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CHINA TAX ALERT

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OECD 2015 BEPS Deliverables issued and China's response

Regulations discussed in this issue:

- Organisation for Economic Co-operation and Development ("OECD") Action Plan on Base Erosion and Profit Shifting issued on 19 July 2013
- OECD BEPS Action 1 Report "Addressing the Tax Challenges of the Digital Economy" issued on 5 October 2015
- OECD BEPS Action 2 Report "Neutralising the Effects of Hybrid Mismatch Arrangements" issued on 5 October 2015

Background

On 5 October 2015 the OECD publicly released its '2015 Deliverables' under the G20/OECD Base Erosion and Profit Shifting (BEPS) initiative. The BEPS initiative aims to enhance the integrity and fairness of the international tax system by realigning jurisdictional taxing rights with the location of 'value creation' and the place where business activities are actually conducted.

The 2015 Deliverables, a package of 13 reports with recommendations on changes to domestic laws and tax treaties amongst other measures, which correspond to the original 15 Actions of the 2013 BEPS Action Plan work programme, were endorsed by the G20 Finance Ministers at their 8 October 2015 meeting in Lima, Peru. In addition to consolidating and updating the seven 2014 Deliverables reports, new reports are provided on controlled foreign company (CFC) rules (Action 3), interest deductions (Action 4), permanent establishment (PE) rules (Action 7), transfer pricing (TP) rules (Action 8–10), measuring and monitoring BEPS (Action 11), mandatory disclosure rules (Action 12), and dispute resolution mechanisms (Action 14). The recommendations presented in the package constitute the substantive conclusion of the initial BEPS Action Plan work.

The Chinese State Administration of Taxation (SAT) have, in recent weeks, set out new guidance which largely clarifies how China plans to 'localise' the BEPS recommendations. In particular the SAT's public discussion draft on 'Special Tax Adjustments', issued on 17 September 2015, deals with the 'localisation' of the BEPS work on TP and CFC; see *China Tax Alert Issue 25 (September 2015)*. As such, it is increasingly possible to foresee what parts of the BEPS agenda will and will not be adopted by China, and the manner of adoption. As the new post-BEPS rules take shape it is becoming evident how multinational enterprises (MNEs) may need to adapt their existing investment structures and business models, as well as their tax risk management systems, to fully cope in the post-BEPS environment.

The BEPS 2015 Deliverables

The 2015 Deliverables package updates and supplements the 2014 Deliverables (full details of which are set out in *China Tax Alert Issue 27 (October 2014)*) and yields final proposals; those relevant for China are set out below. If you would like more detail please see KPMG International's *Tax News Flash - BEPS Special Edition 7 October 2015*.

- *Digital economy (Action 1):* Reiterating the conclusions of the 2014 Action 1 Deliverable, the Task Force on the Digital Economy (TFDE) did not

Regulations discussed in this issue:

- OECD BEPS Action 3 Report "Designing Effective Controlled Foreign Company Rules" issued on 5 October 2015
- OECD BEPS Action 4 Report "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments" issued on 5 October 2015
- OECD BEPS Action 5 Report "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance" issued on 5 October 2015

recommend specific, ring-fenced, Digital Economy tax measures, as the combined effect of other BEPS Actions is argued to effectively combat aggressive tax planning in the Digital Economy space. The relevant other Actions include:

- The Action 7 PE changes, impacting online cross-border sellers with large sales forces and/or large local warehouses in the market state
- The TP Actions (8, 9, 10), tackling shifting of contractual risk and transfer of intangible asset returns to low tax jurisdictions
- The Action 6 use of treaty anti-avoidance concepts to justify applying withholding tax (WHT) to outbound digital business payments which would otherwise be treaty protected from WHT
- The Action 5 clampdown on abusive IP regimes, as well as the potential Action 3 inclusion of digital business income under CFC rules

This said, the final Action 1 report includes VAT guidance tailored for the digital business B2B/B2C cross-border supplies, and indicates (while not advocating) that countries could consider use of specific Digital Economy corporate tax concepts, namely a significant economic presence nexus concept, a specific digital transaction WHT, or an "equalisation levy". The TFDE is to continue work on income characterisation (e.g. cloud computing), the value of data in TP analysis, and monitor Digital Economy tax issues.

- *Hybrid mismatch arrangements (Action 2):* The 2014 Action 2 Deliverable recommendations for changes to domestic law and treaties to counter the effects of hybrid entity, instrument and transfer-driven tax mismatches (see China Alert 27 of 2014), is now supplemented by an extensive series of examples. In addition, new rules are added to ensure that treaty relief is applied appropriately in the case of 'wholly or partly fiscally transparent' entities, such as partnerships and trusts.
- *CFC rules (Action 3):* The report sets out a series of recommended 'building blocks' which countries may use, at their own discretion, to construct a robust set of CFC rules. No CFC 'minimum standard' could be agreed on between the BEPS participant countries, despite the efforts of the US. The building blocks include (i) defining the CFC (type of entity, and type and level of control), (ii) CFC exemptions and tax rate thresholds, (iii) CFC income inclusion, (iv) CFC income computation, (v) CFC income attribution, and (vi) double tax elimination.

  The potential CFC income determination approaches include (i) categorical approaches (targeting income based on legal classification, origin from related parties, or geographic source, which may also be explicitly made to include income from digital sales/services), (ii) substantive analysis (determining whether CFC income was separated from underlying substance on basis of substantial contribution of employees, a TP-linked significant functions approach, a staff/premises substance approach), or (iii) an excess profits approach (covering, inter alia, transfers of intangibles and risk shifting transactions). A combination of these approaches is possible.
- *Interest Deductions (Action 4):* The report sets out a recommended approach (but does not agree a minimum standard) for limiting MNE use of debt-based tax planning. Targeted arrangements are (i) MNE groups placing higher levels of third party debt in their subsidiaries in high tax countries, (ii) groups using intra-group loans to generate interest deductions greatly in excess of the group's actual third party interest expense, and (iii) groups using third party or intra-group financing to fund the generation of tax exempt income. The recommended approach is an 'earnings stripping' rule which limits interest tax deductions to a percentage of earnings before interest, tax, depreciation and amortization (EBITDA). This may be supplemented by a worldwide group ratio rule which allows increased interest deductions where the MNE group at a global level is more heavily indebted/has a greater relative interest servicing burden than the local entity. The OECD will in 2016 refine the rules further for banking and insurance.

Regulations discussed in this issue:

- OECD BEPS Action 6 Report "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" issued on 5 October 2015
- OECD BEPS Action 7 Report "Preventing the Artificial Avoidance of Permanent Establishment Status" issued on 5 October 2015
- OECD BEPS Action 8-10 Report "Guidance on Transfer Pricing Aspects of Intangibles" issued on 5 October 2015
- OECD BEPS Action 11 Report "Measuring and Monitoring BEPS" issued on 5 October 2015

- *Harmful Tax Practices (Action 5):* The 2015 Deliverable finalizes the 2014 initial progress report prepared by the Forum on Harmful Tax Practices (FHTP). The substantial activity requirement for preferential tax regimes, proposed in the 2014 report, has been finalized with a 'nexus approach'. This uses expenditures on R&D activities, in the context of Intellectual Property (IP) regimes, as a proxy for activity. A review of preferential regimes in OECD and non-OECD states found that all the IP regimes reviewed failed the substantial activity test and these are now being revised. The FHTP plans to next roll-out its review using the substantial activity test to non-IP preferential regimes. The parallel framework for the compulsory spontaneous inter-tax authority exchange of rulings on preferential regimes, as well as advance pricing arrangements (APAs), PE cases, conduits, etc, takes effect with the first rulings from 1 April 2016, for those countries with the necessary legal basis already in place.

- *Treaty abuse (Action 6):* The 2015 Deliverable refines (but does not finalize) the 2014 report, adding further notable proposals. The core proposals remain the required adoption in treaties of either or both of a 'principal purposes test' focused on the subjective tax motivations of a taxpayer and a US-style Limitation on Benefits (LOB) provision. However, the release in May 2015 by the US of a proposed new version of the US Model DTA's LOB provision have led to a postponement of the finalization of the BEPS LOB proposal until mid-2016. It will be included in the planned roll-out of the multilateral instrument at the end of 2016.

  The updated treaty wording and guidance also clarifies that domestic anti-avoidance rules can be applied (without being blocked by treaties), facilitating, inter alia, application of exit taxes. In addition to the targeted anti-abuse provisions from the 2014 report, dealing with dividend, capital gains and PE based planning, the 2015 report now also contemplates adoption of recent US anti-abuse proposals. These would deny withholding tax (WHT) relief on payments to 'special tax regimes' or where a treaty partner state introduces an exemption for interest, royalties or dividends after the conclusion of a treaty. These latter proposals, along with additional guidance on applications of treaties to collective investment vehicle (CIV) and non-CIV (e.g. private equity) funds, will be finalized by mid-2016.

- *Permanent Establishment (Action 7):* The 2015 Deliverable adjusts further and finalizes changes proposed in the May 2015 BEPS PE discussion draft. For fuller detail on how the PE changes compare to prior PE concepts, and the implications for China, see *China Tax Alert Issue 12 (June 2015)*.

  In summary, the Agency PE concept, which had previously turned on whether a non-resident had authorized a local market-based person to habitually negotiate/contract with local customers on the former's behalf, has now been replaced. The new rule looks at whether the local market-based person 'habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the [non-resident] enterprise'. Contracts that transfer property owned by the non-resident (or grant a rise to use that property) are now covered. This is intended to catch cases where the non-resident is not legally bound by the contract but his property is the contract object matter (e.g. commissionaire structures).

  The revised OECD Model Tax Convention (MTC) Commentary makes clear that the focus of the new test is on whether the local market-based person convinces, through relationship building efforts, customers to contract. Formalities related to legal authorization of local persons to contract, and formalistic final 'rubber stamping' approvals of contracts by non-residents, which previously provided support for a 'No PE' position, are no longer determinative. Consequently, given the de-emphasis of 'legal agency', the provision might be better regarded as a 'local representative' PE concept, rather than as an 'Agency PE' concept. All prior references to 'agency PE' have been removed from the Commentary. The independent agent concept is now also curtailed where the local person acts largely for foreign related parties.

Regulations discussed in this issue:

- OECD BEPS Action 12 Report "Mandatory Disclosure Rules" issued on 5 October 2015
- OECD BEPS Action 13 Report "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting" issued on 5 October 2015
- OECD BEPS Action 14 Report "Making Dispute Resolution Mechanisms More Effective" issued on 5 October 2015
- OECD BEPS Action 15 Report "Developing a Multilateral Instrument to Modify Bilateral Tax Treaties" issued on 5 October 2015

Furthermore, the 'preparatory and auxiliary' (P&A) PE exemptions for 'specific activities' (e.g. warehousing, purchasing, information collection etc) are now to be all subject to an overriding P&A test (though this is left to country discretion) and to an anti-fragmentation test. The latter is a de facto "force of attraction" approach under which the activities of connected enterprises at the same or separate places in the source country may be aggregated in determining if the P&A threshold has been exceeded, such that a PE exists. Finally, it is clarified that the principal purposes test (and a more mechanical rule if a country does not apply this test) should be applied to deal with 'contract splitting' strategies directed at having cross-border construction activities fall under the time limit for a construction/service PE.

The PE changes are represented as a key plank of the BEPS resolution of Digital Economy tax planning as they would treat online cross-border sellers with large sales forces and/or large local warehouses in the market state as having a local PE, dealing with existing weaknesses in the Agency PE rule and P&A PE exclusions.

- *Transfer Pricing (Action 8, 9, 10, 13):* The 2015 TP deliverables are comprised of a significant number of updates to different parts of the existing OECD TP guidance. Substantial updates are made to:
  - *Chapter 1 (Arm's length principle)*: The new guidance sets out a robust approach to 'delineating the transaction'. This is designed to deal with BEPS concerns about the separation of contractual risk (and associated returns) from value generating activity in order to allocate MNE profits to low tax jurisdictions. The approach taken is to "re-purpose" the five categories of 'comparability factors' from the existing OECD TP guidance (now termed 'economically relevant characteristics') to serve two roles; (i) 'delineating of the transaction' – a form of 'sense test' of the contractual arrangements, in light of the 'options realistically available' to the contracting parties, to determine whether they are an accurate representation of the true nature of the transaction and whether the transaction properly reflects how independent parties would have transacted, and (ii) the subsequent comparability analysis.

    The five categories of characteristic remain, as in the prior guidance, (i) contract terms, (ii) functions performed (taking account of assets and risks) by MNE group members and their value creation significance within the group, (iii) characteristics of property transferred and services provided, (iv) the economic circumstances of the parties and the market, (v) business strategies. While guidance on all the characteristics has been expanded (e.g. economic circumstances of the market now includes local market features), the really substantive changes are item (ii) with respect to whether risks have been properly allocated.

    The Guidance provides that risks contractually assumed by a party that cannot in fact exercise meaningful control over the risks, and which does not have the financial capacity to assume the risks, will be allocated to the party that does exercise such control and have the financial capacity to assume the risk. The guidance on who controls the risk turns strongly on which entity can and does make decisions on assuming risks and/or reacting to their outcomes. Where the contracts are determined not to be a full or adequate description of the transaction actually conducted then additional terms may be 'read into' the 'accurately delineated transaction'. The OECD expresses the view that it should rarely be needed to fully re-characterize a transaction, and that just because a transaction may not be seen in practice between independent parties should not lead to its rejection; transactions should just be re-characterized where they are not commercially rational from the perspective of the transacting parties.

    The clarifications in the 2014 BEPS TP Deliverable on taking into account local market features, cost savings, group synergies, are also carried over to the final updates to Chapter 1.

  - *Chapter 2 (TP methods)*: While no updates have yet been made to the Guidance, a work plan lasting up to mid-2017 has been set out in respect of guidance on use of profit split methods (PSM). This clarifies the range

Regulations discussed in this issue:

- OECD Explanatory Statement to the BEPS 2015 Deliverables issued on 5 October 2015
- OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010 version, with discussion draft on Revision of Chapter 6 of the OECD Guidelines on Intangibles issued on 30 July 2013
- The State Administration of Taxation (SAT) of the People's Republic of China's (PRC) Public Consultation Draft of a Circular on Implementation Measures for Special Tax Adjustments, ("Discussion Draft"), issued on September 17, 2015

of circumstances in which the OECD considers PSM may be optimal to use. These see expanded use of PSM, beyond the existing Guidance on when PSM is appropriate (i.e. where MNE operations are highly integrated, or where parties make 'unique and valuable contributions') to include (i) cases where, in the development of intangibles, parties outsource 'important functions' (e.g. design and control of research and marketing programmes), or (ii) where partially developed intangibles are transferred, as well as (iii) cases (further to the Chapter 1 analysis above) where multiple parties exercise control over a risk, (iv) determination of royalty rates or (v) where MNE group synergies are shared.

It is emphasized that given the highly integrated, synergistic and IP-reliant nature of Digital Economy businesses, PSM may be particularly appropriate to the latter and work will continue on this. Chapter 2 also incorporates guidance on commodities transactions.

- *Chapter 5 (Documentation)*: The new TP Documentation, consisting of Master and Local File and CBC reporting, set out in 2014 and refined in 2015 in relation to the implementation rules, is finalized. See our Tax Alert Issue 25 linked below.
- *Chapter 6 (TP for intangibles)*: The BEPS 2014 Deliverables set out extensive new guidance on determining how to allocation the income derived from contributions to the generation of intangible assets in an MNE, as well as from their transfer and use. A detailed description of this 2014 BEPS guidance, and their roll out into Chinese guidance, can be read in *China Tax Alert Issue 25 (September 2015)*. The Intangibles TP guidance, apart from updates made to align it with the new risk allocation analysis in Chapter 1, has now been further supplemented with updates to the provisions designed to deal with transactions in intangible assets with highly uncertain valuations (e.g. the tax authorities may determine the pricing by 'reading in' a contingent payments mechanism into the transfer agreement) and to deal with 'hard-to-value intangibles' (HTVI).

  For HTVI, to deal with the challenges of information asymmetry between taxpayers and tax administrations, the post-transfer profitability of an intangible may be taken into account in the valuation. The Guidance limits use of the ex-post evidence, however, to determination of whether the taxpayer's ex-ante projections adequately took into account all relevant information at the time; it is not a 'hindsight' approach. Where the taxpayer can prove that differences between ex-ante projections and ex-post results can be explained by unforeseeable developments or reasonable variation resulting from the playing out of probabilities, then ex-post information is not to be used.
- *Chapter 7 (Intra-Group Services)*: An 'allocation key'-based, simplified, elective approach for allocating charges for low value-adding intra-group services is set out.
- *Chapter 8 (Cost Contribution Arrangements)*: The CCA guidance integrates the new Chapter 1 approach to 'delineating the transaction', to valuing HTVIs, and generally requires CCA participants to be able to control the risks and and have the financial capacity to do so.

- *Mandatory Disclosure rules (Action 12):* Recommendations (not a minimum standard) are set out, according to a modular framework, for the design of rules which would give the tax authorities early warning on aggressive arrangements and would deter promoters and taxpayers (both with potential reporting obligations) from entering into such arrangements in the first instance. The guidance covers 'hallmarks' of avoidance which would be the trigger for disclosure, tracking arrangements and penalties.
- *Dispute Resolution Mechanisms (Action 14):* A minimum standard has been developed for the resolution of treaty-related disputes, together with a Peer Monitoring mechanism, falling under the Forum on Tax Administration (FTA) Mutual Agreement Procedure (MAP) Forum. This will commence work in 2016, with first reports due by end of 2017. The minimum standard contains commitments to include MAP clauses in treaties and ensure taxpayer MAP access, time to complete MAP procedures (target 24 months)

Regulations discussed in this issue:

- SAT Circular on Implementation Measures for Special Tax Adjustments (Trial Implementation), Guoshuifa [2009] No. 2 ("Circular 2"), issued on January 8, 2009
- OECD Model Tax Convention on Income and Capital, issued in 2014
- Public Notice regarding information disclosure by resident enterprises on outbound investment and overseas income, SAT Public Notice [2014] No. 38, ("Announcement 38"), issued July 2014 and effective 1 September 2014

and avoid MAP adjustment time-barring, as well as MAP case and procedure transparency. Beyond this (non-binding) best practices are also set out while a group of 20 Western countries have committed to mandatory binding arbitration, with the mechanism to be developed in time for its inclusion in the multilateral instrument in late 2016.

- *Multilateral Instrument (Action 15):* The 2014 Deliverables concluded that a multilateral instrument to update many of the world's 3,500 bilateral tax treaties simultaneously would be feasible and 87 countries (but notably not the US) have joined an ad hoc group (led up by China and the UK) to negotiate the instrument by the end of 2016.

"Mapping" the BEPS 2015 Deliverables to China

Some aspects of 2015 Deliverables have already been 'localised' into Chinese domestic tax law or treaty provisions, or are expected to have a significant future effect, including:

- *Transfer Pricing (Action 8, 9, 10, 13):* The details of how the 2014 BEPS TP Intangibles guidance is being 'localised' through the SAT public discussion draft on 'Special Tax Adjustments' ('discussion draft'), is set out in in *China Tax Alert Issue 25 (September 2015)*. This Alert also includes consideration of the implications for MNE business models. The new Chinese TP guidance in the discussion draft will replace the existing Chinese TP guidance in SAT Circular 2 [2009]. The discussion draft emphasizes that in determining the value contribution of MNE group entities to intangible assets (and the consequent TP profit allocations) emphasis is to be put on the 'middle value chain activities' frequently carried out by MNEs in China (e.g. trial production, enablement of mass production) as well as China market-building activities. As the OECD guidance would not consider these as the most important factors for intangibles value creation, divergent TP approaches between China and other countries could ultimately lead to double taxation.

  The new Chinese TP guidance also tends to push transactions involving intangibles more readily towards PSM, or the new Chinese Value Contribution Method (VCM) introduced under the proposed revision to Circular 2. The latter is supported by the comprehensive 'Value Chain Analysis' section required in the Chinese TP Local File (this appears to diverge from the BEPS TP documentation requirements, and potentially duplicates the CBC information requirements). These new measures exist in parallel with new extensive information requirements for outbound service payment arrangements and demanding tax deduction provisions on outbound service/royalty payments. The discussion draft also notably excludes the BEPS proposed low-value service simplifications.

  Notably absent from the new Chinese TP guidance is any reference to the OECD's approach to 'properly delineating the transaction' by aligning risk attributions with effective risk control, and supplementing/adjusting contractual risk allocations where necessary. In fact, the new Chinese TP guidance (as with the existing Circular 2 TP guidance) provides barely any reference on the weighting to be given to control of risks and relevant decision-making in either 'delineating transactions' or in comparability analysis. This is reflective of a long-standing skepticism, borne out in the practical application of TP rules by the Chinese tax authorities, towards contractual allocations of risk which are considered to be susceptible to manipulation. To this extent, the omission of the BEPS refinements to the OECD's TP risk allocation approaches from the new China TP guidance perhaps reflects a continuation of this cautious approach, which focuses more on the performance of functions.

  The new Chinese TP re-characterization provision in the discussion draft applies to "related party transactions unlikely to occur between independent third parties under comparable economic conditions". While the BEP guidance point out that the mere fact that a transaction may not be seen between independent parties should not lead to its rejection (the

Regulations discussed in this issue:

- Chinese State Administration of Taxation (SAT) Announcement on Administrative Measures for Granting Tax Treaty benefits to non-residents, Gonggao [2015] No. 60 ("Announcement 60"), issued on August 27, 2015, and Interpretative Guidance Notes
- SAT Circular on understanding and recognising the Beneficial Owner in PRC Double Tax Agreements and Arrangements (DTA), Guoshuihan [2009] No.601 ("Circular 601"), issued on 27 October 2009

focus being on whether it is commercially rational) it remains to be seen whether the Chinese authorities will take account of this in applying the re-characterization provision in practice.

The lack of clear correspondence between the BEPS 'transaction delineation' and control-risk approaches and the Chinese approach make it difficult to know how the future OECD PSM guidance (under development) will interact with the new China TP guidance. Likewise, the draft new Chinese TP guidance does not make clear how the 'hard-to-value intangibles' concept would apply in China, providing no guidance on the usage of ex-post results. It remains to be seen whether any of the BEPS guidance is integrated into the final Chinese TP guidance, replacing Circular 2, due to be issued towards the end of this year.

- *PE (Action 7):* As detailed in *China Tax Alert Issue 12 (June 2015)*, the new BEPS PE concepts could, depending on the manner of their roll-out and their application in practice, result in challenges under the new Agency PE concept for existing MNE cross-border distribution and procurement structures into China. Enhanced documentation and operating protocols, adjustments to existing business practices and, in some cases, movement from offshore sales hubs to onshore buy-sell distributors, may be required. The impact of the anti-fragmentation rules on multi-subsidiary arrangements (e.g. China manufacturing, sales, and R&D all in separate MNE subsidiary entities) will need to be considered, as well as the impact of contract-splitting rules on dispatches of staff from multiple overseas MNE entities to China. The SAT are understood to be already developing new PE profit attribution guidance, and given the difficulties with the existing 'deemed percentage of sales' PE profit attribution approach, this will be keenly anticipated.

- *Treaty Abuse (Action 6):* China recently rolled out its new DTA relief system with Announcement 60 [2015] and this will take effect from 1 November 2015; see *China Tax Alert Issue 24 (September 2015)*. While the Announcement is primarily focused on administrative procedures (i.e. a move from DTA relief pre-approval to self-relief and tax authority 'follow up' procedures), it also resets the SAT approach to the 'beneficial ownership' treaty relief criterion in a way which may facilitate a more structured BEPS 'Principal Purposes Test' approach to treaty shopping going forward. Since 2009 the guidance in SAT Circular 601 effectively combined a 'control of income and assets'-based beneficial ownership test with an 'economic substance' driven treaty shopping test. These are now effectively separated under new DTA relief approach, with 'substance' factors underpinning 'follow up' challenges based on the PRC GAAR and on the general anti-avoidance provisions that the PRC has progressively been integrating in its recent concluded and updated DTAs.

  As the GAAR procedures in SAT Order 32 [2014] provide an opportunity for taxpayers to represent their 'reasonable businesses' purposes case and allow SAT review of local tax authority challenges, the move in a direction of a BEPS principal purposes test-style DTA anti-abuse system in China might be welcomed, though it remains to be seen how such measures are applied in practice.

- *CFC rules (Action 3):* The Chinese tax authorities have recently begun to enforce their CFC rules in actual cases. As regards the BEPS CFC 'building block' recommendations, while the SAT have largely left unchanged the existing CFC control definition, as well as the CFC exemptions/thresholds (de minimise test and reasonable purpose test for 'non-distribution' of CFC profits), it has co-opted the BEPS 'CFC Attributable Income' guidance into the 'Special Tax Adjustments' discussion draft.

  In this regard a BEPS 'Categorical' approach is taken with CFC income inclusion generally appropriate for (i) dividends earned by non-securities trading companies, (i) interest earned by non-finance business companies, (iii) insurance premiums earned by non-insurance companies, (iv) royalties earned from related parties, (iv) sales and service income earned where goods and services have been bought-in from related parties and no or low value has been added, and, (vi) in a nod to the BEPS 'Excess Profits'

Regulations discussed in this issue:

- Administrative Measures for implementation of the General Anti-Tax Avoidance Rule (for Trial Implementation), SAT Order No.32 ("Order 32"), issued on December 2, 2014

approach, excess profits derived from intangible asset or risk transfers. This is supplemented/overlaid with a BEPS 'Substantive Analysis' approach; this provides that all three of the BEPS proposed alternatives (i.e. substantial contribution, TP analysis, staff/premises) may be used by the tax authorities but does not give guidance on their application or prioritization. Given the rapid ramp up of tax enforcement against 'Going Out' Chinese MNEs, the precise application of these provisions will be of keen interest.

- *Other BEPS Actions:* Alongside the above BEPS Deliverables, which have most echo in a China context, the other BEPS Actions may be seen to impact as follows:
  - *Action 1:* The SAT has not yet clarified the Chinese position on the taxation of the Digital Economy, though a SAT task force is understood to have been established to examine the issues. It remains to be seen whether the SAT seeks to go beyond the OECD BEPS recommendations and pursues one of the more 'innovative' Digital Economy tax approaches.
  - *Action 2:* Hybrid mismatch arrangements are not a major feature of the Chinese tax environment, with the use of such planning obstructed by foreign exchange controls, limitations of corporate law, regulatory restrictions, as well as aspects of the tax system, such as the absence of loss grouping or comprehensive entity classification rules, and the inability to use foreign branch/partnership losses against local profits. The SAT had in early 2015 indicated their intent to, nonetheless, roll out anti-hybrid rules. It remains to be seen what form these would take, and whether the BEPS Action 2 recommendations to clarify treaties to facilitate treaty claims by 'wholly and partially transparent' entities would be adopted, clarifications much needed in China (and to-date only dealt with in the China-France DTA).
  - *Action 4:* It is understood that the SAT has decided, at least for the moment, not to roll out the BEPS Interest Deduction proposals given that this would necessitate a change to the Corporate Income Tax (CIT) law itself (changes to the CIT law have not been made since its introduction in 2008; tax policy is generally effected through SAT policy circulars which interpret the CIT law). Instead, the existing debt-equity ratio thin capitalization rules have been tightened in the new 'Special Tax Adjustments' discussion draft.
  - *Other Actions:* China's involvement in the Action 5 tax rulings spontaneous exchange system, and its position on the Action 12 mandatory disclosure proposals have not yet been clarified by the SAT. As a minimum standard, China will adhere to the Action 14 dispute resolution recommendations and will be subject to the Peer Monitoring mechanism, though not with respect to mandatory binding arbitration, and the SAT has historically shown some caution in this regard.

    The SAT's leading role in the group developing the Action 15 multilateral instrument and China's role as host of the FTA and the G20 in 2016 arguably points in the direction of China's ultimate application of the multilateral instrument in late 2016 at its conclusion. It remains to be seen what will be the scope of the treaty updates which China would commit to at that time, and to what extent China might seek to update its entire DTA network for Chinese DTA developments.

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