



China tax in the digital age

Issue 1 –
China's digital economy becomes the
economy itself

Contents

Introduction	2
The state of the digital economy today	4
Key challenges to cross-border tax rules from the digital economy - Nexus	10
Key challenges to cross-border tax rules from the digital economy – Digital form of products and characterisation of income	14
Key challenges to cross-border tax rules from the digital economy – Use of data/value creation	17
How KPMG China can help	20
KPMG China contacts	21



This is the first in a series of publications, referred to collectively as China tax in the digital age, from KPMG China's Technology, Media and Telecommunications (TMT) division. This series will examine the existing and emerging tax implications of doing business in China's digital economy. As the Organisation for Economic Co-operation and Development (OECD) noted in its recent publication, 'Addressing the tax challenges of the digital economy': "the digital economy is increasingly becoming the economy itself." Nowhere is this more apparent, and perhaps nowhere are the consequences more far-reaching for the rest of the world, than in China.

The emergence of many new digital economy business models and their increasing use in cross-border activities has triggered a number of new and complex tax issues for companies operating in the TMT sectors. For direct taxes, as identified by the OECD, three key issues stand out: nexus, characterisation and data/value creation. Businesses and tax practitioners are only now starting to get their heads around these subjects.

This first issue in our publication series aims to provide an overview of these issues and seeks to explain how developments in the digital economy are affecting practically all businesses operating in China. Later issues of this publication series will explore these topics in further depth and will focus on specific sectors of the economy.

Introduction

This article is the first in a series of several publications from KPMG China's TMT team that seek to explain the tax implications of China's growing digital economy. This series will focus mostly on issues related to direct taxation. Those interested in learning more about the implications for indirect taxation should consult KPMG China's earlier publication: 'VAT and the digital economy in China.'¹

The OECD noted in a recent publication outlining its efforts to combat Base Erosion and Profit Shifting (BEPS) that "the digital economy is increasingly becoming the economy itself." Nowhere is this perhaps more apparent than in China. The easing of restrictions on inbound and outbound investment along with more flexible foreign exchange rules is allowing more and more companies to operate cross-border, both into and out of China and the country's cross-border digital economy is continuing to grow at breakneck speed as a result.

The rise in the number of digital economy businesses and their operation cross-border has led to many new and complex tax issues. **These businesses, along with many tax advisers, have raised concerns already regarding the implications for withholding tax (WHT), permanent establishment (PE) and transfer pricing (TP),** and are continuing to identify many other issues. The changes expected to be made to China's cross-border tax rules in relation to BEPS only adds to this uncertainty. China's State Administration of Taxation (SAT), the central government body responsible for setting tax policy, has been a major contributor to the global debate on new BEPS tax standards and recommended tax rule updates. In October last year, the government said it would support the BEPS outputs. The SAT has also said that new BEPS rules introduced by China would be accompanied by Chinese tax authorities taking a tougher stance on enforcement.

¹ OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project*, (OECD 2015), p. 11. <http://dx.doi.org/10.1787/9789264241046-en>. Referred to in the text as the 'BEPS Digital Economy Report'.

China has made several other changes to its tax framework to support the growth of the digital economy. These include new regulations, introduced in April, that make e-commerce platforms and postal couriers responsible for collecting indirect taxes from online traders and new arrangements that seek to expedite import and export clearance. China considers the digital economy an important part of the country's transformation from an economy dependent upon manufacturing and exports to one driven by services, consumption and innovation. **Businesses should brace themselves for a steady stream of new tax rules as the country's digital economy continues to expand.**

This publication provides an overview of issues related to direct taxation that are affecting companies operating across all sectors of China's economy as a result of the growth of the country's digital

economy. It pays close attention to three topics in particular that are affecting businesses in China, namely nexus, characterisation and data/value creation. The economic changes unleashed by the digital economy are rapidly making a number of the traditional practices and methods employed in levying and collecting taxes obsolete. This has forced Chinese policymakers to reconsider many of their existing assumptions regarding tax policy and will mostly likely prompt the government to introduce a number of changes to existing tax regulations. The challenge for policymakers will be to make sure that any new tax laws introduced will also keep pace with changes to the country's ever evolving regulatory framework.



The state of the digital economy today

The OECD commented in its report on the new BEPS regulations that:

“The digital economy is the result of a transformative process brought about by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardised, improving business processes and bolstering innovation across all sectors of the economy.”²

Recent developments in ICT have provided the platform for a number of the changes that have allowed the digital economy to grow. ICT has developed rapidly in a number of fields including personal computing, telecommunications, software, content, and cloud-based services. The OECD predicts that future growth areas will include the Internet of Things, virtual currencies, advanced robotics, 3D printing, the sharing economy and collaborative production. The advances in ICT, and the new technologies and businesses that these underpin them, give rise to numerous complex tax issues explored in this publication.

Advanced robotics

In the case of advanced robotics, statistics from International Data Corporation (IDC), a technology research firm, show that the sector is forecast to grow at a compound rate of 17 per cent per year globally and is predicted to be worth around USD 135 billion by 2019.³

The Financial Times said when commenting on these statistics that:

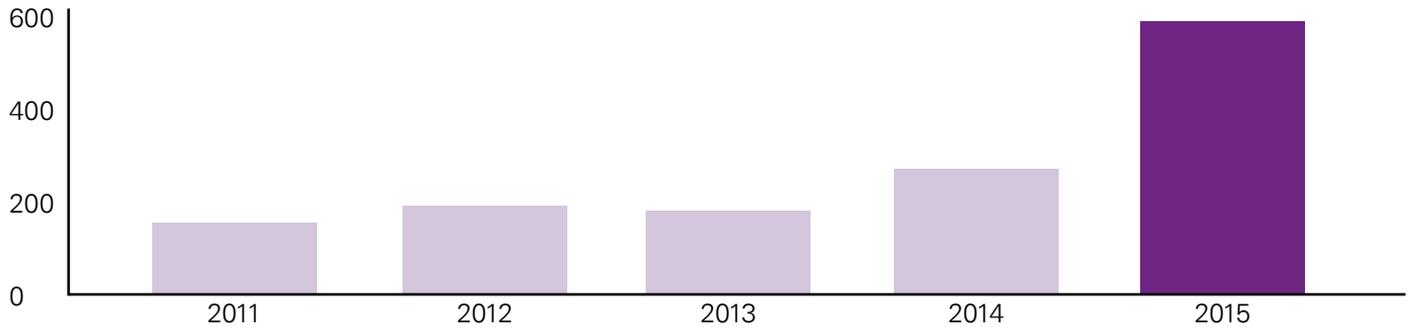
“The cheaper, flexible machines that are emerging are designed to be more adaptive. From driverless cars and drones to the ‘cobots’ that work alongside humans in industrial settings, they try to sense and adapt to their surroundings.”

This new generation of machines is capable of far more pervasive involvement and use in leisure and work than earlier generations of robots. Whereas previous robots were often expensive and useful only in carrying out certain repetitive tasks, for example on automobile manufacturing lines, this new generation of robots is capable of interacting with every aspect of a person’s life and can learn from experiences in order to improve their performance. This has the potential to transform the way value is created in the economy and has major implications for tax policy considering that policymakers throughout the world have been focusing their efforts on ensuring that tax is applied where value is created, following on from the OECD’s work on BEPS.

The graph below shows the growth in the last few years of investment in the global robotics sector:

² OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project*, (OECD 2015), p. 11. <http://dx.doi.org/10.1787/9789264241046-en>.

³ Financial Times, *Rise of the robots is sparking an investment boom*, 3 May 2016, <http://ftsyndication.com/redirect.php?uuid=5a352264-0e26-11e6-ad80-67655613c2d6&title=Rise%20of%20the%20robots%20is%20sparking%20an%20investment%20boom%20%E2%80%8B&action=article>.

Figure 1: Global investment in robotics (USD million)

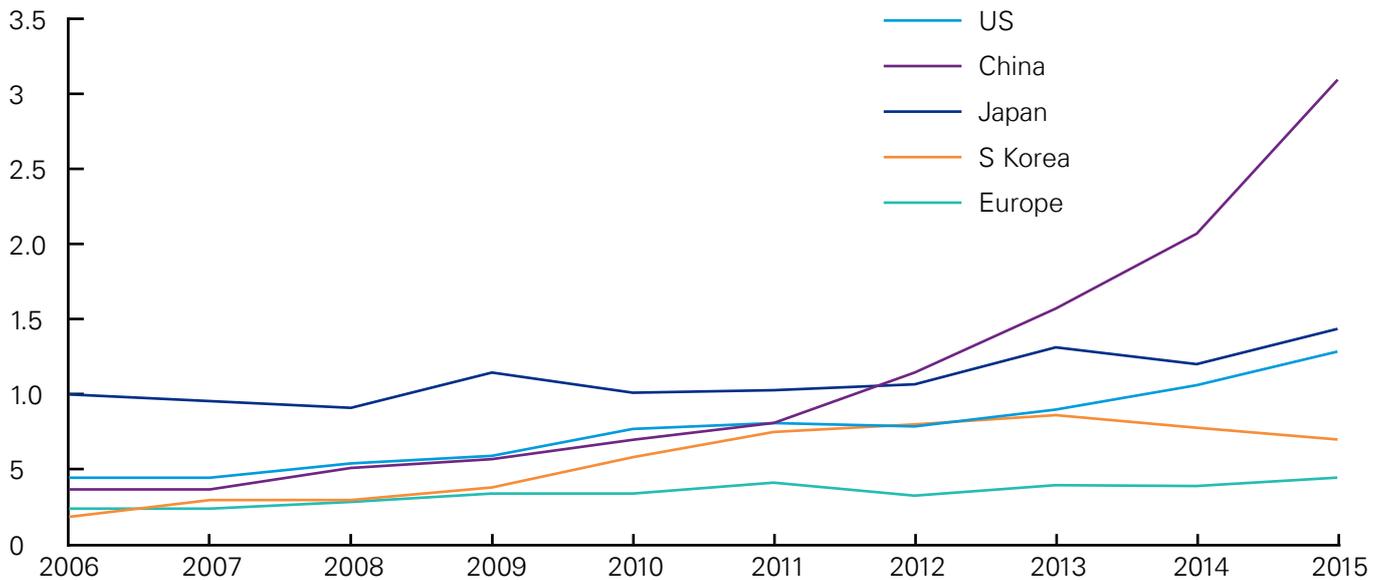
Source: *Financial Times, Rise of the robots is sparking an investment boom, 3 May 2016*

IDC statistics show that investment in robotics in Asia has surged in the last few years with Japan and China accounting for more than 65 per cent of all spending globally. Annual patent filings for robotics technologies, a good indication of the size of the market, have tripled

over the past decade, the *Financial Times* said citing statistics provided by IFI Claims, a US based patents database. China accounted for roughly 35 per cent of all robot-related filings last year, more than double the amount for Japan, its closest rival.⁴

Figure 2: Total robotic patent applications by location

Number of patents submitted ('000)



Source: *Financial Times, Rise of the robots is sparking an investment boom, 3 May 2016*

⁴ *Financial Times, Rise of the robots is sparking an investment boom, 3 May 2016*, <http://ftsyndication.com/redirect.php?uuid=5a352264-0e26-11e6-ad80-67655613c2d6&title=Rise%20of%20the%20robots%20is%20sparking%20an%20investment%20boom%20%E2%80%8B&action=article>.



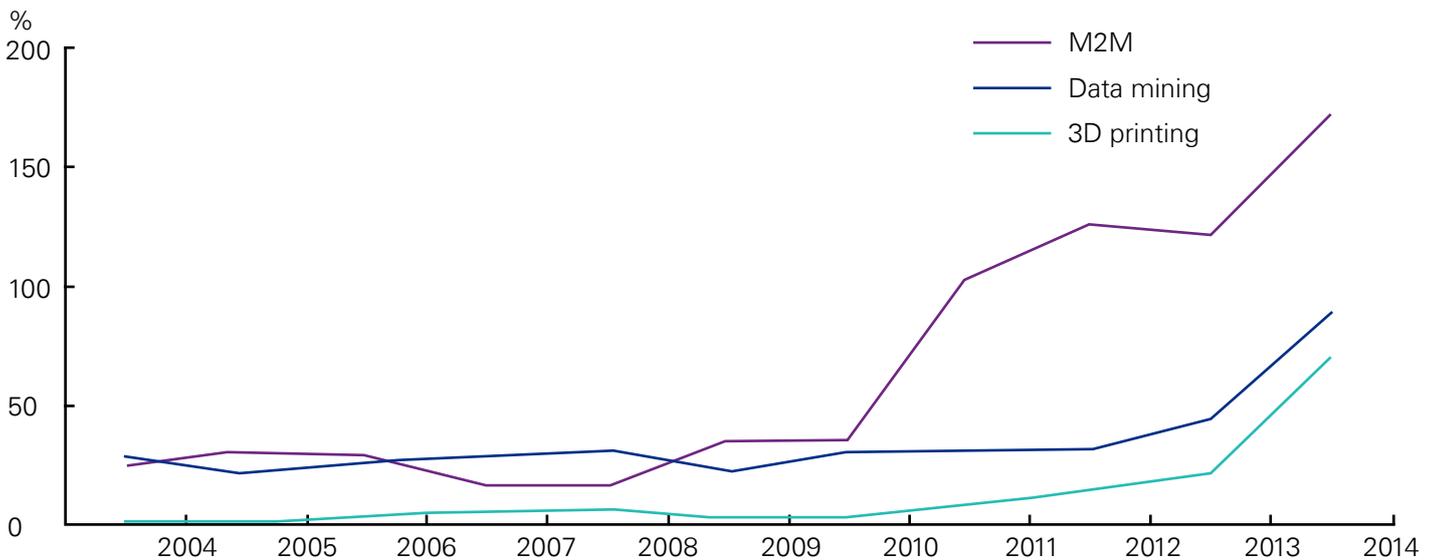
Other technologies

Statistics on patent registrations for machine-to-machine (M2M) learning, data analytics and 3D printing technologies over the past decade also demonstrate

the growth in a number of other emerging areas of ICT. These technologies have the potential to disrupt nearly all major industries, meaning that any tax issues that arise will affect nearly all sectors of the economy.

Figure 3: Patents on M2M, data analytics and 3D printing technologies, 2004-14

Per million PCT patent applications including selected text strings in abstracts or claims

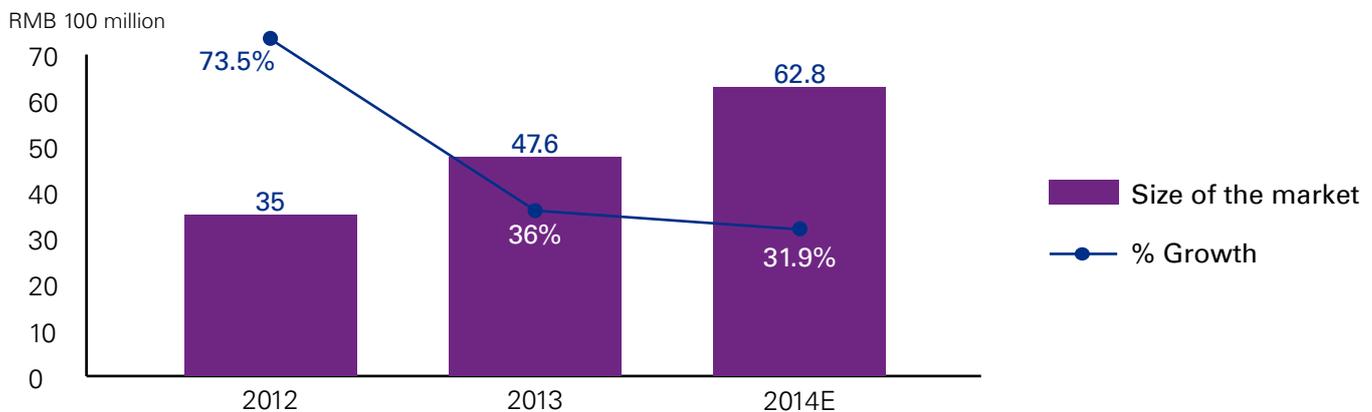


Source: OECD, *Measuring the Digital Economy: A New Perspective* (OECD 2014), p. 36.

Another example of the progress of China's digital economy is the cloud computing services industry. Investment in the industry increased by 31.9 per cent in 2014, although growth has since started to slow.⁵

Given the rapid progress being made in various ICT fields and the increasing use of these new technologies across all sectors of the economy, it is fair to say that the digital economy is fast becoming the economy itself, as the OECD noted.⁶

Figure 4: Size of China's public cloud service market



⁵ China Academy of Telecommunication Research of Ministry of Industry and Information Technology (MIIT) of the PRC, *White book on cloud computing (2014)*, May 2014, <http://data.catr.cn/bps/201405/P020140512339466051910.pdf>.

⁶ OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, (OECD 2015), p. 11. <http://dx.doi.org/10.1787/9789264241046-en>.

Big data

Most of these new technologies rely on data for their usefulness. Data gathered by robots and other devices interacting with humans can be used to monitor performance, design newer technologies and extract insights on consumer behaviour to aid marketing efforts. Data is also important for 3D printing, providing the instructions for new products to be designed.

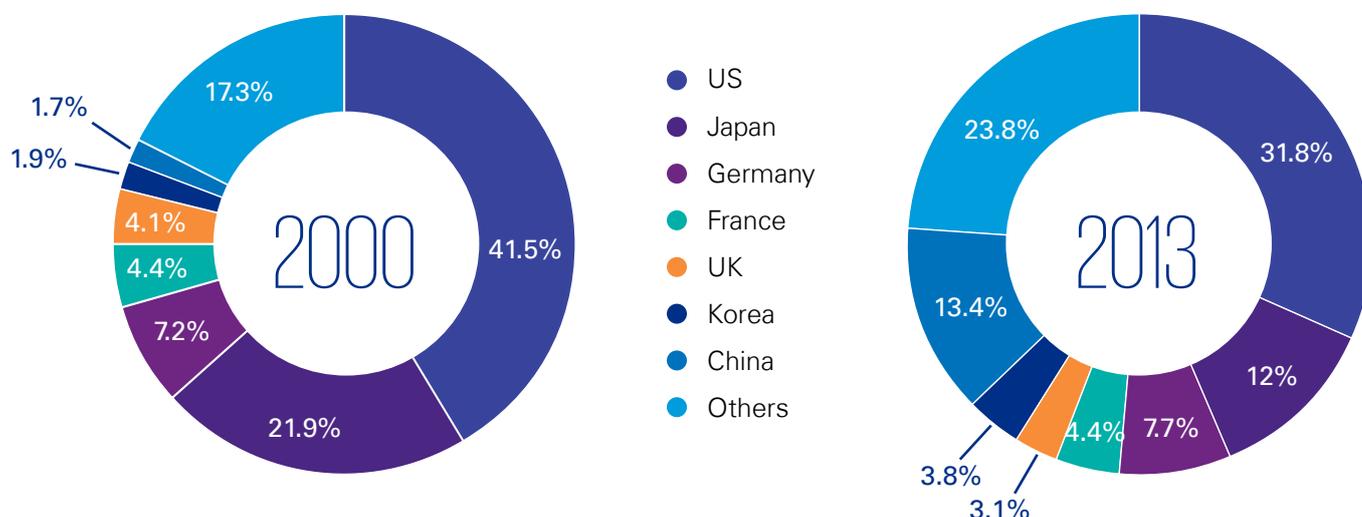
Data flows cross-border have surged in the last few years even as flows of finance, goods and services have started to slow. According to the United Nations Conference on Trade and Development (UNCTAD), around 50 per cent of all traded services are enabled through technology including cross-border data. This is expected to continue to rise as the UNCTAD estimates that by 2019 over half of the world's population will be connected to the internet.⁷ It is possible to imagine in the future that goods will no longer be sent to several countries to be processed at various stages along the value chain. Instead, data will be sent cross-border and the information will be used to enable goods to

be produced using 3D printing technology in a country close to where the consumer is located. While the flow of goods cross-border may slow, globalisation will continue to grow apace, albeit in a different form. As the twenty-first century digital economy ushers in a new era for globalisation, the impact on existing tax rules and regulations is expected to be profound and will raise questions, especially in relation to value creation.⁸

The promise of China's digital economy

According to China's Ministry of Science and Technology (MST), the country's R&D expenditure reached USD 191 billion in 2013, which was equivalent to 13.4 per cent of R&D expenditure globally. This was the first time that China's R&D exceeded Japan's, making China the second largest R&D market globally after the US. According to the most recent statistics, China spent roughly USD 212 billion on R&D in 2014, which represents a 9.9 per cent increase on the previous year.

Figure 5: R&D expenditure proportions of some key countries



Source: MST, *National Innovation Index Report 2014*, July 2015

⁷ United Nations Conference on Trade and Development, *Information Economy Report 2015: Unlocking the Potential of E-commerce for Developing Countries*, http://unctad.org/en/PublicationsLibrary/ier2015_en.pdf.

⁸ Financial Times, *Global trade: structural shifts*, 2 March 2016, <http://www.ft.com/intl/cms/s/0/0e0e6960-da17-11e5-98fd-06d75973fe09.html#axzz494tLvKE5>.



computing, high frequency trading and participative networked platforms. These new businesses employ a variety of different revenue models including advertising, digital content purchases or rentals, sale of goods (including digital products), subscriptions, sale of services, content and technology license, sale of user data and customised market research and 'hidden' fees and loss leaders. These new models bring with them a range of new and complex tax issues, which will be discussed in the following sections of this publication.

Rapid B2C market growth

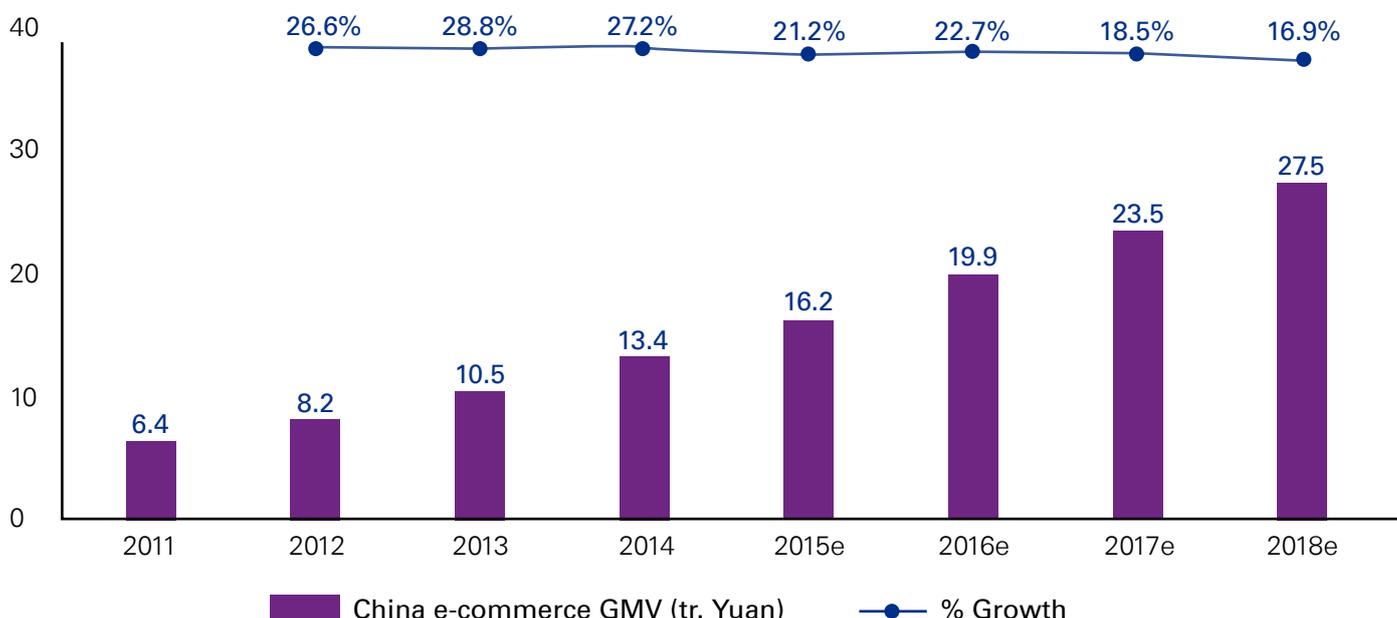
China's digital economy has outpaced most other major markets globally in the last few years. One of the reasons for this is the success of the country's e-commerce industry. China's online B2C market has increased one hundred fold since 2006, according to iResearch China, a professional market research and consulting company, and in 2013 overtook the US to become the largest market globally. The number of digital shoppers in China also grew tenfold during the same period, increasing from 30 million to 300 million. In 2015, online B2C sales in China reached RMB 3.8 trillion and are expected to more than double by 2018.⁹ This is impressive, especially considering that the Chinese B2B e-commerce is around nine times larger than its B2C market.

R&D investment aids innovation and has the potential to transform how people live, learn and work. The growth of China's digital economy is leading to the emergence of several new business models and has resulted in an increase in inbound and outbound trade and investment. The increase in R&D expenditure has also led to an increase in the number of intangible assets, one of the most challenging areas for tax law to deal with. China's tax law has not yet caught up with these new business practices so executives should prepare themselves for further legal changes.

The digital economy has triggered the emergence of several new business models such as e-commerce, payment services, app stores, online advertising, cloud

⁹ KPMG Global China Practice, China Outlook 2016. Accessible at <http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/china-outlook-2016-v1.pdf>.



Figure 6: China's e-commerce gross merchandise volume (GMV) 2011-2018

Source: iResearch, 2015 China's E-commerce & O2O Summary Report (2015 iResearch China)

China's B2C market has grown rapidly for several reasons. On the demand side, rapid GDP growth has driven up disposable incomes, particularly among the urban middle classes and the economy's shift from an investment based to a consumption based model has also boosted consumer spending. On the supply side, China's existing infrastructure, such as shopping malls and transport links, remains insufficient to support a massive expansion in retail and several online shopping platforms such as Alibaba's TMall and Taobao and JD.com have stepped in to fill the void. These companies have also leveraged the willingness of Chinese consumers to use online payment platforms such as Alipay and Wechat Pay, along with the relatively cheap labour available in many of China's cities, to expand their distribution networks.

Tax policy

The twin effects of regulatory changes and the emergence of new business models are fuelling the growth of China's digital economy. Several of China's most successful businesses have already started branching out into other markets overseas. This has inevitably triggered a number of tax policy issues and Chinese policymakers are working diligently on responding to these developments in conjunction with recent changes put forward by the OECD on BEPS. The following sections provide further insight on the tax implications of China's growing digital economy.





Key challenges to cross-border tax rules from the digital economy - Nexus

Policymakers, businesses and tax practitioners around the world have been grappling with direct tax issues created by the digital economy since e-commerce first emerged in the late 1990s. Among the many challenges arising as a result, three issues stand out as requiring special mention, which are those related to (i) nexus, (ii) digital form of products and characterisation of income, and (iii) value creation/data.

Nexus

The concept of 'nexus' under tax law relates to whether an enterprise, which is tax resident in one country, has sufficient connection with a second country from which it derives income. Where sufficient connection with the second country is established, the enterprise can be subject to tax there under that country's tax rules. Traditional cross-border tax rules, which are in place in most countries throughout the world, have often been insufficient to establish nexus in relation to digital economy businesses operating cross-border. This has occurred for several reasons as outlined below.

Key nexus deficiencies of pre-BEPS PE rules in relation to the digital economy

Physical presence focus



Traditional cross-border tax rules assume that a local physical presence will be needed by a foreign company. These rules assume that this is required so that the company is able to reach out to, and transact with, customers in another country and supply them with their product or service. The PE concepts as outlined in the OECD and UN Model Tax Conventions (MTC) look for a fixed place of business, through which the foreign enterprise conducts its business or for a person who acts as a local agent, which binds the foreign enterprise in contract.

Such local physical presence or representation is not necessarily required by digital economy businesses. These companies are able to market themselves to potential customers online. Their customers can place orders and make payments on the internet. The company can then send any physical goods from overseas via third party distributors. They can also supply customers with digital products via remote data transmission. In other words, the foreign company may not require any local market physical presence whatsoever. In the case of cloud computing services supplied from overseas, the flow of data cross-border does not necessarily require companies to set up a fixed place of work or hire a local agent.



For some of the new business models in the digital economy, physical presence nexus becomes even more redundant. Take those businesses reliant upon advertising revenue as an example, such as search engines. The search engine website users themselves will generally not pay for usage. However, these free users of the search engine comprise a huge market with extensive network effects. Companies wishing to advertise their product/service are willing to pay the search engine company for access to this market, displaying their adverts to users whose searches indicate they may have interest in a particular area. Since the users of the site, and the vendors that pay to advertise, may be located in different countries, difficult questions arise. Is a physical presence (if any) interacting with the users or with the advertisers more relevant? Where should advertising income be considered to have arisen from for nexus purposes? The location of the users or the location of the advertisers?

PE rule exclusions



To the extent that e-commerce traders do need a physical presence of some sort in the market jurisdiction, there have been ways to limit tax exposures. The OECD and UN Models treat many types of activities, which are physically conducted in a market country, as being insufficient to give rise to PE. It was implicitly assumed that while these activities could be supportive of the foreign enterprise's business, they would not generate much value by themselves. Specific exclusions were provided for activities considered to be simply preparatory or auxiliary in nature. These include, among others, warehousing for distribution and information collection. The interpretative guidance in the OECD MTC commentary further indicated that other apparatus and activities (e.g. mirror servers) could generally be considered preparatory or auxiliary.

The growth of the digital economy, in particular e-commerce, has challenged the status quo as it became clear that many of the functions that were previously designated as auxiliary could be central to value creation. Timely delivery of physical goods through expansive local warehousing operations could be key to the competitive advantage and commercial success of an e-commerce company. The timely, uninterrupted delivery of digital products or services through a local server could also provide companies with a competitive edge. If the specific exclusions were to remain part of the PE concept then activities critical to value creation might not be taxable by the market state as a result. This is because the assumption that these activities were low value has become outdated.

There has also been concern expressed that some digital economy businesses might have been carving up or 'fragmenting' their physical business operations within a country. This might be achieved by dispersing their activities geographically or placing different activities into separate legal entity subsidiaries. The effect of this could be that the fragmented activities would fall into the PE specific exclusions and avoid local tax nexus.

There has also been some concern that companies that sold their goods and services through the internet but whose sales processes involved extensive in-market liaison with customers were avoiding agency PE. 'Marketing support' subsidiaries in a market country would employ local staff, who would negotiate most of the terms of supply agreements. The staff would then direct customers to the company's website to place the order and provided that the local entity and its staff could demonstrate that they had conferred sufficiently with the overseas entity for instructions, they could argue that they had not been authorised to conclude contracts. Tax authorities would be unable to assert local market agency PE as a result.

The OECD BEPS work has sought to make upgrades to the OECD MTC PE definition to tackle some of the above issues.

OECD BEPS efforts to update PE rules

Specific exclusions

The list of activities that formerly benefitted from specific exclusions are no longer automatic exclusions. Rather, the activities must be individually assessed to see whether they are truly preparatory and auxiliary in the context of the business. To counter fragmentation, BEPS includes a special rule allowing for activities split across legal entities to be considered collectively.

Agency PE

An upgraded agency PE test considers whether local staff 'convinced' the local customers to buy the foreign enterprise's products. The focus is placed on whether these staff played 'the principal role' leading to the conclusion of contracts.

Digital nexus

The OECD did not recommend explicitly countries to adopt nexus approaches, which would completely do away with physical substance. However, it accepted that countries could move ahead with a number of novel nexus approaches provided that they respected their existing treaty commitments. A significant economic presence nexus test, a digital transaction WHT and an equalisation levy were recommended by the OECD. Countries such as India, Israel, Italy and Turkey have since announced or put forward proposals for new taxing approaches along these lines.





China's PE tax rules, which are embedded in the country's tax treaties, currently broadly follow the pre-BEPS OECD MTC as outlined above. This means that China's treaties also suffer from the same issues in taxing digital economy businesses mentioned above. The SAT has indicated its intention to adopt the BEPS proposals and has already begun the process of implementing them. The China-Chile tax treaty, which was signed in May 2015, includes all of the BEPS PE changes. The SAT has indicated that new Chinese PE recognition and profit attribution guidance is being developed and is expected to be released later this year or next year. The SAT has also said that some BEPS PE concepts might already be brought into effect under the current interpretive guidance on China's tax treaties.¹⁰ Digital economy businesses operating in China will therefore need to plan on the basis that the country's PE rules are in a state of transition.

As it stands, many of the foreign enterprises using pure play digital economy business models such as file sharing platforms, search engines and social networks are largely excluded from accessing the Chinese market due to the country's 'Great Firewall'. If China grants them access at a later point to operate freely cross-border into China, it will need to consider how to tax them. If these foreign enterprises set up operations locally to liaise with potential customers then this may, in some instances, provide a pretext to tax these foreign enterprises using the BEPS expanded Agency PE concept. Even for those companies that rely on Chinese servers, this might still provide sufficient grounds for tax authorities to assert fixed place PE.

At the same time, China has been lobbying internationally for a new interpretation of service PE. This interpretation suggests that services can be deemed to have been 'furnished in' China and can be taxed provided that

certain time thresholds are met even when these services are carried out overseas and provided remotely into China, through the internet. As an alternative, China may decide, like India, to implement one of the OECD's new digital nexus concepts. These would target businesses with a certain concentration of cross-border payments and sales in China and might also capture businesses that have tailored their interface or services towards Chinese digital consumers.

For those companies operating in established industries like education or healthcare, the approach China's tax authorities take towards nexus is equally important given the increasing preference of many of these companies for an internet based delivery approach. As a result, practically all businesses need to follow these developments in China closely.

For most B2C e-commerce businesses operating cross-border, the updated PE rules will affect them in several ways. In China, many foreign e-commerce businesses are increasingly using big online shopping platforms such as TMall international to reach Chinese customers. These platforms are already required to collect indirect taxes. For direct taxes, PE can be asserted for e-commerce traders on the following grounds:

- Warehousing in China (leveraging the new BEPS PE preparatory and auxiliary and anti-fragmentation rules),
- Local operations for the purpose of liaising with customers (using the new BEPS Agency PE rules),
- Use of servers (including, potentially, the usage of the servers of the online shopping platforms).

PE and nexus are expected to be among the most important topics discussed in the next several years in relation to cross-border taxation in China.

¹⁰ SAT Guoshuifa (Circular) 75 [2010].

Key challenges to cross-border tax rules from the digital economy

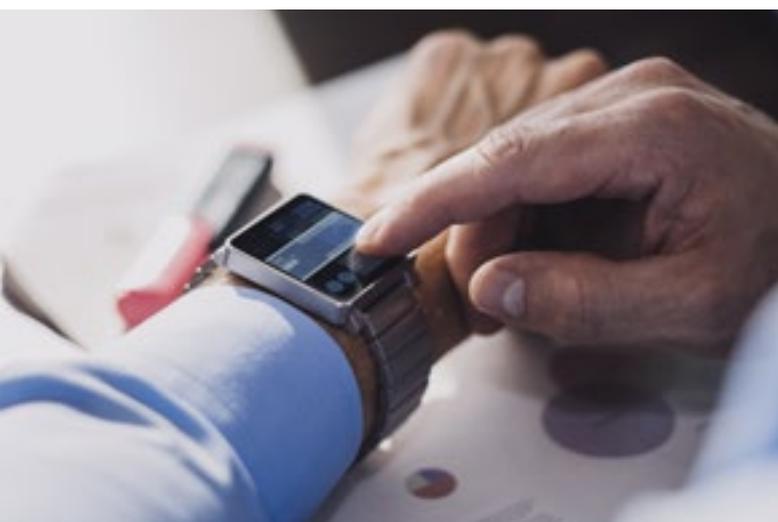
- Digital form of products and characterisation of income

The application of international tax rules hinges, to a great extent, on whether income streams are characterised as services, goods or royalties from licences of rights. Thresholds for the application of corporate tax depend on these characterisations. For example, under the OECD MTC, absence of a local PE with which sales or service income can be effectively connected means that payments characterised as business income will not be taxed by the jurisdiction in which the goods or service are supplied. On the other hand, if the income is characterised as a royalty, tax might be imposed even without a local PE. The tax collection method, whether on a withholding or assessment basis, is also affected

by characterisation. As noted in KPMG China's recent publication, 'VAT and the Digital Economy', VAT rates are affected by characterisation as well. For example, a digital book characterised as a good would be taxed at 17 per cent, whereas if it were characterised as a service it would be taxed at 6 per cent.

Digital offerings can be tailored to be supplied in a form that is most preferential from a tax perspective. Global tax policymakers have been focused for some time on making sure tax rules are structured properly to limit opportunities for tax planning, while at the same time making sure this does not act as a barrier to commerce. In spite of these efforts, no unified global approach to tackling these issues currently exists and countries around the world differ widely in their approach to imposing WHT on licenses of rights and provision of technology.

Most developed countries, guided by the OECD, seek to limit the circumstances in which incidental use of copyright by consumers of digital products, for example downloaded music or films, gives rise to license treatment and to royalties WHT. Many developed countries, in any case, apply zero per cent WHT to royalties in their domestic law or treaties. Developing countries, historically more often importers of intellectual property, technology and related advanced services, have tended to treat any use of rights as a trigger for applying royalties WHT (e.g. incidental use of copyright when a person downloads music for their own consumption). Developing countries are also generally quick to identify



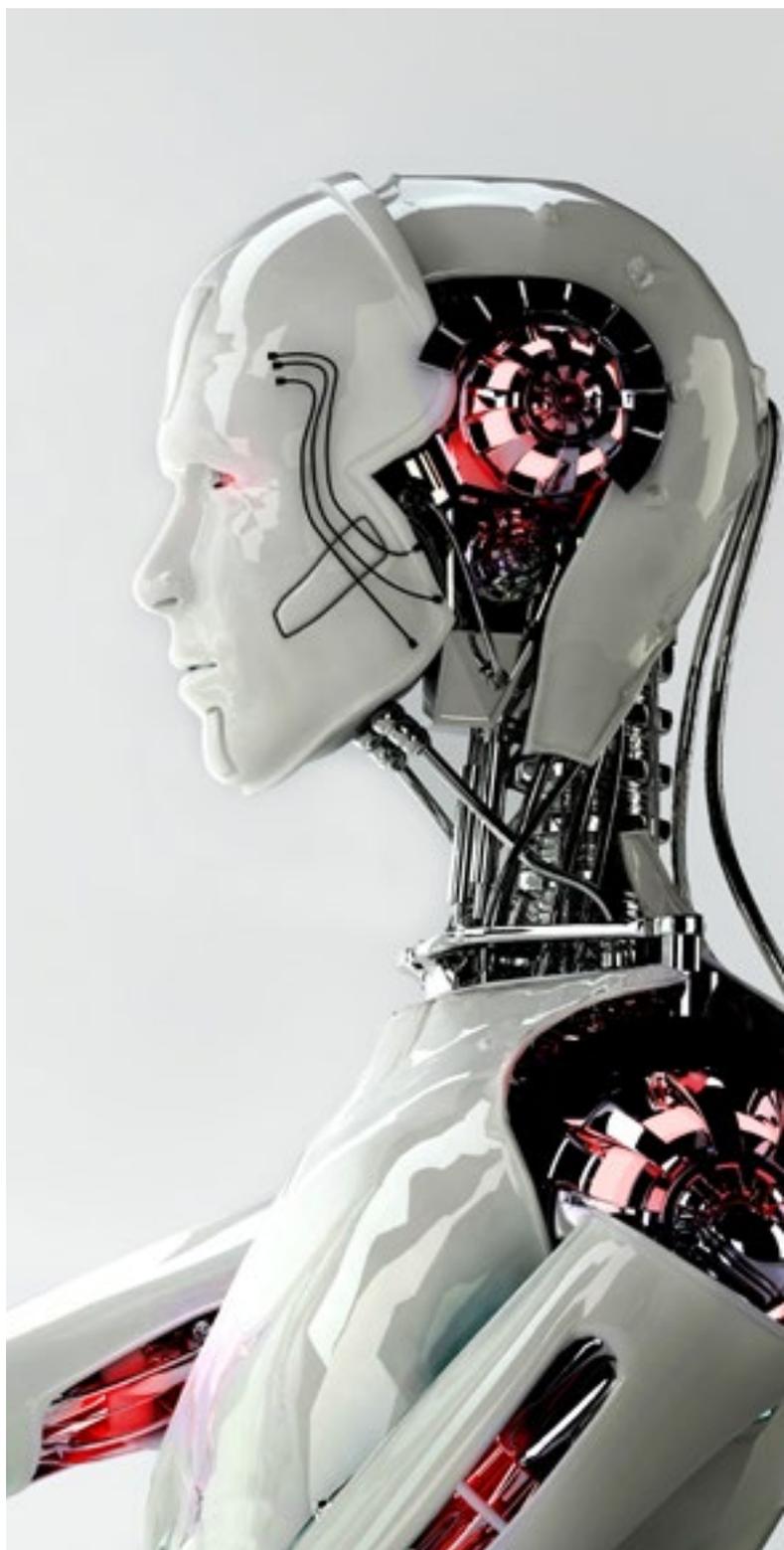
a deemed import of know-how, embedded in advanced services, and to use this as justification for applying WHT (e.g. technical advice on installation and use of an advanced robot). In relation to this, developing countries have also largely reserved the right to apply positive rates of royalty WHT in their treaties. China also generally follows this approach in its treaties.

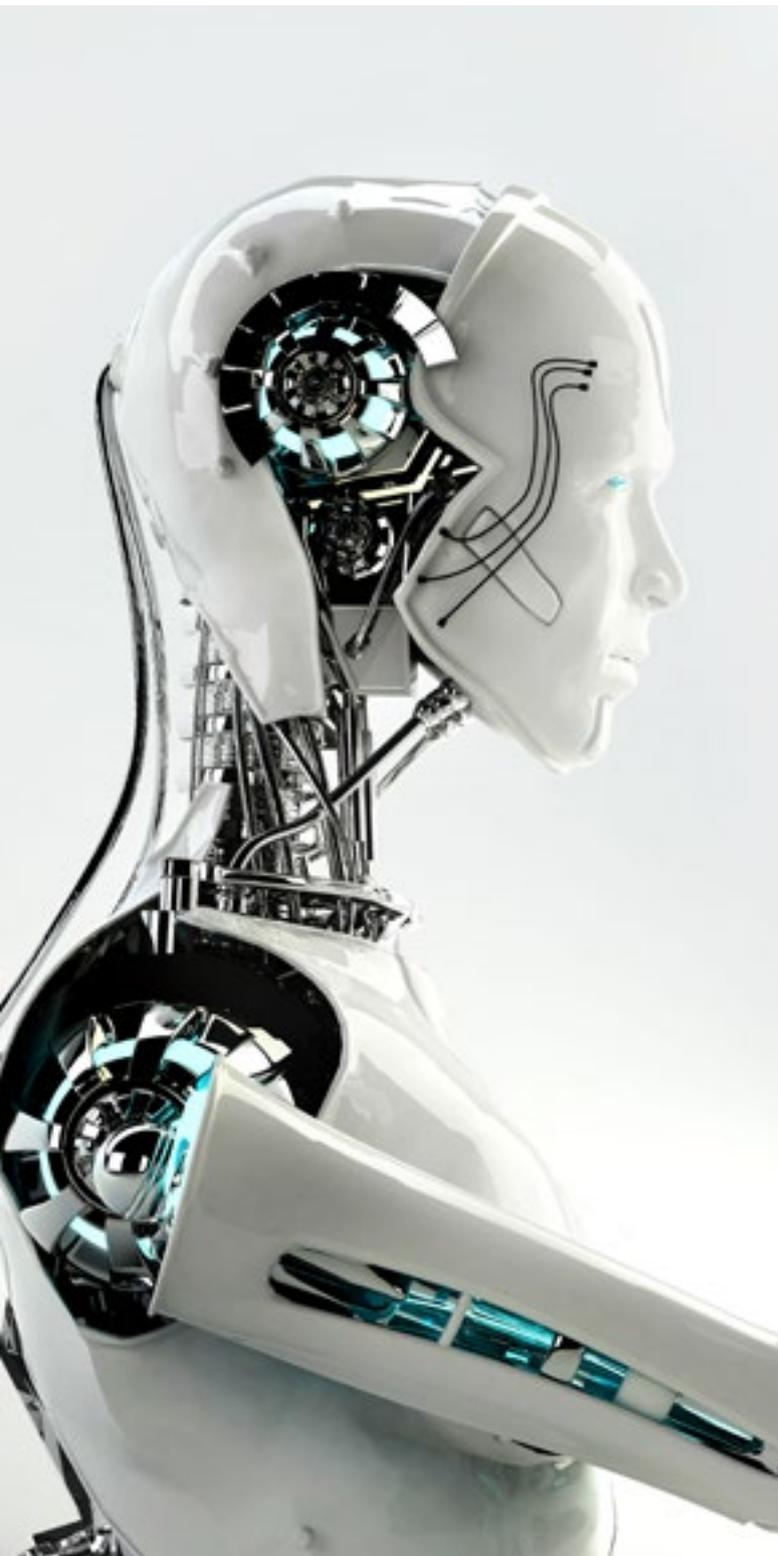
Developing countries are working together in various efforts aimed at strengthening these WHT approaches. The most notable example is the UN's development of a technical services article for inclusion in the UN MTC from 2017. The OECD is continuing its work examining income characterisation for new forms of digital technology such as cloud services. In line with its previous work, the OECD is expected to seek to limit the circumstances in which the provision of digital services gives rise to royalty treatment.

Looking further ahead, income characterisation issues are set to become even more important given the rapid development of China's digital economy and these challenges affect nearly all industries. In healthcare, for example, care providers are increasingly opting to outsource a number of processes overseas such as maintenance of patient records and testing of blood samples. Some of this may occur automatically, for example cancer scanning devices automatically sending data to outsourcing centres for processing, analysis and return. This fusion of hardware and the internet is at the heart of the internet of things as discussed previously.

How will China's tax authorities characterise these payments? Will they argue that the value added by data transformation processes conducted overseas on Chinese data generates an intellectual supply back to the Chinese entity and therefore treat any payments from China as a royalties subject to withholding tax? Will they treat these payments as service fees and argue that these services are furnished in China through the internet and a service PE exists? If China's tax authorities take this approach, will they require the overseas service provider to register a tax branch or will they require the company paying the fees to withhold tax? Could China argue that the cancer scanning machine is itself a fixed place through which services are rendered and therefore qualifies as a PE?

Such questions will become important as new technologies like 3D printing become mainstream. If a





foreign company instructs a manufacturer in China to print a product purchased by a Chinese customer, where does the value lie? Is the Chinese customer paying for a design to be transmitted from overseas to a 3D printing firm? Should withholding tax be applied to this payment as a royalty or should it be treated as a services payment? Will this apply if robots at a Chinese factory are remotely controlled from overseas? The list of potentially complex situations goes on.

Another important subject is the role of intermediaries. The early phase of the digital economy appeared to render the use of traditional commercial intermediaries obsolete in the collection of taxes. Before the internet, popular music was often distributed to customers by a company that manufactured physical records and CDs. These companies would license the right to reproduce the music, often from companies based overseas, and the value added by this intermediary could be taxed by the market country both at the level of the distributor's profits and by imposing WHT on the license fees to the foreign holder of the rights to the music. The growth of the internet provided a channel for music to be sold to users directly without the need of many of these intermediaries and removed the taxing points to be levied.

The emergence of new e-commerce intermediaries including online shopping platforms, app stores and large scale e-commerce couriers has created new taxing points for market jurisdictions. The OECD has advised that online shopping platforms and couriers may be responsible for collecting VAT in its BEPS Deliverables.¹¹ China responded to this advice in April 2016 by publishing Circular 18 [2016].¹² China also plans to make online shopping platforms responsible for supplying information on e-commerce traders for direct tax enforcement purposes in its Tax Collection and Administration Law, which is due to be issued in 2017. Although tax collection issues resulting from loss of intermediary bodies in the early phases of China's digital economy are now becoming less of an issue as new intermediaries are now filling the gap, the tax authority's reliance on these bodies does raise some tax compliance issue for the intermediaries. The government will need to provide further clarification on intermediary roles and obligations as time goes on. It also unclear at this stage whether China, in addition to using such intermediaries to collect indirect taxes, will make these organisations responsible for collecting direct taxes as well.

¹¹ OECD [2015], *supra* n.1. p.119.

¹² SAT/MOF/GAC Cai Guan Shui (Circular) 18 [2016].

Key challenges to cross-border tax rules from the digital economy – Use of data/value creation

The digital economy has overturned many of the traditional assumptions regarding cross-border tax rules, in particular in relation to how and where value is created. The traditional approach taken in transfer pricing was generally to identify the ‘simpler’ MNE group entities, in terms of functions conducted and risks assumed, and reward them for their contributions. Residual profits, from ownership of intangibles and from contractual risk bearing, would be left with the MNE group parent company or other subordinate regional coordinating group entities.

However, as highlighted by the OECD’s BEPS Digital Economy report, the inherent mobility of the digital economy undermines the acceptability of the outcomes from such traditional approaches to tax.¹³ By mobility, this refers to instances either where value-creating digital business functions can be located (e.g. data processing ‘in the cloud,’ virtual co-ordination of marketing and development operations from group entities in low tax jurisdictions) or where value-creating intangibles are located within a global corporate group (e.g. IP transferred to group entities in low tax jurisdictions).



¹³ OECD [2015], supra n.1, p.64.



China and India, in particular, have already taken steps to respond to the outcomes of these approaches pre-BEPS. Both have taken a strong stance on the importance of local market features when conducting TP analysis on the variety of ways in which value is contributed to intangibles. They have also expressed scepticism towards contractual allocations of risk and towards the value of intra-group service and royalty payments. The OECD has sought to integrate these positions, to varying degrees, in the BEPS changes to the OECD's TP Guidance.

The new BEPS TP guidance will significantly affect different business models for companies operating in the digital economy given their reliance upon intangible assets and the difficulty in determining the location of data manipulation functions. The OECD is continuing to work on its TP profits split guidance and has intimated that the integrated nature of digital economy business models may call for greater use of profit splits for these enterprises. The new disclosures on MNE profit, asset and activity distribution over jurisdictions, through country-by-country (CBC) reporting, will certainly lead to

digital economy businesses facing greater scrutiny than they have done previously.

It is unclear at this stage whether countries such as China and India will be able to reach a consensus with more developed countries on the TP attribution of profits. Even though the new OECD TP rules have sought to take their views on board, both countries are expected to push for an approach that emphasises the market and places less emphasis on strategic control functions in relation to allocation of profits.

An important area for future discussion will be the extent to which data and the platforms through which individuals share their data contribute to value creation. Many pure play digital economy business models (e.g. search engines, social networks) derive value from collecting data on their customers. Companies then use this data to improve their products and services or sell the information to other organisations. This also applies to many businesses operating in more established sectors such as healthcare and education. Many organisations operating in these industries have collected



extensive data through their day-to-day business activities and can now put this information to other uses. Some new digital economy business models also add value by providing a platform through which users exchange data, making them effectively the gatekeepers for access to this pool of individuals. Examples of this include file sharing sites, social networks and search engines, which allow third parties to advertise to their platform users.

The most important question is how data use and the platforms through which data is exchanged should interact with TP approaches. There exists a conundrum in reference to nexus rules when data comes from one country and revenue, for example from advertisers, comes from another. This renders any discussion of where value is created challenging. Is it created where the users are located or is value created where the advertisers are located since the data is used by advertisers in the value creating process of targeting customers and tailoring adverts that generate business? Potentially, value is created where the platform that shares/processes the data is based or even where usable insights are extracted, which may be in a third country.

What about if an enterprise provides internal data on its products to a crowd-sourced group of innovators for free and rewards them for any improvements they suggest? Is the value created where the crowd-sourced innovators are located or where the enterprise sifting through and implementing their ideas is based? If several of these value creating activities have validity, how is value between these different activities shared?

While this is often identified as an issue, there have not been any convincing solutions to date. Senior SAT officials have hinted on separate occasions that China's large market of users supercharges the value of existing MNE intangibles that have originally been developed overseas and that this should be recognised in discussions about value creation. The extent to which Chinese customers are engaged with the digital economy also means that the amount of data collected in China is growing rapidly and, as identified in the OECD's work, challenges remain in ascribing value, in TP practice, to such data. As a result, important matters to clarify in Chinese TP practice are the value of the market and the value of market relevant data.



How KPMG China can help

This article highlights both the challenges of China's tax system in relation to the digital economy and also the raft of changes that lie ahead.

China has made clear its intention to be a global thought leader in international taxation, including in relation to the digital economy. This makes sense given that so many new digital economy business models are being pioneered in China and gaining scale in China is important for most companies operating globally. This puts China in the position of being a global laboratory for digital economy tax issues and solutions. China's Ministry of Finance launched its International Tax Research Centre at the G20 summit in Shanghai last year. The organisation will cooperate with international bodies like the OECD, other governments and academia to advance thinking in international tax policy design.¹⁴ Following on from this, businesses should prepare for a steady stream of papers and policy proposals on taxation in relation to the digital economy.

To support these efforts, KPMG China will continue to issue publications in this series, outlining the latest tax

policy developments both in China and internationally as well as their significance for companies operating in China's digital economy.

KPMG China has a dedicated team of tax professionals with a thorough understanding of the practical and commercial implications for businesses operating in the digital economy. The team assists its clients in a number of areas including:

- explaining how the current rules apply to businesses operating in the digital economy,
- preparing and managing tax risk in a rapidly changing compliance environment,
- structuring supply chains to optimise tax outcomes for both direct and indirect taxes,
- representing the tax concerns of digital economy businesses to China policy makers so that a modern and responsive tax framework for digital businesses is put in place.

¹⁴ See Communiqué, G20 Finance Ministers and Central Bank Governors Meeting, Shanghai, February 27, 2016. <http://www.g20.utoronto.ca/2016/160227-finance-en.html>.

KPMG China contacts

National



Khoon Ming Ho

Head of Tax
KPMG China
T: +86 (10) 8508 7082
E: khoonming.ho@kpmg.com



State Shi

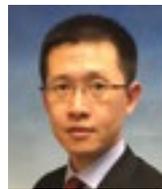
Head of Technology, Media &
Telecommunications (TMT), Tax
KPMG China
T: +86 (10) 8508 7090
E: state.shi@kpmg.com

Northern China



Vincent Pang

Tax Partner
KPMG China
T: +86 (10) 8508 7516
+86 (532) 8907 1728
E: vincent.pang@kpmg.com



State Shi

Tax Partner
KPMG China
T: +86 (10) 8508 7090
E: state.shi@kpmg.com

Central China



Grace Xie

Tax Partner
KPMG China
T: +86 (21) 2212 3422
E: grace.xie@kpmg.com



Sunny Leung

Tax Partner
KPMG China
T: +86 (21) 2212 3488
E: sunny.leung@kpmg.com



John Wang

Tax Partner
KPMG China
T: +86 (21) 2212 3438
E: john.wang@kpmg.com

Southern China



Lilly Li

Head of Tax, Southern Region
KPMG China
T: +86 (20) 3813 8999
E: lilly.li@kpmg.com



Kelly Liao

Tax Partner
KPMG China
T: +86 (20) 3813 8668
E: kelly.liao@kpmg.com

Hong Kong



Benjamin Pong

Tax Partner
KPMG China
T: +852 2143 8525
E: benjamin.pong@kpmg.com



Daniel Hui

Tax Partner
KPMG China
T: +852 2685 7815
E: daniel.hui@kpmg.com

Mainland China

Beijing

8th Floor, KPMG Tower, Oriental Plaza
1 East Chang An Avenue
Beijing 100738, China
Tel : +86 (10) 8508 5000
Fax : +86 (10) 8518 5111

Beijing Zhongguancun

Room 603, Flat B, China Electronic Plaza
No.3 Danling Street
Beijing 100080, China
Tel : +86 (10) 5875 2555
Fax : +86 (10) 5875 2558

Chengdu

17th Floor, Office Tower 1, IFS
No. 1, Section 3 Hongxing Road
Chengdu, 610021, China
Tel : +86 (28) 8673 3888
Fax : +86 (28) 8673 3838

Chongqing

Unit 1507, 15th Floor, Metropolitan Tower
68 Zourong Road
Chongqing 400010, China
Tel : +86 (23) 6383 6318
Fax : +86 (23) 6383 6313

Foshan

8th Floor, One AIA Financial Center
1 East Denghu Road
Foshan 528200, China
Tel : +86 (757) 8163 0163
Fax : +86 (757) 8163 0168

Fuzhou

Unit 1203A, 12th Floor
Sino International Plaza, 137 Wusi Road
Fuzhou 350003, China
Tel : +86 (591) 8833 1000
Fax : +86 (591) 8833 1188

Guangzhou

38th Floor, Teem Tower
208 Tianhe Road
Guangzhou 510620, China
Tel : +86 (20) 3813 8000
Fax : +86 (20) 3813 7000

Hangzhou

8th Floor, West Tower, Julong Building
9 Hangda Road
Hangzhou 310007, China
Tel : +86 (571) 2803 8000
Fax : +86 (571) 2803 8111

Nanjing

46th Floor, Zhujiang No.1 Plaza
1 Zhujiang Road
Nanjing 210008, China
Tel : +86 (25) 8691 2888
Fax : +86 (25) 8691 2828

Qingdao

4th Floor, Inter Royal Building
15 Donghai West Road
Qingdao 266071, China
Tel : +86 (532) 8907 1688
Fax : +86 (532) 8907 1689

Shanghai

50th Floor, Plaza 66
1266 Nanjing West Road
Shanghai 200040, China
Tel : +86 (21) 2212 2888
Fax : +86 (21) 6288 1889

Shenyang

19th Floor, Tower A, Fortune Plaza
61 Beizhan Road
Shenyang 110013, China
Tel : +86 (24) 3128 3888
Fax : +86 (24) 3128 3899

Shenzhen

9th Floor, China Resources Building
5001 Shennan East Road
Shenzhen 518001, China
Tel : +86 (755) 2547 1000
Fax : +86 (755) 8266 8930

Tianjin

Unit 06, 40th Floor, Office Tower
Tianjin World Financial Center
2 Dagu North Road
Tianjin 300020, China
Tel : +86 (22) 2329 6238
Fax : +86 (22) 2329 6233

Xiamen

12th Floor, International Plaza
8 Lujiang Road
Xiamen 361001, China
Tel : +86 (592) 2150 888
Fax : +86 (592) 2150 999

Hong Kong SAR and Macau SAR

Hong Kong

8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
23rd Floor, Hysan Place
500 Hennessy Road
Causeway Bay, Hong Kong
Tel : +852 2522 6022
Fax : +852 2845 2588

Macau

24th Floor, B&C, Bank of China Building
Avenida Doutor Mario Soares
Macau
Tel : +853 2878 1092
Fax : +853 2878 1096

kpmg.com/cn

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2016 KPMG, a Hong Kong partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. Printed in Hong Kong.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Publication number: HK-TAX16-0001

Publication date: July 2016