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China Alert

China implements a transparent and standardised anti-avoidance measure

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Since 2012, with the endorsement and approval of the leaders of G20 countries, the Organization for Economic Co-operation and Development (“OECD”) was entrusted to launch the Base Erosion and Profit Shifting (“BEPS”) project, aiming to combat global tax avoidance. Being a participating country of the BEPS project, when OECD released the first batch of deliverables of the BEPS project in September 2014, China’s State Administration of Taxation (“SAT”) provided the Chinese translation of the deliverables on its website. The SAT stated in a relevant press release that it will “adopt the BEPS deliverables to amend the Administrative Procedures for Anti-Avoidance, increase efforts to prevent the abusive use of tax treaties, and improve the management of cross-border tax source”. Further, during the G20 summit held in Australia in November 2014, Chinese President Xi Jinping said that it was necessary to combat international tax avoidance. Shortly after, the SAT issued “Administrative Measures of General Anti-Avoidance Rules (Trial Implementation)” (hereinafter referred to as “Administrative Measures”), indicating China’s commitment to further defeat tax avoidance on a global scale. This issue of China Alert will give a brief account of the Administrative Measures together with our views towards it.

Scope of the Administrative Measures

China’s new Enterprise Income Tax (“EIT”) law has been enforced since 2008, and a series of anti-avoidance measures were incorporated into the EIT law to form a single chapter - Chapter 6, “Special Tax Adjustments”. It covers anti-avoidance measures in areas of related party reporting, transfer pricing, cost sharing, controlled foreign enterprises, thin capitalization, etc. which apply to the tax administration of specific tax avoidance arrangements. For arrangements besides the specific tax avoidance arrangements, Chapter 6 includes the “General Anti-Avoidance Rules” (i.e. Article 47 of the EIT Law and Article 120 of its Implementation Regulations) to empower the tax authorities to implement special tax adjustments.

The Administrative Measures apply when tax authorities implement special tax adjustments, in accordance with the General Anti-Avoidance Rules (“GAAR”), on enterprises which “implement tax avoidance arrangements in obtaining **tax benefits** but **without reasonable commercial purposes**”



The Administrative Measures have been enforced since 1 February 2015 and further apply to any tax avoidance arrangements that are unsettled before this date.

The Administrative Measures do not apply to the following conditions:

1. Arrangements not related to cross-border transactions or payments;
2. Illegal activities such as avoidance of tax payments, avoidance from recovery of outstanding evaded taxes, fraud in obtaining tax refund, refusal to pay tax and issue of false invoices.

In a press briefing regarding the Administrative Measures, the SAT pointed out that cross-border tax avoidance arrangements will cause a loss in tax revenue while the adjustments of domestic transactions may lead to double taxation. In consequence, domestic transactions are not the major concern of the authorities from a tax avoidance perspective. Any offence relating to tax avoidance should be handled pursuant to the Tax Collection and Administration Law and therefore, the Administrative Measures do not apply.

The SAT also suggested that GAAR is the last resort among all other anti-avoidance measures. Therefore, the Administrative Measures require for those that fall under the scope of special tax adjustments such as transfer pricing, cost sharing, controlled foreign corporations and thin capitalization, the respective specific rules should be applied first. For those that fall under the scope of tax treaties such as beneficial ownership, the relevant treaty provisions should be applied first.

Definition of the key terms

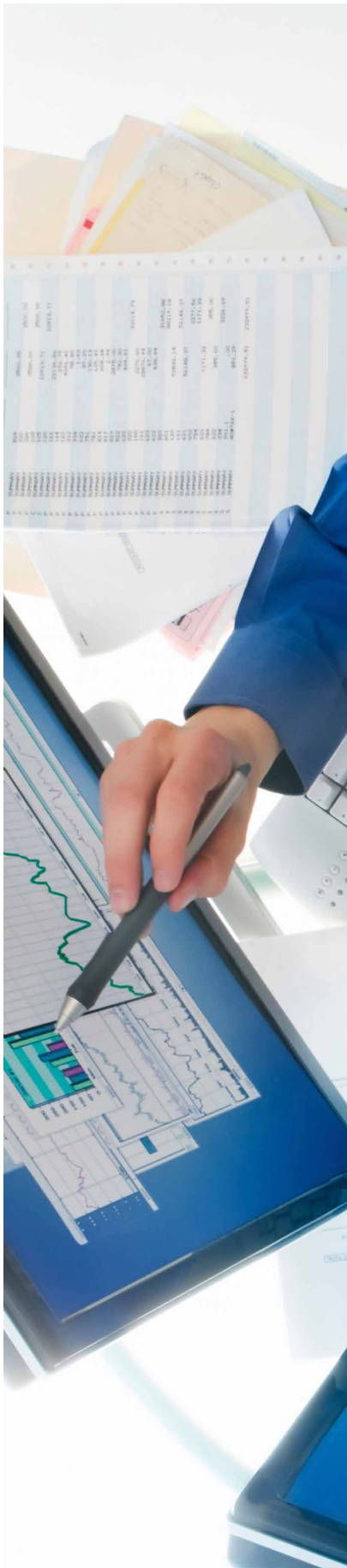
The Administrative Measures define the key tax terms as follows:

A **“tax benefit”** refers to any reduction, exemption or deferral of EIT payable.

The Administrative Measures have not provided any additional information on the term **“without reasonable commercial purposes”**. According to Article 120 of the Implementation Regulations of EIT Law, the term “without reasonable commercial purposes” refers to the main purpose being reducing, exempting or deferring tax payments.

Further, the Administrative Measures indicate the following characteristics of tax avoidance arrangements:

1. The sole or main purpose is to obtain tax benefits;
2. The tax benefits are obtained by using an arrangement that complies with the tax regulations in legal form but does not conform to its economic substances.



Benchmark and methods for making adjustments

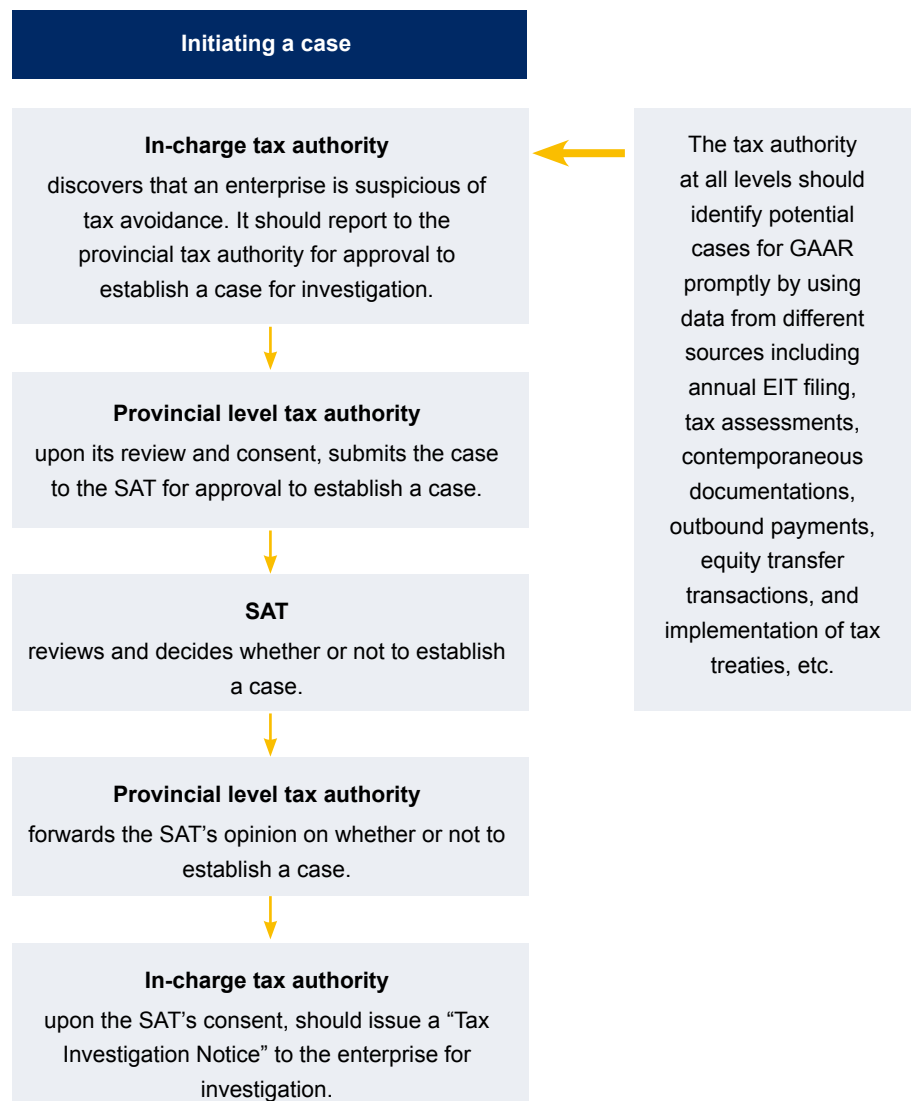
The Administrative Measures emphasize on the “Substance Over Form” doctrine, and use similar arrangements with reasonable commercial purposes and economic substances as benchmark to implement special tax adjustments.

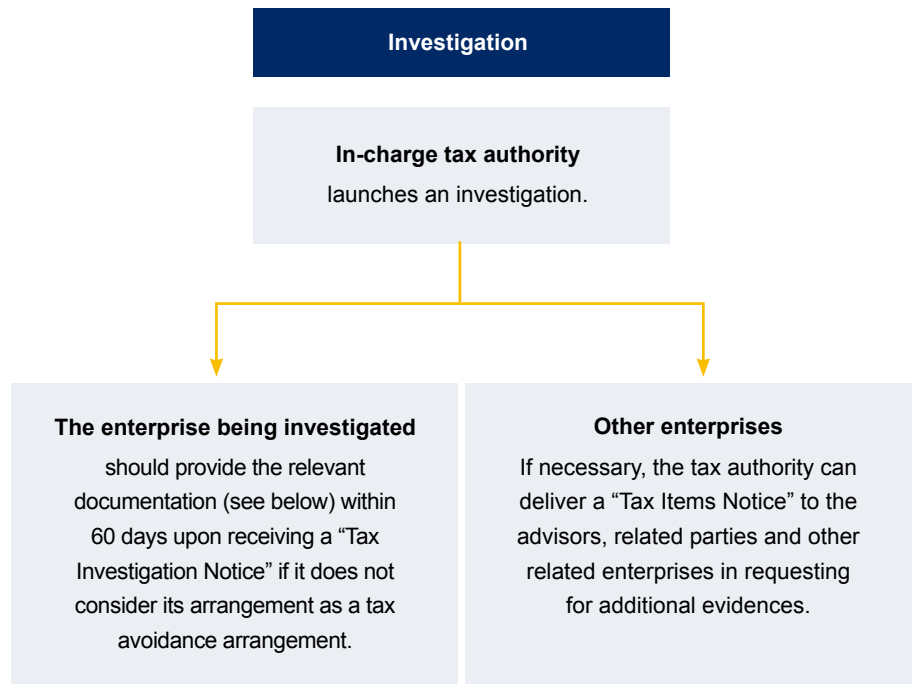
Methods of adjustments include:

1. Re-characterizing whole or part of the transaction;
2. Denying the existence of the transaction for tax purposes, or deeming the transaction parties involved as a single entity;
3. Re-characterizing the relevant income, deductions, tax preferences and foreign tax credits/exemptions, or reallocating these items among the transaction parties;
4. Any other reasonable methods.

Process of GAAR investigation

The process of a GAAR investigation will involve initiating a case, conducting investigation and finally making a conclusion; the process is summarized as follows:





Documentation required

The enterprise being investigated should provide the following documentation within 60 days upon receiving a “Tax Investigation Notice”:

1. Information on the background of the arrangement;
2. Documents explaining the commercial purpose of the arrangement;
3. Documents on internal decisions and related management information, such as board resolutions, memorandums, emails, etc.;
4. Detailed information of the transactions, such as contracts, supplementary agreements, vouchers of payments and receipts, etc.;
5. Correspondences with other transaction parties;
6. Other documentation that can prove that the arrangement is not a tax avoidance arrangement; and
7. Other information as required by the tax authorities.

Extension of deadline

In the event that the enterprise is unable to provide the required information within the prescribed time frame due to exceptional circumstances, it can apply in writing to the in-charge tax authority for an extension. An extension of no more than 30 days will be granted upon approval. If the in-charge tax authority gives no written reply within 15 days upon receiving the application for an extension, it will be deemed to have given a consent to the extension.



Concluding a case

In-charge tax authority

conducts investigation and forms its initial proposal in concluding the case within 9 months.



Provincial level tax authority

upon its review and consent, submits the case to the SAT for approval to conclude the case.



SAT

establishes an opinion for the application to conclude the case

Pursuant to SAT's review, the in-charge tax authority should:

- Issue a "Special Tax Investigation Conclusion Notice" to the enterprise being investigated if the SAT agrees not to make any adjustments;
- Issue a "Preliminary Special Tax Investigation Adjustment Notice" to the enterprise being investigated if the SAT agrees with the initial proposal; or
- If the SAT's opinion is different, revise the proposal accordingly and resubmit the revised proposal to the SAT for approval.

Where the enterprise being investigated does not raise an objection within seven days upon receiving the "Preliminary Special Tax Investigation Adjustment Notice", the in-charge tax authority should issue a "Special Tax Investigation Adjustment Notice" to the enterprise.

If the enterprise raises an objection, the in-charge tax authority should report the objection raised by the enterprise and its decision for not accepting the objection together with the reasons, or revise the original proposal correspondingly to the provincial level tax authority for its review and further submission to the SAT for approval in concluding the case.

Dispute solution

If the enterprise being investigated disagrees with the adjustment, it can apply for legal assistance in accordance with the relevant provisions. If the adjustment results in domestic double taxation, the SAT should coordinate to resolve the issue. If the adjustment leads to international double taxation, the enterprise being investigated may initiate the mutual agreement procedure according to the relevant tax treaty.



Our comments

Improvement in transparency, unity and impartiality

In the press briefing mentioned above, the SAT pointed out that the Administrative Measures is aimed to provide a detailed guideline on the implementation procedures for GAAR, enabling the establishment of a more transparent, united and impartial general anti-avoidance mechanism.

The Administrative Measures state the process of initiating a case, investigating, concluding a case and resolving disputes in a comprehensive and standard guideline, which is highly transparent. The Administrative Measures also clearly outline the functions of tax authorities at each level in the implementation of the GAAR investigation, and requests the provincial level tax authority and the SAT to review and approve the establishment and conclusion of a case in the GAAR investigation, greatly enhancing the unity of the implementation of the GAAR investigation. In addition, for taxpayers, the Administrative Measures list out matters such as the time frame of different procedures, information required, extension of deadline, raising objection, dispute solution, through which the principle of impartiality is realized.

Substantial cross-border transactions are likely to be the target of investigation

Under the Administrative Measures, the in-charge tax authority is required to report to the provincial level tax authority and finally submit to the SAT for approval to establish and conclude a case in the GAAR investigation. It is expected that tax authorities will incur a higher administration cost in the implementation of the GAAR investigation so they may focus more on the substantial cross-border transactions. Enterprises conducting cross-border transactions in substantial amounts should pay particular attention to the new rules.

Significance of documents maintenance

The Administrative Measures emphasize on the 'Substance Over Form' principle, and make tax adjustments to the arrangements without reasonable commercial purpose and lacking of economic substances. The information and documentation submitted by the enterprise being investigated to the tax authorities should be able to prove that the arrangement does not fall under the scope of tax avoidance. Therefore, it is very important for enterprises to maintain the relevant documents in good condition. All relevant documents and information should be well-recorded, made ready and kept properly to prove the reasonable commercial purpose and economic substances of the arrangement in question.



Extended information collection scope

Under the Administrative Measures, the in-charge tax authority may request the advisor of the arrangement, related parties and any other relevant enterprises to provide relevant information or evidential documentation during the process of conducting the GAAR investigation. The extended information collection scope may lead to more information obtained by the tax authority. The more information for further investigation, the higher the risk is for the enterprise.

Strictly follow updated tax rules

In releasing the Chinese translation of the deliverables of the BEPS project in September 2014, the SAT indicated that the Administrative Procedures for Anti-Avoidance Procedures would need to be amended. Aside from the Administrative Measures, the SAT is looking to amend the “Implementation Measures of Special Tax Adjustments (Trial Implementation)” (Guoshuifa [2009] No. 2). Enterprises should closely follow the latest changes in Chinese tax rules and assess their implications in order to respond promptly and minimize their tax impact.



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