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Roadmap of China's international taxation policies for the current five- year-plan period

According to an official newspaper supervised by the State Administration of Taxation (SAT), the SAT recently released an internal circular entitled *Guidance on the Administrative Mechanism for International Taxation* for the 2011 - 2015 five-year-plan. This may be the first time that the Chinese tax authorities have mapped out such a comprehensive roadmap of China's international taxation policies for a reasonable timeframe.

In June 2012, a senior tax official from the SAT's International Taxation Department delivered the keynote speech at PwC's Hong Kong Tax Symposium. The SAT official elaborated on the aforementioned circular with respect to the trend shaping China's international taxation policies for 2012 and the coming decade.

This newsalert summarizes the speech's key points along with our observations.

Objectives of China's international taxation development

The SAT official highlighted the following objectives of China's international taxation development during the current five-year-plan period and beyond:

- Protecting China's tax base and national interest;
- Improving the quality of international tax administration;
- Eliminating double taxation;



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- Focusing on double non-taxation;
 - Building a fair, efficient, transparent, and internationally collaborative tax system;
 - Improving services to taxpayers; and
 - Facilitating discourse on international taxation.

Key focus areas of China's international taxation policies

The SAT official discussed how the following policies will help achieve the above objectives:

Anti-tax-avoidance policies

New initiatives in this area include:

- Standardizing the anti-tax-avoidance procedures by establishing a joint-hearing/panel review mechanism;
- Broadening the scope of the anti-tax-avoidance regime;
- Broadening the types of enterprises subject to scrutiny from foreign investment enterprises to include domestic enterprises, especially enterprises that are going abroad;
- Expanding the industry focus from manufacturing and processing industries to tertiary industries such as financial and trade services;
- Broadening the types of targeted related-party transactions beyond purchases and sales of tangible assets to include transfers of equity and intangible assets, as well as financing activities;
- Expanding application of the procedures beyond the southeast coastal area to the central and western regions;
- In addition to transfer pricing (TP) and advance pricing arrangement (APA) administration, exploring new anti-tax-avoidance measures with respect to cost allocations, controlled foreign corporations (CFCs), thin-capitalization, and the general anti-avoidance rule (GAAR); and
- Broadening the use of quantitative analytical methods in value chain analysis and in assessing the value of equity and intangible assets, China market premiums, and cost/location savings to ensure that profits are properly reported in China.

PwC observations: The global financial turmoil and current economic difficulties in the West could lead countries to compete for tax revenues. Against this international and macroeconomic backdrop, the SAT is concerned about the erosion of China's tax base should other countries collect tax to which the SAT believes China is entitled. The SAT also believes that China should collect tax from multinational businesses, both inbound and outbound, that are paying no (or minimal) tax anywhere. We expect the Chinese tax authorities soon to increase efforts to protect tax revenues generated from cross-border transactions.

The new focus on industries and targeted transaction types for anti-tax-avoidance administration and investigation echo the transformation of China's economy. Previously, Chinese tax authorities focused on the purchase and sale of tangible goods. Going forward, diversified transaction types including services, equity, and intangible asset transfers also would fall within the scope of Chinese anti-tax-avoidance examinations. In assessing equity and intangible asset transfer transactions, the SAT acknowledges the importance of valuation and is working on a

set of valuation rules. The Chinese tax authorities are notifying taxpayers that they can handle more complex TP/tax issues as they build their technical skills and practical experiences.

China is moving to a new stage of anti-tax-avoidance enforcement following the experimental phase of using GAAR to combat indirect equity transfers of Chinese companies. More tax rules include the anti-tax-avoidance concept, including treaty benefit claims and group restructuring. China also is contemplating embedding more general anti-tax avoidance concepts and provisions in amendments to the individual income tax law and other tax laws.

Non-resident tax administration

New initiatives in this area include:

- More interaction and cooperation with tax-resident enterprises (TREs);
- For non-tax-resident enterprises (non-TREs) having an establishment or a place (collectively referred to as establishment) in China, the tax administration will focus on tax registration and proper profit attribution; for non-TREs without an establishment in China, the focus will be on the enforcement of withholding at source; and
- Intensifying the administration of granting treaty benefits; while challenging treaty shopping by increasing the scrutiny of beneficial ownership.

PwC observations: Annual tax revenue collected from non-TREs in China surpassed RMB100 billion in 2011, representing significant year-on-year growth of 31.8 percent. We anticipate this growth to continue in 2012 and beyond. The SAT will continue to focus on tax administration and tax collection from non-TREs, so that they pay their appropriate share of tax for their operations and investments in China. The SAT has found that the interaction and cooperation between the administration arms for non-TREs and TREs is useful for monitoring the tax revenue collections from non-TREs, because TREs are the service recipients, withholding agents, payers, or targets (e.g., equity transfers) of the non-TREs' taxable activities. However, under this approach, the SAT would have to better enforce withholding obligations and impose more onerous reporting requirements on the TREs so that the TREs could encourage and perhaps even monitor non-TRE tax compliance.

The SAT would adopt different risk management approaches for different non-TRE groups. For those with an establishment in China, the SAT official expects more detailed guidance for calculating the fair share of profits attributable to the establishment and cost allocation. Non-TREs without an establishment in China would receive more attention with respect to income flows, particularly when the income flows to tax havens. In granting treaty benefits, the SAT would continue to monitor the beneficial ownership issue.

Improvement of services and tax administration to Chinese enterprises investing abroad

New initiatives in this area include:

- Improving tax policies governing the reporting and tax collection of foreign income and claiming foreign tax credits (FTCs) in China, and improving export tax-refund policies to support the needs of Chinese enterprises going abroad;
- Supporting the interpretation and application of tax treaties and assistance

in resolving bilateral tax controversy via Mutual Agreement Procedures (MAPs); and

- Standardizing and strengthening corporate income tax (CIT) administration regarding the determination of overseas-registered Chinese-capital CFCs as Chinese TREs according to the concept of 'place of effective management'.

PwC observations: The SAT's workplan for Chinese outbound investment enterprises may be a 'double-edged sword'. On one hand, the Chinese tax authorities would support and service Chinese enterprises investing abroad. According to the SAT official, China would develop more concrete workplans, including new tax treaties with jurisdictions that have Chinese outbound investments but no tax treaty with China. More notably, the new emphasis on MAPs reflects the SAT's commitment to help its residents settle cross-border disputes and discrimination via proper and effective procedures.

On the other hand, the workplan highlights potential tax loopholes that the SAT would monitor. The SAT already is focusing on anti-tax-avoidance administration and investigation of Chinese enterprises, in particular on TP and CFC issues for enterprises going abroad. In response to the increasing need for an escalated and centralized administration of Chinese enterprises going abroad, the SAT would set up a new division for foreign income tax administration.

International collaboration

New initiatives in this area include:

- Carrying out various competent authority functions under Sino-foreign tax treaties;
- Promoting and applying all forms of exchange of information (EoI) including on request, automatic, and spontaneous; and
- Studying authorized representative visits, joint international tax audits, industry-specific EoI, and mutual assistance for tax collection.

PwC observations: China acknowledges that effective EoI is the key to international tax collaboration and recently has advanced adherence to the high standards of international cooperation in EoI. One example is speeding up the negotiation and signing of tax information exchange agreements (TIEAs) with low-tax jurisdictions and tax havens. China's recent success in meeting the assessment requirements by the peer review of Global Forum on Transparency and Exchange of Information for Tax Purposes¹ is another. The SAT plans to further implement EoI as an effective tool to combat tax evasion and avoidance, in particular for TP, treaty shopping, and inappropriate cost deduction issues.

Conclusion

We believe the SAT's vision of China's international taxation policies provides a roadmap for 2012 and beyond. The Chinese tax authorities are fine-tuning their approach to enforce compliance on both inbound and outbound investments. They also are leveraging various resources including tax legislation, information

¹ After assessing the legal and regulatory framework as well as the practical implementation and effectiveness of this framework in China, the peer review confirms in its review report on China published in June 2012 that, notwithstanding some recommendations for improvement, China's practices with respect to exchange of information in tax matters are of a very high standard and have met the international standards for transparency and exchange of information for tax purposes.

technology, and human resource support to increase capabilities and achieve higher work quality. Of course, the roadmap also presents many challenges to the SAT and its branches.

In response to the observable trends in China's international taxation policies, taxpayers should expect more tax compliance requirements, more disclosure and reporting obligations, and more inspections for those graded as high tax risk. But at the same time, the roadmap reflects fair competition, tax certainty, transparency, and sustainability for taxpayers.

The changing tax environment could challenge many taxpayers. Businesses in China should monitor the local financial, tax and operating environment. Taxpayers should establish sound internal tax risk control and management mechanisms to ensure self-compliance. Furthermore, proactive and efficient communications with local tax authorities would help build and enhance trust and effective channels to help address uncertainty and resolve any potential tax controversies and disputes.

PwC will continue to monitor developments and will issue newsalerts as appropriate.

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