CHINA

Key Highlights

Ever since the OECD initiated the BEPS project in 2013, the landscape of international taxation in China has largely been shaped by BEPS-related tax issues.

During the past year, the Chinese tax authorities have continued to focus on transfer pricing, anti-treaty shopping and anti-avoidance. With China's new transfer pricing regime fully implemented from May 2017, multinational companies (MNCs) have faced increasing challenges related to transfer pricing issues. In the area of anti-treaty shopping, the new beneficial ownership rules issued by the State Administration of Taxation (SAT) reinforce the emphasis on economic substance as the most critical factor for treaty benefit applicants to qualify as beneficial owners.

The past year has also been marked by China's reinvigorated effort to enhance the competitiveness of its tax regimes to attract foreign investment. In December 2017, the dividend tax deferral regime was introduced to encourage reinvestment in China. Then in February 2018, the new beneficial ownership rules allowed MNCs a certain degree of increased access to treaty-based dividend withholding tax rates. Other major tax policies introduced to ease tax burdens include:

- expanding the technologically-advanced service enterprise tax incentive (i.e., a reduced enterprise income tax rate of 15%) nationwide and to cover more industries such as R&D services
- expanding the R&D super-deduction incentive to cover expenses incurred for outsourced offshore R&D activities
- reducing VAT rates in various sectors by 1%

In July of this year, China also completed a tax administration reform to merge the state and local tax bureaus throughout the country. While one of the stated purposes of this reform is to reduce taxpayers' compliance burdens, the reform may also pose greater audit risks for taxpayers going forward.

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China

Asia Pacific Tax
Recent Developments and Highlights

Recent Developments

1. China Completes the Tax Administration Reform to Merge State and Local Tax Bureaus

In March 2018, China started a reform to merge state and local tax bureaus into a consolidated local tax authority. Separate state and local tax bureaus were originally established at the provincial, municipal and lower levels in 1994 with a division of responsibility for different types of taxes. For example, the state tax bureaus were responsible for enterprise income tax and VAT, while the local tax bureaus were responsible for individual income tax and business tax.

China announced the provincial-level merger on 15 June 2018, the municipal-level merger on 5 July 2018 and the county/district-level merger on 20 July 2018. After these mergers, the new local tax authority has assumed all of the functions previously performed by the separate state and local tax bureaus.

The reform may have both positive and negative implications for taxpayers.

- First, the reform will reduce the compliance burden for taxpayers as a taxpayer will only have one in-charge tax authority and will no longer need to complete duplicative tax formalities with two tax bureaus.
- Second, taxpayers could face increased tax audit risk by being supervised by a single tax bureau as there may be more sharing of information within the tax bureau. In the past, for example, the state tax authorities handling enterprise income tax tended not to coordinate closely with the local tax authorities dealing with individual income tax, even though in certain areas such as, permanent establishment, both types of taxes are relevant. After the merger, the departments within the single tax bureau may coordinate more closely.
- Finally, taxpayers can expect more sophisticated technical discussions with the local tax authorities because the SAT will play a greater role in directing the local tax authorities. Generally speaking, the SAT has a deeper understanding of the tax laws and regulations as compared to the local tax authorities and this may filter down to the local levels due to the SAT's greater influence post-merger.

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Asia Pacific Tax
Recent Developments and Highlights

In response to the greater information sharing within the tax authority after the reform, taxpayers and advisors should take a more comprehensive approach when assessing tax risks, with a greater focus on the potential interplay among different types of taxes, so that they are well prepared before the tax authority comes knocking on the door. Given the anticipated greater influence of the SAT on the local tax authorities, taxpayers may also consider leveraging SAT relationships when appropriate to develop more sophisticated technical discussions in disputes with local tax authorities. Taxpayers should be more confident about challenging local tax authority decisions to achieve a better outcome when a sound legal basis exists.

2. China's Latest Anti-Treaty Shopping Rules Create New Tax Saving Opportunities for MNCs

On 3 February 2018, the SAT issued the Bulletin on Issues Relating to Beneficial Ownership in Tax Treaties, SAT Bulletin [2018] No. 9 ("**Bulletin 9**"). Bulletin 9 took effect on 1 April 2018 and replaced China's prior anti-treaty shopping rules under Guo Shui Han [2009] No. 601 ("**Circular 601**") and SAT Bulletin [2012] No. 30 ("**Bulletin 30**").

Bulletin 9 provides for a three-step beneficial ownership analysis:

- **Step 1 – safe harbor**. Under the pre-existing rules, an income recipient that is both a tax resident and publicly listed in the treaty partner jurisdiction is treated as a per se beneficial owner. Bulletin 9 significantly expands the scope of per se beneficial owners of dividend income to include government bodies and individuals who are tax resident in the treaty partner jurisdiction. Further, this safe harbor is now extended to a dividend income recipient that is not a per se beneficial owner if (a) it is directly or indirectly 100% owned by one or more per se beneficial owners, and (b) all intermediate entities, if any, between the income recipient and the per se beneficial owner(s) are tax resident in China or the treaty partner jurisdiction.

- **Step 2 – standard "negative-factor" analysis**. Circular 601 listed seven negative factors for determining whether an income recipient met the beneficial ownership test. These seven factors are consolidated into five factors under Bulletin 9. One key change is the tightening of the anti-conduit factor. Under Circular 601, the income recipient could be viewed as a conduit if it was obligated to pay 60% or more of the China-sourced income to a tax resident of a third jurisdiction within 12 months after receipt. The 60% test is reduced to 50% in Bulletin 9, and both an actual payment and an obligation to pay will be taken into account.

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A welcome change under Bulletin 9 is that "substantive" investment management activities alone may meet the beneficial ownership test. However, whether investment management activity is substantive must be evaluated based on whether the income recipient possesses sufficient assets and personnel to perform the investment functions, to bear the corresponding risks and to own the economic rights over the investment income. If an income recipient conducts only passive investment activities, it must also carry out an additional active trade or business to meet the beneficial ownership test.

- **Step 3 – beneficial ownership attribution rule**. The new beneficial ownership attribution rule will increase access to treaty-based dividend withholding tax rates for MNCs where the income recipient itself does not qualify for the safe harbor and does not possess enough local economic substance to pass the more general "negative-factor" test. The beneficial ownership attribution test contains both a same-country scenario and a non-same country scenario.

  In the same-country scenario, where a same-country affiliate that directly and/or indirectly owns 100% of the dividend income recipient would have met the standard beneficial ownership test had that affiliate received the Chinese dividend directly, the income recipient will qualify as the beneficial owner through attribution. In the non-same country scenario, if (i) an affiliate in another jurisdiction that has a tax treaty with China directly and/or indirectly owns 100% of the dividend income recipient and would have passed the standard beneficial ownership test had that affiliate received the Chinese dividend directly, and (ii) that affiliate and all intermediate entities between that affiliate and the income recipient are "qualified persons", the treaty applicant can still be viewed as the beneficial owner of the dividend. For this purpose, a "qualified person" is one that would obtain the same (or a lower) dividend withholding tax rate under the tax treaty between its own jurisdiction of residence and China as (than) the rate the income recipient may obtain under its applicable tax treaty with China.

The most significant development in Bulletin 9 is the beneficial ownership attribution test, which is similar to the derivative benefits test under the OECD BEPS Action 6, as this development is likely to deliver the most tangible benefits to MNCs in the near term. It is noteworthy, however, that the attribution of beneficial ownership is limited to the direct or indirect parent(s) of the income recipient. In this respect, attribution under Bulletin 9 is narrower than in some other jurisdictions with broadly similar rules.

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In other respects, Bulletin 9 preserves the beneficial ownership requirements under Circular 601 related to substantive business activity, which will remain the most critical factor for most applicants seeking beneficial ownership status under China's tax treaties. It will be more important than ever for MNCs seeking to benefit from lower treaty withholding tax rates to have sufficient economic substance in the ownership chain above China, to maintain detailed supporting documentation, and to ensure that the necessary tax residency certificates are available to the relevant companies in the chain.

On balance, we see Bulletin 9 as a major improvement to the previous rules in Circular 601 and its offspring. We would encourage MNCs to analyze the impact of the new rules in the context of their existing holding structures for China, as well as to explore new structures that can fully take advantage of the planning opportunities provided by Bulletin 9.

3. China Revives Tax Incentive for Dividends Reinvested into Chin

On 21 December 2017, China issued Cai Shui [2017] No. 88 ("**Notice 88**") to allow a non-resident enterprise to defer payment of withholding tax on dividends derived from a Chinese company if the non-resident enterprise directly reinvests the dividends into industries "encouraged" by the Chinese government. Notice 88 applies to dividend distributions on or after 1 January 2017. This incentive is a deferral, not an exemption, as the non-resident enterprise must pay the deferred withholding tax after it has recovered the reinvestment.

Direct reinvestment refers to equity investments in the form of a capital increase to an existing resident enterprise, the contribution of capital to a newly formed resident enterprise, and a share acquisition of a resident enterprise from an unrelated party. Aside from the requirement that the reinvestment must be in an industry encouraged by the State, stringent fund flow requirements also apply. The cash dividends must be transferred directly from the distributing enterprise's bank account to the bank account of the invested enterprise (in the case of a capital contribution) or the transferor (in the case of acquiring a Chinese target enterprise).

MNCs that have accumulated profits in Chinese subsidiaries and plan to increase investment in China should consider strategies to enjoy the new dividend tax deferral. This is especially important for MNCs whose home country tax systems provide participation exemptions for foreign sourced dividends as they may not be able to utilize foreign tax credits arising from the Chinese withholding tax that would otherwise be levied.

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China

Asia Pacific Tax
Recent Developments and Highlights

Outlook for 2019

One key development that is expected at the start of 2019 is implementation of an amended *Individual Income Tax Law* and a corresponding step up of enforcement efforts. The most notable change is the introduction of anti-avoidance rules that will parallel the GAAR and other anti-avoidance measures in the enterprise income tax regime today. Other changes include reducing the time presence threshold for an expatriate to become a Chinese tax resident, revised categories of taxable income, new rules on deductions, and adjustment of tax brackets.

In the realm of corporate income tax, developing the most appropriate strategies for dealing with tax controversy, from preliminary investigations to formal audits to administrative review and in some cases to formal appeal will be one of the highest priorities for the leaders and staff of MNC tax departments in 2019 and beyond. As a result of legislative efforts over the past several years, China now has a comprehensive and detailed anti-avoidance regime for international taxation, including new indirect share transfer rules (Bulletin 7), new transfer pricing regulations (Bulletin 42, Bulletin 64 and Bulletin 6), and new anti-treaty shopping rules (Bulletin 9). Furthermore, China has developed and deployed ever increasing resources for enforcement of the anti-avoidance regime, most notably for transfer pricing. Therefore, we expect that MNCs and their subsidiaries in China will face more and more scrutiny from the tax authorities and an increasing number of tax audits.

Historically, MNCs have tended to adopt a settlement strategy to tax controversies in China because of concerns about the potentially negative consequences of initiating an administrative review or litigation against the tax authorities. While this approach may still make sense in many cases, at least as a starting point, our more recent experience and successes show that challenging tax authority decisions on a principled legal basis, including recourse to administrative review, litigation or competent authority procedures, are worthwhile options to consider in certain circumstances. The SAT has been taking measures to promote transparency and uniformity in tax administration and enforcement, and the Chinese tax authorities have become more open to engaging with taxpayers on the legal and technical merits of tax issues and to basing their decisions on the law. We expect that formal dispute resolution mechanisms (including competent authority procedures) will play an increasingly important role in helping taxpayers achieve better resolutions in tax disputes.

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