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In this issue of the China Tax Monthly, we will discuss the following tax developments in China:

1. China Signs Multilateral Instrument: Impact on China's Tax Treaties and Treaty Practice
2. Shandong Case: Tax Bureau Reassesses Share Transfer Tax on Seller after Tax Withholding by Buyer
3. Beijing Case: Tax Bureau Penalizes FIE for Underwithholding IIT on Employee Allowances
4. Jiangsu Case: Tax Bureau Enforces Controlled Foreign Corporation Taxation

1. China Signs Multilateral Instrument: Impact on China's Tax Treaties and Treaty Practice

On 7 June 2017, 68 jurisdictions (including China) signed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* ("**Multilateral Instrument**" or "**MLI**"). The MLI covers more than 2,350 existing bilateral tax treaties between the jurisdictions, leading to over 1,100 matched treaties among them. Three more signatories joined the MLI in July and August and more signatories are expected to join. The OECD expects the MLI's first modification to the covered treaties will become effective in 2018.

Introduction to the MLI

The MLI is a tool jointly developed by over 100 jurisdictions to allow them to multilaterally introduce a series of treaty-related tax measures resulted from the Base Erosion and Profit Shifting (BEPS) Project into existing treaties without having to negotiate bilaterally. These include measures against hybrid mismatch arrangements (BEPS Action 2) and treaty abuse (BEPS Action 6), strengthened definition of permanent establishment (PE, BEPS Action 7) and measures to make mutual agreement procedures (MAP) more effective (BEPS Action 14).

The MLI modifies the bilateral tax treaty between two MLI signatory jurisdictions if both jurisdictions notify the OECD of their intent to modify the bilateral tax treaty through the MLI. A specific MLI provision amends the bilateral treaty only if neither signatory jurisdiction makes a reservation on the application of the provision (for a non-optional provision) or if both jurisdictions choose to apply the provision (for an optional provision). The OECD maintains a website[1] that publishes each signatory jurisdiction's MLI position and an MLI Matching Database[2] that can automatically generate information on the matching outcome of two signatory jurisdictions and on the MLI's modifications to the tax treaty between these two jurisdictions.

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1 See http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf.

2 See http://www.oecd.org/tax/treaties/application-toolkit-multilateral-instrument-for-beps-tax-treaty-measures.htm.

Chinese DTAs to be covered by the MLI

China listed 101 double taxation agreements (DTAs) out of its existing 103 DTAs to be covered by the MLI.[3] The DTAs with Chile and India and three double taxation arrangements with Hong Kong, Macau and Taiwan are not included in the list. As of 17 August 2017, 48 counterparty jurisdictions (as listed below) of the 103 selected DTAs have signed the MLI and selected their DTAs with China to be covered by the MLI.

The 48 counterparty jurisdictions are: Armenia, Australia, Austria, Belgium, Bulgaria, Canada, Croatia, Cyprus, Czech, Denmark, Egypt, Finland, France, Georgia, Germany, Greece, Hungary, Iceland, Indonesia, Ireland, Israel, Italy, Japan, Korea, Kuwait, Latvia, Lithuania, Luxembourg, Malta, Mexico, Netherlands, New Zealand, Nigeria, Pakistan, Poland, Portugal, Romania, Russia, Serbia, Seychelles, Singapore, Slovakia, Slovenia, South Africa, Spain, Sweden, Turkey and the UK.

Key China positions and impact on China treaty practice

China's current key MLI positions are:

- **Anti-treaty abuse:** China has adopted the MLI provision to clearly state the intention of combatting treaty abuse in the preamble of a treaty. More importantly, China adopts the principal purpose test (PPT), which denies treaty benefits if the principal purpose or one of the principal purposes of the arrangement concerned is to obtain treaty benefits. As compared to China's domestic general anti-avoidance rule, which targets arrangements with the sole or main purpose to obtain tax treaty benefits, the PPT rule seems to have a broader scope and thus may create potential concerns for business-driven arrangements that result in treaty benefits. In fact, some of China's recent DTAs have already included a PPT rule for passive income (e.g., China-Netherlands tax treaty) or even for active income (e.g., China-France tax treaty). However, the Chinese tax authorities have rarely applied the PPT rule to deny treaty benefits. Instead, they have mainly relied on the domestic interpretation of the beneficial ownership requirement, which is based on the "substance over form" principle and appears to be more stringent than the PPT rule.

  In addition, China has adopted the 365-day lookback period for reduced treaty dividend withholding tax. This change is inconsequential since China already has a one-year lookback period under its domestic law.

  Notably, China made a reservation on the 365-day lookback period for taxation of capital gains relating to land-rich entities because China uses a three-year period under its domestic law.

- **Avoidance of PE status:** China has opted out of all MLI PE provisions, including PE provisions to address commissionaire arrangements, specific activity exemptions and contract-splitting. That being said, China has been pushing out the OECD on the PE issue. Even before the BEPS Project, the State Administration of Taxation (SAT) adopted positions on

[3] Both the current and the new (not yet effective) China-Romania DTAs are included in the DTA count.

interpreting the meaning of PE in its tax treaties that are consistent with the new PE principles under BEPS project.

- **Hybrid mismatch:** China did not adopt the MLI provisions on transparent entities and double taxation relief in relation to hybrid instruments because the SAT has not yet finalized transparent entity and partnership rules at the domestic level and China would prefer to negotiate these treaty rules on a bilateral basis. However, China adopted the MLI rule that the residency status of dual resident entities shall be determined by MAP (rather than defaulting to place of effective management) and that, in the absence of a mutual agreement between the competent tax authorities, the entity is not entitled to treaty benefit. Once ratified and finalized into a DTA, this may change the treaty benefit analysis for dual resident entities.

- **Improving dispute resolution:** China reserved on the provision that a taxpayer can present a MAP request to either contracting state. China will maintain its position that a taxpayer can only initiate a MAP request with the competent tax authority of the taxpayer's resident jurisdiction or state of nationality (for non-discrimination cases).

- **Arbitration:** China has opted out of the MLI provisions on mandatory arbitration due to concerns about sovereignty.

Observations

The MLI is likely to modify almost half of China's DTAs or even more as other jurisdictions join the MLI. These modifications will mainly be found in anti-treaty abuse rules since China has opted out of most other major MLI provisions, particularly the PE provisions. The introduction of the PPT rules coupled with the Chinese tax authorities' increasing scrutiny of treaty benefit cases may present greater challenges for taxpayers to claim tax treaty benefits in China.

Notably, although China has opted out of the MLI PE provisions, China has unilaterally adopted PE interpretations that are consistent with the BEPS PE principles. In fact, Chinese tax authorities have been increasing PE assessments, and the SAT has expressed its willingness to strengthen PE administration. We expect the Chinese tax authorities to continue to strengthen scrutiny of PE issues.

2. Shandong Case: Tax Bureau Reassesses Share Transfer Tax on Seller after Tax Withholding by Buyer

On 25 August 2017, the China Taxation News reported that the Laizhou State Tax Bureau (LSTB) in Shandong collected CNY 8.5 million in additional taxes from a Singapore enterprise on a share transfer, despite the buyer having withheld and paid tax to its in-charge tax bureau.[4]

[4] See http://www.ctaxnews.net.cn/html/2017-08/25/nw.D340100zgswb_20170825_3-10.htm.

Facts

Earlier this year, a Singapore enterprise transferred its 49% equity interest in a Chinese enterprise located in Laizhou to another Chinese enterprise located outside of Laizhou. After the share transfer, the Chinese buyer withheld and paid tax to its in-charge tax bureau.

Although none of the three enterprises reported the share transfer to the LSTB, the LSTB identified the share transfer during its daily tax examination on the transferred enterprise. The LSTB learned that the Chinese buyer withheld the tax based on the transfer price, which was calculated in accordance with the transferred enterprise's net asset value on the pricing date rather than the share transfer date.

As the net asset value on the share transfer date was much higher than on the pricing date, the LSTB decided to reassess the tax payable on the share transfer based on the net asset value on the share transfer date. As a result, the LSTB collected CNY 8.5 million in additional taxes from the Singapore seller.

Observations

In a share transfer from a non-resident enterprise to a domestic enterprise, the rule authorizes the transferred enterprise's tax bureau to reassess the tax on the seller if the buyer does not withhold tax in accordance with the law. The Shandong Case indicates the possibility of tax reassessment by the transferred enterprise's tax bureau if the buyer does not withhold sufficient tax.

However, instead of having the seller pay additional tax to the transferred enterprise's tax bureau, the transactional parties always have the choice to involve the buyer's tax bureau and pay additional tax there (if any) since the rule has made it clear that the domestic buyer shall withhold and pay tax to its in-charge tax bureau. From the seller's perspective, it should not be held liable for additional taxes as long as the buyer has withheld and paid sufficient tax to its tax bureau. Meanwhile, if the buyer pays additional tax at its in-charge tax bureau, the buyer will be better positioned to claim a step-up basis at the adjusted transfer price for the shares acquired because any future share transfer by the buyer is under the charge of the buyer's tax bureau. We recommend transactional parties facing similar tax reassessments to consider this alternative option to achieve the best tax results for both parties.

3. Beijing Case: Tax Bureau Penalizes FIE for Underwithholding IIT on Employee Allowances

On 13 June 2017, the China Taxation News reported that the Beijing Local Tax Bureau initiated an audit on a foreign-invested enterprise (FIE) that underwithheld individual income tax (IIT) on employee allowances.[5] In addition to recovering CNY 16 million in IIT, the tax bureau imposed a penalty of CNY 12 million on the FIE.

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5 See http://www.ctaxnews.net.cn/html/2017-06/13/nw.D340100zgswb_20170613_1-06.htm?div=-1.

Facts

The FIE, a wholly-owned Chinese subsidiary of a Global 500 multinational company, employed around 100 foreign employees in Beijing. While analyzing the FIE's tax data, the tax bureau found that the FIE's foreign employees derived more than 50% of their salaries as tax-exempt allowances, significantly higher than the average level of 20% in similar enterprises.

The tax bureau then examined the FIE's accounting book and vouchers and identified the following non-compliance:

- **The FIE reimbursed its foreign employees for their children's offshore education fees and withheld no IIT.** Current Chinese tax law exempts a foreign employee from IIT on allowances for the education expense for the employee's children if those expenses are incurred in China. The tax bureau decided that the reimbursements for the education fees should be included into the employees' salary payments and subject to IIT.

- **The FIE reimbursed its foreign employees on fees paid for piano lessons and body-building and withheld no IIT.** Other than language training fees, Chinese tax law provides no IIT exemptions for other training fees incurred by a foreign employee. Thus, the tax bureau decided that reimbursements for piano lessons and body-building should be included into the employees' salary payments and subject to IIT.

- **The FIE reimbursed its foreign employees on airfare for family members to visit the employees and withheld no IIT.** Current tax rules only exempt reimbursements for travel expenses incurred by the foreign employee to visit family (limited to twice a year). Thus, the tax bureau decided the reimbursements for family members to travel should be included into the employees' salary payments and subject to IIT.

- **The FIE reimbursed its foreign employees for housing-related fees such as utilities, property management and cleaning fees and withheld no IIT.** Although the FIE argued that such fees should fall within the scope of tax-exempt housing allowances, the tax bureau decided that tax-exempt housing allowances only cover rent. Thus, the reimbursements for these housing-related fees should be included into the employees' salary payments and subject to IIT.

Moreover, the tax bureau found that the supporting vouchers for one employee's language training fees were fake invoices. Thus, the tax bureau decided that the language training fees should not be exempted from IIT due to lack of valid supporting invoices.

The tax bureau decided the FIE had violated IIT rules by unduly expanding the scope of tax-exempt allowances. In addition to ordering payment of the underwithheld IIT, the tax bureau imposed a penalty of CNY 12 million on the FIE, equal to 75% of the underwithheld IIT.

Observations

It comes as no surprise the tax bureau denied the tax exemptions for the reimbursements since the reimbursements either were outside the statutory

tax exemption scope or were lacking valid supporting vouchers. Nowadays, employee allowances are subject to increasing scrutiny by local tax bureaus. In light of this case, we recommend every enterprise hiring foreign employees conduct a thorough review of its compliance with tax rules related to employee allowances to avoid unnecessary tax penalties.

4. Jiangsu Case: Tax Bureau Enforces Controlled Foreign Corporation Taxation

On 27 June 2017, the China Taxation News reported that tax authorities in Jiangsu attributed the undistributed profits of a Hong Kong company ("**HK HoldCo**") to its Chinese parent company ("**ParentCo**") based on controlled foreign corporate (CFC) rules and collected about CNY 7.79 million in taxes from the ParentCo.[6]

Background

Although CFC rules were codified on 1 January 2008 in the *Enterprise Income Tax Law*, the rules are rarely enforced. The first recorded case enforcing CFC rules was reported in Shandong in 2015.[7]

According to the CFC rules, the profits of a CFC established in a low-tax jurisdiction will be included in the Chinese corporate shareholder's taxable income in the current year if the CFC does not distribute profits without a reasonable commercial need. A low-tax jurisdiction refers to a jurisdiction where the effective income tax rate is lower than 50% of the EIT rate (i.e., lower than 12.5%).

Case facts

The HK HoldCo was a wholly-owned subsidiary of the ParentCo. Since its incorporation in 2006, the HK HoldCo did not realize any profits until 2014. By the end of 2015, the HK HoldCo had accumulated CNY 31.16 million in profits. Yet, the HK HoldCo still did not distribute any profits to the ParentCo.

The tax bureau discovered the undistributed profits when it reviewed the ParentCo's foreign investment report and then decided to launch an investigation. As the ParentCo refused to provide the HK HoldCo's financial data, the tax bureau turned to the investment promotion bureau for further information. According to the ParentCo's recordal with the investment promotion bureau, the HK HoldCo's main business was corporate management consultancy while it derived most of its income from equity investment and transfer.

The tax bureau reapproached the ParentCo. Faced with the information gathered from the investment promotion bureau, the ParentCo cooperated and provided the HK HoldCo's financial data. With this data, the tax bureau confirmed that the HK HoldCo had undistributed profits of CNY 31.16 million by the end of 2015. Further, the tax bureau discovered that the HK HoldCo did not pay any taxes in Hong Kong even though the Hong Kong headline profit tax rate was 16.5%.

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6 See http://www.ctaxnews.net.cn/html/2017-06/27/nw.D340100zgswb_20170627_1-06.htm?div=-1.

7 For more details of the Shandong CFC case, please refer to our 2015 Midyear Issue of China tax monthly.

On this basis, the tax bureau preliminarily concluded that the HK HoldCo's undistributed profits should be included in the ParentCo's taxable income. In response, the ParentCo raised two arguments:

- The HK HoldCo should not be viewed as a CFC because all of its income was derived from active investment activities.[8] The tax bureau rejected this argument as dividends and capital gains from equity transfers are passive income according to common, international standards.
- The HK HoldCo did not distribute the profits because of its long term development, which is a reasonable commercial need. The tax bureau rejected this argument because the HK HoldCo's undistributed profits were used neither for business development nor for reinvestment.

After several rounds of negotiation, the ParentCo eventually agreed to pay CNY 7.79 million in EIT.

Observations

As the tax bureau did in the Shandong CFC case, the Jiangsu tax bureau also used a company's effective income tax rate rather than the headline rate in a particular jurisdiction when applying the CFC rules.

More importantly, this case sheds light on how local tax bureaus will interpret "reasonable commercial need" for CFC purposes. The Jiangsu tax bureau seemingly required the CFC to use its profits for either business development or reinvestment to establish a "reasonable commercial need" to justify not distributing profits. The news report does not say whether the tax bureau required evidence of actual use of profits or of planned use of profits. The planned use seemed to be more reasonable requirement since, if the profits were actually used, there would be no undistributed profits in the CFC. Thus, every CFC should maintain documentary evidence of its planned use for profits to provide a "reasonable commercial need" for not distributing those profits.

In addition to demonstrating how the tax authorities will apply CFC rules, this case also indicates their increasing willingness to enforce CFC rules. Since the first reported case in 2015, other cases were reported in which the tax authorities enforced CFC rules. More CFC rule enforcement appears to be part of a broader trend in China's tax enforcement expanding beyond its historically narrow focus on inbound international taxation to outbound international taxation.

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[8] The PRC tax law provides an CFC exemption for an offshore enterprise that mainly derives income from active operational activities.