Coordinating Efforts to Tackle Cross-Border Tax Avoidance
Chairman’s Message

Since the mid-1990s, and accelerating after China joined the World Trade Organization (WTO), the Chinese government made an effort to reform and simplify its tax laws, standardize tax collection, and implement and enforce its tax system. Effective in 2008 and 2009, the government significantly revised various aspects of its tax laws and regulations with respect to turnover and income taxes applicable to business enterprises and with the objective to uniformly apply tax laws to both Chinese and foreign taxpayers.

The Chinese government is also becoming savvier in the use of powerful tax policy tools to further social and economic goals. Indeed, the PRC government has developed a tax system of exemptions, credits, and deductions designed to encourage particular economic behavior such as, among other things, investments in the economically depressed areas of the country, investments in environmentally advanced technology, investments in higher value technology and innovation-driven industry sectors, charitable donations to lessen the impact of natural disasters, and employment of traditionally disadvantaged minority groups and disabled workers.

All of these changes to China’s tax policy are constructive and positive so long as they are consistent with WTO obligations. That said, this is all very new and uncharted territory for the tax authorities and the government will indeed go through a learning curve as it refines its policies and implements the law.

AmCham China is hopeful that the Chinese government will apply the tax laws and regulations in a fair, uniform, and transparent manner, and we will be monitoring China’s enforcement record going forward on behalf of our member companies.

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August 2015
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Introduction

Major changes occurred in China’s cross-border tax regulatory system in 2014. For example, the Organization for Economic Co-operation and Development and G20 (OECD/G20) initiative for multilateral cooperation in addressing tax base erosion and profit shifting (BEPS) made steady progress. China played an important consultative role in the BEPS initiatives and is expected to implement various domestic rules to achieve the major objectives contemplated by BEPS (i.e., preventing multinational companies from eroding the Chinese income tax base and moving profits beyond the reach of Chinese tax regulators). Meanwhile, China’s corporate tax rate as a percentage of government revenues has risen dramatically from approximately seven percent in 2000 to nearly 25 percent in 2013. Furthermore, the central government loses approximately US $134 billion (RMB 825 billion) per year in tax evasion, corruption, and capital outflows. At the November 2014 Brisbane G20 Summit, President Xi cited the need to “strike at international tax evasion” and to work with other countries on modernizing international tax rules. In addition to heightening enforcement in the international taxation arena, China has pushed ahead with turnover tax reforms which aim to eventually unify value-added taxes (VAT) and business taxes.

Recent Developments and Regulatory Challenges

Transfer Pricing

In September 2014, the OECD released the first seven deliverables under the BEPS project (2014 BEPS Deliverables), setting out its recommendations to enhance the integrity and fairness of the international tax system and ensure that taxing rights are aligned with economic activities and value creation. Through China’s membership in the OECD’s Committee of Fiscal Affairs, the State Administration of Taxation (SAT) has been intimately involved in the BEPS initiative. The SAT’s actions have clearly shaped China’s transfer pricing framework, as the 2014 BEPS Deliverables provide support for several key issues at the heart of China’s new transfer pricing measures, such as those concerning location-specific advantages and profit splits.

AmCham China’s overriding concern and recommendation is for the SAT to make clear that it will seek to ensure that China’s tax rules and enforcement practices remain consistent with the emerging global consensus, and that it will seek to avoid hasty adoption of new rules and practices in advance of such consensus being realized in the finalized BEPS deliverables. For example, we urge the SAT to adopt country-by-country (CBC) reporting requirements that are consistent with BEPS standards and do not require additional columns of information in the CBC template.
The demands of the BEPS initiative – both during its development and implementation phases – continue to place significant strain on the SAT’s Anti-avoidance Division. In the 2014 White Paper, we urged the Chinese government to put more resources into transfer pricing by increasing the number of officials working in the Division, and we would like to reemphasize this recommendation. While the Division has increased the level of transfer pricing enforcement throughout China, it has done so largely by leveraging local tax authority resources rather than increasing staffing at the Division. We believe there is a need for coordination capability and a degree of expertise that can only be achieved through the expansion of the Division itself.

As we noted last year, AmCham China members highly value the availability of advance pricing agreements (APAs) to help manage their global tax affairs and prevent double taxation. Transfer pricing developments in the BEPS initiative seem to augur greater uncertainty in such areas as determining what functions are most important and how risks should be allocated and assessed. We believe APAs will become even more important in this environment. Again, an increase in the number of officials in the Division is the most effective way to increase the availability of APAs.

Large Cross-Border Payments

The SAT’s increased focus on transfer pricing matters is reflected in the July 2014 issuance of Shuizongbanfa [2014] No. 146 (Directive 146), which instructs local tax authorities to survey large cross-border payments of service fees and royalties made by Chinese entities between 2004 and 2013. While we understand the need for greater scrutiny of these types of payments per se, we urge Chinese tax authorities to weigh the evidence carefully and not simply disallow deductions for them as a matter of course.

Regarding service payments, the SAT has laid out its view of what constitutes an appropriate inquiry in its April 2014 letter to the UN working group on transfer pricing issues. While the SAT places special emphasis on certain elements of the inquiry, we believe that the SAT’s position is largely consistent with global standards reflected in the OECD’s Transfer Pricing Guidelines. However, we suggest that some of the criteria advocated by the SAT should be considered relevant to the quantification of the amount of the arm’s length service fee rather than leading to the disallowance of the service fee in total. For example, if certain headquarter’s activities benefit both the headquarters and the Chinese subsidiary – even if the benefit to the headquarters is greater – then it would nonetheless be appropriate to charge the subsidiary a service fee commensurate with its share of the total benefit. In addition, we recognize the challenges involved in authenticating the amount of the service fee, but hope that authentication will not be an insurmountable hurdle in practice.

With respect to royalties, Directive 146 instructed that greater focus should be placed on payments to intermediaries with relatively little substance. This focus is understandable, but it should be recognized that such intermediaries often have acquired the intangibles at an arm’s
length from the affiliate that actually developed the intangibles, or that the intermediary pays substantial royalties to the developer on an ongoing basis. Outright disallowance of deductions for royalty payments in these situations would be inappropriate. In addition, no artificial limit should be imposed on the absolute value of a royalty fee. In some circumstances, a royalty rate well in excess of 10 percent of sales for particularly valuable intangibles is entirely consistent with the arm’s length standard. We raise this caveat not only to the relevant tax authorities but also those in the Ministry of Commerce (MOFCOM) responsible for authorizing the cross-border remittance of technical royalties.

**Treaty Qualification in Entrusted Investment Structures**

In April 2014, the SAT issued guidance in Bulletin 24 which contains rules on determining beneficial owner status in “entrusted investment” structures and that clarifies previous SAT guidance on tax treaties issued since 2009.

Bulletin 24, which went into effect June 1, 2014, provides that a nonresident investor may apply for tax treaty benefits as the beneficial owner of income derived from an entrusted investment. An entrusted investment structure is one in which a nonresident entrusts its own funds to an offshore financial institution that is engaged in the business of securities brokerage, asset management, and custodial services (e.g., for funds, securities) for the purpose of making equity or debt investments in Chinese resident enterprises.

In general, it is our understanding that the rule encompasses certain investment arrangements that investors make with qualified foreign institutional investors (QFIIs) under the current Chinese regulations, whereas investments through other financial institutions engaged in asset management and investment (e.g., private equity funds, collective investment vehicles, trusts) will likely be excluded from the scope of entrusted investment due to differences in the investment decision-making process, risk, and benefits, among other reasons. Moreover, Bulletin 24 imposes strict documentation requirements on nonresident investors to prove the existence of a qualifying entrusted investment structure, which some investors may find difficult to satisfy due to confidentiality concerns.

In addition, under most of China’s tax treaties, a reduced withholding tax rate on dividends will generally be granted where the beneficial owner directly holds at least 25 percent of the capital of the company paying the dividends. Therefore, when an offshore professional institution is regarded as a nonresident investor’s nominee or agent for purposes of the beneficial ownership requirement under a treaty, the nonresident investor can enjoy the reduced withholding tax rate only where it meets the 25 percent shareholding requirement. This requirement may restrict the application of Bulletin 24 since current rules may not allow QFIIs to own more than a certain percentage of a Chinese company.

With the emergence of various investment structures for offshore funds to invest into China, the SAT hopes to clarify the determination of beneficial ownership for certain common in-
vestments, and Bulletin 24 thus provides welcome guidance. However, taxpayers that had hoped for clarification of beneficial ownership for a broader range of investment structures than the qualifying entrusted investment structures defined in Bulletin 24 may find the narrow scope of the bulletin disappointing.

**Anti-Treaty Shopping**

China has renegotiated several of its tax treaties since November 2013, including:

- New treaties with France, Germany, and Russia were signed but have not yet come into force;
- New treaties with Belgium and the United Kingdom entered into effect in the first half of 2014; and
- New treaties with Ecuador and the Netherlands took effect in January 2015.

Some common features of these treaties include:

- A reduced five percent withholding tax rate on certain dividends (down from 10 percent) and a reduced withholding tax on certain royalties;
- A miscellaneous rule that enables tax authorities to apply their domestic general anti-avoidance rules, notwithstanding the provisions of the treaty;
- Additional anti-treaty shopping clauses in the dividend, interest, royalties, and other income articles that deny treaty benefits where the main purpose, or one of the main purposes, of an arrangement is to take advantage of the relevant treaty article; and
- Other changes to bring the new treaties more in line with the OECD model treaty.

The 2014 BEPS Deliverables agreed to by China include the report on Action 6, “Preventing the Granting of Treaty Benefits in Inappropriate Circumstances.” This report outlines the means by which treaty shopping should be countered, as agreed upon by the countries participating in the BEPS process.

We propose that, for China to align itself with this globally agreed-upon approach, the SAT should:

1) Decouple the general anti-avoidance rule (GAAR) from the beneficial ownership determination when evaluating whether treaty-withholding tax relief is available. The beneficial ownership test should simply be a test of rights of control over income;

2) Clarify that the GAAR is the instrument used when countering treaty shopping, whether in respect to passive income treaty-withholding tax relief (where it may be used in conjunction with the purpose test in the passive income articles of newer treaties), or in respect to capital gains treaty-withholding tax relief; and
3) Indicate that the new OECD model tax convention (MTC) guidance on the principal purposes test (PPT) can be referred to when applying the GAAR to treaty shopping arrangements.

The reasoning for the above recommendations is detailed in the following paragraphs.

The report on Action 6 specifies that, at a minimum, the defenses to be established by countries against treaty abuse will include a treaty-based limitation on benefits (LOB) clause together with a treaty-based PPT or, alternatively, a PPT or an LOB as supplemented by domestic anti-abuse rules (e.g., GAAR) to address conduit arrangements. As China has historically not favored the LOB approach, AmCham China recommends that China align its approach with the globally agreed practice of utilizing its GAAR, in addition to the “main purpose” tests it is increasingly including in the passive articles of its treaties, to address treaty shopping.

However, at present, many commentators feel that China is combating treaty shopping through an unorthodox use of the beneficial ownership definition, as described in SAT Circular 601 (2009), which effectively includes an “embedded GAAR.” Although the beneficial ownership evaluation factors, as detailed in Circular 601, do consider whether the treaty relief claimant controls the disposition of the income and the underlying property – in line with the internationally understood meaning of beneficial ownership – factors such as whether the staffing, premises, and other business activities and assets of the relief claimant are commensurate with its income are also considered.

In the view of most commentators, such substance-based factors are relevant for a GAAR analysis of the artificiality of the arrangements in evaluating whether treaty shopping is at issue. However, combating treaty shopping through the beneficial ownership requirement is at variance with the internationally agreed approach detailed in the report on Action 6, and we recommend that the SAT unbundle the GAAR application from the beneficial ownership definition. At the same time, we suggest that when capital gains tax relief is denied by the SAT regarding the Double Tax Agreement and withholding income tax (DTA, WHT), it be done on the basis of the GAAR, rather than Circular 601. While commentators have long inferred that this is the basis on which DTA relief is denied, it has never been expressly stated by the tax authorities.

Viewed from the perspective of adherence by China to the agreed international approach in the report on BEPS Action 6, use of the GAAR to combat treaty abuse is a stand-in for Chinese adoption of the PPT. As such, the SAT would best fulfil its commitment to adopt the aligned BEPS approach to treaty abuse by confirming that the PPT application guidance should be followed when applying the domestic law GAAR to counter treaty shopping. Some of the BEPS Commentary provides helpful guidance regarding GAAR application, including:
“Merely reviewing the effects of an arrangement will not usually enable a conclusion to be drawn about its purposes”; “Where...an arrangement can only be reasonably explained by a benefit that arises under a treaty, it may be concluded that one of the principal purposes of that arrangement was to obtain the benefit”; and “Where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit.”

In particular, given that the SAT has recently, with release of the *Shuizonghan* [2014] No. 317, launched a wide-ranging examination of historic dividend payments with a view to challenging, *inter alia*, treaty shopping arrangements, now is the time to clarify the manner in which such treaty shopping will be challenged.

VAT Reform

China’s VAT reform, originally launched as a pilot program in Shanghai on January 1, 2012, is expected to be completed in 2015. The pilot program removed certain services from the scope of the business tax (BT) regime and into the scope of the VAT regime. This step was the first phase of an overall plan to replace the dual BT/VAT systems with a single system applied to the supply of both goods and services. Under the current regime, VAT is levied on certain supplies of goods and services, while BT is levied on other services and the transfer of intangible assets and real property. Different rates are imposed under the VAT and BT regimes and, unlike VAT, an input tax credit is not available under the BT system. Such reform aims to eliminate the double or multiple taxation that arises under the current tax system.

Since its inception, the reform has expanded both geographically and in scope. The reform was extended to another eight cities and provinces later in 2012 and then nationwide on August 1, 2013. While initially limited to leases of tangible movable property and the provision of transportation services and modern services (i.e., research and development and technical services, information technology services, cultural and creative services, logistics and ancillary services, and certification and consulting services), the scope of the VAT reform now encompasses telecommunications and other services, railway transportation, and postal services and freight forwarding services.

The Ministry of Finance (MOF) and the SAT have issued an abundance of guidance since 2012 on the scope of the reform and the VAT treatment of specific transactions. The following bullets highlight some of the guidance issued since December 2013:

- Circular 106, issued on December 12, 2013, contained a new set of rules that apply to the VAT reform beginning January 1, 2014 and superseded many of the rules in Circular 37. Circular 106 specified that railway transportation and postal services would be subject to the 11 percent VAT rate and that pick-up and delivery services would be sub-
ject to the six percent rate. It also amended the rules relating to finance leasing companies, international freight forwarders, and shipping agencies.

- Circular 43, issued on April 29, 2014, further extended the scope of the VAT reform to apply to telecommunications services beginning June 1, 2014 at a rate of 11 percent for basic telecommunications and six percent for value-added telecommunications. These rates represent a significant increase for the telecoms sector as compared to the three percent BT that previously applied. For taxpayers in this industry, the real challenge is to ensure there are sufficient VAT inputs to mitigate the negative impact.

- Bulletin 42, issued on July 4, 2014 and effective September 1, 2014, extended VAT-exempt treatment to international freight forwarding services provided through other forwarders. Initially addressed in Circular 106, the VAT exemption for such services applied only to the last forwarder in the chain (i.e., the forwarder that was in direct business contact with the international transportation service supplier, such as a shipping company), but not to forwarders that did not have direct contact with international suppliers and did not make direct payments to such suppliers. With the issuance of Bulletin 42, all other forwarders in the chain became eligible for VAT-exempt treatment, provided that all of the income received from customers (or other forwarders) and international transport and agency fees paid to other forwarders are settled through a financial institution. As international freight forwarding services are frequently provided through a chain of forwarders, this practical clarification was welcome.

- Bulletin 49, issued on August 27, 2014 and effective beginning October 1, 2014, contains comprehensive guidance on the application of VAT-exempt treatment for cross-border services. Under VAT-exempt treatment, no output VAT is payable, but the input VAT incurred on costs is not recoverable. Although less beneficial than zero-rated VAT treatment, under which the input VAT incurred on cost is recoverable, the VAT exemption is still considered as an incentive to promote the development of cross-border services. Circular 49 extends the scope of the VAT exemption to include exports of services that are part of the VAT reform and clarifies the treatment where taxpayers are eligible for both zero-rated treatment and a VAT exemption. It also permits a taxpayer to claim a VAT exemption if the taxpayer elects to relinquish the zero-rated treatment.

Although it was inevitable that unanticipated tax issues would arise during the rollout of the pilot reform, the issuing of such guidance demonstrates the willingness of the MOF and SAT to take positive steps to address such issues. While we welcome the MOF’s and SAT's efforts in this context, there are many areas in which interpretational uncertainty and local variations still persist. In view of the Chinese government’s statement that VAT reform will be completed by the end of 2015 and its demonstrated ability to meet announced deadlines, further expansion of the VAT regime’s scope – in addition to the services already brought into the pilot reform in 2014 – is widely anticipated. In particular, we are carefully monitoring developments regarding speculation as to whether and when real estate services and financial services will be brought within the scope of the VAT regime.
Recommendations

- **The SAT should increase the number of employees in its Anti-avoidance Division.**
- Any country-by-country reporting requirements that the SAT adopts should be consistent with BEPS standards.
- The amount of additional evidence requested by the Chinese tax authorities to authenticate services and royalties should be reasonable and not create an insurmountable hurdle in practice.
- The SAT and MOFCOM should not set artificial limits on the absolute value of a royalty fee but, instead, assess the arm’s length nature of the royalty amount based on specific facts and circumstances.
- When a service rendered from overseas benefits a foreign affiliate more than the Chinese recipient, the Chinese tax authorities should allow a deduction for the portion of the service fees that are commensurate with the Chinese entity’s share of the total benefit, rather than denying the entire deduction.
- The SAT should broaden the scope of investment structures that are explicitly eligible for treatment in Bulletin 24 so that more legitimate investment arrangements in the financial sector can benefit from the relaxed rules on beneficial ownership.
- The SAT should decouple the GAAR from the beneficial ownership determination when evaluating whether treaty-withholding tax relief is available and, instead, rely on a PPT to tackle treaty-shopping arrangements, thereby aligning itself with the globally agreed-upon approach.
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