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China Tax Monthly is a monthly publication of Baker & McKenzie's China Tax Group.

In this issue of the China Tax Monthly, we will discuss the following tax developments in China:

1. Public Reacts to Seagate's Planned Closing of Suzhou Factory: Impact of Social Media on Tax Policy and Enforcement in China?

On 10 January 2017, Seagate announced it was closing one of its China factories, located in Suzhou. This announcement triggered heated discussion and speculation on social media that the factory closure was the result of an extremely high tax burden following a tax audit and advance pricing arrangement (APA) in 2015.

The Seagate audit was reported by the China Youth News[1] and the China Taxation News[2] in April and May of 2015. As these reports did not refer to Seagate by name, the public in China did not connect Seagate to the audit until the company announced the closure of the Suzhou factory.

According to news reports in China, the tax adjustment in the 2015 audit was the largest on record since China began aggressively enforcing its transfer pricing and other anti-avoidance rules. Although the reports also noted that Seagate will continue to increase its investments in China, the announcement of the Suzhou factory closure had many observers linking it to Seagate's increased tax burden following the audit. These concerns played out on Chinese social media in an unprecedented frenzy of criticism aimed at the tax authorities, resulting in substantial pressure on the government.

On 16 January 2017, in a somewhat unusual step, the Jiangsu Provincial State Tax Bureau publicly responded to this speculation by publishing an explanation[3] of the Suzhou factory closure. The explanation stated that Seagate closed the Suzhou factory in order to integrate the Suzhou factory's product line with the company's Wuxi factory product line. Moreover, the explanation stated that Seagate would use the integration as an opportunity to increase its investment in Wuxi.

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[1] See http://zqb.cyol.com/html/2015-04/26/nw.D110000zgqnb_20150426_6-02.htm.
[2] See http://www.ctaxnews.net.cn/html/2015-05/04/nw.D340100zgswb_20150504_1-04.htm.
[3] See http://www.jsgs.gov.cn/art/2017/1/16/art_60_292666.html.

During the following two days, the State Administration of Taxation (SAT) also weighed in on the Suzhou factory closure. It reproduced on its official WeChat account two articles that were previously published on Xinhua Net[4] and Economy Daily[5]. Both articles stated that the Suzhou factory closure was not related to the APA and was instead a normal business decision in response to excessive production capacity and a changing market.

Observations

That the Chinese government (including the tax authorities) publicly and repeatedly emphasized the Suzhou factory closure was not related to tax enforcement indicates they are concerned about public perception of the impact of tax enforcement on foreign investment. The public pressure against this case may impact the posture of the tax authorities in audits and potentially temper their confidence in situations where a taxpayer has a strong position supported by law and shows the resolve to support and maintain that position. Our experience also indicates that, although it is not uncommon for tax authorities to use threats and intimidation as strategies during an audit, they typically are very averse to risking an appeal or litigation against their audit decisions.

We expect the Chinese tax authorities will be more sensitive and cautious in future audits of multinational companies (MNCs) and their subsidiaries in China. Given that tax anti-avoidance audits, in particular transfer pricing audits, are areas in which the tax authorities have wide discretion, the mindset of the tax authorities affects the dynamic between taxpayers and tax authorities and therefore the final audit result. As such, MNCs under an audit should fully consider the dynamic of the relationship, think holistically about strategy at each stage of an audit, and adopt the most appropriate strategy that can achieve the best tax result.

2. The SAT Releases 2015 APA Annual Report

On 26 December 2016, the SAT released the *2015 China Advance Pricing Arrangement Annual Report* ("**Annual Report**").[6] The seventh edition of this annual report focuses on China's APA mechanisms, procedures and practices. It also provides statistics and analysis for 2005 through 2015.

Although the Annual Report's statistical information generally does not include annual statistics, a side-by-side comparison of the Annual Report with the 2014 and 2013 annual reports reveals taxpayer and SAT activity during 2015.

APAs signed

Twelve APAs (six unilateral and six bilateral) were signed in 2015 — a 33.3% increase from the nine APAs (three unilateral and six bilateral) signed in 2014. Although still lower than the 19 APAs (11 unilateral and 8 bilateral) signed in 2013, this increase over 2014 indicates the SAT has begun to rededicate resources to the APA program since suspending bilateral APA negotiations in September 2014.

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[4] See http://news.xinhuanet.com/fortune/2017-01/16/c_1120322826.htm. Xinhua Net is owned by Xinhua News Agency, which is directly supervised by the central government.
[5] See http://paper.ce.cn/jjrb/html/2017-01/18/content_323273.htm. Economic Daily is run by the State Council.
[6] The English version of the 2015 APA Report can be downloaded at http://www.chinatax.gov.cn/n810214/n810606/c2420314/part/2420338.pdf.

Open requests

On 31 December 2015, 152 APA requests (143 bilateral and 9 unilateral) were open, an 11.8% increase over the 136 open APA requests (119 bilateral and 17 unilateral) at the end of 2014. We expect this year-end trend to continue where open bilateral requests significantly outnumber open unilateral requests.

Industries covered

The Annual Report lists seven industry categories in which APAs were signed from 2005 to 2015:

- manufacturing (104)
- commercial services (5)
- wholesale trade and retail (9)
- transportation, warehousing, and postal services (2)
- scientific and technical services (2)
- electricity, heating, gas and water generation and supply (1)
- information transmission, software and information technology services (2).

All of the 12 APAs signed in 2015 involve the manufacturing industry.

Transfer pricing methods

The following table lists the transfer pricing methods used in APAs signed from 2005 to 2015 and in 2015 alone[7]:

Table 1

Transfer pricing method	2005 to 2015	2015
Comparable uncontrolled price (CUP) method	5	0
Resale price method	1	0
Cost plus method	17	0
Transactional net margin method (TNMM) - full cost mark-up ratio	59	11
TNMM - return on capital	2	0
TNMM - return on sales	48	3
Profit split method	3	0
Other methods	4	0

[7] An APA may involve two or more categories of related-party transactions and thus may involve two or more transfer pricing methods.

As shown in the table, TNMM is the most frequently used transfer pricing method, while the CUP method, the resale price method and the profit split method are rarely used.

In the Annual Report, the SAT explains that the infrequent use of the CUP method results from its high comparability standard. This explanation indicates that the SAT generally thinks enterprises have difficulty in meeting the high comparability standard required by the CUP method. Thus, the SAT may disfavor the CUP method in future APA negotiations.

Meanwhile, the SAT explains that the resale price method and the profit split method were applied less frequently due to enterprises providing insufficient information about transactions and pricing. Thus, the SAT is encouraging enterprises to provide sufficient information so that the resale price method and the profit split method can be used more frequently.

Term length

From 2005 to 2015, 94.7% of unilateral and 65.3% of bilateral APAs were completed[8] within two years. Of the completed bilateral APAs, 49% were completed within one year. Among the 12 APAs completed in 2015, all six unilateral APAs and one bilateral APA were completed within two years. Three bilateral APAs took more than three years. Although the SAT aims to complete the review and negotiation process for bilateral APAs within two years, the actual time required varies.

Nonetheless, based on the numbers from previous years, taxpayers should remain optimistic that the APA process will normally take less than two years once the SAT formally accepts the APA application.

Bilateral APAs

All six bilateral APAs completed in 2015 were signed with Asian countries, four signed with Korea and two signed with Japan. These numbers are consistent with previous years in which Asian countries have signed the most APAs with China.

What to expect in 2017

Once again, the Annual Report states that the Chinese tax authorities have received a large amount of APA applications but have struggled to quickly process them due to a lack of resources. Although the Anti-Avoidance Division III was established within the SAT in 2016 to help with due diligence work during the mutual agreement procedure (MAP) and APA negotiations, this division is unlikely to solve delays in the APA program in the near term. The SAT will first need to focus on the MAP due to the peer review pressure from the MAP Forum under the Base Erosion and Profit Shifting Project.

According to the Annual Report, the Chinese tax authorities will prioritize APA applications that contain a complete and accurate value/supply chain analysis and that apply innovative transfer pricing methods or high quality quantitative analysis for intangibles, cost savings or market premiums. Any MNC that hopes to seek certainty via an APA should include an appropriate analysis on such issues to demonstrate its APA application should receive priority treatment.

[8] The time starts to run only if the APA request is formally accepted by the SAT.

3. China Clarifies the Tax Treatment of the Shenzhen-Hong Kong Stock Connect

On 5 November 2016, the Ministry of Finance, the SAT and the China Securities Regulatory Commission jointly issued Cai Shui [2016] No. 127 to clarify the tax policies for the Shenzhen-Hong Kong Stock Connect.

Effective from 5 December 2016, capital gains derived by investors (enterprises or individuals) in the Hong Kong market from the sales of stocks listed on the Shenzhen Stock Exchange (SZSE) through the stock connect are exempt from income tax, and the net revenue derived by investors in the Hong Kong market from the sales of SZSE securities are exempt from value-added tax (VAT). However, dividends derived by investors who invest through the stock connect in A Shares in the Hong Kong market will be subject to 10% withholding tax. The mainland listed companies will be responsible for withholding the tax. The non-resident enterprises and individuals may apply for tax treaty benefits and receive a tax refund from the mainland tax authorities.

Between 5 December 2016 to 4 December 2019, capital gains derived by mainland individuals from the sale of stocks listed on the Stock Exchange of Hong Kong Limited (SEHK) through the stock connect are also exempt from individual income tax (IIT). However, capital gains derived by mainland resident enterprises from the sale of SEHK securities through the stock connect will be subject to enterprise income tax (EIT). Dividends derived by mainland resident enterprises and individuals that invest in SEHK securities will be subject to EIT or IIT in accordance with mainland laws. However, dividends received by resident enterprise investors on H shares held for at least 12 months are exempt from EIT. The net revenue derived by mainland resident enterprises and individuals from the sales of SEHK securities will be either subject to or exempt from VAT in accordance with mainland laws.

There are no stamp duty exemptions. Both foreign investors and domestic investors will be subject to stamp duty in accordance with mainland laws and Hong Kong laws. Currently, 0.1% mainland stamp duty has been imposed on the transferors for A share transfer documents concluded in sales and purchases, inheritances and donations.

4. China Issues Environmental Protection Tax Law

On 25 December 2016, the standing committee of the National People's Congress approved the *Environmental Protection Tax Law*, which will replace the current pollutant discharge fee on 1 January 2018.

Taxpayers and taxable pollutants

The scope of taxpayers and taxable pollutants under the new law is identical to the current rules governing the pollutant discharge fee. According to the new law, enterprises, public institutions and other business operators that directly discharges taxable pollutants into the environment within the territory of China or within other sea areas under the jurisdiction of China are liable to pay environmental protection tax. Taxable pollutants include certain air and water pollutants, certain solid waste, and noise in excess of national standards.

Taxable rates and calculation of tax payable

The applicable tax rates under new law are as follows:

- RMB 1.2 to RMB 12 per equivalent weight[9] for air pollutants
- RMB 1.4 to RMB 14 per equivalent weight for water pollutants
- RMB 5, RMB 15, RMB 25 or RMB 1,000 per ton of solid waste (depending on the nature of the solid waste)
- RMB 350, RMB 700, RMB 1,400, RMB 2,800, RMB 5,600 or RMB 11,200 per month for noise (depending on the decibel level).

Notably, the tax on air and water pollutants is generally calculated on each discharge outlet. For each discharge outlet, tax is only levied on the top three air pollutants, or the top five first class water pollutants and the top three other water pollutants (measured at equivalent weight). The provincial-level local government will determine the applicable tax rates for air and water pollutants within the specified range, and may increase the taxable items for a single discharge outlet. Both determinations are subject to the approval of the provincial-level people's congress.

Tax relief

Like under the current rules governing the pollutant discharge fee, the new law provides a 50% tax reduction to a taxpayer if the concentration of the air or water pollutants discharged by the taxpayer is 50% lower than national and local standards. A 25% tax reduction is available if the concentration is 30% lower than national and local standards.

Tax collection and administration

Tax liability arises on the day when the taxpayer discharges a pollutant. The taxpayer should generally calculate the tax monthly and pay it quarterly to the tax bureau at the pollutant discharge location.

Observations

Currently, local governments have yet to announce the applicable tax rates for air and water pollutants. Thus, enterprises must wait to see how their costs will be impacted under the new law and should watch closely for these local announcements. In addition, enterprises should thoroughly review the new law's procedural requirements because they differ significantly from the pollutant discharge fee's procedural rules.

5. Zhangye Case: Third-party Appraisal Report Rejected by Tax Bureau

On 7 February 2017, China Taxation News reported that the Zhangye State Tax Bureau in Gansu Province rejected a third-party appraisal report in a share transfer and collected RMB 15.51 million in EIT and interest from the non-resident seller.[10]

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[9] Equivalent weight is calculated by dividing the discharge amount by a prescribed equivalent value.

[10] See http://www.ctaxnews.net.cn/html/2017-02/07/nw.D340100zgswb_20170207_1-06.htm?div=-1.

Facts

A Chinese company had 49% of its shares transferred between two offshore companies. The tax bureau learned about the share transfer from the local commerce bureau and decided to look into the transfer. After reviewing documents submitted by the Chinese company, the tax bureau found that the buyer was a subsidiary of the seller and would pay the consideration by issuing shares to the seller.

The tax bureau notified the seller that it suspected the seller had avoided China tax through the transaction. The tax bureau requested the seller to provide evidence the transaction was conducted at arm's length. In response to the request, the seller submitted a third-party appraisal report issued by a well-known international firm. According to the appraisal report, the Chinese company had a total value appreciation of RMB 110 million. The seller allocated 49% of the value appreciation to the transferred shares and voluntarily paid RMB 5.38 million in EIT.

The seller's voluntary tax payment did not end the tax bureau's investigation. Instead, the tax bureau was unsatisfied with the appraisal report because the appraised value of the Chinese company only reflected the value appreciation in some real property and did not reflect the value appreciation from the company's expected earnings. The tax bureau then engaged evaluation experts to revalue the transferred shares.

In the end, the tax bureau adjusted the value of the transferred shares to approximately four times of the appraised share value in the appraisal report. The seller paid an additional RMB 10.13 million in EIT and interest.

Observations

Under the PRC law, a company is required to make a tax recordal after a shareholder change. As such, even without information from the commerce bureau, the tax bureau will be able to learn about a share transfer through a subsequent tax recordal. Cross-border share transfers between related parties are a continuous focus for tax audits. In auditing these transfers, the tax authorities have typically relied on third-party appraisal reports issued by qualified PRC appraisal institutions and accepted their valuation methods to assess the share transfer price. Although unclear from the news report, it may be that the international firm does not have appraisal qualification in China, thus giving the tax bureau an additional basis to challenge the appraisal report. Nevertheless, the fact that the tax bureau rejected the valuation method used in the appraisal report shows that the tax authorities have become quite sophisticated and may challenge the valuation method in third-party appraisal reports. Therefore, taxpayers cannot fully rely on a third-party appraisal report and should be prepared to defend the share transfer price in front of the tax authorities.

6. Pingtan Case: Tax Bureau Taxes Service Fees in Equipment Sale

On 20 January 2017, China Taxation News reported that the Pingtan State Tax Bureau in Fujian Province allocated part of an equipment purchase price to installation services and imposed RMB 0.43 million in EIT and late payment surcharges on the deemed service fees.[11]

Facts

In August 2015, the tax bureau learned from an online news report that a Japanese company had been selling equipment to a Chinese company located in Pingtan. The tax bureau investigated because it had not received any tax payments from the Japanese company.

During the investigation, the tax bureau found the two companies signed an equipment sale and installation service agreement in 2013. According to the agreement, the Japanese company would sell equipment to the Chinese company for JPY 1.46 billion (approximately RMB 88.16 million). However, the agreement did not provide a service fee for the installation services. The tax bureau decided to use the deemed method under Guo Shui Fa [2010] No. 19 to calculate the service fee and impose tax accordingly. This deemed method allowed the tax bureau to deem at least 10% of the total purchase price as service fees if no comparable transaction existed with the service fees specified.

The Japanese company argued that it should be exempt from tax in China on the service fees under the China-Japan tax treaty because the Japanese company did not have a permanent establishment (PE) in China. However, the tax bureau found that the Japanese company previously had employees in China providing installation services, and those employees had stayed in China long enough to establish a PE. Faced with this finding, the Japanese company agreed to pay tax on the service fees.

Observations

Technically, income from equipment sales and service fees are both exempt from tax unless the non-resident recipient has a PE in China. In practice, however, tax bureaus are generally very cautious with outbound service fee payments and will require offshore service providers to prove that they do not have a PE in China. As such, some offshore companies attempt to sidestep this onerous proof burden by embedding service fees in the equipment purchase price so that the tax bureau will not notice the service fees. This strategy has worked because outbound remittances for equipment purchases do not require a tax recordal with the tax bureau whereas outbound remittances of service fees do require a tax recordal.

However, this case shows that the tax authorities are now using various resources and techniques to identify service fees. Embedding service fees in the equipment purchase price might not conceal the service fees from the tax authorities. A failed attempt to conceal service fees can result in late payment surcharges and other penalties for late tax payments on service fees. As such, taxpayers selling equipment and providing services should thoroughly assess pricing arrangements when a transaction involves both the sale of equipment and the provision of services.

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[11] See http://www.ctaxnews.net.cn/html/2017-01/20/nw.D340100zgswb_20170120_1-10.htm?div=-1.