within the six categories of non-deductible services.

3. Anti-avoidance and Non-residents

3.1 Indirect Transfer Cases

3.1.1 Haidian Case: 15 Non-resident Enterprises Taxed on Indirect Transfers

On 15 July 2016, China Taxation News reported that the State Tax Bureau of Haidian District in Beijing collected RMB1.2 billion (approximately US$183 million) in EIT from 15 non-resident enterprises on indirect share transfers.[15]

Facts

The indirect share transfers were realized through two transfers of shares in a Cayman Island company ("**Target**") that indirectly owned shares in three PRC companies (two in Beijing and the other in Tianjin). The transferors involved were 15 non-resident enterprises. The total consideration for the two share transfers was US$2.75 billion, which was paid in cash and equity. In 2015, the transferors submitted share transfer documents to the tax bureau for recordal purposes. After reviewing these documents, the tax bureau decided to further analyse whether China had the right to tax the share transfers.

The tax bureau first analysed the applicability of the Bulletin 7[16] safe harbor provisions:

- the public trading safe harbor was not applicable because the two share transfers were not public trading activities;
- the treaty safe harbor was not applicable because 12 of the transferors were from non-treaty partner jurisdictions (the remaining 3 transferors came from treaty partner jurisdictions in Luxemburg, Singapore and Mauritius);
- the internal restructuring safe harbor was not applicable because the transferors and transferees were not related parties and a part of the consideration was paid in cash.

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[15] See http://www.ctaxnews.net.cn/html/2016-07/15/nw.D340100zgswb_20160715_1-05.htm?div=-1.

[16] *State Administration of Taxation Bulletin on Several Issues of Enterprise Income Tax on Income Arising from Indirect Transfers of Property by Non-resident Enterprises*, SAT Bulletin [2015] No. 7, dated 3 February 2015, effective as of the same date.

The tax bureau then analysed the reasonable commercial purpose of the share transfers. The tax bureau decided that the share transfers should, in accordance with Article 4 of Bulletin 7, directly be deemed as lacking reasonable commercial purpose because:

- the Target and the intermediate holding enterprises had no substantial business activities;
- the main value of the Target's equity was derived from the three PRC companies;
- nearly all of the Target's revenue was sourced from China; and
- none of the resident jurisdictions for the 15 transferors taxed the share transfers.

On this basis, the tax bureau concluded that the share transfers should be subject to tax in China.

To determine the amount of taxable capital gains, the tax bureau and the transferors agreed to:

- set the transfer price for the shares in the PRC enterprises as the transfer price stated in the share transfer agreement minus the intermediate holding enterprises' cash assets in proportion to the transferred shares; and
- set the cost basis for the shares in the PRC enterprises as the PRC enterprises' paid-in capital in proportion to the transferred shares.

According to the agreed transfer price and cost basis, the tax bureau recognized taxable capital gains of approximately US$2 billion. Further, to calculate the capital gains subject to tax in Haidian District, the tax bureau referred to the allocation method in Shui Zong Han [2013] No. 82 ("**Notice 82**"), i.e., the capital gains should be allocated to the three Chinese enterprises based on three factors of equal weight: the paid-in capital, the net asset value and the total operating income of each enterprise.

Observations

Treaty Safe Harbor

China's tax treaties with Luxemburg, Singapore and Mauritius allocate the exclusive right to tax capital gains arising from a share transfer to the resident state if: (i) the target company is not a land-rich company; and (ii) the transferor's shareholding in the target company is less than 25 percent. The news report did not contain enough information to explain why the Luxemburg, Singapore or Mauritius transferors were not entitled to the treaty safe harbor. Perhaps they each indirectly held 25 percent or more shares in each of the three PRC enterprises.

Another possibility is that the PRC tax authorities denied treaty benefits based on the beneficial ownership test for the capital gains. Although China's tax treaties do not subject treaty benefits for capital gains to the beneficial ownership requirement, there are several published cases where Chinese tax authorities mistakenly applied the "beneficial ownership" analysis to deny treaty benefits for capital gains. Despite not knowing whether the beneficial ownership test was applied in this case, MNCs should be aware that the tax

authorities may apply the beneficial ownership test to deny treaty benefits for capital gains.

Yet another possibility is that the PRC tax authorities denied treaty benefits because they treated the 15 transferors' share transfers as a single transaction. The share transfers seemed to have been realized through the same share purchase agreement; therefore, the PRC tax authorities might have denied treaty benefits to all transferors because a majority of the transferors were not entitled to a treaty exemption for capital gains. In consideration of this possibility, MNCs should group transactions under a single share purchase agreement only if all the transactions have similar tax consequences. Otherwise, MNCs should use separate share purchase agreements to avoid losing the opportunity to claim the most favourable tax treatment for each transaction.

Capital Gains Allocation Method

Another issue worth noting is the application of the capital gains allocation method under Notice 82. Although Notice 82 only applies to the Trust-Mart acquisition and has no binding authority in other cases, this case shows Notice 82 has persuasive authority when the tax authorities are examining similar transactions.

3.1.2 Daxing Case: Tax Bureau Allocated the Value of Foreign-owned Trademark to Chinese Entity

On 30 September 2016, China Taxation News reported that the Daxing District State Tax Bureau in Beijing allocated the value of a foreign-owned trademark to the underlying Chinese company in an indirect transfer and collected RMB89.04 million in EIT and interest from the non-resident transferor.[17]

Facts

The indirect transfer was realized through a transfer of an offshore company, which indirectly owned a Chinese company called Xiabu Xiabu Catering Management Co., Ltd ("**Chinese Target**").

In January 2013, the non-resident transferor reported the transaction to the tax bureau and declared an EIT liability of RMB69 million. However, in the subsequent tax assessment, the tax bureau and the transferor disagreed on the portion of the transfer price that should be allocated to the Chinese Target. The key issue in dispute was whether the value of the "XIABU XIABU" trademark should be allocated to the Chinese Target.

The transferor allocated the value of the trademark to an offshore entity because the trademark was registered offshore. Whereas, the tax bureau decided the value of the trademark should be allocated to the Chinese Target because the value of the trademark was created in mainland China.

After more than three years' negotiation, the transferor finally agreed to allocate the value of the trademark to the Chinese Target and paid

[17] See http://www.ctaxnews.net.cn/html/2016-09/30/nw.D340100zgswb_20160930_6-10.htm?div=0.

RMB89.04 million in EIT and interest, which was RMB20 million more than the tax originally declared by the transferor.

Observations

The tax bureau's decision in the Beijing Case is consistent with the Chinese tax authorities' long-held position that the economic value of an intangible should be allocated to the party that contributes to the intangible's value creation rather than the legal owner. In light of the Beijing Case, each multinational company should fully consider the tax implications of legal vs. economic ownership of intangibles when structuring its IP regime.

3.2 Treaty Benefit Cases

3.2.1 Wuzhong Case: Hong Kong Company Denied Treaty Benefits for Dividends

On 23 September 2016, China Taxation News reported that the Wuzhong State Tax Bureau in Ningxia reported that it denied a Hong Kong company's treaty benefit claim for dividends and that it collected RMB7.84 million in EIT from the Hong Kong company.[18]

In June 2016, an FIE declared a dividend distribution of RMB174 million. As a result, the Hong Kong company, which held 49 percent shares in the FIE, derived RMB78.39 million in dividends. The FIE made a Bulletin 60[19] recordal with the tax bureau for the Hong Kong company, claiming the reduced 5 percent withholding tax rate on the dividends China-Hong Kong Double Taxation Arrangement ("**China-HK Arrangement**"). However, after reviewing the submitted documents, the tax bureau decided the Hong Kong company was a conduit company and could not qualify as the beneficial owner of the dividends because:

- the Hong Kong company could not provide a Hong Kong residency certificate;
- the Hong Kong company's main income was dividends;
- the Hong Kong company conducted almost no business activities and therefore incurred almost no operational expenses; and
- the Hong Kong company's assets, staff and operations did not match its income.

As a result, the tax bureau imposed a 10 percent withholding tax on the dividends.

Observations

Although Bulletin 60 has replaced the approval procedure with a recordal procedure for a non-resident taxpayer to claim tax treaty benefits, the Wuzhong Case shows the PRC tax authorities' readiness to scrutinize the taxpayer's eligibility for the treaty benefits. According to the *PRC Tax Administration and Collection Law*, the tax authority may levy late payment surcharges (i.e., 0.05% per day) and potential penalties (in the range of 50%

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[18] See http://www.ctaxnews.net.cn/html/2016-09/23/nw.D340100zgswb_20160923_1-10.htm.
[19] *State Administration of Taxation's Bulletin on the Administrative Measures for the Non-resident Taxpayer to Claim Tax Treaty Benefits*, SAT Bulletin [2015] No. 60, dated 11 August 2015, effective from 1 November 2015.

to 500%), in addition to any underpaid tax if the taxpayer has enjoyed but is found to be disqualified for the treaty benefit. To avoid unnecessary tax costs, every MNC should make a careful assessment before it decides to claim the treaty benefit.

3.2.2 Huzhou Case: Tax Bureau Applies Beneficial Ownership Test to Treaty Benefits for Capital Gains

On 2 September 2016, China Taxation News reported that the Huzhou State Tax Bureau of Zhejiang Province denied a Hong Kong company's treaty benefit claim for capital gains from share transfer and that it collected RMB77.79 million in EIT from the Hong Kong company.[20]

Facts

In April 2016, a PRC listed company announced that one of its shareholders, a Hong Kong company, planned to reduce its shareholding in the PRC company. After obtaining this information, the tax bureau approached the PRC company and the Hong Kong company, requiring the Hong Kong company to pay tax once the planned share transfer was completed.

Faced with this requirement, the Hong Kong company argued that it should be exempt from EIT in China according to the China-HK Arrangement because it only held 24.77 percent of the PRC company.[21]

The tax bureau rejected this treaty benefit argument because the Hong Kong company was not the beneficial owner. According to the tax bureau, a non-resident should be the beneficial owner in order to enjoy the treaty exemption on capital gains. Whereas, the Hong Kong company could not provide evidence that it had substantial business activities. Thus, the tax bureau decided that the Hong Kong company was not the beneficial owner and was not entitled to the treaty exemption. The Hong Kong company finally accepted the tax bureau's decision and agreed to pay the tax.

Observations

As none of the capital gains provisions under the China-HK Arrangement or China's other tax treaties have a "beneficial ownership" requirement for capital gains tax exemption, it is technically incorrect to apply the beneficial ownership analysis to treaty benefits on capital gains. However, even before this case, several published cases had mentioned the Chinese tax authorities mistakenly applying "beneficial ownership" analysis to deny treaty benefits on capital gains. These cases mainly involved taxpayers from traditional tax havens, such as Barbados. However, the Huzhou Case indicates the tax authority's scrutiny of capital gains treaty benefits may expand to other jurisdictions even though the tax authorities are using a technically questionable method.

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[20] See http://www.ctaxnews.net.cn/html/2016-09/02/nw.D340100zgswb_20160902_1-10.htm?div=-1.

[21] Under the China-HK Arrangement, income from a share transfer in a company other than a land rich company is taxable only in the resident jurisdiction if the transferor holds less than 25 percent of the capita of the target company.

3.3 PRC Tax Authorities Increase Scrutiny on Service PEs

Recently, an increasing number of cases are being published in which the PRC tax authorities are reported to have decided a non-resident enterprise to have a PE due to its services performed in China.

Nanjing Case

According to a news report published on the Hainan Local Tax Bureau's website, the Nanjing State and Local Tax Bureaus in Jiangsu cooperated in an investigation to collect RMB5.89 million in EIT and RMB31 million in IIT.[22]

The local tax bureau started the investigation when it learned that a Chinese company had paid large service fee amounts to an offshore company. As the services were rendered over a long period, the local tax bureau decided to look into whether the offshore company had created a PE in China. The local tax bureau contacted the state tax bureau and asked to review the service contract submitted by the PRC company to the state tax bureau for recordal purposes.

After reviewing the service obligations in the service contract, the two tax bureaus suspected that the offshore company would need employees in China to perform the obligations. After questioning the PRC company's employees and conducting an on-site investigation, the tax bureaus found that the offshore company did have technical staff in China. After further investigation, the tax bureaus confirmed that these technical staff had stayed in China long enough to establish a PE. Therefore, the offshore company was liable to pay EIT and withhold IIT for its technical staff working in China.

In order to determine the EIT payable, the state tax bureau allocated RMB157.12 million from the total service fees (i.e., RMB368.31 million) to the PE and taxed the PE using the deemed profit method.

Ningbo Case

On 12 August 2016, China Taxation News reported that the Ningbo State Tax Bureau in Zhejiang collected RMB10.88 million in EIT from a UK university on service fees received from a Chinese university ("**Payer**").[23]

The Payer was a Sino-foreign cooperative university jointly owned by the UK university and a Chinese university. The UK university and the Payer entered into a service agreement, according to which the former provided education services to the latter. These education services included seconding experienced teaching and management staff to China.

The tax bureau decided to investigate because the UK university had been receiving increasing service fees in recent years but had never paid EIT in China. A key issue under investigation was whether the seconded staff created a PE for the UK university. The UK university argued that no PE was created because the seconded staff signed labor contracts with the Payer and therefore were the Payer's employees. The tax bureau rejected this argument because the investigation showed that the seconded staff were

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[22] See http://www.tax.haina n.gov.cn/hnportal/yasf/869245.jhtml.
[23] See http://www.ctaxnews.net.cn/html/2016-08/12/nw.D340100zgswb_20160812_1-10.htm?div=-1.

hired and paid by the UK university. On this basis, the tax bureau decided the UK university had a PE in China and was liable for tax on income attributable to the PE.

In order to determine the EIT payable, the tax bureau allocated 47 percent of the total service fees to the PE and taxed the PE using the deemed profit method.

Observations

Due to the tax recordal mechanism for outbound remittances,[24] the PRC tax authorities can examine outbound payments to determine whether a PE is created. The Nanjing and Ningbo Cases indicate the PRC tax authorities are being especially rigorous in searching for service PEs. We expect this trend to continue.

If a service PE is created, the offshore service provider's EIT burden depends largely on how much income is attributable to the PE. As such, every offshore service provider should maintain sufficient documentation on the income allocation between services performed inside and outside of China to prevent the PRC tax authorities from arbitrarily allocating income to the PRC PE.

4. Enterprise Income Tax

4.1 New Rules on Super Deduction of R&D Expenses

On 2 November 2015, the Ministry of Finance (MOF), the SAT and the Ministry of Science and Technology (MOST) jointly issued Notice 119[25], addressing the new rules on super deduction of R&D expenses..

Super deduction refers to the tax incentive available to enterprises engaged in R&D. An enterprise can either (i) take a one-time enterprise income tax (EIT) deduction in the current year equal to 150 percent of the actual R&D expenses if no intangible asset results from the R&D, or (ii) amortize the resulting intangible asset at 150 percent of the actual R&D expenses that are calculated into the cost of the relevant intangible asset.

Super Deduction expanded to new industries

Previously, the super deduction was only available to enterprises engaged in listed high-tech industries. Notice 119 expands the super deduction to cover all industries except for those on a "negative list". The negative list includes the following industries:

- tobacco manufacturing;
- hotel and catering;
- wholesale and retail;
- real estate;
- leasing and business services;

[24] Under PRC law, a PRC taxpayer must make a tax recordal for each non-trade outbound remittance in excess of US$50,000.
[25] *Notice on Improving the Super Deduction Policy of R&D Expenses*, Cai Shui [2015] No. 119, dated 2 November 2015, effective from 1 January 2016.

- entertainment; and
- other industries specified by the MOF and the SAT.

Qualified activities expanded

Same as the previous rules, Notice 119 defines R&D activities as systematic activities conducted by an enterprise to obtain and creatively apply new scientific and technological knowledge or to materially improve technologies, products (services) and techniques.[26] Notably, Notice 119 extends the super deduction to creative design activities.

Qualified expenses expanded

Notice 119 categorizes qualified R&D expenses into the following seven broad categories:

- labor costs;
- direct investment expenses;
- depreciation expenses;
- amortization of intangible assets;
- design fees for new products, formulating fees for new technique procedures, clinical test expenses for new drug development and field trial expenses for the exploration and development of technology;
- other related expenses; and
- other expenses specified by the MOF and SAT.

"Other related expenses" should not exceed 10 percent of the total qualified R&D expenses. The new qualified expenses under Notice 119 are labor costs for external R&D personnel, inspection fees for trial products, expert consulting fees, insurance premiums for high-tech R&D, and travel and conference expenses directly related to the R&D. The last three items are classified as other related expenses and thus subject to the 10 percent limitation.

Contract R&D

For contract R&D, Notice 119 leaves unchanged the rule that permits the principal rather than the entrusted party to take the super deduction. But Notice 119 limits the qualified R&D expenses to 80 percent of the actual expenses. Further, under Notice 119, expenses incurred by a foreign entrusted party are not eligible for the super deduction.

Notice 119 makes a welcome change in only requiring the breakdown of contract R&D expenses between related parties instead of between unrelated parties as the previous rules required.

Simplified procedures

In addition to its expanded scope, Notice 119 has simplified procedures. First, Notice 119 changes the accounting requirement from the previous

[26] Notice 119 specifically names seven activities to be excluded from the super deduction because the activities do not meet the definition of R&D activities.

special account to subsidiary account. Compared to the complicated standards for special accounts, the simpler standards for subsidiary accounts will lower compliance burdens.

Second, Notice 119 reduces the burden on an enterprise during a dispute with the tax authority over eligibility for the super deduction. Previously, a tax authority might require an enterprise to submit an appraisal opinion issued by a government science and technology department if the tax authority disputed the enterprise's eligibility for the super deduction. Notice 119 instead requires the tax authority to directly solicit that appraisal opinion from the competent science and technology department. Therefore, the enterprise will no longer bear the cost of obtaining the appraisal opinion.

Retroactive super deduction

According to Notice 119, starting from 1 January 2016, an enterprise, which is eligible for but fails to enjoy the super deduction, can retroactively enjoy the super deduction after completing a recordal procedure within three years. Notice 119 does not clarify how this retroactive super deduction will be implemented: e.g., cash refund or decrease in the tax due in the year the enterprise claims to enjoy the super deduction.

Article 51 of the *PRC Tax Collection and Administration Law* (TCAL) should provide the tax authorities with guidance in handling the retroactive super deduction. This general provision states that a taxpayer can claim a refund of overpaid tax within three years from the date of the tax payment. Therefore, after applying the retroactive super deduction, the tax authorities should refund any overpaid tax in cash. However, it remains to be seen how the tax authorities will implement the retroactive super deduction in practice.

Observations

With its expanded scope and simplified procedure, Notice 119 will benefit resident enterprises directly conducting R&D activities or outsourcing R&D activities to other resident enterprises.

As the entrusted party under a contract R&D arrangement is not entitled to the super deduction, a Chinese subsidiary conducting R&D activities on behalf of a foreign principal will not be able to enjoy the super deduction. To enjoy the super deduction, the Chinese subsidiary needs to conduct the R&D activities on its own behalf. The foreign principal could transfer the intellectual property (IP) ownership to the Chinese subsidiary so that it could enjoy the super deduction. But, in practice, as IP protection concerns in China remain paramount for most foreign companies, the super deduction incentive will likely not induce many foreign companies to move R&D activities and IP ownership to China.

Notice 119 makes one more significant change. It expressly excludes expenses for R&D outsourced to foreign companies from the super deduction incentive. This exclusion will likely discourage enterprises from purchasing foreign R&D services.

4.2 New Rules Regarding the HNTE Recognition

4.2.1 New HNTE Recognition Rules

On 29 January 2016, the Ministry of Science and Technology (MOST), the MOF and the SAT jointly issued the revised *Administrative Measures for the Recognition of High and New Technology Enterprise*s ("**Notice 32**").[27] Notice 32 retroactively takes effect from 1 January 2016 and replaces the previous HNTE Recognition rules in Notice 172.[28] An HNTE is subject to EIT at the preferential rate of 15 percent rather than the standard 25 percent.

Changes to HNTE qualifications

Notice 32 makes some notable changes to the previous HNTE recognition qualifications:

- *Ownership of IP is required.* Previously, to qualify as an HNTE, an enterprise needed to obtain core IP rights of the main products / services within the last three years by way of self-development, transfer, donation, merger & acquisition, or a global exclusive license for a period of more than five years. Notice 32 removes the three-year requirement and provides that the enterprise must own the relevant IP for the enterprise to qualify as an HNTE.
- *Personnel requirements are lowered.* Previously, science and technology ("**S&T**") related employees with an associate degree (three-year program or above) had to account for at least 30 percent of the total work force, and at least 10 percent of the total work force had to be engaged in R&D activities ("**R&D Personnel**"). Notice 32 repeals both the educational requirement for S&T related employees and the R&D Personnel minimum percentage requirement. Under Notice 32, S&T related employees engaged in R&D or technology-innovation activities should account for at least 10 percent of the total workforce.
- *R&D expense requirement is lowered.* Notice 32 leaves unchanged the rules that R&D expenses in the past three accounting years should not be lower than 4 percent of sales revenue for an enterprise with sales revenue ranging from RMB50 million (excluded) to RMB200 million (included) in the last year, and 3 percent for an enterprise with sales revenue over RMB200 million in the last year. However, Notice 32 lowers the floor for R&D expenses from 6 percent to 5 percent for an enterprise with sales revenue of no more than RMB50 million in the last year.

In addition, Notice 32 now requires the enterprise to have no serious safety or quality accidents and no serious illegal environmental acts within one year prior to its application.

Observations

The IP ownership requirement under Notice 32 is likely to affect many Chinese subsidiaries of MNCs. Due to IP protection concerns in China, many

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[27] *The Revised Administrative Measures on the Recognition of High and New Technology Enterprises,* Guo Ke Fa Huo [2016] No. 32, dated 29 January 2016, retroactively effective from 1 January 2016.
[28] *The Administrative Measures on the Recognition of High and New Technology Enterprises*, Guo Ke Fa Huo [2008] No. 172, dated 14 April 2008, retroactively effective from 1 January 2008, repealed on 1 January 2016 .

MNCs are reluctant to allocate IP ownership to Chinese subsidiaries. Therefore, in practice, many Chinese subsidiaries obtain IP via a license from a foreign affiliate. Under Notice 32, these Chinese subsidiaries will no longer qualify as HNTEs.

4.2.2 New Guidelines for HNTE Recognition

On 22 June 2016, the MOST, the MOF and the SAT jointly issued the revised Working Guidelines for the Recognition and Administration of High and New Technology Enterprises ("**Notice 195**")[29] to implement the new HNTE recognition rules issued under Notice 32 earlier this year.

IP requirement

Notice 195 restates the intellectual property (IP) ownership requirement under Notice 32. It requires an enterprise to own the core IP in its main products or services for the enterprise to qualify as an HNTE. When an IP is jointly owned by two or more enterprises, only one of them can use the IP to apply for HNTE status.

Notice 195 further classifies IP into two categories:

- **Type I** covers invention patents, exclusive rights over integrated circuit layout-design, new plant varieties, etc.; and
- **Type II** covers utility model and design patents and software copyright (excluding trademark).

A particular piece of Type II IP can only be used for one HNTE application, i.e., the applicant cannot reuse the same piece of Type II IP to renew its HNTE status after its original HNTE qualification expires. Whereas, there is no such limitation on a Type I IP.

Main products or services

According to Notice 32, an enterprise must own the IP in its main products or services to qualify as an HNTE. However, Notice 32 does not clearly define what constitutes a "main product or service". Notice 195 closes this gap by providing a revenue threshold in its definition. According to Notice 195, a "main product or service" are high-tech products or services which generates an aggregate revenue in excess of 50 percent of the enterprise's total revenue from high-tech products or services in the current period.

Total revenue

Notice 32 requires the revenue from the high-tech products or services to account for more than 60 percent of the enterprise's total revenue without defining the term "total revenue". Notice 195 provides that total revenue equals the overall revenue less the non-taxable revenue. Both the overall revenue and non-taxable revenue should be calculated in accordance with the *PRC Enterprise Income Tax Law* and its implementing regulations.

Previously, some local authorities (e.g., in Hunan) did not consider non-operating revenue when calculating the total revenue. Now under Notice 195,

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[29] *Working Guidelines for the Recognition and Administration of High and New Technology Enterprises*, Guo Ke Fa Huo [2016] No. 195, dated 22 June 2016, retroactively effective from 1 January 2016.

the total revenue calculation will also include non-operating revenue since non-operating revenue is subject to enterprise income tax. Under this expanded scope of total revenue, enterprises with large non-operating revenue may find it more difficult to reach the revenue threshold for HNTE qualification.

Observations

Taking effect retroactively on 1 January 2016, Notice 195 may significantly affect an enterprise's HNTE qualification. Every enterprise that intends to apply for or renew HNTE qualification should assess its qualification against the requirements under Notice 32 and Notice 195, and make necessary adjustments, if possible, to increase the likelihood of successfully applying for an HNTE.

4.3 TASE Tax Incentives Extended to More Pilot Zones and Service Sectors

On 12 October 2016, China issued Notice 108[30] to extend the enterprise income tax (EIT) incentives for technology-advanced service enterprises (TASEs) to 10 more cities, including Shenyang, Changchun, Nantong, Zhenjiang, Fuzhou, Nanjing, Urumchi, Qingdao, Ningbo and Zhengzhou. According to Notice 108, qualified TASEs in these 10 cities may enjoy a reduced EIT rate of 15 percent and a higher deduction cap (i.e., 8 percent of the salary expense) for employee educational expenses[31] from 1 January 2016 to 31 December 2018.

Further, on 10 November 2016, China issued Notice 122[32] to expand the TASE incentive to more service sectors in 15 pilot zones, which include some traditional TASE pilot cities such as Shanghai and Shenzhen and some new pilot zones such as Hainan and Weihai. The new service sectors cover computer and information services, R&D and technical services, cultural technical services and medical services related to traditional Chinese medicine. The TASE incentive under Notice 122 took effect retroactively from 1 January 2016 and will remain in effect until 31 December 2017.

4.4 Yantai Case: Offshore Upstream Merger Disqualified from Notice 59 Exemption

In late December 2015, a Chinese district court ruled that an offshore upstream merger carried out by two Italian companies was disqualified from receiving the tax-free treatment under Notice 59[33].

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[30] *Notice of the Ministry of Finance, the State Administration of Taxation, the Ministry of Commerce, the Ministry of Science and Technology and the National Development and Reform Commission on Increasing Model Service Outsourcing Cities Entitled to the Enterprise Income Tax Policies for Technology-advanced Service Enterprises*, Cai Shui [2016] No. 108, dated 12 October 2016, retroactively effective from 1 January 2016.
[31] The general EIT rate is 25 percent, and the general deduction cap for employee educational expenses is 2.5 percent of the salary expense.
[32] *Notice of the Ministry of Finance, the State Administration of Taxation, the Ministry of Commerce, the Ministry of Science and Technology and the National Development and Reform Commission on Expanding the Enterp*rise Income Tax Policies for Technology-advanced Service Enterprises to Service Trade Innovative Development Pilot Zones, Cai Shui [2016] No. 122, dated 10 November 2016, retroactively effective from 1 January 2016.
[33] *Announcement of the Ministry of Finance and the State Administration of Taxation on Issues Concerning the Enterprise Income Tax Treatment of Enterprise Restructurings*, Cai Shui [2009] No. 59, dated 30 April 2009, retroactively effective from 1 January 2008.

Facts

On 17 July 2012, an Italian company named Illva Saronno Holding S.p.A ("**Italian Parent**") passed a resolution to merge with its wholly owned Italian subsidiary, i.e., Illva Saronno Investments S.r.l. ("**Italian Subsidiary**"). As a result of the merger, the Italian Parent, as the surviving company, acquired all of the Italian Subsidiary's assets and debts, including a 33 percent share in a Chinese resident company, i.e., Changyu Group Co. Ltd. ("**Target**"). The Italian Subsidiary was deregistered on 21 November 2012 following the merger.

On 9 September 2013, Zhifu State Tax Bureau issued a notice ("**Notice**") to the Italian Parent, stating that the merger had resulted in a taxable share transfer. The tax bureau decided to adjust the share transfer price to RMB994,845,943.21, which equals to 33 percent of the book value of the Target's net assets. Thus, the Italian Subsidiary was deemed to realize from the share transfer a gain of RMB463,421,683.21, i.e., the share transfer price of RMB994,845,943.21 less the share acquisition cost of RMB481,424,260. Accordingly, the Italian Parent was required to pay RMB46,342,168.32 in EIT.

However, the Italian Parent thought the merger had satisfied the conditions for the tax-free treatment in Article 5 of Notice 59 and therefore should not trigger EIT liability in China. After paying the required tax, the Italian Parent initiated an administrative review to the Yantai State Tax Bureau requesting a revocation of the Notice. The Yantai State Tax Bureau rejected the Italian Parent's request because the share transfer did not meet the additional conditions in Article 7[34] of Notice 59.

The Italian Parent then brought the case to the Zhifu District Court.

Holding and ruling

The court identified three issues in the case:

- *Whether the offshore merger should be characterized as a share transfer for Notice 59 purposes* — The court held that it was proper for the tax bureau to characterize the restructuring as a share transfer because (i) the merger directly resulted in a change of ownership over the 33 percent share in the Target; and (ii) Bulletin 72[35] clearly states that a share transfer as a result of an offshore merger belongs to a share transfer by a non-resident enterprise.
- *Whether the offshore merger satisfied the conditions for tax-free treatment under Notice 59* — For a cross-border share transfer to qualify for the tax-free treatment, Article 7 requires the offshore transferor to hold 100 percent shares in the offshore transferee. Whereas, in this case, it was the transferee holding 100 percent shares in the transferor. Therefore, the court held that the offshore merger was disqualified from receiving the tax-free treatment.

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[34] In order to enjoy the tax-free treatment, a cross-border share transfer must meet not only the general conditions in Article 5 but also the additional conditions in Article 7 of Notice 59.
[35] *Announcement of the State Administration of Taxation on Issues Concerning the Special Tax Treatment Applicable to Equity Transfer by Non-resident Enterprises*, SAT Bulletin [2013] No. 72, dated 12 December 2013, effective as of the same date.

- *Whether the offshore merger could enjoy tax-free treatment based on the non-discrimination provision under the China–Italy tax treaty* — The court held that taxing the offshore merger did not constitute discrimination toward the non-resident enterprise because international practice allows for a jurisdiction to establish specific tax rules for non-resident enterprises.

Based on these holdings, the court ruled that the tax bureau's decision was correct and dismissed the Italian Parent's claim.

Observations

The Italian Parent's major argument in this case was that the offshore merger should be characterized as a "merger " rather than "a share transfer" for Notice 59 purposes. Although Notice 59 does not expressly limit the word "merger" to a merger carried out by resident enterprises, the PRC tax authorities have generally interpreted the Notice 59 rules on mergers as applying only to domestic mergers between resident enterprises. Bulletin 72 reinforced this interpretation by stating that a transfer of equity interest in a resident enterprise resulting from an offshore merger should be treated as a share transfer for purposes of Notice 59.

The court's decision is consistent with the tax authorities' general view of cross-border reorganizations. Technically speaking, the court in this Yantai Case is only a district court and its judgment is not binding on other courts. However, this court decision may still have some influence on how the tax bureaus and other courts decide on the tax treatment of cross-border reorganizations.

5. Turnover Tax

5.1 Bye-bye BT! Comprehensive VAT System to Cover All Industries

On 1 May 2016, China completed its VAT pilot program and ended the bifurcated VAT and business tax (BT) system that had been in place since 1994. A comprehensive and uniform VAT system now applies to all industries, and BT has been swept into the dustbin of history.

The MOF and the SAT jointly issued Notice 36[36] on 23 March 2016 to extend the VAT pilot program to the four industries still under the BT regime at that time: financial services, real estate services, construction services and consumer services. Notice 36 also introduces significant changes to the previous VAT pilot program rules. On 31 March 2016, the SAT released seven bulletins, numbered consecutively from SAT Bulletin [2016] No. 13 to SAT Bulletin [2016] No. 19, to address the detailed implementation of Notice 36 starting on 1 May 2016.

In this section, we first comment on the general changes introduced by Notice 36 and the seven bulletins (collectively "**New VAT Rules**") and then discuss certain industry-specific changes. We also provide some general recommendations for taxpayers.

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[36] *Notice of the Ministry of Finance and the State Administration of Taxation on Fully Expanding the Value-added Tax Pilot Program*, Cai Shui [2016] No. 36, dated 23 March 2016, effective from 1 May 2016.

5.1.1 General analysis

(i) Expansion of VAT pilot program

The New VAT Rules has transitioned all remaining BT taxpayers into VAT taxpayers. The applicable VAT rates for the four new industries covered by the VAT regime are as follows:

- 6 percent for financial services;
- 11 percent for real estate services, as well as the leasing or sale of immovable property and the transfer of land use rights;
- 11 percent for construction services;
- 6 percent for consumer services.

The applicable VAT rate for small-scale VAT taxpayers in these industries is 3 percent, in common with small-scale VAT taxpayers generally, with an exception that small-scale VAT taxpayers is taxed at 5 percent on revenues from leasing or sale of immovable property.

In general, the New VAT Rules permits the use of input VAT credits in these four industries, with certain exceptions that we will discuss later in Section 5.1.2*(ii)*.

(ii) Broad definition of intangible assets

The previous BT and VAT rules provided that the transfer of certain types of intangible assets was subject to BT or VAT. The New VAT Rules similarly provide that the sale or licensing of the following intangible assets is subject to VAT:

- patented and unpatented technology;
- trademarks;
- copyrights;
- goodwill;
- land use rights; and
- other use rights to natural resources, such as mining exploration rights, mining rights and water rights.

But Notice 36 goes a step further by providing a new catch-all category of "other intangible assets" (其他权益性无形资产). This category covers all types of intangible assets capable of generating economic benefits. The examples provided in Notice 36 include, among other things, operation rights to infrastructure, franchise rights, distribution rights, memberships, quotas, name rights and agency.

This expanded definition of intangible assets resolves the difficulty under previous rules of allocating business transfer value for turnover tax purposes. Previously, when a business was sold at a premium above the net asset value of the business, the technical turnover tax treatment of this premium value was unclear, and it was often treated under the general category of "goodwill". Under the New VAT Rules, the broader concept of "other intangibles" will be able to cover all or part of this premium value.

(iii) Exemption and zero-rating for exported services

The New VAT Rules continue the previous exemption or zero-rating for domestic suppliers of exported services and domestic sellers or licensors of intangibles to overseas parties, and include the new services and intangibles that are now subject to VAT within the scope of exemption or zero-rating.[37]

Notice 36, however, adds an additional criterion for enjoying VAT exemption or zero-rating, i.e., that the relevant service or intangible must be "completely consumed outside China". "Completely consumed outside China" is defined to mean: (i) the actual service recipient is outside China or the intangible is completely used outside China; *and* (ii) the service or intangible is not connected with goods or immovable property located in China.

This new criterion may disqualify certain exported services or transactions that would enjoy VAT exemption or zero-rating under the previous VAT pilot program rules. For example, sales and marketing services provided by a Chinese enterprise to a foreign affiliate used to be exempt from VAT based on local interpretation. It is possible based on Notice 36 that the tax authorities will assert these sales and marketing services are connected with goods located in China and therefore not qualified for the VAT exemption.

As a transitional rule, Notice 36 grandfathers service contracts signed before 30 April 2016 and allows the VAT exemption or zero-rating to continue in accordance with the previous rules until the contracts expire.

(iv) Adjustment to sale price that lacks reasonable commercial purpose

Notice 36 follows the previous VAT rules in authorizing the tax authorities to adjust a taxpayer's taxable revenue if the taxpayer provides services or transfers real estate or intangibles at an obviously high or low price without a reasonable commercial purpose.

For the first time in the turnover tax context, Notice 36 defines "lack of reasonable commercial purpose" to mean using artificial arrangements to reduce, avoid or defer VAT payments or to increase VAT refunds, with the main purpose of obtaining these tax benefits.

As the present VAT rules do not define "lack of reasonable commercial purpose", tax authorities have tended to interpret this term broadly to cover many situations where services are provided substantially below the market price for commercial reasons. This new definition may give taxpayers more room to undertake legitimate transactions at an obviously high or low price with good commercial reasons.

(v) Mixed sale of services and goods

Where one transaction involves both the sale of goods and the provision of services, Notice 36 provides that the entire transaction should be subject to VAT as either a sale of goods or a provision of services depending on the taxpayer's main business. If the taxpayer's main business is the manufacture, wholesale or retail of goods, all of its revenue from mixed sale transactions is subject to VAT at 17% as a sale of goods. The revenue of other taxpayers

[37] Under both the VAT exemption regime and the VAT zero-rating regime, no output VAT is levied on service fees. However, a credit or refund of input VAT incurred in the provision of the relevant services is only available under the VAT zero-rating regime.

from mixed sale transactions is subject to VAT as the provision of services at the applicable rate under the New VAT Rules.

This new rule takes away the ability of taxpayers under the previous rules to separate revenue from mixed sale transactions into sale of goods and provision of services and pay VAT at the different rates applicable to each revenue category.

(vi) Transfer of going concern

Notice 36 keeps the previous transfer of going concern (TOGC) rules under the BT and VAT regimes. This rule provides that a business transfer falls outside the scope of VAT where the transfer includes all of the assets and associated creditor rights, debts and workforce of an enterprise or of a line of business within an enterprise.

The failure of the previous TOGC rules to address the transfer of intangible assets has created technical and practical uncertainty about whether TOGC treatment covers the transfer of intangibles or only the transfer of other assets, such as inventory, fixed assets and real property. Unfortunately, the TOGC rule in the New VAT Rules fails to clarify this uncertainty.

(vii) Adjustment to credited input VAT

Where a taxpayer has credited input VAT arising from the acquisition of fixed assets, real estate or intangible assets, but subsequently uses the asset for one of the purposes listed below, Notice 36 requires that part of the input VAT credited in the previous period must be deducted from the total creditable input VAT for the current period:

- in connection with generating revenue that is taxed using the simplified calculation method;
- in connection with generating revenue that is VAT-exempt;
- for collective welfare or personal consumption; or
- the asset incurs an abnormal loss.

The amount of the adjustment to current period creditable input VAT is equal to the net value (after depreciation or amortization) of the fixed asset, real estate or intangible multiplied by its applicable tax rate.

5.1.2 Industry analysis

(i) Existing industries

(a) Modern services

Notice 36 adjusts the previous sub-categories with the broad category of modern services. Among other things, Notice 36:

- introduces a "business support services" category and a catch-all modern services category;
- expands leasing services to cover financial leasing;
- excludes transfer of technology, trademarks, copyrights and goodwill from modern services and re-categorizes them as transfers of intangibles; and

- expressly categorizes market research services as consulting services.

"Business support services" includes (i) enterprise management services, (ii) human resource services, (iii) agency services, and (iv) security protection services.

In general, the VAT treatment of modern services provided by domestic suppliers remains unchanged. With respect to the export of modern services, the VAT treatment may change in practice depending on the tax authority's interpretation of the requirement that the service be completely consumed outside China (see Section 1.3 above).

(b) Transportation, express and freight forwarding services

Transportation services

Overall, the tax treatment of transportation services remains unchanged except that non-vessel operating common carrier (NVOCC) service is expressly categorized as a transportation service subject to VAT at 11 percent. According to Notice 36, NVOCC services provided by a domestic entity or individual to a foreign person are exempt from VAT. With respect to international transportation services provided via an NVOCC, Notice 36 applies a look-through principle, i.e., the actual domestic transportation company is eligible for VAT zero-rating while the domestic NVOCC is VAT exempt.

Although NVOCC service is now recognized under domestic law as a transportation service for VAT purposes, it is unclear whether NVOCC service will enjoy treaty benefits as an international transportation service under applicable tax treaties.

Express delivery services

Like the previous VAT rules, Notice 36 divides express services into transportation services subject to VAT at 11 percent and pick-up and delivery services subject to VAT at 6 percent.

International transportation services provided by a domestic transportation enterprise are zero-rated for VAT purposes. But pick-up and delivery services are VAT exempt only where provided for exported goods.

Freight forwarding services

Although re-categorized from logistics support services to business support services, domestic freight forwarding services receive the same VAT treatment under Notice 36 as under the previous rules, i.e., they are subject to VAT at a 6 percent rate. International freight forwarding services (direct or indirect) remained exempted from VAT on a transitional basis.

Notably, Notice 36 provides that the taxable revenue for freight forwarding services (international or domestic) is the total revenue and any additional charges received less government fees collected from and paid on behalf of the principal. This means the netting method for international freight forwarding services under the previous rules is no longer available under Notice 36.

(ii) New industries

(a) Real estate services

Applicable tax rates and taxable revenue

Normally, a general VAT taxpayer is liable to VAT on gross sales revenue[38] from the transfer or lease of real property at 11 percent with input VAT credits available.[39] As an exception, a general VAT taxpayer can elect the simplified taxation method, i.e., elect to be taxed at 5 percent of taxable revenue without input VAT credits, for the transfer or lease of real property that the taxpayer acquired before 30 April 2016. A small-scale taxpayer is automatically taxed using the simplified taxation method.

Provisional filing and prepayment

Regardless of the taxation method, all taxpayers (excluding individuals) must provisionally file and prepay VAT where the real property is located if the property is not located in the same county (city) as the taxpayer. The applicable VAT prepayment rates are:

- 5 percent on the gross sales revenue from transfer of self-built real properties;
- 5 percent on the net sales revenue from transfer of real properties other than self-built real properties;
- 5 percent on the gross rent from lease of real properties acquired before 30 April 2016; and
- 3 percent on the gross rent from lease of real properties acquired after 1 May 2016.

After the VAT prepayment, a general VAT taxpayer must file with its own in-charge tax authority.

This prepayment procedure will increase the administrative burden on real property sellers and landlords and increase the likelihood of overpayment. Although a taxpayer can claim a VAT refund if the prepaid tax exceeds the VAT payable,[40] claiming a tax refund is always a painful exercise for taxpayers. Moreover, the tax authorities may disagree over which of them is responsible for issuing the refund.

Input VAT credits from real property

Under the New VAT Rules, a general VAT taxpayer can credit the input VAT from real property acquired after 1 May 2016 or where construction of the real property started after that date. The credits should be taken in two instalments: 60 percent creditable in the current period when the taxpayer obtains the VAT special invoice; and the remaining 40 percent creditable in the thirteenth month following the taxpayer obtains the VAT special invoice.

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[38] "Gross sales revenue" as used in Section 5.1 means total sales revenue plus any additional charges.

[39] As an exception, for a real property development enterprise that is taxed using the general taxation method, its taxable revenue equals the gross sales revenue less the purchase price of the land use rights paid to the government.

[40] The language of Notice 36 suggests that the tax authority is more likely to allow the taxpayer to stop future VAT prepayments or payments for a period than it is to grant a tax refund in the current period.

However, a general VAT taxpayer can credit the input VAT from the following real property without being subject to the above instalment limitation:

- real property self-developed by a real property development enterprise;
- real property obtained via financial leasing; and
- temporary construction or buildings built on a construction site.

Transfer of a residential property by an individual

Under Notice 36, the VAT treatment on a transfer of a residential property by an individual differs depending on how long the residential property was held: for less than two years, 5 percent VAT on the gross sales price; for two years or more, VAT exempt. However, in Beijing, Shanghai, Guangzhou and Shenzhen, an individual is liable for VAT on the net sales revenue from the transfer of a non-ordinary residential property held for two years or more.

(b) Construction services

Applicable tax rates and taxable revenue

Construction services provided by a general VAT taxpayer are normally subject to VAT at 11 percent on the gross sales revenue, while those provided by a small-scale VAT taxpayer are subject to VAT at 3 percent on the gross sales revenue less any amounts paid to a sub-contractor.

Notably, a contractor with general VAT taxpayer status can choose to apply the simplified taxation method, i.e., to be taxed at 3 percent on the gross sales revenue less any amounts paid to a sub-contractor, if:

- the contractor provides the construction services for a project but does not provide the construction materials or only purchases (and provides) auxiliary materials;
- the contractor provides the construction services for a project and the owner independently purchases all or part of the equipment, materials and power; or
- the contractor provides services for "old construction projects".[41]

Provisional filing and prepayment

A taxpayer that provides construction services in a county or a city other than where the taxpayer is registered must provisionally file and prepay VAT where the construction services are provided. The applicable VAT prepayment rates are:

- 2 percent on the gross sales revenue if the taxpayer applies the general taxation method; or
- 3 percent on the gross sales revenue less any amounts paid to a sub-contractor if the taxpayer applies the simplified taxation method.

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[41] "Old construction projects" refers to construction projects with a commencement date on or before 30 April 2016 as indicated in the Construction Permit for Construction Engineering or the construction project contract (the latter if there is no Construction Permit for Construction Engineering).

(c) Financial services

Tax rates and taxable services

VAT applies at a 6 percent rate to financial services provided by a general VAT taxpayer and at a 3 percent rate to financial services provided by a small-scale VAT taxpayer. Financial services are further divided into the following four sub-categories:

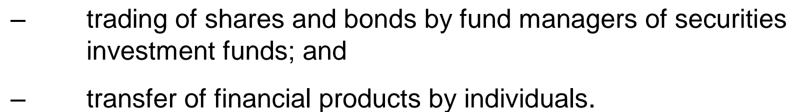
- **Lending services** – include interest income from the provision of capital, such as loan interest, interest on bonds held to maturity, sale-and-lease-back financing arrangements and fixed or guaranteed minimum returns on monetary investment;
- **Chargeable financial services** –include service fees from the provision of services related to the flow of funds and other financial operations, such as currency exchange services, credit card services, financial guarantee services and clearing, and settlement and payment services;
- **Insurance services** –include commercial insurance services, including personal insurance and property insurance; and
- **Transfer of financial products** – includes foreign currency, securities, non-goods futures and other financial products (such as all forms of financial derivatives and all forms of asset management products, such as funds, trusts and financial instruments).

Notably, financial leasing is excluded from financial services. Instead, it is grouped under leasing services, which are subject to VAT at 17 percent for tangible assets and 11 percent for real property.

Items not subject to VAT and VAT-exempt items

Insurance compensation and bank deposit interest are not within the scope of VAT. In addition, the following items are exempt from VAT as a continuation of the present BT exemption:

- Specific types of interest income, such as interest on:
- national and local government bonds;
  - loans from the People's Bank of China to financial institutions;
  - foreign exchange loans provided by the State Administration of Foreign Exchange via financial institutions in the course of foreign exchange operations; and
  - intra-bank and interbank borrowing and lending;
- Insurance premium income from personal insurance with a period of more than one year; and
- Income from:
  - trading of securities by a qualified foreign institutional investor;
  - trading of A shares by Hong Kong investors via the Hong Kong Shanghai Stock Connect program;
  - trading of China funds by Hong Kong investors via the mutual recognition of funds program;



– trading of shares and bonds by fund managers of securities investment funds; and

– transfer of financial products by individuals.

Input VAT on lending services

Input VAT on lending services and on financing advisory fees, handling fees and consultancy fees directly related to a loan paid by the borrower to the lender cannot be credited against the taxpayer's output VAT.

The non-creditable input VAT will increase the borrower's financing costs. Therefore, taxpayers will be incentivized to choose financing methods other than loans (e.g., finance leasing) or to use independent financial advisors to arrange loans.

Netting method for transfer of financial products

Similar to the previous BT position, the VAT taxable revenue on the transfer of financial products is the gain, i.e., the sale price less the purchase price. Losses can be carried forward to taxable periods in the same year but cannot be carried forward to the next calendar year. The taxpayer can choose either the weighted average method or the moving weighted average method to calculate the purchase price. Once selected, the method cannot be changed for 36 months.

Further, Notice 36 provides that special VAT invoices cannot be issued for the transfer of financial products. This taxation approach based on gains rather than revenue is more realistic and practical for trading in financial products, although the prohibition of carrying forward losses from one year to the next will continue to result in loss of tax relief.

Cross-border financial services

VAT exemption is extended to insurance services for exported goods (including export goods insurance and export credit insurance) and chargeable financial services provided to foreign entities if the chargeable financial services do not involve flow of funds to or from Chinese entities and are not related to goods, intangible assets or immoveable property in China. However, Notice 36 does not generally allow VAT exemption or zero-rating for cross-border lending services or financial product transfers.

(d) Consumer services

Tax rates and taxable services

From 1 May 2016, consumer services provided by a general VAT taxpayer are subject to VAT at a 6 percent rate, and consumer services provided by a small-scale VAT taxpayer are subject to VAT at a 3 percent rate.

Consumer services are divided into the following six sub-categories:

- cultural and sports services;
- educational and medical services;
- tourism and entertainment services;

- catering and accommodation services;
- daily services for residents; and
- other consumer services.

Taxable revenue

Generally, taxable revenue from the provision of consumer services is the gross sales revenue received. As an exception for the tourism services, a taxpayer can choose to calculate its taxable revenue by deducting travel fees paid to third parties from the gross sales revenue received from the service recipients. Under this method, the taxpayer is not allowed to issue special VAT invoices to the service recipient for the deducted amount.

Non-creditable consumer services

Notice 36 provides that input VAT on catering services, daily residential services and entertainment services cannot be credited against the taxpayer's output VAT.

5.1.3 Actions to consider

In response to the transition of all industries under the VAT regime, we recommend that companies engaged in the new sectors subject to VAT, whether as a service provider or service recipient or as a seller or buyer, consider the following actions:

- analyse the impact of the New VAT Rules on its business activities and choose appropriate pricing strategies to reflect the tax burden on both transactional parties;
- review contracts signed while BT was the applicable tax, analyse whether the service provider or seller has the right to collect VAT from the service recipient or buyer, and consider renegotiating the contracts where necessary; and
- ensure compliance with VAT administration rules, such as general VAT taxpayer registration, invoice management and VAT declaration.

5.2 New VAT Exemption Measures

On 6 May 2016, the SAT issued Bulletin 29[42] to address the implementation of the VAT exemption rules under the new VAT regime, i.e., Notice 36.

Consistent with the full expansion of the VAT pilot program, Bulletin 29 expands the scope of the previous VAT exemption Measures[43] to cover:

- construction services for projects located outside China;
- construction supervision services for projects located outside China;

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[42] *Announcement of the State Administration of Taxation on the Issuance of Administrative Measures for VAT Exemption on Cross-border Taxable Services Under the VAT Pilot Program (For Trial Implementation)*, SAT Bulletin [2016] No. 29, dated 6 May 2016, retroactively effective from 1 May 2016.

[43] *Announcement of the State Administration of Taxation on the Re-issuance of Administrative Measures for Value-Added Tax Exemption on Cross-border Taxable Services Under the VAT Pilot Program (For Trial Implementation)*, SAT Bulletin [2014] No. 49, dated 27 August 2014, effective from 1 October 2014.

- insurance services for exported goods; and
- chargeable financial services provided to foreign entities if the chargeable financial service does not involve flow of funds to or from Chinese entities and is not related to goods, intangible assets or immoveable property in China.

Notice 36 requires certain services[44] and intangibles to be completely consumed outside China if they are to be VAT exempt. Bulletin 29 restates this requirement, and provides examples of services that are not completely consumed outside of China and therefore not VAT exempt, such as services of which the "actual service recipient" is a domestic organization or individual.

Unfortunately, the term "actual service recipient" is not clearly defined under Bulletin 29. Therefore, it remains uncertain in what situations the tax authorities will refuse to accept a contract service recipient as the actual service recipient.

6. Exchange of Information

6.1 China Signs the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information

On 16 December 2015, China signed the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information ("**CRS MCAA**"), which is put in place as an international framework that allows the automatic exchange of Common Reporting Standard (CRS) information between jurisdictions. As of 2 November 2016, the CRS MCAA has 87 participating jurisdictions.[45]

The CRS is an OECD proposal, under which a financial institution in one jurisdiction will be required to identify financial accounts held by tax residents of other jurisdictions and to report that financial information to the local government. The local government will then pass the information to the account holder's country of tax residence. The CRS information mainly includes:

- the name, address, jurisdiction(s) of residence and tax identification number(s) of each reportable person;
- the account number;
- the name and identifying number (if any) of the reporting financial institution;
- the account balance or value as of the end of the relevant calendar year or other appropriate reporting period; and
- the total gross amount of interest or dividends received.

[44] These services include intellectual property services, logistic support services, attestation and consulting services, and business support services, etc.
[45] See http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/MCAA-Signatories.pdf, visited on 24 January 2017.

As of 26 July 2016, 54 jurisdictions have committed to implementing the CRS by 2017, and 47 jurisdictions (including China) have committed to implementing it by 2018[46].

Each country that signs the CRS MCAA is required to notify the OECD Co-ordinating Body Secretariat of the jurisdictions with which it intends to cooperate with in enforcing the CRS MCAA. The CRS MCAA becomes effective between two jurisdictions when: (i) both jurisdictions have provided such notice of intent; and (ii) the Convention on Mutual Administrative Assistance in Tax Matters ("**Convention**") has entered into force and is in effect for both jurisdictions[47].

On 14 October 2016, the SAT published the draft *Administrative Measures on Due Diligence of Tax-related Information of Non-resident's Financial Accounts* for public comments until 28 October 2016. The draft requires Chinese financial institutions to collect from non-resident account holders CRS information. Afterwards, Chinese financial institutions are required to submit such information to the SAT. The draft is expected to be finalized soon and will likely take effect retroactively from 1 January 2017.

Observations

In the first few years of implementation we do not expect that each of the countries that implement the CRS will conduct automatic exchange of CRS information with every other country that implements the CRS.

To date, it remains unclear when the CRS MCAA will become effective between the PRC and a specific participating jurisdiction. However, the PRC has been pushing to implement the automatic exchange of information. According to a meeting held by the SAT on 10 October 2015 in Beijing, the PRC plans to implement the CRS and start automatically exchanging CRS information with more than 45 countries by the end of 2018.

Non-PRC residents usually do not hold accounts in PRC financial institutions due to foreign currency control policies. Thus, the PRC's automatic exchange network for CRS information is unlikely to have an immediate impact on non-PRC residents. However, once the automatic exchange network for CRS information is established, the PRC tax authorities will be able to obtain information about a PRC resident's account in an offshore financial institution. Therefore, PRC residents must prepare for the forthcoming information exchange. Among other things, each PRC resident should:

- Identify what personal and financial information is maintained by his or her financial institutions;
- Ensure the information maintained by the financial institutions is accurate (which will help prevent unwarranted tax investigations);
- Assess potential exposure and risks from the information exchange; and
- Involve tax advisors to develop proper strategies to help maintain PRC tax compliance.

[46] see http://www.oecd.org/tax/automatic-exchange/commitment-and-monitoring-process/AEOI-commitments.pdf, visited on 24 January 2017.
[47] China signed the Convention on 27 August 2013. The Convention has become effective for China from 1 February 2016, and has become applicable to China from 1 January 2017.

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6.2 China Signs the MCAA for Automatic Exchange of CbC Reports

On 12 May 2016, China signed the CbC MCAA. As of 19 January 2017, the CbC MCAA has 51 participating jurisdictions[48], which have committed to automatically exchange CbC reports among them.

CbC reporting is an OECD proposal under Base Erosion and Profit Shifting Action Plan 13, which requires each multinational enterprise with annual consolidated group revenue equal to or exceeding EUR750,000,000 (approximately US$848,475,000) to provide aggregate CbC data about its entities (and permanent establishments) in every country. These CbC reports are expected to expose instances where profits are booked in low-tax jurisdictions where little or no economic activity takes place.

The CbC MCAA will come into effect between two jurisdictions when: (i) each jurisdiction has provided a notice to the OECD Coordinating Body Secretariat that it intends to cooperate with the other jurisdiction in enforcing the CbC MCAA; and (ii) the Convention has entered into force and is in effect for both jurisdictions. There is currently no public information on the list of jurisdictions, with which China intends to enforce the CbC MCAA, and the list of jurisdictions, which intend to enforce CbC MCAA with China. Thus, it remains unclear when the CbC MCAA will become effective between the PRC and a specific jurisdiction.

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[48] The data is sourced from the OECD's website:http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/CbC-MCAA-Signatories.pdf, visited on 24 January 2017.