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Editorial

Ralph Cunningham,
Managing editor,
International Tax Review

Welcome to China – Looking Ahead, a series of articles published in association with KPMG analysing and commenting on the implications for tax of China's 12th Five Year Plan, which covers 2011 to 2015. It was approved in March this year by the National People's Congress.

What this guide is not is an update on latest developments in China's existing tax law. Instead, these articles look at how the tax system might change if it is to fulfil the goals of the 5YP which include wealth distribution, increased domestic consumption and regional development. They do not state categorically that particular measures will be introduced.

Taxpayers may be concerned that corporate taxation has only been overhauled in China in the last few years with the introduction of the Enterprise Income Tax Law in 2008. They may even be alarmed that the country is setting out plans for more changes so soon after this substantial legislation.

However, the 5YP is likely to affect more parts of the tax system than just corporate tax. The specialists from KPMG look other important tax policy areas such as transfer pricing, green taxation, VAT and property.

We hope these articles will help you when dealing with your tax affairs in China.

INTERNATIONAL TAX REVIEW

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Looking ahead

Khoonming Ho, Tax Partner in charge of China and Hong Kong SAR, KPMG

The National People's Congress of China approved the 12th Five Year Plan (5YP) in March 2011, laying out the blueprint for the country's development from 2011 to 2015. As a major source of the country's fiscal revenue and a powerful tool for macroeconomic management, taxation is critical to the 5YP. Based on the broad themes outlined in the 12th 5YP, the Chinese government is now formulating new tax policies. These new tax measures will help China reach its goals of:

- Distributing wealth more equitably
- Encouraging domestic consumption
- Discouraging personal and business conducts not aligned with the 5YP such as excessive energy use and pollution
- Developing key regions such as Central and Western China
- Remodelling its economy, including providing support for the service sector

In this publication, we will cast our mind forward and explore what the future holds for China tax policy against the backdrop of the 12th 5YP, especially in relation to foreign investors in China. It should however be noted that the content of this publication is not intended as predictions or forecasts in respect of the Chinese tax policies and should not be relied upon as such.

As the American scientist, Carl Sagan, remarked: "You have to know the past to understand the present." In the chapter "Interesting times" we look back and try and make sense of the developments in Chinese tax policies in the past three decades. The new thinking on China tax enforcement such as compliance agreements and advance ruling mechanisms is discussed in the chapter "Trust but verify, and verify some more". This is followed by the chapter, "The long arm of China GAAR", which addresses, among other issues, the question of the future of anti-avoidance measures such as Circular 601 and Circular 698.

How the landscape of Chinese transfer pricing regulations and practices will evolve? The chapter, "Redefining the rules", bravely takes on that subject. A bolder attempt is made to pin down the ever-elusive tax measures on corporate restructuring reliefs and the shape of things to come in the chapter, "Now you see it, now you don't". With the same sense of anticipation, opinions are ventured on the forthcoming VAT reform in the chapter, "When goods meet services...finally". In the chapter, "Beyond processing trades", we deliberate on how Chinese customs policies should and will move with the times as China shifts from an export-driven economy to one powered by domestic consumption.

The exponential economic growth of China in the past decades has brought wealth to the people. But has there been equity in income distribution within the Chinese population? The chapter, "Re-dividing the pie", elucidates how the Chinese government will reform the Individual Income Tax Law to address the wealth gap issues and the implications of such policy change for businesses. Another cost of growth is the impact of economic developments on the environment. In the chapter, "Green by any other name", we opine on the importance of the role that taxation policy plays in environmental protection in China. Whether taxation will be

equally effective in saddling the seemingly runaway property market in China is another matter. The ensuing chapter of "Hot and bothering" endeavours to discern the trends of real estate-related taxes and their impact on businesses, such as developers and property funds.

Last but not least, in the chapter, "Reinventing Hong Kong", we put forward recommendations on tax policy changes that should help bolster the unique economic position of this Special Administrative Region of China.

The 12th 5YP has painted a broad stroke picture of the future tax policies of China. There remain considerable uncertainties and variables in terms of the exact nature, extent, timing and geographical spread of the tax policy changes. But one thing is for sure. With China having surpassed Germany as the world's top exporter and become the second largest economy in the world, a readiness for engagement with foreign tax administrations will inform China's fiscal thinking and action.

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Khoonming is the tax partner in charge of China and Hong Kong SAR. Since 1993, Khoonming has been actively involved in advising foreign investors in respect of their investments and operations in China. He has experience in advising on issues such as investment and funding structures, repatriation and exit strategies, M&A and restructuring.

Khoonming has worked in different parts of China, including Beijing, Shanghai and southern China, and has built up strong relationships with tax officials at both local and state levels. He has also advised the Budgetary Affairs Committee under the National People's Congress of China on post-WTO tax reform. He is also actively participating in the government consultation project in respect of the forthcoming VAT Law. He is a frequent speaker at tax seminars and workshops for clients and the public, and an active contributor to thought leadership on tax issues.

Interesting times – A retrospective on how tax policy has changed

"May you live in interesting times!" – a Chinese saying, so it seems. This cannot be more apt when it comes to the development of tax policy in China over the past three decades. The last 30 years have witnessed tax policy changes of such magnitude that will not be seen in China for some time to come, say Eileen Sun, David Ling and Zichong Xu of KPMG.

Since the late 1970s, the Chinese tax system has gone through three main phases of changes. The first phase happened in the 1980s. It served to break the ground in tax conceptual development and prepare for the subsequent enhancement in the tax legislative network. The second phase occurred in the 1990s. It unified and streamlined the host of tax laws from the 1980s and laid the foundation for the PRC tax system that exists today. The third phase took place in the 2000s. It refined the tax system built in the 1990s and closed gaps with international common practice.

Tax reform in the 1980s

In 1978, China started economic reform and the Chinese economy entered into a new era, that is, the commencement of the "open door" policy. The tax system also sustained significant changes to accommodate the new economic environment. Before then, state owned enterprises (SOEs) in China did not pay tax and simply contributed their profits to the state treasury coffers . Income tax rarely applied to individuals. At the beginning of 1979, the PRC treasury and tax departments deliberated over the levying of corporate income tax and individual income tax and submitted their proposals to the National People's Congress (NPC). Based on these proposals, between 1980 and 1981 the NPC enacted a series of tax laws addressing the income taxation of individuals, foreign invested joint ventures, and foreign enterprises,. Specifically, the tax legislation passed by NPC during this period included the Income Tax Law on Chinese-Foreign Equity Joint Ventures, the Foreign Enterprise Income Tax Law, and the Individual Income Tax Law. These tax laws established a basic income tax system in China, helping improve the whole tax regime to meet the rapid economic and social changes.

Among the deep changes that were initiated during the economic reform were to the SOEs' social and economic roles. In essence, the SOEs moved from a situation in which everything was determined by the government before the reform to one in which company managers had significant rights to make decisions and took responsibilities for profits and losses of the business operation after the reform. To be consistent with the new economic reality, in 1983, the State Council decided to end the 30-year old system under which SOEs turned over profits to the state in lieu of paying taxes (profit in lieu of tax). In 1984, the central government issued a number of administrative regulations to authorise the collection of, for example, income tax, value added tax (VAT), product tax, and business taxfrom SOEs. The imposition of these taxes reflected a policy change which viewed SOEs as independent business entities rather than an outreach of the State. Taxation was once again given the role of income and wealth adjustment in economy. Soon afterwards, new regulations were promulgated to cover the income taxation of privately owned companies in China.

The 1980s marked the beginning of PRC modern tax reform. China's tax reform in this decade was characterised by the co-existence of a variety of tax laws to impose tax on different types of business entities that had been gradually sanctioned by the economic reform. By the end of the decade, this abundance of tax laws and regulations resulted in a multitude of taxes applicable to different taxpayers according to their identity and characterisation. The confusion that was often caused by this situation among the taxpayers and tax administrators alike was one of the reasons for the tax reform that took place in China during the early 1990s.

Tax reform in the 1990s

The approach taken by China's policy makers during the tax reform in the 1990s was to increase the level of uniformity in tax treatment. In 1991, the PRC income tax laws for foreign invested joint ventures and foreign enterprises released 10 years earlier were combined into a single law to govern the corporate income tax treatment of foreign investors doing business in China. In 1994, six tax regulations, including VAT, consumption tax, business tax, corporate income tax, resource tax and land appreciation tax, were released and implemented simultaneously, along with the revised Individual Income Tax Law.

First, material changes were introduced in the indirect tax area to simplify the PRC turnover tax structure. Before 1994, there were several types of turnover tax in China: VAT, product tax, and business tax as well as consolidated industrial and commercial tax. The first three taxes were designed at the time of reforming and ending the profit in lieu of tax system for SOEs in 1984. Product tax was levied on a variety of commodities at rates ranging from 3% to 60% of sales value, as a government mechanism to regulate prices. Under the 1994 tax reform, the VAT system was revised to phase out and replace the product tax, with the objective that VAT would become the primary turnover tax in China. The pre-reform multiplicity of VAT rates was reduced to two rates: a standard rate of 17% and a reduced rate of 13% applying to foodstuffs, agricultural inputs and other basic products. The applicability of VAT was extended from the production stage, to which it was limited previously, to cover the wholesale and retail stages in the supply chain. In addition, the invoice method was stipulated for the assessment of the VAT, that is, the tax paid on inputs can be used as credit to offset the tax payable on output.

Second, a new law, the Provisional Regulations on the Enterprise Income Tax, unified the separate income taxes that were imposed on domestic enterprises according to ownership characterisation under the older system. The new law was devoted to solving various problems produced by the old system, and to provide a more uniform playing field for all domestic enterprises. The top bracket enterprise income tax rate was reduced from 55% in the older system to 33%, and a variety of surtaxes were eliminated, making the tax structure leaner and more transparent. The unification of income tax for domestic and foreign enterprise was nonetheless delayed until 2007.

Third, as a part of an effort to standardise the tax system, the original Individual Income Tax, Individual Income Adjustment Tax, and income tax on urban and rural unincorporated private businesses were consolidated and integrated into the new Individual Income Tax, which is generally applicable to Chinese citizens and foreign nationals earning income within China. The tax base for computing Individual Income Tax was also broadened by adding business income and contractual and management fees as taxable individual income.

Finally, the 1994 tax reform introduced the Tax Sharing System (TSS) in use today. The TSS specified the way tax revenues are administered and shared between the central and local (provincial) governments. Under the TSS, taxes collected were reassigned between the central and local governments according to a combination of tax categories and taxpayers. Roughly speaking, taxes assigned to the central government include customs duty, consumption tax, VAT collected by customs and income tax from certain state owned companies, while taxes assigned to the local government consist of, for example, business tax, corporate income tax of local business entities and Individual Income Tax. VAT not collected by customs is shared, at the fixed ratio of 75% for the central government, and 25% for local governments.

The 1994 tax reform represents an improvement from the older system in the previous decade. It was the most com-

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David has extensive experience in China tax planning and tax negotiation with counterparties. His expertise includes advising foreign companies in establishing operations in China, particularly in the establishment of investment holding companies and foreign invested trading companies. He also has extensive knowledge of the PRC Customs regulations, foreign exchange control policies and other regulatory regulations.

David has long-time relationships with various PRC authorities including the Ministry of Commerce, the State Administration for Industry and Commerce, the State Administration for Foreign Exchange, Customs and the tax authorities at both central and local levels.

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Zichong Xu, a tax partner with KPMG China, was a senior tax official with the Policy Section of the Shanghai Municipality Tax Bureau before joining KPMG. With more than 20 years of experience with the PRC tax authorities, particularly his role with the Policy Section for more than eight years, he has in-depth knowledge about interpretation and implementation by the PRC tax authorities in respect of a wide range of technical issues. Furthermore, he has developed extensive and excellent relationship with different tax bureaux throughout the country. His network allows KPMG to turn that to value for their clients.

Zichong has often acted as the technical advisory resource on many major engagements since joining KPMG. Through his technical skills and extensive network, he has assisted many major clients in resolving taxation issues with the PRC tax authorities.

Zichong is a frequent speaker on PRC taxation issues at external seminars as well as client seminars.

prehensive reform of the PRC tax regime to date, and leveraged significantly from international tax practice and standard. After the reform, the corporate income tax burden was equalised among domestic enterprises, indirect tax structures were simplified, and tax administration became more efficient. Although problems remain, the tax framework created by the 1994 reform laid the foundation for the PRC tax system that exists today.

Tax reform in the 2000s

In 2003, the Chinese government began to consider a new round of tax reform, building on the 1994 tax regime to further improve the socialist market economy. The reform concept was written into the Eleventh Five-Year Plan Guidelines for National Economic and Social Development of the PRC in 2006. The three important reform targets identified were corporate income tax, individual income tax, and VAT.

First, there was a growing recognition that the generous tax incentives previously afforded foreign investment enterprises were no longer necessary under China's improved investment climate, China enacted a new Corporate Income Tax Law in 2007. The central focus of the new law was the unification of the corporate income tax rate for domestic enterprises and foreign investment enterprises/foreign enterprises at 25%. To a large extent, the new law eliminated many of the privileges that foreign investment enterprises enjoyed under the previous system. Although it still contains tax incentives, such as a 15% preferential tax rate for high & new technology enterprises, these incentives apply to both foreign investment enterprises and domestic companies. In addition, the new law introduced widely used doctrines in the international tax arena, such as the substance over form, business purpose, and tax residency principles. Overall, the new tax law brought greater clarity, transparency and fairness to the PRC tax system and made competition more fair and efficient.

Second, until 2005, the standard tax deduction for the individual income tax of a Chinese national remained at the standard Rmb800, as stipulated in the original Individual Income Tax Law enacted in 1980. This threshold lagged way

behind the rapid economic and social transformation in China that had mthat had taken place over the previous25 years earlier. To cope with the fast-rising living costs and increased inflation rates, the Individual Income Tax Law was amended first in 2005 and then in 2007. As a result, the standard tax deduction for individual income from wages and salaries was increased to Rmb1,600 a month in January 2006, and then to Rmb2,000 a month in March 2008.

Thirdly, the VAT system underwent major overhauls in the credibility of input VAT for equipment and machinery bought by taxpayers, and gradually transitioned from a production type VAT regime to a consumption type VAT system. In 2004, China began such VAT reforms in the Northeast region in an effort to revitalise the old industrial base. After the success of the pilot programme there, it was extended in 2007 to 26 old industrial-base cities in Central China. In 2009, the State Council revised the 1994 VAT regulations and officially ordered the reform to be implemented nationwide. Today, with the exception of certain specified industries, Chinese companies are able to offset the full amount of input VAT paid on newly purchased machinery and equipment against VAT collected when they sell their products. Furthermore, the VAT rate is reduced for small-scale taxpayers in all industries from 6% to 3%. These changes marked a major step in rationalising China's VAT system and using tax as a mechanism to stimulate business activities. It is expected that in due course, the VAT and business tax will be streamlined and integrated into a single, standard VAT regime comparable to international VAT practice.

Tax system develops

The statistics released by the Central Government of China stated that, as of 2008, turnover taxes on goods and services in China accounted for 58.9% of the overall tax revenue, down by 24.7%, compared with 83.6% in 1978; income tax made up 29.7% of all tax collection in China, up 19.3%, compared with 10.4%in 1978. The growing composition of income tax in overall tax collection reflects that the PRC tax system is fulfilling a greater role in regulating income distribution and channelling investment in the economic system. The number of taxes imposed also decreased from about 37 categories at the beginning of 1990 to about 25 categories now. This also indicates the positive trend that the Chinese tax system is moving towards the direction of greater administrative efficiency. Considering the primitive state of its tax legal framework only three decades ago, China has made significant headway in developing and building a relatively sophisticated and multi-faceted tax regime today.

Trust but verify, and verify some more

A new kind of thinking on tax compliance management is steadily emerging. The nascent Tax Compliance Agreement framework is premised on mutual trust between the tax authorities and taxpayers. Time will be required for the building up of such trust. But the first step in the right direction has been taken. Chris Ho, Karmen Yeung and Tracy Zhang of KPMG believe that these changes can have a big impact on the manner in which foreign corporations manage their tax compliance risk in China.

In China, taxpayers generally determine the amounts of tax due on a self-assessed basis, following relevant tax, legal and regulatory guidance. Taxpayers incorporate their positions into tax filings and submit them to the tax authorities for review. Tax authorities conduct audits based on information provided or maintained by the taxpayer to verify the positions and computations, and where justified carry out the appropriate adjustment to the taxpayers' liability.

As a result, tax audits play a pivotal role in ensuring tax compliance and protecting the revenue base of the treasury in China. According to statistics released by the State Administration of Taxation (SAT), 313,000 taxpayers underwent some form of tax audit in 2009, coughing up an additional tax payment of RMB 119 billion ($18 billion) on top of tax payments made when filing tax returns. This figure exceeds the aggregate amount of tax audit adjustments in the preceding three years in China, and clearly reflects the government's resolution to intensify tax collection efforts to reduce fiscal deficits.

All the tools in the bag

The tax audit legal framework in China is provided in the PRC Tax Collection and Administration Law, which lists three functions of the Chinese tax authorities in a tax compliance cycle: administration, collection and examination. The PRC Tax Investigation Bureau (TIB), a special tax organisation under the SAT, is dedicated to performing tax audits of different scopes. In general, TIB carries out three main types of tax audits in China: (1) general audit, (2) case investigation, and (3) special audit. General audit refers to tax examinations of a routine nature without specific targets or any central coordination from upper level tax authorities. The focus of a general audit is usually on taxpayers' accounting and tax filing processes and tax compliance procedures. In contrast, a case investigation refers to an audit with the goal of discovering specific tax evasion or tax fraud, and is usually triggered by certain external events such as requests from upper level tax authorities, information from whistle blowers, and information exchange with other tax authorities.

A special audit is typically initiated when the SAT issues guidelines to the lower level tax authorities in the form of a circular targeting certain industries, transactions, tax issues or even specific taxpayers. In the last three years, the instructional circulars from the SAT usually divided the items to be examined in special audits into two categories: mandatory items for which local tax bureaus are required to investigate without exception, and discretionary items among which local tax authorities can select one or two to look into according to the circumstances in the local region.

In a special audit, local tax authorities face completion deadlines and are required to prepare documents to summarise the process for the SAT at the end. For instance, in the recently issued circular, Guo Shui Fa [2010] No. 24, the SAT requested the regional tax bureaus to conduct mandatory tax investigations on the following items: capital asset transactions, tax invoice abuse in the advertising industry, and value added tax (VAT) refund fraud in fictitious electronics and apparel export transactions. In addition, the real estate industry, construction industry, high-income indi-

viduals, and non-residents in the financial sector were identified as high-risk discretionary areas for local tax authorities to focus on. Furthermore, 14 taxpayers in the domestic airline business were specifically targeted in this round of special audit, which started in March 2011 and will finish in October 2011. Finally, the SAT prescribed work plans to be followed by the local tax authorities during the special audit.

Special attention to large enterprises

In recent years, the Chinese tax authorities gradually adopted a differentiated and proactive approach with respect to tax compliance management. The SAT realises that the traditional tax audit system is reactive in nature. It was designed to catch issues in a cat-and-mouse fashion and on an after-the-event basis. Because TIB cannot audit every taxpayer or every transaction, the imposition of penalties and late payment surcharges on tax issues uncovered was not effective by itself in preventing new occurrences of tax irregularities. Furthermore, the tax authorities' resources were not efficiently allocated to audit targets according to their risk profiles, and high-risk taxpayers often did not receive sufficient scrutiny from the TIB.

In August 2008, by a decree of the State Council, the SAT went through an internal restructuring and established five new divisions, one of which is the Large Enterprise Administration Division (LEAD). The SAT recognized that large enterprises accounted for a large portion of the overall tax collection and designated LEAD to specialise in the tax administration of these important revenue sources, including tax risk profiling and management. In May 2009, the SAT issued a circular, Guo Shui Fa [2009] No. 90, or the Tax Risk Management Guidelines for Large Enterprises (Circular 90). Circular 90 reflects the SAT's new tax compliance approach that an effective internal control system should be put in place by strategic taxpayers to manage tax risks proactively and reduce the likelihood of tax law violations on a preventive basis.

Thou shall audit thyself

In 2009, a whirlwind of self-audits swept across China. In three national circulars, the SAT ordered 70 selected large enterprises to conduct self-audits. Ten of these targeted enterprises were foreign controlled multinational companies with globally known names. According to the circulars, the self-audit must be conducted by the taxpayer's own staff thoroughly at all subsidiary and branch levels of the corporate group within China, and the SAT prescribed a detailed work plan for the taxpayer on tax issues that it needed clearance on at the end of the self-audit. Government's tax inspection teams, which consisted of members from the SAT and local tax authorities in charge, were assigned to each targeted taxpayer and supervised the self-audit closely. The headquarters of each corporate group was asked to prepare a detailed self-audit report for review by LEAD. Companies whose self-audit efforts were not thorough enough or satisfactory in their outcome were subject to a detailed government-led special investigation.

The self-audit puts heavy pressure on taxpayers to tidy up any historical backlog and come clean with previously unreported tax obligations. The taxpayers have the burden of proof to demonstrate that their internal control systems are so sound that no underpayment of tax was discovered despite a thorough search.

The self-audit attracted much attention in 2009. A number of articles sprang up on the internet on the methods and techniques of dealing with government tax investigators in a self-audit, and those written by anonymous self-audit tax inspectors were the most popular ones as they shed light on the mind of the opposite side. The results of the national self-audit initiative supposedly were satisfactory because in recent months several provincial tax authorities have launched their own self-audit campaigns for all taxpayers in their local regions.

In search of best practice

When performing tax examination and verification functions, the PRC tax authorities normally resort to traditional tax audit mechanisms such as general audit, case investigation,

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special audit, and more recently self-audit. Nevertheless, a new PRC tax administration system, the tax compliance agreement (TCA), is making a historical debut. On April 28 2011, the Beijing State Tax Bureau signed TCAs with five selected companies with premium taxpayer ratings. Earlier in the month, tax bureaus in Henan, Wuxi, Sichuan, Qingdao, and Guiyang were all reported to have entered into TCAs with companies with exceptional tax compliance records.

There are indications that the SAT is considering putting in place a compliance agreement framework like the horizontal monitoring system (HMS) in the Netherlands and other similar systems outside China. In essence, a system like HMS was developed to address tax authorities' concerns that are similar to those of the SAT with respect to the traditional vertical tax monitoring system, such as sole reliance on after-the-fact discovery and rectification, and tax audit resource mismatch. The objective of the HMS or its peers is to reduce the tax administration and compliance burdens for both the tax authorities and taxpayers and enhance the relationship between the two parties.

Under an HMS agreement, the tax authorities will accept a taxpayer's self-governance in tax compliance to a certain degree and rely partially on the taxpayer's internal control system for information in tax administration. Other references can be drawn from the Compliance Assurance Programme (CAP) in the US. Under CAP, participating large US corporate taxpayers work collaboratively with a team from the Internal Revenue Service (IRS) to identify and resolve potential tax issues before the tax return is filed each year. With the most important potential tax issues mostly settled before the tax return is filed, taxpayers are generally subject to shorter and narrower post-filing tax examinations. CAP has been operating on a trial basis for the past six years and was just made permanent in March 2011.

Breaking new ground

There are indications that China's SAT may be considering a move similar to the HMS or CAP. Like its counterparts in the west, a TCA is likely not an obligation for a Chinese taxpayer, but instead, an opportunity offered by the SAT to eligible candidates. Neither the tax authorities nor taxpayers however, will give up their respective rights, such as a tax audit and tax appeal, which are granted to them under the tax law. In due course, for large enterprises who are in the TCA programme, the PRC tax authorities may be inclined to grant advance ruling requests from the taxpayers on uncertain tax positions. China does not have an advance ruling system in existence other than the APA programme in the transfer pricing context. The availability of a tax ruling on an *ex ante* basis could be a huge attraction to Chinese taxpayers as it greatly reduces their PRC tax risks before undertaking large transactions. In addition, if the HMS regime were to be followed by the SAT, taxpayers entering into a TCA with tax authorities should also have an opportunity to close open tax issues before signing the agreement. This may also serve as an attraction to those taxpayers wishing to mitigate tax uncertainties and unnecessary tax provisions in their financial statements.

It is not clear what a Chinese tax compliance agreement will specifically cover but chances are that it would leverage off the principles and concepts employed by the HMS or systems in other countries. For instance, a Chinese TCA may define the roles and responsibilities of the signing parties and describe the extent of supervision by the tax authorities, which may vary according to the perception of how strong the taxpayer's internal control system is. Under the TCA, the taxpayer commits itself to disclose known tax issues and risks to the tax authorities and may consult the tax authorities on grey areas of the tax law. The tax authorities commit themselves to being open and transparent, and will revert back with their views and interpretations within a specified period of time. Past tax issues can be solved by negotiation, and future tax issues can be prevented through communications in the present.

Trust is the heart of the matter

Does this sound too good to be true? To be sure, any widespread implementation of TCAs in China will face challenges in the near future.

First, the TCA regime is possible only if the taxpayer has an effective and transparent tax risk internal control system (TRICS), as a part of its general internal control network and the tax authorities have reviewed the TRICS and considered

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it adequate. This is because the taxpayer's TRICS is likely the starting point for the tax authorities when reviewing tax returns. The tax authorities must understand the mechanisms and the capabilities of the taxpayer's TRICS before relying on it. Once the tax authorities determine that the TRICS can be depended upon, the subsequent tax return review, tax risk assessment and tax audit work may be greatly simplified. Circular 90 issued by the SAT to large enterprises in 2009 paved the way for the implementation of the TCA regime. SAT may enter into TCAs with selected large enterprises that have solid TRICS, and if the programme is successful, redirect the tax audit resources freed up by the TCA programme to focus on taxpayers with high-risk profiles.

Second, the success of a TCA programme largely hinges on mutual trust and respect between taxpayers and the tax authorities. Without trust, taxpayers may feel reluctant to disclose information or seek consultation, while tax authorities may hesitate to relinquish traditional tax audit activities. Such behaviours would lead to difficult situations in the TCA programme. In the nascent stage of the development of a TCA programme, it is likely that the Chinese tax authorities will take a trust but verify stance or a combination of reliance on a taxpayer's internal control system and conducting limited scope audits.

Like many countries, China is fielding various forms of tax audit and strengthening efforts to protect its tax revenue base in the midst of the global economic crisis. To better align its tax audit resources, China is learning from international practices in tax administration and considering implementing a TCA programme for selected taxpayers. Despite potential challenges, such a system, if successfully executed, offers significant advantages over traditional audit mechanisms. Both the tax authorities and eligible taxpayers can benefit from such a programme, in the form of reduced work burden, more efficient resource utilisation, better tax compliance, greater transparency, and more certainty. As a result, a new landscape of PRC tax compliance may emerge in the future.

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The long arm of China's GAAR

While GAAR are new in China taxation, they have made great waves in the past couple of years. The controversial Circular 698 on indirect disposals will be here to stay in one form or another, but not without increasing resistance from foreign corporations and tax administrations. John Gu, Chris Xing and William Zhang of KPMG expect that the SAT may have to provide clearer guidance and explore an advance ruling system as a way to address the concerns of taxpayers.

In 2008 the China Corporate Income Tax (CIT) law introduced a suite of specific and general anti-avoidance rules (GAAR) that offered an array of new tax law enforcement measures for the Chinese tax authorities. Such measures to date include not only thin capitalisation, controlled foreign companies (CFC), and transfer pricing rules, but also anti-abuse rules, as well as a measure requiring taxpayers to report related party transactions. In keeping with China's growing international economic prominence that necessitates a transparent but effective tax administration system, the introduction of GAAR into the CIT Law was geared towards overcoming a significant perceived gap in the Chinese tax law enforcement landscape.

In the relatively short period since its inception, GAAR has proved to be a flexible and effective tool for the Chinese tax authorities in tackling certain areas of tax abuse that are particularly relevant for foreign investors, due to extensions to include tax treaty shopping, offshore indirect disposals of Chinese enterprises, abusive use of corporate structures and tax haven entities, among others. The introduction of GAAR together with relatively active tax authorities enforcement have given rise to a high degree of interest among foreign enterprises who are keenly monitoring GAAR's continued evolvement.

GAAR status under CIT law

The GAAR provision in the CIT law is brief and states that arrangements undertaken 'without reasonable business purposes' and resulting in tax benefits to the taxpayer may be adjusted by the tax authorities. The CIT implementation rules provide that 'without reasonable business purposes' means having as a primary purpose the reducing, avoiding or deferring of tax payment.

Further exposition of the scope of GAAR was rendered by the State Administration of Taxation (SAT) under the circular Guo Shui Fa [2009] No.2 (Circular 2), which clarified that the GAAR provision was directed at schemes undertaken by taxpayers that are intended to abuse tax incentives under the CIT Law, double tax treaties or corporate organisation structures, or to avoid tax by using tax havens or other arrangements without reasonable commercial purposes. The circular sets out a list of criteria for the tax authorities to consider in determining whether an abusive scheme is occurring. Importantly, Circular 2 emphasises the application of the substance over form principle and requires that GAAR investigations and adjustments are subject to SAT approval, ensuring central control over the application of this provision to avoid the unreasonable or abusive use of this provision by local tax authorities.

Circular 601 to tackle treaty shopping

The Chinese tax authorities have applied GAAR far more aggressively and frequently in the area of tax treaty abuse and offshore indirect transfers of PRC companies than many other areas of the specific anti-avoidance provisions under the CIT Law (other than perhaps the transfer pricing provisions). Specifically, GAAR, as applied

principally in the circulars, Guo Shui Han [2009] No. 601 (Circular 601) and Guo Shui Han [2009] No. 698 (Circular 698), has become a prominent feature of Chinese tax authorities' tax law enforcement efforts, and both circulars have direct application to foreign investors.

Circular 601 is directed at limiting the abuse of double tax treaties for treaty shopping purposes. Although Circular 601 couches its provisions in the language of beneficial ownership, the adverse factors which the circular sets out for consideration by the tax authorities to make such a determination appear to go beyond what would typically be required by the OECD tax treaty interpretive guidelines and overseas judicial interpretations of beneficial ownership. For example, the Chinese tax authorities will consider the tax rate applied to the income in the relevant jurisdiction in which the tax treaty claim is made, the resources available to that entity in terms of staff and assets, and the presence or absence of business activities, other than mere holding investments, in the holding company. Circular 601 is supported by another circular, Guo Shui Fa [2009] No. 124 (Circular 124). Circular 124 lays down the implementation steps and requirements for applications to be made to the Chinese tax authorities to obtain clearance to enjoy treaty benefits.

Circular 698 to plug loopholes in offshore indirect disposals

Circular 698 sets out the conditions whereby disposals of shareholdings in non-Chinese resident companies which directly or indirectly hold shares in Chinese companies are to be reported to the Chinese tax authorities. According to Circular 698, where the transfer arrangements involve an abusive use of organisational forms and the taxpayer is unable to demonstrate economic substance in the offshore company, the Chinese tax authorities may apply GAAR. Circular 698 was rolled out amid concerns expressed by foreign investors and advisers about the extraterritoriality implications of the rules and the practicability of its application.

Expected key trends and likely changes on China GAAR

- Further guidance issued on implementation of Circulars 601 and 698.
- Concepts such as economic substance and reasonable business purposes to be more clearly defined
- Issues on interaction between Circular 698 and tax treaty application specifically addressed
- Greater engagement with overseas tax administration with increasing application of Mutual Agreement Procedures
- Advance ruling mechanism being actively explored
- Enhanced tax information collection process and access to wider intelligence sources
- More focused and targeted audit approach with upgraded training of tax officials

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A feature of the application of Circular 698, which is generally considered particularly disadvantageous to foreign investment groups, is the seeming lack of a consistent focus by the Chinese tax authorities when applying the GAAR to the purpose of a transaction *per se*, and the absence of significant weighting of non-tax versus tax purposes. In some respects, the commercial substance test (that the offshore holding company is required to positively show that it has employees, office premises and business operations in the offshore jurisdiction which are commensurate with the level of income) has been used as a proxy for the reasonable business purpose test. Further, due to the lack of guidance on what constitutes the abusive use of offshore holding structures, the application of the provision by local tax authorities still varies and the grounds which they give for its application are also frequently unclear.

Cases so far

There are a growing number of high profile cases in which circulars 601 and 698 and GAAR principles have been applied: for example, the much publicised *Xinjiang* case and *Chongqing* case which took place before the issuance of Circular 698.

In the *Xinjiang* case, the SAT endorsed the enforcement approach adopted by the Xinjiang State Tax Bureau by denying the application of treaty relief on capital gains to a Barbados-incorporated company disposing of an investment in a Chinese company only a short time after acquiring it. In the *Chongqing* case, the Chongqing State Tax Bureau appeared to have taken a look-through approach in taxing

gains derived by a Singaporean investor from the disposal of a Singapore-incorporated special purpose vehicle (which was lowly capitalised and allegedly had no operational activities) that held an equity interest in a Chinese resident company.

These cases have signaled that the tax authorities view the GAAR as an effective primary tool of tax enforcement, and the choice of high profile foreign investors in decided or pending cases indicates a willingness, on the part of the tax authorities, to emphasise their determined stance to eradicate abuses of foreign investment structures.

Time to take stock

As China takes an ever more significant role in the global economy, greater certainty in tax outcomes from investments and implementation of commercial transactions in China will be sought by Chinese domestic and foreign investors alike. While GAAR has granted a broad scope of enforcement powers to the SAT, they should equally recognise that a fair and transparent tax system, which allows for greater certainty, is a hallmark of a developed economy, and GAAR provisions thus should be wielded in an even-handed manner.

Although the rules in Circular 601 reach beyond the standard application of the beneficial ownership concept, they are not altogether out of line with developments elsewhere where treaty shopping has been met with a tough new enforcement approach. A similar approach has been seen in the Australian tax authorities' attack on a private equity fund in *TPG Myer* case, albeit on capital gains, and the German tax authorities' recent new anti-treaty shopping rules. However, lack of clarity in the basis taken for the denial of treaty benefits, and the lack of avenues for advance rulings, makes Circular 601 a key source of uncertainty and discontent for foreign investors.

With regard to the enforcement of the rules in Circular 698, a significant level of uncertainty and difficulty has also arisen for foreign investors in planning for investment exits and group restructuring. In reality, the manner in which the Chinese GAAR are being applied may be seen as having ramifications beyond what even some officials within the SAT may have expected. This may be due in part to the manner of operation and enforcement of tax laws in China and perhaps the failure to recognise the infringement of taxing rights under international tax law. In other jurisdictions the limitations which are placed on the application of the GAAR, in particular the right of appeal or judicial review, help to ensure that the GAAR is applied fairly, consistently and evenhandedly. However, such constraints exist only to a limited extent in China in reality because of the lack of a public consultation process, the lack of strong litigious culture, and because the responsibility for the consistent application of Circular 698 rests predominantly with the SAT in practice. Hence there is inevitably concern on the taxpayer's part about whether the SAT could reasonably balance its dual roles as the enforcer and gatekeeper of GAAR, whilst trying to protect the revenue base.

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Chris has assisted a variety of international and domestic Chinese private equity funds and corporations on tax due diligence, and has also advised on a wide range of tax issues concerning corporate establishment, mergers & acquisitions and private equity investment transactions in the PRC and Hong Kong.

Chris has assisted a number of clients in undertaking investments in the PRC with regard to transaction structuring and devising tax efficient strategies for implementing PRC business operations and arrangements.

Chris has also advised a variety of private equity clients on tax issues arising from transactions and foreign direct investments in PRC industry sectors including infrastructure, real estate and consumer markets.

In an international context, while there has been relatively little resistance by taxpayers in respect of Circular 698, this might change in the future, particularly given the potential for jurisdictional conflicts with other countries which might violate China's treaty obligations, and recent statements by the Internal Revenue Service (IRS) advising US businesses to carefully evaluate their position under the GAAR pursuant to Circular 698. When presenting to the International Tax Institute in New York in April this year, Michael Danilack, deputy commissioner (international), IRS Large Business and International Division, was reported to be advising US corporations to seek advice from the US competent authority before agreeing to pay tax under Circular 698 to avoid the risk of not being able to obtain foreign tax credits back home.

Further guidance on application of GAAR required

It is expected that the SAT will likely make refinements to the guidance on Circular 698 and other provisions based on the GAAR, and this will assist in providing greater certainty for taxpayers. Progress in this direction has been made to a degree with the recent SAT Announcement [2011] No.24 (Announcement 24), issued on March 28 2011, which gave certain clarification around notification and tax settlement requirements and procedures. However, it remains to be clarified what is considered to constitute abuse of organisational

structures and reasonable business purpose, as well as many practical points such as the interaction of tax impositions, pursuant to Circular 698, with China's network of tax treaties. It is further hoped that the SAT would consider relaxing the corporate reorganisation rules to ameliorate the potentially adverse application of GAAR in the context of legitimate and qualifying corporate reorganisations undertaken offshore.

Advance ruling system to define scope of GAAR application

As a way to address uncertainty associated with the anti-avoidance provisions, the SAT may phase in an advance ruling system starting with pilot schemes with selected large transactions. Such a regime may help further the aim of achieving greater certainty in commercial transactions and become a mechanism to curtail the potentially adverse application of GAAR post-transaction. In rolling out an advance ruling system, the SAT will likely draw on China's evolving experience in the unilateral and bilateral advance pricing agreement process.

Such an advance ruling system would likely be welcomed by taxpayers. The dialogue between the taxpayer and the tax authorities in the course of obtaining an advance ruling would give the taxpayer a chance to state its case, and prove that it has a reasonable business purpose, outweighing tax motives, in conducting the transaction. The existence of such a system would enhance the credibility of the SAT, and would mitigate the risk of conflicts of jurisdiction with other tax authorities. Published rulings would provide helpful precedents, which are otherwise lacking given the nature of the judicial system.

Enhanced international and regional engagement

China may engage in enhanced exchange of information with other jurisdictions, facilitated by China's extended and improved network of tax treaties and the conclusion of dedicated agreements on information exchange. China's active participation in international tax collaborations, such as the Joint International Tax Shelter Information Centre (JITSIC) and the Study Group on Asian Tax Administration and Research (GATAR) is expected to provide important avenues for the SAT to tap experiences from more advanced tax jurisdictions in terms of tax controversial strategies and best practices. Established in 2004, JITSIC counts Australia, Canada, Japan, South Korea, the UK, US, and China as members, with France and Germany as observers. China is one of the 16 members in the Asia Pacific region of GATAR and has been conducting annual meeting among the members.

More intensive intelligence gathering and targeted enforcement

To improve the application of GAAR, SAT will likely adopt more purpose-focused audit approaches and enhance its information sources on taxpayers or potential taxpayers. In doing this, the SAT will draw on best practices internationally to enhance their information collection approaches, and they will also see the need to give more consideration to foreign investors' views.

Financial intermediaries may be subject to more comprehensive reporting requirements, as the data sets they can provide on taxpayers have proved instrumental to the tightening of tax administration in other jurisdictions, for example, the EU Savings Directive or the new US Foreign Account Tax Compliance Act (FATCA) provisions. This is likely to be accompanied by stronger efforts to encourage higher levels of disclosure by taxpayers and their advisers in order to allow Chinese tax authorities to bring about targeted enforcement actions with greater precision.

The SAT may refer to foreign best practice measures including the UK tax law requirement for the reporting by tax advisors of tax avoidance schemes they are promoting, or the US accounting requirements around detailing uncertain tax positions (FIN 48 reporting requirement). China has already moved towards greater taxpayer disclosure with the measures in Articles 43 and 44 of the CIT Law, and the annual related party transactions reporting form. More targeted enforcement of tax laws may also be facilitated by greater use of risk-based, automated, computerised audit approaches and participation in multi-country audit programmes.

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William has been providing PRC tax and business advisory services and planning ideas for various multinational companies since 1997. His experience ranges from assisting multinational companies in formulating expansion strategy into the PRC, setting up and structuring their business operations in the PRC, fulfilling relevant registration and filing requirements to finding practical solutions to various tax issues and exploring possible tax planning ideas.

William worked with the international corporate tax group of KPMG London office for one year during which he was substantially involved in various international tax projects for European companies.

William is a member of the China Institute of Certified Public Accountants and a member of the China Institute of Certified Tax Agents.

Furthermore, it is expected that the SAT will likely provide greater training for and exercise stricter control of local authorities in their application of the GAAR. It is likely that the SAT will organise systematic training for SAT officials in relation to the conduct of Mutual Agreement Procedures in anticipation of greater engagement with their counterparts in other jurisdictions in the enforcement of GAAR. Such initiatives should assist in reducing variability in tax treatment and ensuring that greater certainty and consistency can be achieved in the application of GAAR.

Outside pressure

It is likely that the SAT will be facing increasing pressures from foreign corporations and tax administrations about the extraterritoriality implications of Circular 698 and the lack of certainty and clarity surrounding the reporting and taxation requirements. To a lesser extent, due to growing taxpayer concerns, the SAT will have to tackle similar issues in the implementation of Circular 601. Nevertheless, the provisions in these circulars will continue to be applied in one form or another as the SAT's view, or as its related rules are applied to protect China's tax revenues in cross-border transactions. In due course, it is expected that the SAT will issue clearer guidance on the implementation of the GAAR and exercise greater oversight on the enforcement of those rules at the local levels. This may be facilitated to a large extent by the advent of an advance ruling system, which provides a forum for the taxpayers to state their case and to obtain clarity on the likely tax results.

Redefining the rules – A new transfer pricing landscape

Chinese transfer pricing rules and practices will break new ground in the coming years, finding solutions that cater to the special economic and commercial circumstances of China. Factors such as China market premiums and location savings will become more important in applying the arm's-length principle, believe Cheng Chi, Irene Yan and Lu Chen of KPMG

The 12th Five-Year Plan (5YP) puts Chinese people's livelihood and prosperity as key goals alongside national strength. To achieve these goals, the plan has a strong emphasis on promoting structural transformation of the Chinese economy. More specifically, the plan calls for a move away from being a manufacturing hub to one that occupies multiple and more value-added functions in the global supply chain, focusing on R&D, high-end manufacturing and service sector development. In addition to the economic goals, the plan also underscores the importance of efficiency and credibility of government and public services. Inevitably, the transfer pricing and anti-avoidance agenda of the State Administration of Taxation (SAT) will be deeply influenced by the plan.

In general, under the 5YP, the SAT will look to strengthen the efficiency and consistency of its administration of transfer pricing issues across the country. The trend of furthering and refining the legal and regulatory framework would continue, but with particular focus placed on adjusting and expanding the administrative system and the enforcement of it in keeping up with the new characteristics of the overall economic and social development, such as the need to address the more complicated transfer pricing issues (for example, intangibles, financial transactions and business restructuring). With limited resources, the SAT also needs to address how to efficiently and effectively take its transfer pricing and anti-avoidance programme to the next level. The centralisation of the administration of nation-wide transfer pricing and anti-avoidance activities will likely continue, while tax avoidance prevention will become the new focus.

Strengthening of legal and regulatory framework

China's efforts in transfer pricing and anti-tax avoidance administration date back to 1986, during which the first transfer pricing case was initiated. In recent years, China has made tremendous efforts in improving and implementing the regulatory framework governing transfer pricing administration, which consists of a series of transfer pricing related laws, regulations and rules. Specifically, with the introduction of the new Corporate Income Tax (CIT) Law and its implementation rules in 2007, and the Implementation Measures of Special Tax Adjustments (Provisional) (Guoshuifa [2009] No.2) (Circular 2) in 2009, the SAT leveraged the experiences of other countries. Following the issuance of Circular 2, the SAT also issued many transfer pricing related circulars addressing issues such as contemporaneous documenation administration, intragroup services transactions, licence royalty treatment and single-function entites, amongst others.

Given that the 5YP plan is calling for government efficiency and credibility, SAT's likely response is to develop a more elaborated regulatory framework so that its transfer pricing resources will be able to operate with more specific guidance, leading to a

higher degree of efficiency and consistency across the country. Specifically, we believe China will issue more detailed rules and guidance on complex transfer pricing and anti-avoidance issues, such as pricing for intangible properties, CFCs, contract R&D and headquarters services, amongst others.

On the enforcement of the anti-avoidance measures, the SAT has done a great deal of work to standardise the anti-tax avoidance process and continue to push for a greater level of national consistency across the regions and different layers of the taxation administration system. To standardise the process and prevent an arbitrary enforcement/interpretation of the relevant laws and regulations, the SAT has established an integrated management system, which encompasses aspects such as related party transaction filing, administration of contemporaneous documentation and case registration/follow-up/closing procedures for transfer pricing investigation.

Prevention as the key and investigation as the supplement

In the past few years, Chinese tax authorities have gained extensive experience in anti-tax avoidance practice, in particular, through conducting transfer pricing audits. The Chinese tax authorities were known as having one of the world's toughest transfer pricing administrations. Given its limited resources and the number of taxpayers in China who, to a significant extent, may engage in related-party transactions, it is expected that the SAT will put more emphasis on prevention than they do on transfer pricing investigation. Recently, the Chinese tax authorities, particularly the SAT, were often quoted saying that the anti-avoidance administration system should comprise of three main dimensions, including (1) administration/management, (2) service and (3) investigation and that the first two dimensions are in place to generate incentives and create channels for minimising transfer pricing risks such that investigation will only serve as the last resort.

In the near future, this trend can only continue. The Chinese tax authorities, in their anti-avoidance administration, will increasingly rely on mechanisms such as mandatory related-party transaction reporting/disclosure, random selection of taxpayers for examination of documentation, encouragment of taxpayers to perform self-examination of their transfer pricing, as well as promoting multiple channels for official or unofficial communication between the tax authorities and taxpayers, especially for certain more complicated transfer pricing arrangements or issues. More detailed and specific regulatory guidance will also be considered as an effective means for regulating taxpayers' transfer pricing arrangements. All these mechanisms are expected to minimise transfer pricing risks and the chances of a dispute as well as double taxation.

In July 2010, the SAT launched a nation-wide inspection of the contemporaneous transfer pricing documentation of taxpayers for 2008 and 2009, after allowing for one and a half year's preparation time since the promulgation of Circular 2. Feedback indicated concerns over the quality of documentations inspected, centring on vague disclosure of related party transaction pricing policy, monotonous use of transfer pricing testing methodology, and lack of in-depth economic analysis. We would expect the SAT to orchestrate an overhaul on the documentation practice with a focus on quality, where taxpayers must support their transfer pricing policy with sound economic analysis in order to mitigate the risk of investigation.

Key trends in China transfer pricing

- Focus will be shifted from manufacturing operations to intangible assets, financial transactions, corporate restructuring and special services.
- China-specific factors such as location savings, China market premiums and environment cost compensation will be important considerations in examining corporations' transfer pricing policies.
- Chinese tax authorities will become more selective in their choice of pricing methodologies. So far, infrequently used methods, such as profit split, will become more common.
- More emphasis will be placed on prevention of tax avoidance than on detection for example transfer pricing investigation.
- There will be more advance pricing agreements (APA), especially bilateral or multilateral ones.
- There will be greater efficiency and nationwide consistency in administration and enforcement of transfer pricing policies.
- SAT will build its own national database based on information gathered from taxpayers nationwide.
- SAT will explore the system of self transfer pricing audits by taxpayers.
- SAT will encourage the use of mutual agreement procedures (MAP) to resolve transfer pricing controversy.
- SAT will pay more attention to the quality of contemporaneous transfer pricing documentations prepared by taxpayers, with a focus on the strength of technical analysis.

The Advance Pricing Agreement (APA) programme

We expect the trend of encouraging APA applications to continue, particularly for bilateral negotiations and in some cases for multilateral negotiations. There will be heightened engagement between the Chinese tax authortities and their overseas counterparts. In December 2010, the SAT issued its first ever annual report on APA in China for 2009. The 2009 APA report includes an introduction to the Chinese APA programme, the implementation procedures and related forms, and the recent development of the APA practice in China, together with a statistical survey of China's APA programme for the period from January 1 2005 to December 31 2009. This groundbreaking report puts China in line with certain other national tax authorities, including the US, Japan, Korea, Australia, Canada and Italy, to publicise comprehensive reports on their APA programmes.

The issuance of this report not only signifies the SAT's interest in further developing and promoting its APA programme but also provides a higher degree of transparency. With the plan emphasising the enhancement of the national strength, which goes hand-in-hand with the effort of being a credible international player, it is expected the SAT will be more interested in engaging in bilateral APAs and other channels of bilateral negotiations for resolving tax disputes.

The APA programme's development will continuously be constrained by the limited resources the SAT can deploy to the programme. We expect there will be a tendency of accepting APA applications involving more complex transfer pricing issues, in particular for those relating to intellectual property development, high-value-add service provisions, headquarters services, financing transactions and business restructuring. In 2010, in a landmark case, the State Tax Bureau in Dalian, a city in north east China required the arm's-length principle to be applied to share transfers in an internal corporate restructuring. These types of business transactions are critical for China's effort in transforming the economy; and the APA programme, as a key taxpayer service, will support such effort by providing certainty to taxpayers engaging in such activities. On the other hand, we expect there will be a discouragement for engaging in APA negotiations for pure contract manufacturing and other low-value-add activities.Alongside the strengthening notion of APA is the growing prominence of MAP in resolution of transfer pricing controversy. As an important means for taxpayers to eliminate international double taxation, MAP is catching the eyes of the Chinese tax authorities in recent years and we expect the SAT to encourage continued development in this area in the next five years to come. There are currently 39 MAP cases in the pipeline of the SAT, involving multinational companies in Japan, Korea, the US, and Denmark, who are all in leading positions in their respective industry. In the MAP, the Chinese tax authorities have claimed concepts such as location saving and market premium in view of conserving the interest of China as a developing nation. The SAT has also placed emphasis on China's market characteristics, as a country of emerging market, such as purchasing power and low-cost supply of land and labor, and demanded recognition of their counterparts in developed nations on the contribution of such special factors to creation of value.

Centralized national control

In recent years, the SAT continues to strengthen transfer pricing administration, through centralized control at the national level. Since 2005, all transfer pricing and anti-tax-avoidance cases must be reported to the SAT for final review and assessment after they have been examined by different tax authorities at various levels. The SAT reviews and approves all unilateral APA cases and directly manages the bilateral and multilateral ones. Starting from 2010, each significant case reported to the SAT must first undergo an expert committee review at the provincial level, before a similar review at the SAT level is conducted. As the SAT is constrained by resources we expect to see the deployment of a national expert joint committee consisting of selected local transfer pricing officials supporting the SAT on transfer pricing investigation, regardless of the location of the taxpayers. It is expected this expert joint committee will review and approve all significant transfer pricing investigation cases. As such, what the taxpayers can expect, in terms of enforcement, may very well be more standardised procedures, more expert opinion/expertise from the tax authorities' side, greater information sharing across all levels of tax authorities, and more check and balance between the SAT and the local in-charge tax authorities.

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Chi started his transfer pricing career in Europe with another leading accounting firm, covering many of Europe's major jurisdictions while based in Amsterdam, before returning to China in 2004. He holds a masters degree from Maastricht University in international business studies. He is also a chartered controller in Belgium.

In addition to lecturing at many national and local training events organised by the Chinese tax authorities, Chi has provided technical advice on a number of recent transfer pricing legislative initiatives in China. A frequent speaker on transfer pricing and other matters, his analyses are regularly featured in tax and transfer pricing publications around the world, including *International Tax Review*. Chi has been recommended as a leading transfer pricing advisor in China by the Legal Media Group.

Transfer pricing audit

The Chinese tax authorities have been carrying out transfer pricing audit through a series of national, regional and industry level joint investigations. These examinations have mainly been focusing on companies that suffer long-term losses or have very little profit but at the same time continue to expand operations in China. However, there are signs that the tax authorities plan to broaden the scope of such joint investigations to include more companies in certain targeted industries by looking beyond just the bottom line.

Through the past couple of years' related party transaction reporting, as well as the selective examination of transfer pricing documentation, the tax authorities have gathered a fair amount of information on taxpayers' related-party dealing and they have emphasised how imperative it is to establish a national database where all such transactional level information will be entered into the system and be shared by all levels of tax authority. Building upon the information gathering and sharing, the SAT has been advocating the application of consistent evaluation methods and profitability level indicators within a specific industry.

Another observation is that, since the adoption of national and industry-wide joint examination approach, many companies have begun to give more and more attention to transfer pricing and proactively conducted self-examination and adjustment. Consistent with the goal of using formal transfer pricing investigation as the last resort, it is expected that the SAT hopes to push for guidelines and instructions of joint examinations as a way to encourage self-examination and, potentially, adjustments initiated by the taxpayers.

Special considerations on Chinese market's unique characteristics

The past years of development of China's legal and regulatory framework for transfer pricing administration can be mainly characterised as learning from the internationally accepted guidelines and practice. However, as the Chinese economy becomes the second largest in the world, the Chinese tax authorities are increasingly keen to put their own mark on what will be internationally accepted when it comes to governing transfer pricing, especially from a developing country's perspective. What we can expect in the next couple of years is that the SAT to be more active in formulating and voicing new viewpoints on a full spectrum of transfer pricing issues. The current and highly publicised participation of the SAT in working with the UN as well as other developing countries in drafting the Transfer Pricing Guidelines for Developing Countries is a prime example.

There are indications from the Chinese tax authorities that the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) albeit representing the most internationally accepted views on transfer pricing, have been developed and applied mostly from a developed country's perspective. As such, the Chinese tax authorities are expected to make their views known on a host of characteristics that they believe are unique to the China market and these characteristics' implications on transfer pricing. The channels of making such views known may include the issuance of more circulars to address relevant issues and applying such thinking to transfer pricing audit and investigation cases as well as APA or competent authority negotiations.

Such China-specific considerations as China market premium, location savings, as well as environmental costs compensation, are expected to serve as arguments for more non-routine profit to be retained in China. With respect to the China market premium and location savings, in applying these concepts, the main challenges include whether it can be proven empirically that such premium or savings exist and, if so, whether they could be measured in a relatively accurate way – as well as the issue of determining the attribution of the premium or savings to the different parties involved. The SAT acknowledges such challenges in measurement and attri-

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bution, however, at the same time believes that inherent merits exist in these theoretical arguments, which in their view also reflect and capture the actual development trend of the Chinese economy.

Another example – which was often used by the SAT to show how certain internationally accepted practices may not be the most reasonable approach to take, given the facts and circumstances – has to do with the common practice of searching for comparable companies among publicly listed ones, when applying the Transactional Net Margin Method (TNMM). The SAT tends to believe that, given the Chinese capital market has a short history of merely 20 years and there are only about 2,000 listed companies in China, it will be extremely difficult to find truly comparable companies for the tested party in such a small sample. Alternative methodologies such as the profit split method under applicable circumstances will gain more prominence.

All these views and the associated efforts to refine the theoretical arguments and gathering empirical support show that the SAT is determined to supplement what have been regarded as the internationally accepted rules with their own terms on a lot of transfer pricing issues from a developing-country specific or China-specific perspective.

Transforming the system

With China embarking on its ambitious 12th 5YP, the SAT will put more emphasis on how to run its transfer pricing administration in a more efficient and effective manner and with a higher degree of consistency and transparency. This involves providing more regulatory guidance, exercising more centralised control at the national level, and continuing with an industry-centric approach for investigations. We also expect the SAT to further promote the use of its services in the area of APA and other channels of communication for certainties and for avoidance of contentious audits. China is on its way to transforming its transfer pricing administration from an ex-post audit focused one to one that is actively focusing on ex-ante tax avoidance prevention.

Now you see it, now you don't

Under the prevailing tax regulations in China, the conditions for corporate restructuring reliefs are either over-stringent or highly ambiguous. The 12th Five Year Plan has brought hope that things might get better on this front because the plan encourages industrial consolidation to improve domestic enterprises' global competitiveness. The Chinese tax authorities may therefore see the need to relax or clarify the rules, point out Grace Xie, Vincent Pang and Abe Zhao of KPMG

In China's 12th Five Year Plan (5YP), corporate restructuring is identified as a major mechanism to achieve consolidation within industries and build internationally competitive large enterprises. However, the existing Chinese tax rules on reorganisation are often vague and rigid. As a result, many legitimate reorganisation transactions have been denied the tax deferral treatments that should have been intended for them. The current corporate reorganisation tax rules and our recommendations in connection with some of those rules are discussed below.

Corporate income tax

Basic principles

Tax deferral treatment is often accorded to a reorganisation based on the continuity-of-investment principle. In a reorganisation, the new enterprise holding the corporate assets is basically a continuation of the old corporation that transfers these assets, and the new equity interest received in exchange for old equity interest is a continuation of equity interest in the old corporation. Therefore, no gains are recognised by the transferring corporations and shareholders in general, while some gains may be recognised to the extent that the introduction of non-qualifying consideration (boot) partially taints the continuity of investment. The unrecognised gains will be deferred until a future, triggering-event occurs.

Consistent with this international tax principle, the Ministry of Finance issued a circular, Cai Shui [2009] No. 59, to provide guidance on the tax treatment of parties to a reorganisation. Circular 59 has brought in the concepts of ordinary tax treatment and special tax treatment. Ordinary tax treatment is the default mode, under which gains realised are usually subject to immediate taxation. Special tax treatment, which means complete or partial tax deferral on gains realised, is the exception, and only transactions that meet specified requirements can enjoy it.

Circular 59 identifies five types of corporate reorganisation eligible for special tax treatment: debt restructuring; equity acquisition; asset acquisitions; mergers and; de-merger.

Conditions

Five conditions must be satisfied for special treatment to be applied to a reorganisation transaction:

1. The reorganisation must have a reasonable business purpose. Its main objective cannot be the reduction, exemption or deferral of tax payment (business purpose).
2. Consideration threshold – For equity acquisition, asset acquisition, merger and de-merger, at least 85% of the consideration used in the transaction must consist of qualified equities (consideration threshold).
3. For equity acquisition, asset acquisition and merger, the acquired or surviving company must obtain at least 75% of the transferor's asset or stock in the target company (object threshold).

4. The original core business operation of the acquired assets continues for at least 12 months after the reorganisation (continuity of business enterprise principle).
5. The original investors that hold more than 20% of the equity interest of the transferor or the target company in the reorganisation do not transfer their equity interest during the 12 months after the reorganisation (continuity of interest principle).

More specific requirements are prescribed for the individual types of reorganisation. If all relevant conditions are satisfied in a domestic equity acquisition, asset acquisition, merger or de-merger transaction, tax deferral treatment is generally granted to the parties that realise the gains, except where the extent that non-qualifying asset (boot) is used as consideration, in which case the transferring corporations will be taxed to that extent at the time of transfer.

Cross-border tax reorganisations face additional restrictions. On top of all the requirements for domestic reorganisation transactions, only three types of cross-border transactions are eligible for special tax treatment:

1. A non-resident enterprise transfers the shares of a resident enterprise to a directly and wholly owned non-resident subsidiary (non-resident to non-resident). Relief will be granted on the condition that such transfer does not allow the non-resident subsidiary to access more preferential PRC withholding rate on capital gains in a hypothetical transfer of the resident enterprise's shares, and no actual transfer by the non-resident subsidiary occurs within three years after the reorganisation transaction;
2. A non-resident enterprise transfers the equity interest in a resident enterprise to a directly and wholly owned resident subsidiary (non-resident to resident);
3. A resident enterprise contributes assets or equity interests to a directly and wholly owned non-resident subsidiary (resident to non-resident). In a resident to non-resident transaction, even if the resident enterprise meets the criteria for special tax treatment under Circular 59, it still has to recognise built-in gains of the assets or equities contributed offshore, albeit over a period of 10 years (partial deferral) versus immediately in the absence of special tax treatment.

International references

During the process of drafting Circular 59, it is believed the SAT researched the corporate reorganisation rules of other countries, in particular the US rules, which have evolved over nearly a century. To understand the rationale behind the rules in Circular 59 and identify gaps in those rules, it is useful to refer to the US tax reorganisation rules.

The business purpose, the continuity of interest and the continuity of business enterprise requirements of Circular 59 all have their counterparts in the US federal income tax law. Nevertheless, compared with the extensive regulatory authority and case law in the US, the business purpose and the continuity of business enterprise requirements in the Chinese tax regulations are broadly defined and susceptible to subjective interpretations.

Key recommendations on tax rules for corporate reorganisation:

- Clarify key requirements for special tax treatments of reorganisations such as business purpose and core operation
- Relax conditions for corporate income tax deferral on cross-border equity and asset transfers to a reasonable extent
- Clarify scope of VAT and business tax reliefs for corporate reorganisation
- Permit corporations to apply for advance rulings on their planned reorganisations

The 75% object threshold required in Circular 59 is more or less on a par with similar provisions in US tax reorganisation rules. For example, a US Type C reorganisation, which is roughly comparable to an asset acquisition in Circular 59, requires that substantially all of the target company's assets be obtained. The substantially all threshold is usually taken to mean 70% of gross assets and 90% of net assets of the target company. In a US Type B reorganisation, which is roughly comparable to an equity acquisition transaction in Circular 59, the acquirer needs to obtain at least 80% of the qualified stock from the target's shareholders.

Compared with the 85% consideration threshold requirement in Circular 59, a US Type A reorganisation in the US federal tax law, which is roughly comparable to a merger under Circular 59, accepts as much as 50% of boot without disqualifying the reorganisation; In a US type D reorganisation, up to 100% of the consideration can be boot, as long as the continuity of the interest requirement is satisfied (for example in situations where the transferor and the transferee are commonly controlled).

In a US type B reorganisation, the acquirer does not have to obtain 80% or more of the target's qualified stock in the reorganisation transaction alone. Creeping acquisitions with the ultimate ownership percentage reaching the necessary 80% threshold is acceptable. Although Circular 59 indicates that steps occurring 12 months before and after the reorganisation transaction will be consolidated under the substance over form doctrine, if the steps are pursued as part of the same reorganisation plan, it does not provide details on how creeping acquisition should be treated, especially in the equity acquisition scenario. For instance, if the acquirer already owns 21% of the target's stock via an old and cold cash transaction several years ago, it is unclear whether the acquirer can purchase 59% more of the target stock with equity of its own and qualifies the purchase as a stock acquisition eligible for tax deferral under Circular 59. The answer would be yes in a similar scenario under the US federal income tax law.

Excessive restrictions for cross-border transactions

As mentioned above, only three types of cross-border reorganisation were earmarked for special tax treatment under Circular 59. Among the three, the non-resident-to-non-resident and non-resident-to-resident transactions are both equity acquisitions, in which the transferee must be a 100% subsidiary directly owned by the transferor. This appears more restrictive than necessary from a policy standpoint. Imagine a case where the transferee is a 90% subsidiary of the transferor, a sister company under the common control of the transferor, or a parent of the transferor. It is hard to foresee how the policy purpose of tax deferred reorganisation would be defeated if special tax treatment is granted in these alternative scenarios, assuming all other applicable requirements are met.

As a further limitation, if the non-resident-to-non-resident transfer results in a reduction of PRC withholding rate on a future transfer of the resident company's equity interest because a more favourable PRC income tax treaty is available to the transferee, Circular 59 will also deny tax deferral treatment to the non-resident transferor.

In equivalent situations under the Internal Revenue Code (usually involving US real property interests), a US taxpayer can be given the option of waiving treaty benefits to qualify for tax benefits under domestic tax law such as non-recognition of gains. This latter approach appears to achieve the result of preventing treaty abuse without unduly burdening legitimate business transactions.

The third type of cross-border reorganisation sanctioned by Circular 59 is an outbound contribution of asset or stock by a resident company. Again, the requirement for the transferee to be a 100% subsidiary directly under the transferor's control would exclude many legitimate business transactions from special tax treatment without much gain from a tax policy perspective.

In addition, even the special tax treatment granted to a successful applicant is not a full tax deferral but an annual recognition during a 10-year period, and therefore a partial one. In contrast, although the Internal Revenue Code Section 367(a) serves to prevent US assets from leaving the US tax net on a tax-free basis, it contains various exceptions to create room for genuine business transactions. For instance, assets used in a foreign trade or business can be contributed outbound without immediate gain recognition. Certain stocks, especially stocks of foreign subsidiaries, can be contributed outbound with tax deferral if the US taxpayer enters into a gain recognition agreement with the tax authorities. Such agreement specifies future events upon which the deferred gains must be recaptured.

Answers that create more questions

The SAT has been aware of some of the restrictions mentioned above. In early 2010, it was reported that the SAT was preparing an implementation guideline to explain Circular 59 and relax some of the requirements. Although a draft version was circulated for discussion purposes, it did not receive internal approval to be released. Instead, the SAT issued a different interpretative guideline in July 2010 (Announcement 4), focusing on the procedural and definitional side of Circular 59. An unusual point raised in Announcement 4 is the characterisation of qualified equities as consideration in tax reorganisation. According to Article 2 of Circular 59, qualified equities include equities of the acquirer and equities of the controlling enterprise. Despite the lack of definition in Circular 59, originally it was widely expected that the controlling enterprise refers to the parent of the acquirer, as in a triangular reorganisation situation. Surprisingly, Announcement 4 states that the controlling enterprise refers to the subsidiary directly owned and controlled by the acquirer. Such a definition is unconventional as it creates issues on the continuity of interest and may lead to possible tax abuse. Furthermore, although the new definition makes it seemingly easier to satisfy the 85% consideration threshold, it casts doubt on the feasibility of triangular reorganisation in China, since the equity interest of the acquirer's parent may not be qualified equity anymore. The US feder-

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al income tax law accepts either the acquirer's stock and the parent's stock as consideration in certain tax reorganisation, but not both. US triangular reorganisation exists under the Type A (merger), Type B (equity acquisition) and Type C (asset acquisition) categories.

VAT

In China, the sales of goods including inventories and fixed assets are subject to VAT. In asset reorganisation, one question to consider is whether the transfer of assets from one company to another would generate VAT liabilities. In January 2011, the SAT issued a circular (Announcement 13) to address this issue. According to Announcement 13, certain qualified corporate reorganisation involving the transfer of tangible goods is regarded as outside the scope of VAT imposition. The qualifying scenario for VAT free treatment is as follows:

- The taxpayer transfers tangible goods in a corporate reorganisation that takes the form of merger, de-merger, sale or exchange;
- The taxpayer transfers all or part of the tangible assets; and
- The related debt claims, liabilities and work force are transferred along with such assets.

On the face of it, Announcement 13 should be welcomed by taxpayers with open arms. In practice, considerable uncertainty remains. Although it is not apparent from the wording of Announcement 13, intelligence suggests that the ruling is intended for transactions involving assets transferred in lieu of equity interest.

Putting that aside, Announcement 13 addresses VAT issues in the context of reorganisation and yet it does not refer to Circular 59 in language. Some terms used in Announcement 13, such as merger, de-merger, sale or exchange were undefined and could not be readily linked to Circular 59. It is unclear whether this VAT exclusion applies to all tax reorganisations or only those reorganisations entitled to special tax treatment under Circular 59. Finally, it does not address whether input tax credit of the transferor can be carried over to the transferee and be used to offset the transferee's output tax liability in future.

Business Tax

Announcement 13 only covers VAT. In China, there is another turnover tax, business tax, which applies to the transfer of intangible assets and immovable properties at 5%. So what if the property to be transferred in an asset reorganisation includes intangible assets or immovable properties? In the circular, Guo Shui Han [2002] No. 165 (Circular 165), the SAT signifies that the transfer of assets, debt claims, liabilities and workforce of an enterprise in their entirety should be outside the scope of business tax. Announcement 13 does not contain the entirety wording and seems to imply that transfer of a portion of the target's assets in corporate reorganisation will still qualify for VAT waiver. In this aspect, Circular 165 is more stringent than Announcement 13. It is unclear whether this is the true intention of the SAT.

More guidance necessary

In view of the rigidity and uncertainty in the current PRC tax regulations on corporate reorganisation, more detailed government guidance in these areas would be most useful:

- Elaborate on what constitutes reasonable business purpose and what represents the core business operation of the transferred assets.
- Clarify whether creeping acquisition of a target's equity interest is allowed subject to step transaction doctrines.
- Relax the wholly and directly owned subsidiary requirement for the transferee in cross-border reorganisations.
- Replace the non-reduction of PRC withholding tax on capital gains requirement in a non-resident-to-non-resident reorganisation with a treaty benefit waiver escape provision.
- Allow the contribution of foreign operating assets and foreign equity interest by a resident enterprise into a

non-resident entity on a tax deferral basis with a written commitment from the non-resident entity that such contributed assets will not be transferred within three years, or the deferred tax will be recaptured with accumulated interest.

- Clearly state the scope of applicability of VAT and business tax relief under Announcement 13 and Circular 165. If such relief is widely available, define terms in Announcement 13 and Circular 165 and confirm whether asset reorganisation needs to qualify for special tax treatment under Circular 59 first in order to enjoy the VAT and business tax relief.
- Considering the uncertainty in the tax regulations on reorganisation, allow corporations to apply for advance rulings

New guidelines urgent

Corporate reorganisation plays an important role in China's economic structure reform and industrial consolidation. Yet, the existing tax regulations do not provide sufficiently clear guidance and incentive for taxpayers who are engaged in bona-fide reorganisation transactions. Compared with a more sophisticated tax reorganisation framework, like that in the US, the Chinese reorganisation relief, built around Circular 59, still needs considerable refinement. It is recommended that SAT issue new guidelines to provide more clarity to the taxpayers on the issues listed and lower the entry barrier for special tax treatment so that more taxpayers can conduct corporate reorganisation in a tax effective manner in China, as envisioned by the Chinese government.

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When goods meet services … finally

The merging of VAT and Business Tax to produce a unified goods and services tax (GST) type of indirect tax is necessary for the healthy development of the Chinese economy. However, formidable obstacles lie in the path of reform, the greatest of which is that the central/local government revenue sharing system would be upset. Dealing with such obstacles will be a delicate balancing act, explain Lilly Li and Anthony Chau of KPMG

The prevailing indirect tax regime was first established back in 1994. There are three indirect taxes in China: VAT, Business Tax and Consumption Tax. VAT is principally levied on sales and the importation of goods, the provision of processing services and the provision of repair services in China. Business tax is imposed on the provision of services other than processing and repair, transfer of intangible assets and sales of immovable properties in China. Consumption tax is levied on the production of 14 types of special consumer goods.

The standard VAT rate is 17%. A reduced rate of 13% is applicable to specified basic supplies including foodstuffs, agriculture related products, certain utilities and publications. Exports are zero-rated, but certain products do not enjoy full input tax refunds. The standard Business Tax rates are 3% or 5%.

The issue of tax cascading

VAT is generally creditable in full. (Before 2009, however, input tax on fixed assets was not creditable.) But Business Tax is generally not creditable. Tax cascading is a major issue with Business Tax as it can give rise to double or multiple taxation. The cascading effect of Business Tax affects the way businesses organise themselves and run their operations. For example, businesses may feel compelled to place many operations or functions in one entity or location to avoid recharges and the concomitant Business Tax although commercially or technically it might be better to do otherwise. Business Tax is therefore an important factor in considering tax effective supply chain management in China.

Taxing right and revenue entitlement

In 2010, the abovementioned three indirect taxes comprised more than 60% of the total tax revenue of China – the single highest collected tax classification. VAT and Consumption Tax are collected by the State Tax Bureaus while Business Tax is collected by the Local Tax Bureaus. VAT and Business Tax are meant to be mutually exclusive in terms of their scope of charge. However, in practice, there are risks of overlapping in cases of composite supplies and mixed supplies. Given that VAT and Business Tax are dealt with by different tax authorities, the question of which authority has the taxing right can be problematic. Sometimes, taxpayers may get caught in between and find it necessary to get tax authorities of a higher level or even the State Administration of Taxation (SAT), the central authority in Beijing, involved.

In terms of revenue allocation, 75% of VAT collected belongs to the central government and 25% local; whereas Business Tax mainly goes to the local governments. Understandably, local governments are protective about their tax revenues. This may explain why indirect tax grouping is not available under the VAT regime. In some locations, the local governments also grant financial subsidies to businesses established in their regions with reference to the locally retained portions of the taxes paid by the businesses.

Enters the 12th Five Year Plan

In March 2011, China launched its 12th Five Year Plan (5YP), seeking to achieve balanced, coordinated and sustainable economic and social developments. The future of China's fiscal policy aims to facilitate and enhance this process, with the objectives of optimising revenue distribution among different levels of governments, improving government budgeting and embarking on tax reform which is designed to achieve a more equitable, better regulated and fairer tax system. The major plank of the Chinese government's tax reform process is to introduce a fully fledged turnover tax, modelled on international norms such as New Zealand's or Australia's GST, or the EU's VAT.

Actually even before the launching of the 12th 5YP, at the beginning of 2010, the State Council stated in its *2010 Legislation Agenda* that the codification of VAT shall be a priority legislation project that had to be completed "within a year". This would imply that the new VAT Law might take effect from 2013. (At the moment, the VAT provisions only attain the level of "provisional regulations" which is below the status of "law"). As part of the codification process, it was expected that the scope of VAT would also be expanded to cover transactions currently subject to Business Tax.

In March 2010, the Ministry of Finance (MoF) and SAT formed VAT codification task force. At that time, it was envisaged that the VAT codification blueprint would be presented at the last meeting of Standing Committee of the National People's Congress (NPC) in 2010. As it transpired, that did not materialise. In the legislation agenda of 2011, VAT codification was reprioritised. That does not mean that the Chinese government has shelved the legislation project. However, there is a risk that the progress of the codification process may be delayed by a year or two. However, in the meantime, the scope of VAT may still be expanded on a pilot basis to cover activities that fall within the ambit of Business Tax.

Must have and nice to have

Since early 2010, the Chinese government has launched into an extensive consultation programme on the VAT reform that involved governmental authorities, academics, corporations and professional intermediaries from all over the world. There are indications that the following issues have been subject to in-depth discussion:

- Expansion of the scope of VAT to subsume transactions and activities that are covered by Business Tax: This would follow that input tax credit will be available to transactions and activities subject to Business Tax, eliminating leakages to businesses and reducing the excessive burdens on consumers that are caused by tax cascading. To asset-intensive businesses such as transportation, telecommunication, construction and installation and leasing operations, the potential tax savings can be substantial.

Key trends on indirect taxes

- Expansion of scope of VAT to absorb transactions and operations subject to Business Tax
- Elevation of legislative status of VAT from provisional regulations to law
- Pilot schemes on selected service industries such as transportation and telecommunication
- Zero-rating of certain exported services
- Special treatment of financial services
- Electronic invoicing

- Zero-rating of exported services: Only exports of goods are zero-rated at the moment. A rare exception, if that can be considered as one, is the Business Tax exemption of the provision of offshoring services to overseas customers. Under the new VAT Law, it is possible that exported services will also be zero-rated. However, it is useful to note that even under the VAT regime, a considerable number of goods only enjoy partial zero-rating since their VAT refund rates are lower than their VAT charge rates.
- Special treatment of financial services: To spearhead China's efforts to turn Shanghai into an international financial centre by 2020, it is suggested that services provided by financial institutions should be zero-rated or at least exempt from VAT. At present, banks in China are liable for Business Tax at 5% on turnover from lending activities and trading in financial products, which can weaken their global competitiveness.
- Alignment of the place of supply rules: Repair and processing services are regarded as being provided in China if the services take place in China. On the other hand, services other than repair and processing are treated as rendered onshore if either the service providers and / or the service recipients are in China. The Business Tax scope of charge is certainly broader than that of VAT. It is hoped that when the VAT scope is widened to absorb the existing Business Tax items, the place of supply rules for those Business Tax items will be realigned to those for VAT items.
- Electronic invoicing: At present, China principally runs a paper-based invoicing system. One of the key objectives of the paper-based system is to prevent and detect VAT invoice frauds. However, the system has created significant operational and administrative issues for businesses. For example, for businesses that have operations in different provinces or cities in China, it is necessary to maintain personnel in each location to administer the invoicing process. The Chinese tax authorities are aware of the issues and exploring ways to alleviate the difficulties caused. The State Tax Bureaus in some provinces / cities have already taken steps to try out electronic invoicing, including Chengdu, Chongqing, Dalian, Fujian,

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- VAT rates: It is not clear as to whether the VAT rates will be adjusted under the reform. Given that the Corporate Income Tax rate has already been reduced from 33% to 25% since 2008, which is close to the international norm, it would be surprising if the standard VAT rate of 17% would be adjusted significantly one way or the other. However, the scope of the reduced 13% rate may be broadened to include businesses in the service industry that have minimal tangible goods input. Special relief may be provided for certain types of service businesses by way of a simplified tax rate mechanism.
- VAT grouping: Such grouping is not available under the VAT system at the moment. However, given the way in which local governments are organised, it would be challenging to reconcile the interests of the parties concerned in administering VAT grouping.

Balancing act

One of the reasons for the delay in the VAT reform process as witnessed in 2010 may be that more time is required to deal with the issue of the reallocation of the revenue between the central and local governments that might be caused by the VAT reform. As mentioned earlier, all the Business Tax revenue at present goes to the local governments. Once Business Tax items are absorbed into the scope of VAT, unless the tax revenue sharing mechanism is re-jigged, 75% of such revenue will revert to the central government. This can have a substantial negative impact on provinces or cities with a significant service sector.

In addition, the structure of the tax authorities may also be affected by the reform. As mentioned earlier, the Local Tax Bureaus and State Tax Bureaus are responsible for the collection of Business Tax and VAT respectively. With Business Tax being merged into VAT after the reform, resources may have to be redeployed within and / or between the Local and State Tax Bureaus. It will take a lot of political will and administrative prowess to initiate, manage and execute the whole VAT codification process.

To keep the reform momentum going and ensure a smooth transition from the old regime to the new, it is likely that the Chinese government will apply the new policy to specific industries on a pilot basis. Being asset-intensive, transportation, construction and installation, telecommunication and

leasing businesses may be the first batch of industries to try out the new system.

Transition to indirect tax reform

The Chinese government's 12th 5YP, together with its proposed tax reform agenda, is bold and visionary. It is hoped that the move to a broad based, single scale and fully creditable turnover tax in 2013 will be achieved. Indirect tax reform in China will have a far-reaching impact on the development of the Chinese economy. As such, the Chinese government is approaching the reform process with caution and is seeking to clearly understand the economic impact of the reform beforehand. It would therefore not be surprising if the Chinese government decides to phase in the indirect tax reform.

A careful, deliberate transition will allow the Chinese policymakers to make adjustments where needed, manage the political process and soften the potentially enormous impact on businesses and consumers.

Beyond processing trades – new customs developments

With China moving from an export-driven economy to one that encourages domestic consumption, the traditional processing trade regime which has served China well in past decade is due for upgrading and modernisation. Such policy changes will bring both risks and opportunities to businesses. Alex Capri, Melsson Yang and Cheng Dong investigate.

China's 12th Five-Year Plan (5YP) will address a critical period in the country's history, as it aims to develop into a balanced economy in which wealth is more evenly spread among the people and growth is achieved on a sustainable basis. Beijing's new policy objectives are aimed at shifting away from a predominantly export-driven economy to a model in which growth is powered by domestic production and consumption, increased investments are made by Chinese enterprises in strategic sectors overseas in the venturing out push, and smart foreign capital is absorbed into China to develop priority industries at home.

Application of customs duty rates

Import and export duty collection is one of the four fundamental functions of China customs. China's customs duty policy moderates national economy and foreign trade, catalyses structural shifts in the economy, and raises national financial revenue. In accordance with China's commitments to the World Trade Organisation (WTO), China has made great progress in lowering customs duty rates and eliminating non-trade barriers. In 2010, China fulfilled one of its primary WTO commitments to reduce its import duty rates. The average import duty rate is 9.8%. During the 12th 5YP, China will implement customs and trade policies to serve the national economy and social development plan through tariff quotas, interim rates, and free trade agreements. Below are prospective changes that will impact international trade and customs.

- Under the 11th 5YP, China established import duty and VAT exemption policies to target necessary basic raw materials and key components used in assembly and production equipment (such as big capacity generator units). These policies will continue in the 12th 5YP. Additionally, ships, automobiles, construction materials, textile, and other key supported manufacturing industries may be granted the aforementioned import duty and VAT exemption policy in respect of raw materials and key components in the 12th 5YP. Basic raw materials and key components needed in energy conservation, next generation information technology, bio technology, and new energy and other strategic emerging industries may also get support through import duty and VAT exemption policies. Machines and equipment needed for strategic emerging industries that are still not available for domestic production may get transitional support in import duty and VAT exemptions.
- China may offer import customs duty and VAT exemptions on equipment and machines needed for R&D activities, international service outsourcing, and high and new technology industries.
- China may use interim rates to collect export duties on coal, crude oil, fertiliser, and other high energy consumption, high pollution, and resource-related products.
- Jewellery, watches, and other luxury goods may see lower import customs duty rates in the future.

Key trends of China customs policies

- Strategic application of customs duty rates
- Modernising of processing trade policy
- Functional integration and rationalisation of special customs zones
- Expansion of free trade agreement network
- Increasing application of antidumping and countervailing duties
- Enhancing of export controls and licensing

Further development of domestic consumption and balancing of the flow of imports and exports will be the main objectives of the 12th 5YP. To increase imports, mitigate trade surpluses and concomitant pressure for the Chinese currency to appreciate, China's import duty rates and consumption tax (CT) rate will likely be reduced on selected products. This will most likely affect luxury goods and other high-value imports. To world renowned brands, this presents not only an opportunity, but also a challenge. With import duty rates and CT rates being reduced, the customs authority will step up its efforts to protect its revenue base by increasing its examination on valuation of imports, particularly those in transactions between related parties, and paying closer attention to royalties related to patent, trademark and other intellectual property.

Modernising of processing trade policy

The Processing Trade Regime accounts for half the volume of China's foreign trade. During more than 30 years of reform and opening up of the Chinese market to the rest of the world, processing trade grew enormously. In 2010, imports and exports under China's processing trades amount to $1.157 billion, representing a year on year increase of 27.3%. This included $740.33 billion in exports – an increase of 26.2%, and $417.43 billion in imports – an increase of 29.5%. The processing trade surplus was $322.9 billion, representing a year on year increase of 22.2% and accounting for approximately 1.76 times of the year's surplus. These figures are extracted from information released by the office of the Central People's Government of China.

Under the 12th 5YP, to accommodate shifts in national industrial structure, the direction of processing trade policy will change. China will refine its policy to stimulate processing trade to expand from assembly processing to more advanced activities such as research and development (R&D), design, core component production and logistics. In the future, single function and simple assembly operations may not get further support through favourable customs duty and VAT exemptions. Re-evaluation and planning ahead on supply chain arrangement will be necessary for processing trade industries.

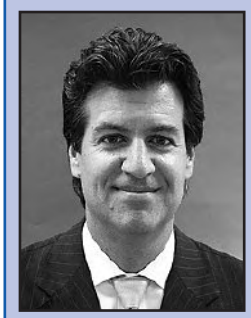
There should be some amendments and refinement to the current foreign investment industries guides and directories as well as the restricted and prohibited catalogues that pertain to the processing trade regime. China will optimise industrial structures and guide foreign capital to further engage in modern agriculture, high and new technology, advance manufacturing, energy saving, green energy and modern service sectors. The central and western regions of China will see increased investment, which will be driven in part through the amendment of processing trade guides and directories. Accordingly, regionally promoted industries will be adjusted to realise these strategic goals.

Coastal regions will concentrate on stimulating global processing and assembly bases to perform R&D advanced production and service-related functions. Promoting the opening of the service sector, developing international trade in services and attracting international service entities will be of utmost importance to these regions.

The inland regions of China will use different development zones as platforms, use comparative advantages associated with certain resources and labour forces to expand foreign investment industries and actively absorb the migration of international and coastal industries.

China has encouraged processing trade entities to be concentrated in special customs zones. In the future, China may

Biography



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Alex Capri has more than 19 years of international trade related experience, both as a government official and a consultant. Before becoming a customs consultant in 1998, Alex was an import specialist and an executive manager with the Bureau of Customs & Border Protection, in the US. In Asia, he has worked extensively on matters involving customs valuation, tariff classification, free trade agreements (FTA), anti-dumping and countervailing duties and more. In addition, Alex has worked on complex global projects for fortune 100 companies where he coordinated customs planning needs with international tax and transfer pricing strategies.

Alex was an adjunct professor in the School of Business and Management at Pepperdine University, in Los Angeles, for five years. He is also the author of *Importing into the USA: The Complete Guide to Customs Procedures* and has authored numerous articles. He writes for the *China Economic Review*.

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After graduating from the University of International Business and Economics, Melsson started his career as an officer with China customs. He then moved to the private field, and was responsible for customs operations in one of the well-known telecommunication manufacturers. He also served at leading logistics and supply chain management companies as the regional customs & brokerage manager for Southern China.

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Cheng is a senior manager of KPMG's trade and customs practice in Shanghai. Before joining KPMG, Cheng served as the Director of Policy Research in the Shanghai Customs from September 1991 to December 2003.

Cheng has extensive knowledge and experience in all major areas of custom duty activities, such as valuation, classification, duty reduction and exemption, duty collection methodology and customs policy implementation study.

Since joining KPMG, Cheng has been integrally involved in the analysis and development of resolution strategies for multiple trade and customs issues. The services delivered by him comprise strategic planning, duty saving and industry-specific analysis.

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make reforms to increase customs clearance efficiency, optimise the customs regulatory environment to allow reasonable management in special customs zones, and, in general, create a more harmonised trade and customs environment to attract entities into special customs zones.

Special customs zones

Special customs zone integration and development will be a central point to China's opening up and achieving a balanced import/export environment during the 12th 5YP. At present, China has a three level special customs zone system: (1) bonded ports and comprehensive bonded zones at the top; (2) free trade zones (FTZ), export processing zones, bonded logistics centres, and bonded logistics parks as its backbone, and, (3)export supervised warehouses and bonded warehouses as its base and network. These functions and policy facilities are different. Therefore, they have influenced the development of the relevant industries.

During the 12th 5YP, China will further promote the integration, rationalisation and upgrade of special customs zones. Export processing zones have already been granted trade and logistics functions. As such, existing low level special customs zones such as FTZs, export processing zones and bonded logistics parks will have the opportunity to be upgraded to high level special customs zones (such as bonded ports and comprehensive bonded zones). Finally, current restraints on R&D, testing and maintenance business in special customs zones may be open.

Moreover, in the next five years, the approval of the opening of special customs zones may lean towards the central and western region to match the regional development of the promoted industries.

Expansion of free trade agreement network

China has separately signed free trade agreements (FTAs) with Pakistan, New Zealand, Chile, Hong Kong and Macau, Taiwan, Singapore, and Association of Southeast Asian Nations (ASEAN). China is engaging Australia, Peru, Norway, and the Southern African Customs Union (SACU) in talks regarding new FTAs. During the 12th 5YP, China will speed up its FTA strategy, further strengthening economic relationships will major trading partners and intensifying co-operation between countries in the emerging market and developed countries.

Under the 12th 5YP, China will likely remain committed to a strategy of attracting inbound and outbound investing and trading with major trading partners. For various industries and sectors, how to fully utilize benefits from different FTAs, especially tariff concessions, will be of significant importance.

Anti-dumping and countervailing duties

Under the 12th 5YP, China's domestic economy will continue to develop and its home-grown industrial and technological base will expand. An increasingly strong Chinese currency will make the importation of key materials, components and goods more attractive to certain sectors. As such, nascent domestic industries may be threatened or pressured by imports from overseas competitors.

This will lead to an increase in anti-dumping duty and countervailing duty, as well as an increase in non-tariff barriers, which, among other things, take the form of licensing and inspection requirements. Furthermore, as general duty rates continue to fall both as a result of WTO tariff reductions and the implementation of FTAs, Chinese authorities will turn more to antidumping duty and countervailing duty.

Enhancing of export controls and licensing

As China's domestic high technology and R&D capabilities develop and expand in the coming five years, there will be an increase in special licensing around exports of sensitive technology, software, hardware and items with military applications. What will make this development unique is that an increasing number of these restrictions will be home-grown Chinese export controls pertaining to Chinese products and intellectual property.

At present, in 2011, the majority of export controls are of the US or Waseenaar variety. This number of export controls is also likely to increase, as competition between Chinese technology companies increases with other non-Chinese entities.

Upgrade and modernise

As China's economy advances to its next stage of development, there is a greater need to upgrade and modernise its traditional processing trade model, and the related trade and customs policies will have to adapt accordingly. The decrease in reliance on exports, the encouragement of domestic consumption and the moving of domestic Chinese companies up the value chain mean that China will have to rationalise its special customs zone structure, utilise its import duty regime in a strategic manner. To protect its revenue base, it is expected that the Chinese customs authority will strengthen the enforcement of the customs rules. Areas such as valuation and intellectual properties in connection with imports will receive special attention. All these changes will bring both risks and opportunities to businesses.

Re-dividing the pie

Income redistribution and law enforcement are the two key pillars of the forthcoming individual income tax (IIT) reform. Businesses and individuals will feel the impact of the changes. There will be continued focus on the tax withholding obligation of businesses in respect of their employees. Dawn Foo and Yong Yong Ng of KPMG believe commercial transactions of entrepreneurs, including sales of businesses to foreign corporations, will be placed under closer scrutiny.

IIT Law was first enacted in 1980, when the main source of income for individuals was employment income, and the average monthly wage of Chinese workers was RMB64. Minor amendments have been made over the years, but the fundamental structure of assessment or collection of IIT has not changed. The system of taxing income under separate and distinct categories through withholding at source serves the purpose of facilitating efficient tax collection while maintaining low cost of tax administration. However, as per capita income increases and the income streams of individuals multiply and become more sophisticated, resulting in widening inequality in income distribution, the shortcomings of the system in performing the function of redistribution of wealth become increasingly obvious. This in turn puts strain on social harmony.

Comprehensive reform is imperative in order to maintain social order and to synchronise the IIT system with China's dramatic economic transformation in recent years.

In recognition of the need for both short- and long-term measures towards IIT reform, the Chinese government has set out the following objectives in its 12th Five Year Plan (5YP):

- Increasing the personal exemption amount for salaried workers;
- Adjusting the tax rates and tax base;
- Establishing a consolidated annual IIT filing system, built upon the foundation of the existing withholding system; and
- Strengthening enforcement of IIT compliance and refining the tax collection process.

A central theme of IIT reform under the 12th 5YP is income redistribution through reduction of the IIT liability for low- and middle-income individuals and increase of the IIT burden of high-income individuals. In this article, we highlight the potential changes in the IIT policies that will be put in place to materialise the objectives set out in the 5YP.

Personal exemption and tax rates for salaried workers

Given the short-term need to mitigate the effects of inflation on the disposable income of the general population, it seems only a matter of time before the personal exemption for salaried workers is raised and IIT on the lower bands of income is reduced. According to the exposure draft of the revised IIT Law that have been preliminarily examined by the Standing Committee of the National People's Congress, the tax threshold on employment income will be increased from RMB 2,000 a month to RMB 3,000, and the number of tax brackets will be reduced from nine to seven with the 15 percent and 40 percent brackets being eliminated.

It is possible that dependent exemptions could be introduced as part of the consolidated annual IIT filing system, if and when it is eventually established. There is a clear argument for this case: a married individual, who is the sole breadwinner for a family of four, earning the same salary as a single individual with no dependents, should not be held to the same amount of tax. The need to consider each individual's

ability to pay tax given his or her family status cannot be overlooked by policy-makers. However, this could only happen in the long-term as a system of effective management would need to be put in place. Qualification tests would need to be set out – there may be requirements on the relationship to the taxpayer and thresholds on the amount of support provided to, as well as the gross income of, a dependent.

Strengthening enforcement of IIT compliance of high-income individuals

The State Administration of Taxation (SAT) has issued two tax circulars over the past 12 months, addressing the need for local tax authorities to strengthen enforcement of IIT compliance of high-income individuals. In Guoshuifa [2011] No.50, issued on April 15 2011, and Guoshuifa [2010] No.54, issued on May 31 2010, the SAT set out instructions for local tax authorities to scrutinise and police IIT compliance for high-income individuals particularly from sources of income other than employment, such as income from disposal of property, business income from self-employment, and independent personal services income.

This initiative is key to enhancing the function of IIT in income redistribution under the 12th 5YP. In recent years, high-income individuals have amassed significant wealth from business operations and sale of assets. Due to lack of a clear mandate, it has not been prevalent practice for buyers of goods and services or assets to withhold IIT at the time of purchase.

In the following years, the SAT will need to continue subjecting high-income individuals and their sources of income to scrutiny, and to put in place a robust IIT collection mechanism in the areas identified to be lacking. Measures implemented so far have included imposing an IIT withholding obligation on auction agents with respect to auction income, requiring local tax authorities to work with the relevant industry and commerce administration departments to track dispositions of ownership interests in private companies, and coordinating with housing registration departments to collect IIT before completing registration of real property transfers.

The SAT may also move to crack down on wealthy individuals who are choosing to move their assets offshore for the purpose of tax evasion. Publicity from celebrity cases would support this cause.

Highly compensated expatriate employees should note that they have also been identified as a target in this exercise. China has entered into an extensive network of tax treaties with other countries and regions, through which they exchange tax information with treaty partners . This provides the PRC tax authorities with an avenue to discover undeclared offshore income of expatriate employees in China. With continued focus by the PRC tax authorities on offshore payments and reasonableness of the income declared by expatriate employees in China, it may become increasingly difficult for expatriate employees who have not been declaring offshore compensation correctly to continue this practice.

Key trends in China IIT

- Tax threshold will be lifted
- Tax rate scale will be recalibrated and tax base widened
- Consolidated annual IIT filing system will be introduced
- IIT law enforcement will be strengthened

Biography

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In Foo's more than fifteen years in China, she has continuously been advising multi-national clients on the implications of tax and business regulations in relation to their business, guiding them through the vicissitudes of tax legislative changes and assisting in the structuring of their transactions to achieve optimal tax efficiency. In recent years, as the tax authorities strengthened their tax collection and administration on taxpayers, she has focused her attention on assisting companies minimize employment costs through optimal usage of available incentives and structuring of roles and responsibilities. In line with globalization and the need for a global workforce, she is actively engaged in advising on the structuring of cross-border employment duties to minimize multiple individual income taxation as well as manage the risks of corporate income tax arising from the activities of the individuals in various countries.

Establishing a consolidated annual individual income tax filing system

The introduction of the annual Individual Income Tax Return, beginning in calendar year 2006, is commonly viewed as a preparatory step by the Chinese government towards establishing a consolidated annual individual income tax filing system. The annual IIT return requirement, however, is only applicable to individuals with an annual income of over RMB 120,000.

The annual IIT return in its current form does not require individuals to aggregate the 11 categories of income and recal-

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Yong Yong started her career as an individual income tax professional with KPMG Singapore in 1999. She then worked in KPMG San Francisco, before joining KPMG Shanghai in 2005. She has more than ten years experience in providing individual income tax compliance and advisory services to multinational clients from a wide range of industries with international assignees inside and outside China.

During her time with KPMG Shanghai, Yong Yong has assisted multinational companies operating in China with managing PRC individual income tax compliance processes, structuring taxoptimized remuneration packages, and advising on foreign exchange and cross-border taxation issues.

culate an IIT liability based on total income from all sources. If the intentions of the 12th 5YP for comprehensive IIT reform are carried through, this would be set to change in the future.

Categories of income that are now subject to IIT at progressive rates – i.e. employment income, business income from self-employment, income from contracting or leasing to enterprises or institutions, and independent personal services income – may become subject to consolidation under the new IIT system. Other categories of income that tend to take the form of fixed and periodic payments to asset owners, such as royalties and rental income, may also be included in the consolidated IIT calculation.

Consolidation of these categories of income would be consistent with the theme of the 12th 5YP to increase the IIT burden of high-income individuals, as pooling of income from different sources would better reflect the total income of such individuals, potentially subjecting them to IIT at higher marginal rates. Also, in the case of individuals who have been taking advantage of differentiation of income to minimise IIT, for example where an individual sets up two separate contracts to receive both employment income and independent personal service income from the same company, pooling of income effectively negates this method of tax planning.

The consolidation of these different categories of income in calculating an annual IIT liability would require a new set of progressive tax rates, since each category of income is currently taxed at different rates and based on different timeframes.

The other categories of income that are currently taxed at flat rates – authors' remunerations, interest and dividends, income from transfer of property and incidental income may continue to be taxed separately, without becoming part of the consolidated annual IIT calculation. For these types of income which may be more prone to fluctuation, IIT collection could continue to be effectively administered via withholding at source to the extent the income is paid by or through entities in China.

Excluding these categories of income from the consolidated IIT calculation could maintain a certain degree of simplicity for the new IIT system, without compromising the principle of equity. This also allows for flexibility in adjustments to the tax rates and policies on such income. For example, if gains from sale of shares on the Chinese stock exchanges ceased to be tax exempt, separate IIT withholding at source on the gains per transaction would be simpler to administer than an annual reconciliation process.

Challenges to comprehensive IIT reform

There are two major obstacles to comprehensive IIT reform.

Firstly, the general population will need to be educated on tax filing procedures. Under the present IIT system where tax collection is implemented via withholding at source, individuals in China have limited knowledge of tax compliance requirements, as they have become accustomed to receiving income net of IIT which is the payer's responsibility to determine. The introduction of the annual IIT return in calendar year 2006 has only just begun to raise awareness of an individual tax filing obligation. With the launch of the consolidated annual IIT filing requirement, the SAT will need to ensure that a comprehensive set of instructions are provided with the tax forms, to provide clear directions to individuals on how to compute their IIT liability. Detailed implementation guidelines will need to be released together with the new IIT Law.

Secondly, the SAT will need to build up a centralised database of taxpayer information. Each individual should be given a single, unique tax identification number, under which all income-related transactions should be recorded. All payers of income should be required to submit individual taxpayer information to this database on a periodic basis. This would facilitate a system of checks and balances, not only in terms of ensuring that individual taxpayers fulfil their tax filing requirements, but also in controlling any dependent exemption claims such that the same dependent is not claimed by multiple taxpayers. In order to facilitate preparation of the consolidated annual IIT returns, payers of income should also be required to provide annual income statements to individual taxpayers.

New law, tougher enforcement

Within the next 12 months, there will almost certainly be a revision to the personal exemption and tax rates for salaried workers. It is possible that more revisions may be made over the course of the next five years, if inflation continues unabated. These revisions would continue to serve as stop-gap measures, even as the SAT works on the long-term project of comprehensive IIT reform.

The strengthening of enforcement of IIT compliance for high-income individuals will continue. This movement is likely to gather force if the enforcement efforts lead to significant recovery of IIT from such individuals. The data collected in this area of enforcement would also provide insights to the policy-makers in determining the appropriate tax rates and tax base under the new consolidated tax filing system.

As far as businesses are concerned, the IIT reform could potentially increase the staff costs as the tax burden of the higher earners will increase, which might be translated into higher compensatory remuneration or greater tax costs borne for their employees under tax equalisation or protection schemes. The withholding obligation on employers is unlikely to change even with the introduction of consolidated annual IIT filing. Corporations will have to enhance their internal controls over their IIT withholding obligations on salaries paid, even as highly compensated employees are put under the magnifying glass and the Chinese tax authorities tighten the noose on tax evasion as well as avoidance through creative tax planning. Foreign companies acquiring businesses from entrepreneurs in China may also find themselves taking up a role in IIT law enforcement, as tax investigations on the sellers of businesses can also implicate and/or create negative publicity for the buyers.

Green by any other name

China will rationalise the Resource Tax regime and use tax policies to discourage environment pollution and promote renewable energy. Businesses should closely monitor developments in this regard and anticipate the risks and opportunities created by new fiscal measures, say Jean Li, Jonathan Jia and Shirley Shen of KPMG

China is counting the costs of its unprecedented growth. Fresh from the Cultural Revolution and an economic hiatus of 30 years, it has only taken China another three decades to become the second largest economy in the world. Among other things, the environment has borne the brunt of such breakneck economic advancement. It is not surprising that the vision of sustainable growth underpins the 12th Five Year Plan (5YP) of China. Fiscal measures will be indispensible in helping the Chinese government to materialise that vision. The Chinese government will use or continue to use tax policies to encourage energy and water conservation, optimise the energy supply structure, compel the protection of environment and promote the development of renewable energy.

With those objectives in mind, the Chinese government will forge ahead with the reform of the Resource Tax regime in order to ensure that the tax costs borne by businesses in exploiting natural resources realistically reflect the increasing rarity of those resources. The Chinese government will seriously consider imposing a new levy – be it called Environment Tax, Green Tax or Carbon Tax – to make sure that the polluters of the environment are held accountable for the way they run a business. To reduce the risk of pollution at the source, the Chinese government will continue to use tax incentives to encourage the development of the renewable energy industry.

Revamping tax base of Resource Tax

According to 12th 5YP, to promote the sustainable exploitation and utilisation of resources, the Chinese government will deliberate over increasing Resource Tax burden of the operators in the resource industry to an appropriate extent. There will be initiatives to improve the levying and collecting method of Resource Tax, with the tax base for key resource products being changed from quantity to value. Such changes are intended to produce a fair distribution and allocation of the tax revenues of the areas where mineral resources are located and exploited and those of the areas where downstream operations are carried out and consumers are concentrated.

By way of background, in 1993, the State Council issued the prevailing Provisional Regulations on Resource Tax which covered crude oil, natural gas, coal, ferrous metals, nonferrous metals, nonmetallic ore and salt. The tax base prescribed by the provisional regulations is production volume. Such computation method made economic sense at that time because of the heavily regulated price controls by the State. However with the relaxation of price control over time on recourse products and the substantial hike in the demand for resources in the past decade, the legacy calculation method has severely thwarted the potential of Resource Tax in revenue generation. Economically, the resource-rich provinces are mostly inland provinces in the central and western region, the Resource Tax regime does not seem to provide a fair share of the tax revenues from the natural resource products exploited and produced from their regions. The regime also unintentionally encouraged oil and mining companies to focus on production quantity rather than the quality, efficiency and sustainability of resources. Therefore, the Resource Tax regime is due for a major revamp.

Key trends on energy-related taxes

- Changing of tax base of Resource Tax from production volume to production value
- Rationalisation of natural resources related tax, levies and royalties
- Introduction of new tax or expansion of scope of existing taxes to tackle environment protection
- Granting of tax and non-tax incentives to promote renewable energy

With that in mind, the Ministry of Finance (MOF) and the State Administration of Taxation (SAT) have jointly instituted a pilot program to experiment with a value-based tax computation method. Starting from June 1 2010, in Xinjiang Autonomous Region, taxpayers will be subject to a 5% flat-rate Resource Tax, based on the value of crude oil and natural gas extracted. From December 1 2010, the pilot program has been extended to 12 provinces and cities in the Western Region. This move has also paved the way for the nationwide rollout of the policy in due course.

Catching coal?

The idea of expanding the scope of Resource Tax to cover coal has also been mooted. However, there is a concern that dragging coal into the Resource Tax net may add fuel to the inflationary flames in the Chinese economy. Therefore it is likely that the Chinese government will take a prudent approach in this regard. One possibility is for the State to first try out taxing coal products, as it has done with the rebasing of Resource Tax, in certain provinces and cities, such as Inner Mongolia, Shanxi and Xinjiang.

In the longer term, it would not be surprising if the scope of Resource Tax is expanded to cover a wide range of minerals, such as ferrous metals, nonferrous metals, nonmetallic ore, salt, mineral water and geothermal products.

Rationalisation of resources-related levies

Apart from Resource Tax, Chinese mining enterprises are also subject to Mineral Resource Compensation Fee which is based on a certain percentage of their sales revenue. There has been speculation as to whether Resource Tax will merge with Mineral Resource Compensation Fee to form a unified mining levy. However, there will likely be formidable obstacles on the path of such unification. First of all, the Mineral Resource Law will have to be amended because the law provides for the imposition of both Resource Tax and Mineral Resource Compensation Fee. Secondly, the revenues of different government bodies will be affected; Resource Tax is collected by the tax authorities while Mineral Resource Compensation Fee is levied by the agencies under the Ministry of Land and Resources. Therefore time should be allowed for the reconciliation of the interests of different authorities if unification is going to happen at all.

Polluters shall pay

In the 12th 5YP, the Chinese government has set the targets of reducing CO_2 emissions per unit of GDP by 17%, Chemical Oxygen Demand (COD) and SO_2 emission by 8% respectively, and ammonia nitrogen concentration and nitrogen oxides emission by 10% respectively. One of the measures to achieve these targets is to develop a new Environment Tax regime. The Environment Tax as envisaged is premised on the "polluter pays" principle. It would not be the first time that such ecological philosophy has been adopted.

In 2002, the State Council issued Administrative Provisions on Collection and Application of Sewage Charges to attempt to curb the pollution of water, air and land. However, the effectiveness of these measures has been limited by collection and revenue allocation issues. Enacting Environment Tax will be a legislative process that will elevate the status of the relevant provisions from the relatively low status of administrative rules as with the current sewage charges with the well established infrastructures and long accumulated experiences of the tax administration, it is hoped that Environment Tax will be able to serve the environment protection purpose better than sewage charges.

Sulphur dioxide blazing a trail

The potential targets of Environment Tax are sulfur dioxide, waste water and solid waste. The tax base will be the quantity of actual emission or effluence of pollutants. The sulfur dioxide and waste water may be the first batch of pollutant categories that are subject to Environment Tax because the technology required for tracking and measuring the relevant emission or effluence are relatively mature in these areas. For example, the tax on waste water can be collected based on the COD of manufacturing entities.

Right before the 2009 UN Climate Change Conference in Copenhagen, the Chinese government indicated the target of cutting its carbon dioxide emissions per unit of GDP by up to 45% by 2020. Since the scope of existing sewage charges does not cover carbon dioxide emission, there have been speculations about the introduction of Carbon Tax. Another school of thought is that the ambit of Environment Tax may easily be stretched to cover carbon dioxide emission. Be it a stand-alone Carbon Tax or all-inclusive Environment Tax, given the time needed for the development of the required technologies and the reconciliation of corporate and governmental interests, an implementation date earlier than 2013 may prove overly ambitious.

Nipping the problem in the bud

As a more forward looking approach, the Chinese government is also exploring granting more tax incentives to renewable energy sector. Renewable energy has played an increasingly important role in helping China meet its surging energy demand, optimise its energy structure, ensure its

energy security, protect the environment and stimulate economic growth. Wind, solar, hydro, biomass, geothermal and ocean power generally fall within the category of renewable energy.

In the past decade, the Chinese government has made significant efforts to diversify the sources of energy, progressively placing less reliance on conventional energy sources such as coal, oil and gas. The Renewable Energy Law, which made its debut in 2006, was recently revised, and the revised law has taken effect from April 1 2010. This law has helped fuelling unprecedented growth of the renewable energy industry in China, particularly the wind and solar power sectors. Statistics show that China has surpassed Germany and the United States of America in terms of renewable energy investments. Not contented with its achievement so far, the Chinese government has set itself a national target of having 15% of its total energy generation originated from renewable energy by 2020.

Existing tax incentives for renewable energy

Considering the unique characteristics of the renewable energy industry, such as capital intensiveness, output constraint and instability as well as geographical remoteness of operations, many countries have realised that it is necessary to provide tax and non-tax incentives to encourage its development. China is no exception.

The prevailing CIT law and its implementation rules, which are effective from January 1 2008, offer preferential treatments including "3+3" tax holiday, reduced CIT rate for high-tech companies and the reduction of taxable income derived from the synergistic utilisation of resources.

From indirect tax perspective, the Chinese government provides various favourable treatments to the renewable energy sector. For example, wind farms are eligible for a 50% refund of VAT. Furthermore, Customs Duty exemption is available for imported equipment used in the renewable energy sector where demands for such equipment cannot be met by domestic supplies.

Non-tax incentives also pulling their weight

The Renewable Energy Development Fund has been set up to provide subsidies to the renewable energy industry. The fund comes from surcharges on electricity generated from renewable sources and allocations from the annual national fiscal budget. The fund is used to compensate the operators in the renewable energy industry for the difference between the costs incurred in connecting electricity generated from renewable sources to the grid and the costs that would normally be incurred in the grid connection of electricity generated from conventional sources.

In addition, where a renewable energy project falls within the scope of the Catalogue for Guidance on Development of Renewable Energy Industry and satisfies certain conditions on creditworthiness, the project may avail itself of subsidised loans from financial institutions.

Taking incentives to the next level

The 12th 5YP has reaffirmed the commitment of the Chinese government to achieving sustainable growth, including the promotion of the development of renewable energy. The newly amended Renewable Energy Law has also helped the alternative energy industry to increase its shares of the Chinese power generation market by offering various incentives.

However, there may be directional changes of incentives at the sub-sector level. The support for sectors that have reached critical mass, for example wind power, may be phased out over time. It is worth noting that the hydropower sector has not been afforded much support in recent years because of social and structural issues.

On the other hand, action may be taken to resolve the issue of transmission bottleneck experienced by the renewable energy sector when accessing the nation's power grid; the power grid facilities fail to keep up with the rapid increase in the power generation capacity of renewable energy. In the coming years, the Chinese government may grant

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Shirley has rich experience in energy and natural resources industry. She has been providing tax health check, tax provision review, tax due diligence, structuring and planning advice to major multinational and domestic clients.

She is also now actively involved in the forthcoming VAT reform in China by assisting the Legislative Affairs Office of Budgetary Affairs Commission of National People's Congress and the Ministry of Finance.

tax incentives or financial subsidies to the grid companies to encourage investment in their infrastructure.

Multiple methods

To achieve sustainable growth, China will likely adopt a three-pronged fiscal approach of (1) rationalising the Resource Tax and mining royalty regime, (2) discouraging environment pollution via Environment Tax or equivalent and (3) promoting renewable energy by means of tax and non-tax incentives. Much progress has been made in this direction. The 12th 5YP should keep the momentum going. Businesses should plan ahead in order to take advantage of the opportunities and mitigate the risks presented by the related policy changes.

Hot and bothering – property tax reform

Taxation is a major tool for the central government of China to tackle the issue of increasingly heated property markets in China. It is likely that the central government will revamp the real estate tax regime in the coming years to make the taxation tool more effective. Property owners, developers and investors such as real estate funds will directly or indirectly be affected by the change, warn Lewis Lu, Chris Abbiss and Jennifer Weng of KPMG

The overheating of the real estate markets in China has long been a concern of the central government of China, especially those in Beijing, Shanghai and Shenzhen. Besides economic costs that would result from the bursting of a property bubble, there is a worry that the sharply rising housing prices in the past few years have accentuated the wealth gap issues. The low-to-middle income population has found it increasingly hard to afford home ownership. This is a development that is inconsistent with the vision of sustainable growth as set out in the 12th Five Year Plan (5YP) and the model of a harmonious society that has been pursued by the Chinese government.

In the past few years, the central government has rolled out various measures to try and saddle the seemingly runaway property market. In 2010, the State Council issued circulars to restrict the credit line available for purchase of residential properties of certain size by imposing minimum down payment of 30% or 60% and, in some cases, minimum interest rates. In 2011, the State Council issued rules that require potential buyers to produce household registration certificates or, failing that, local tax receipts or social security contribution records as evidence of close connection with the location of the properties before they are allowed to acquire those properties. These measures were intended to discourage or prevent speculative behavior.

The central government has also used taxation to try and deter property speculation. This policy objective complicates the already complex fiscal rules in relation to real estate transactions. In this chapter, we consider the course that the property-related tax policies may take in the coming years and how businesses such as real estate developers and investors in real estate projects, such as property funds, may be affected by policy changes.

Alphabet soup of taxes

Property developers are subject to a myriad of taxes in China. There are Deed Tax (DT) and Stamp Duty (SD) on the purchases of land use rights. When selling the properties, the developers will be liable for Business Tax (BT), Land Appreciation Tax (LAT) and, again, SD. As a BT payer, the developers will also be required to pay Urban Maintenance and Construction Tax (UMCT) and an Education Levy (EL). They will also be liable for Corporate Income Tax (CIT) on the profits derived from the property sales. If the developers continue to own the property for self-use or letting activities, they will have to pay Real Estate Tax (RET) and Urban & Township Land Use Tax (UTLUT) as well.

Tax imbalances in cycle of property ownership

There has been a concern that the preponderance of real estate taxes is on the transfer of properties as opposed to the holding of properties. LAT on the sales of property is as high as 60%. On top of that, there is 5% BT for the sellers and 3% DT for the buyers, whereas for the owners of properties, the rates of RET and UTLUT are much lower. In addition, the developers will generally have to pay hefty premiums

to obtain the land use rights from the local governments. With the property markets heating up in the recent years, attention of the authorities at the local level has been focused on properties transfer, rather than property retention. This has created a host of economic and social issues including demand-supply mismatch, land hoarding, neglected property maintenance, short-termism, and so on.

It is interesting to note that LAT has its inception as a fiscal tool to dampen the overheated real estate sector of China in the early 1990s. However, soon after the LAT regulations were promulgated in 1994, due to the Asian financial crisis in the latter part of the 1990s, the Chinese property markets crashed, and this rendered LAT more or less obsolete. Having been in abeyance for a decade or so, LAT has been called upon again to regulate the pricing of real estate projects. This explains the increased enforcement of the collection of LAT in the past few years.

Any attempt to redress the imbalance of tax burden over the life cycle of property ownership can affect the tax costs, and hence the financial returns, of the developers and in turn those of real estate investors, including property funds. There have been talks about the introduction of a realty tax (*Wu Ye Shui*) with a view to, among other things, evening out the tax revenue over the life cycle of property ownership.

From "virtual operation" to "actual operation"

One version of Realty Tax is basically an enhanced RET. At present, RET basically applies to properties used by businesses, with exemption being granted to self occupied non-business properties of individuals. Realty Tax would extend the scope of RET to cover residential properties of individuals as well.

Since 2006, a number of provinces / municipalities have successively joined a "virtual operation" program to carry out internal test run of Realty Tax. These locations include Anhui, Beijing, Chongqing, Fujian, Henan, Jiangsu, Liaoning, Ningxia, Shenzhen and Tianjin. Under "virtual operation", the tax authorities collect and analyze the data on Realty Tax that may potentially be collected but they do not actually collect the tax from anyone. Similar to RET, the "virtual operation" model has two alternative computation methods, that is, 1.2% of the appraised value of self-used properties at a discount of 30% or 12% of the return on rented properties.

The implementation of such Realty Tax is potentially controversial. There is a question as to whether Realty Tax should replace or absorb the land premiums collected by the local governments or even LAT and UTLUT, or, if they are not replaced or absorbed, whether LAT and UTLU taxes can be reduced accordingly. Also there will be practical and administrative obstacles to overcome in order to implement Realty Tax, for example the lack of a reliable system to collect complete and accurate data on property ownership and the shortage of independent appraisers to arrive at the market value of properties which would be the tax base of the Realty Tax. It is therefore highly questionable if Realty Tax will be rolled out in the near future. Based on past experiences, if Realty Tax is introduced at all, it will likely be tried out first on selected categories of properties, for example, commercial buildings, in certain cities such as Beijing, Shanghai, Chongqing and Shenzhen.

On the other hand, the fact that Shanghai and Chongqing have already rolled out provisional Property Tax (Fang Chan Shui) has clouded the picture even more. Will Property Tax simply be a mutation of Realty Tax? Or will Property Tax and Realty Tax go hand in hand? These are the questions that beg for answers.

Key trends on property related taxes:

- Continued experimentation with the Property Tax regime
- Rebalancing of tax burdens over life cycle of property ownership
- Possible pilot program for "actual operation" of Realty Tax
- Strengthening of tax enforcement especially in relation to Land Appreciation Tax
- Simplification of the real estate tax system

A tale of two municipalities

In 2011, the concern over the out-of-control property price hike, particularly residential properties in the first-tier cities, led to the issuance of the provisional measures on Property Tax in Shanghai and Chongqing respectively. The two cities have promulgated Property Tax rules that would be applicable to individuals who own residential properties. For residents in the two cities, if the following conditions are met, the individual owners will have to pay Property Tax on an annual basis.

Shanghai

The taxable residential properties refer to the following properties purchased on and after 28 January 2011, including newly purchased second-hand and newly constructed properties:

- Residential properties purchased in Shanghai by a resident household of Shanghai that constitutes the second or subsequent properties of such resident household ; and
- Residential properties newly purchased in Shanghai by a non-resident household of Shanghai.

In addition, it is further stipulated that for the Shanghai resident household, even if the above conditions are met, if the total construction area of their residential properties does not exceed 60 square meters per capita, Property Tax exemption will be temporarily granted. Property Tax will only be levied on the construction area per capita that exceeds 60 square metres.

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Chongqing

Property Tax will only be applied to the following properties that are located in nine districts in Chongqing:

- Detached houses owned by individuals
- Newly acquired high-end residential properties (including second-hand and newly constructed properties). The high-end residential properties refer to the properties priced at least two times the average price of all newly-built properties in the abovementioned nine districts for the previous two years
- Second or above newly purchased properties (including second-hand and newly constructed properties) by non-permanent residents who do not work or run companies in Chongqing

Property Tax exemption could be granted for:

- The first 180 square metres for detached houses acquired prior to January 28 2011;
- The first 100 square metres for detached houses and high-end residential properties

The jury is still out

Because of the seemingly stringent conditions, not too many home-owners in the two cities have actually suffered the Property Tax. Up to now, it is still unclear how much Property Tax has been collected in Shanghai and Chongqing. According to the recent statistics, for example in Shanghai, up to April 27 2011, only 2,306 units have been confirmed as taxable properties among 18,960 newly acquired residential units since January 28 2011. However, Property Tax on only 20 units has been paid to the Shanghai tax bureau up to now.

It seems that the impact of Property Tax in Shanghai and Chongqing has thus far been more psychological than real. Given the lagging effect of the imposition of taxes to deter undesirable behaviour, it remains very questionable whether Property Tax would be an effective tool to adjust property prices. As to whether Property Tax will be a major source of revenue for the local government, there remain many obstacles. Property Tax regulations will need to be revamped to account for a wider taxpayer base. Local governments will need the flexibility to set and adjust rates for Property Tax. Valuation of properties for tax purposes can also be challenging. A better mechanism is also needed to facilitate the sharing of Property Tax revenues among various levels of government.

In Shanghai and Chongqing, the rates of Property Tax and the scope of taxpayers are determined by the local government as opposed to central government. In order to avoid divergence of interests between the local and central governments, Property Tax regulations will have to be elevated to the status of a national level legislation.

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Along similar lines as those discussing Realty Tax above, there is an argument that the consideration paid to the local governments for land use rights should already reflect the costs of acquiring the ownership of the properties. To pay Property Tax again does not appear reasonable. In addition, property developers have paid various taxes or fees during the development period. Such costs have also been reflected in the property price paid by individuals. As such, it is felt that the central government should consider simplifying the tax and fees imposed on property developers and owners, such that while the tax rates may remain high, the tax system would be much simpler, reducing the costs of collection and enforcement.

Cautious reform

With most of the related regulations being issued in the early 1990s or earlier, the Chinese real estate tax regime is due for a revamp. The need to use taxation to contain the buoyant real estate market in China should serve as a catalyst to the real estate tax reform process. However, given the potential impact of the tax reform on all aspects of the society and economy, it is likely that the central government will tread very carefully. Another issue that the central government will have to consider is the effect such tax reform will have on the way the tax revenues are allocated between central and local governments and among different authorities. The central government will also have to reconcile the interests of all the parties that will be affected by the tax reform. However, as the need for reform has become more urgent, the introduction of Realty Tax and/or Property Tax in the next five years or so should not come as a surprise.

Reinventing Hong Kong – New tax policies needed for plan

The 12th Five-Year Plan of China recognises the competitive advantages of Hong Kong and sets out some initiatives to bolster its unique position. Exactly how the Hong Kong government uses tax policies to implement the initiatives proposed in the Five-Year Plan will be critical for the continued prosperity of Hong Kong, say Ayesha Macpherson, Darren Bowdern and Garry Laird of KPMG

China's 12th Five-Year Plan (5YP) has incorporated a chapter on Hong Kong. It is the first time Hong Kong has been included in a 5YP. By way of background, as a Special Administrative Region, Hong Kong has a tax regime that is different from that of the Mainland of China under a "One Country, Two Systems" framework.

The Hong Kong chapter emphasises the support of the mainland government for the future development of Hong Kong in the following three major areas:

* Consolidating and enhancing Hong Kong's competitive advantages. They include consolidating and enhancing Hong Kong's position as an international financial, trade and shipping centre, and support for Hong Kong's development of its offshore RMB and international asset management activities.
* Supporting Hong Kong in nurturing emerging industries and developing the six industries where Hong Kong enjoys clear advantages, such as (1) cultural and creative, (2) innovation and technology, (3) environmental, (4) testing and certification, (5) education and (6) medical. The relevant statements will assist the six industries to extend the fields of co-operation and scope of services on the mainland of China.
* Deepening economic co-operation between the mainland and Hong Kong. This includes continuing the implementation of the Closer Economic Partnership Arrangement (CEPA) and confirming the Hong Kong-Guangdong co-operation. The core functions and positioning of Hong Kong in the development of the Pearl River Delta region are clearly defined and provide a clear direction and basis for Hong Kong in taking forward further regional co-operation with other provinces.

The Hong Kong government has indicated that all relevant policy bureaus would be responsible for formulating policies and measures according to the substantive content of the 5YP. Such policy areas would include:

* The Hong Kong government will develop offshore RMB business by further enhancement of the RMB settlement platform, encourage overseas enterprises and mainland enterprises to issue RMB bonds in Hong Kong and reinforce Hong Kong's status as an offshore RMB centre. The government will also look to establish channels to allow enterprises to invest in the mainland the RMB funds raised in Hong Kong and promote the diversification of RMB financial products and services.
* The Hong Kong government will facilitate the development of asset management businesses by seeking to enter into more agreements for the avoidance of double taxation, continuing to develop an Islamic financial platform, providing fiscal incentives and stepping up overseas promotion. The government will also continue to strengthen the competitiveness of our asset management industry.
* The Hong Kong government will proactively strengthen the co-operation with the mainland to explore and serve the domestic market in the mainland making use of CEPA and existing regional co-operation platforms.

* The Hong Kong government will support Hong Kong's development into a high-value goods inventory management and regional distribution centre. It will gradually make available long-term sites in Kwai Tsing to attract third-party logistics services providers to operate in Hong Kong. The Hong Kong government will also promote the wider use of e-logistics services, and continue to promote to the mainland and overseas markets the professional logistics services which Hong Kong can offer. The Airport Authority is actively increasing the handling capacity of the airport to meet future demand, including the midfield expansion project and construction of a new air cargo terminal.
* On regional co-operation, the Hong Kong government will co-operate further with mainland provinces and municipalities in taking forward the relevant measures. The focus will be on forging ahead with advanced manufacturing industry and modern services industries, Qianhai development, the opening up of the Guangdong market to Hong Kong service industries, cross-boundary infrastructure development and the building of the Guangdong-Hong Kong-Macao Quality Living Area.
* With the central authorities' support of the continuing implementation of CEPA, the Hong Kong government will continue its dialogue with the relevant central government ministries in taking forward the related work.

To allow Hong Kong to take full advantage of the macroeconomic opportunities envisaged in 5YP, it is important that Hong Kong adapts its tax system. It is recommended that Hong Kong should consider modifying its tax laws in the following areas:

Expanding the DTA network

As an international financial, trade and shipping centre and asset management centre, Hong Kong should have a broad network of double taxation agreements (DTAs) with its major trading partners. The existence of such a network will provide Hong Kong companies conducting business overseas with a number of tax benefits. It will also facilitate mainland investors in structuring their overseas investments through Hong Kong and act as a spring-board for overseas businesses investing in the mainland.

Before 2010, when Hong Kong amended its legislation to allow it to incorporate in its DTAs the latest international standard on exchange of information of the OECD, Hong Kong had only concluded five DTAs. To be deemed to have substantially implemented the internationally agreed standard by the OECD, Hong Kong needed to conclude 12 DTAs containing the latest exchange of information article. Presently, Hong Kong has concluded a double tax arrangement with the mainland and DTAs with 19 other countries, namely Belgium (2003), Thailand (2005), Luxembourg (2007), Vietnam (2008), Austria, Brunei, France, Hungary, Indonesia, Ireland, Japan, Kuwait, Liechtenstein, the Netherlands, New Zealand, Switzerland, UK (all 2010), Portugal and Spain (both 2011).

Key changes recommended on Hong Kong tax

- Further expanding the network of comprehensive double taxation agreements (DTAs).
- Creating a level playing field for Islamic finance.
- Granting tax incentives for asset management.
- Allowing loss carry back and group relief.
- Granting tax incentives for research & development.
- Widening scope of tax deduction for intellectual property rights.
- Giving depreciation allowances for expenditure on manufacturing plant and machinery utilised in certain cross-border activities.
- Relaxing principles for determining the source of profits in respect of processing operations.
- Facilitating the maintenance of substance in investment holding companies.

Compared to other jurisdictions in the region, and despite the commendable steps taken to conclude negotiations in 2010 and 2011, Hong Kong still is not seen as having an extensive network of DTAs.

Further, the number of double tax arrangements and agreements concluded to date does not compare favourably with our competitors in the region. Accordingly, to enhance its position, Hong Kong should give priority to expanding its network of DTAs with particular emphasis being given to concluding DTAs with Hong Kong's major trading partners, such as the US, Australia and Taiwan and countries in South America and Africa where Chinese outbound investments are heading.

Islamic finance

To complement Hong Kong's position as an international financial centre and asset management centre it is important that the Hong Kong government supports alternative financing arrangements such as Islamic finance. In this regard, the Financial Secretary announced in the 2009/10 Budget, that the government would further develop and increase financial co-operation with emerging markets and improve Hong Kong as a platform for the growing area of Islamic finance.

To comply with Shariah law, Islamic finance arrangements operate in the form of equity finance but, in substance, are similar to debt finance. Tax law has always treated debt and equity differently. The interest income and interest expenses arising from a debt finance arrangement may be taxable and deductible subject to certain conditions. In contrast, dividend income and distributions arising from an equity finance arrangement are generally not taxable or deductible. Moreover, the sale and repurchase of certain assets such as property under Islamic finance arrangements can be subject to stamp duty in Hong Kong and the periodic rental payments can be subject to profits tax or to property tax. Consequently Islamic finance can be exposed to a heavier tax burden when

compared to conventional finance, which places it at a competitive disadvantage in the market place.

To address this issue the government initially planned to submit a proposal in 2009-10 to create a level playing field for Islamic financial products vis-à-vis conventional financial arrangements. This proposal would include making changes to or clarifications of the arrangements for stamp duty, profits tax and property tax. A similar announcement was made by the Financial Secretary in the 2011/2012 budget but unfortunately, the necessary legislative amendments have yet to be introduced. The only development, to date, has been the issue of guidelines to the finance industry towards the end of November 2009 to facilitate applications for tax exemption in relation to the launch of and transactions in Islamic bonds. However, these procedures are time consuming and complicated and do not represent an appropriate mechanism to facilitate the development of Islamic finance.

Asset management tax incentives

There are no incentives provided for either onshore or offshore asset management business carried out in Hong Kong. However, regional competitors, such as Singapore, promote fund management activities in Singapore by offering a concessionary tax rate of 10% for fund management and investment advisory activities, subject to certain conditions. It is recommended that Hong Kong should consider offering similar incentives to attract fund management businesses to Hong Kong.

Allowing loss carry back and group relief

Hong Kong only allows tax losses to be carried forward indefinitely for set-off against future profits. By contrast, many other jurisdictions allow tax losses to be carried back to offset against taxable profits in earlier years or to be transferred between group companies.

Hong Kong's loss rules work well when companies operate separate businesses under the same legal entity. However, enterprises no longer commonly organise their businesses under a single entity. Rather, companies are usually organised along lines of business operating through separate legal entities notwithstanding that the group is managed and controlled as a single economic unit. This structure may be utilised to limit the liability and risk of their investments or to reflect the structure of their businesses. To address this issue Hong Kong should introduce group relief.

There is also a need to allow the carry back of losses to be set-off against the assessable profits of a preceding year. For instance, a company engaged in securities trading is assessed or allowed a deduction for unrealised gains or losses when they are taken to the profit and loss account and this can result in an inequitable result. For example, an unrealised gain is assessed in a year due to a rise in market value. Subsequently, when the security is disposed an actual loss may eventuate. This loss may not be able to be utilised if the taxpayer does not have any other business profits. Allowing companies to carry losses back for say three years would help to address this issue.

R&D incentives

Hong Kong's expenditure on R&D represents less than 1% of its GDP. It is essential that Hong Kong's tax policy should encourage investment in R&D projects. Hong Kong provides relatively limited tax relief for R&D expenditure. These reliefs are not as generous as Hong Kong's regional competitors (see table below) which provide bonus R&D tax deductions.

Country	Bonus deduction
Australia	125% – 175%
China	150%
Singapore	Up to 400%
UK	130% (175% for SMEs)

Thus, Singapore for example provides a tax deduction of up to 400%. Other relief measures provided by other countries include accelerated depreciation for expenditure on plant and machinery, providing a tax credit/rebate, a partial tax exemption, or some combination thereof. To encourage investment

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in R&D, Hong Kong needs to introduce tax incentives in line with those offered by its competitors.

Intellectual property

Hong Kong allows a deduction for expenditure on the registration of trademarks, patents or designs used for the purposes of earning assessable profits. However, only expenses for the registration of a trademark or design are allowable, although a deduction is allowed for either the registration or grant of a patent. In addition a deduction is allowed for the cost of purchasing patent rights or rights to any know-how, provided that the rights are to be used in Hong Kong in producing profits chargeable to profits tax. Where the rights are to be used partly in Hong Kong and partly elsewhere, only that part of the cost which is attributable to the use in Hong Kong is deductible.

If the rights are subsequently sold, the proceeds of sale are to be brought in as a trading receipt and, charged to profits tax. However, the taxable amount is not limited to the original cost and there is the potential for what is a capital gain to be taxed.

The categories of intellectual property rights that qualify for deduction is to be extended to copyrights, registered designs and registered trademarks. The requirement that the patent rights or rights to any know-how must be used in Hong Kong will also be removed. The deduction will be available over five succeeding years of assessment or a lesser number of years of assessment in the case of a copyright or registered design whose maximum period of protection is due to expire earlier than the five year limit. The provisions only apply to expenditure on the acquisition of copyrights, registered designs and registered trademarks, as opposed to 'in-house' expenditure on the development of such intangibles.

While this widening of the categories of intangibles that qualify for deduction is welcome it does not extend to all types of intangible assets. Deductions are not available for such intangible items as brand names and purchased goodwill. Expenditures on excluded intangible items are effectively treated as non-deductible capital expenditure. An anomaly results in that profits produced from the use of these intangible items are assessable, but no deduction is available for the corresponding costs. These costs represent real economic costs to the enterprise that should be deductible in ascertaining its assessable profits. This is a strong disincentive to enterprises performing IP enhancement activities in Hong Kong. As can be seen from the table below, Hong Kong is not an attractive jurisdiction to hold IP and the government should introduce suitable incentives to enhance Hong Kong's position.

Manufacturing plants and machinery

Among the priority industries listed in the 5YP is high-end manufacturing, which is an area where Hong Kong can directly assist the mainland. However, the tax system in Hong Kong does not assist this process. It is a common arrangement for a Hong Kong manufacturer to provide plant and machinery to a mainland enterprise which manufactures goods on its behalf. However, the Inland Revenue Department (IRD) considers that such arrangements amounts to a lease of the plant and machinery and denies a deduction for depreciation allowances on the basis that their use is wholly or principally outside Hong Kong. Despite repeated calls to the Hong Kong government to amend the relevant legislation this has not been forthcoming. The Hong Kong government should re-visit this matter to allow tax relief to Hong Kong manufacturers providing plant and machinery to mainland enterprises.

Determining the source of profits

Previously Hong Kong manufacturers were able to enter into contract processing arrangements with mainland enterprises. Under such contract processing arrangements, the IRD accepted that only 50% of the profits were assessable on the basis that they arise from manufacturing activities undertaken partly in Hong Kong and partly in the mainland. However, the mainland has been phasing out contract processing arrangements in favour of import processing and other arrangements.

Biography

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Darren Bowdern is a partner in corporate tax. He has been involved in developing appropriate structures for investing into the Asia Pacific region, tax due diligence reviews in connection with M&A transactions and advising on cross border transactions for more than 12 years. Many of these projects comprise tax effective regional planning including consideration of direct and indirect taxes, capital and stamp duties, withholding taxes and the effective use of double taxation agreements. He also advises on establishing direct investment, private equity and other investment funds in Hong Kong.

Darren graduated from the University of Melbourne and is a fellow of the Hong Kong Institute of Certified Public Accountants and a member of the Institute of Chartered Accountants in Australia.

Biography

Garry Laird

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Garry Laird is a senior tax advisor with KPMG. Before joining KPMG he was a tax specialist for more than 30 years, initially with the Australian Taxation Office before joining the Inland Revenue Department (IRD) in Hong Kong. His responsibilities with the IRD included the preparation of departmental interpretation and practice notes, examination of advance clearance applications, negotiation of double taxation agreements and assisting in the introduction of new tax legislation.

Garry advises clients on a wide range of technical issues and has assisted clients to obtain tax clearances from the IRD on a range of issues, such as Islamic financing, source of profits and the deductibility of interest expenses. He is the co-author of *Hong Kong Taxation Law & Practice*.

Garry holds a Bachelor of Economics from the University of Tasmania.

Whilst in substance import and contract processing arrangements are similar, the IRD considers that they are different and does not accept that import processing arrangements can be assessed on a 50:50 basis. The department considers that import processing arrangements are taxable as a trading arrangement, and that the profits are taxable if sourced in Hong Kong.

This situation is clearly anomalous and unfairly discriminates against Hong Kong manufacturers engaged in import processing. As the arrangements are in substance identical they should be placed on an equal footing.

Beneficial ownership test

Under the circular of the State Administration of Taxation (SAT), Guo Shui Han [2009] No. 601 (Circular 601), a non-Chinese resident enterprise in a treaty country or territory, such as Hong Kong, deriving dividends, interest or royalties from the mainland, will not be able to enjoy the treaty benefit unless it can show that it has economic substance in that treaty country or territory. This is referred to as the beneficial ownership test.

If the Hong Kong government provided tax incentives to corporate groups to use Hong Kong to hold investments in overseas subsidiaries, including Chinese subsidiaries, then more foreign investors will be motivated to establish such operations in Hong Kong and in turn to maintain a sufficient level of economic substance in Hong Kong. Such incentives could apply to regional headquarter functions, regional trading activities, shared services, R&D, etc. The incentives could take the form of a reduced tax rate, tax deductions and / or credits that are linked to the amount of investments held outside Hong Kong.

Similar requirements on economic substance in the territory of offshore investment holding companies also exist in another circular issued by the SAT, Guo Shui Han [2009] No. 698 (Circular 698), which deals with indirect disposals of equity interests in Chinese resident enterprises by foreign investors. To a certain extent, the abovementioned tax incentives may encourage foreign companies to set up offshore holding companies in Hong Kong to deal with the issues arising from Circular 698.

Time to make policy decisions

The 5YP presents an opportunity for Hong Kong to enhance its position as an international financial, trade and shipping centre and as an international asset management centre. However, to fully capitalise on these opportunities the Hong Kong government needs to make policy decisions and amend current tax legislation to ensure that it is compatible with both the 5YP and the mainland's support for Hong Kong.

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