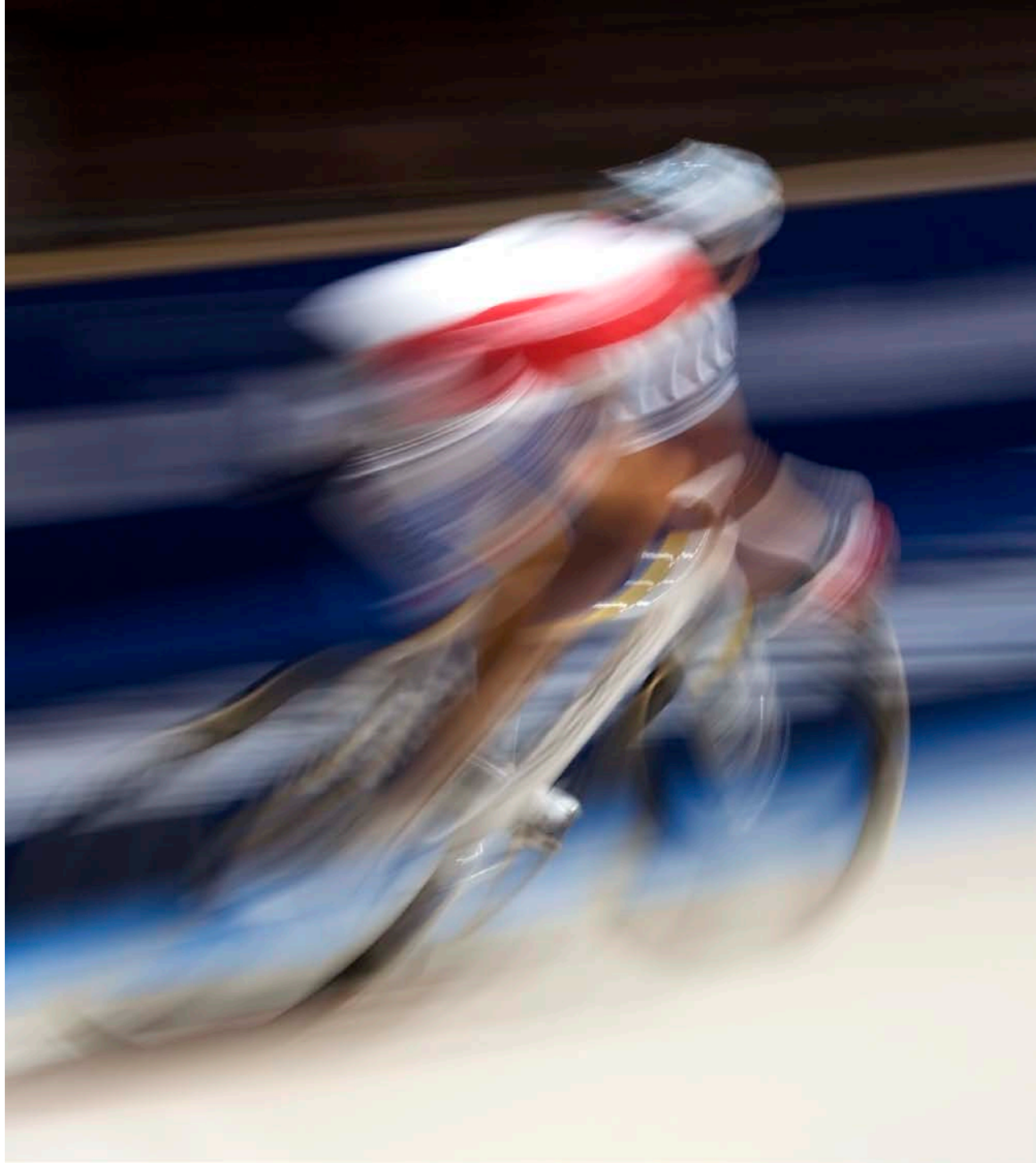




# China and India: What is Going on in the Two Fastest Growing Economies of the World?

Ryan Chang, Deloitte China  
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Patrick Lee, Deloitte Tax LLP

March 1 - 4, 2015



# Agenda – China

- Overview of recent Tax developments
- Updates on reorganizations
  - Offshore Indirect transfer
  - Special reorganizations
- Updates on BEPS and GAAR
  - BEPS development
  - Transactions on intangibles
  - Intra-group payments
- Questions and answers

# Overview of recent tax developments

# Overview of Recent Tax Developments

## Issues and trends to watch and follow

### Special Tax Adjustments

- (Issued) **GAAR Regulations** in relation to cross-border transactions
- (recently issued) **Bulletin on Offshore Indirect Transfer**
- (being monitored) Revision to **Circular 2** – Special Tax Adjustments
- (To watch for) **Outbound payments** (six tests?)
- (To watch for) **Disclosure of “aggressive tax arrangements”**
- (Issued) **15 unacceptable behaviors**
- (Issued) **13 high tax risk examples issued by Jiangsu office of SAT**

### China (Shanghai) Pilot FTZ and other FTZs

- (Issued) **Further relaxation and tailored expansion**
  - To monitor for further developments

### Tax Reform

- (In progress) **VAT Reform**
  - Construction and real estate, Consumer sector (e.g. Hospitality, GFSI)
- (New) **Tax Administration and Collection Law**
- (To watch for) **Individual Income Tax**

### New Foreign Investment Law

- **Inbound investments (barriers to entry reduced/eliminated):**
  - Central approval mechanism to replace case by case mechanism
  - Restrictions concerning form to be eliminated
  - Preferential treatment: investors from Hong Kong, Macau and Taiwan?
- **VIE structures:** Stricter compliance (possible grandfathering )

### Corporate Reorganizations

- (Issued) **Circular 109**
  - Special reorganization **minimum acquisition threshold now 50%** (from 75%)
  - New special reorganization transaction: **“Assignment” of shares or assets between resident enterprises**
- (Issued) **Circular 116**
  - **Deferred taxation of gain** in cases in which **resident enterprise contributes nonmonetary assets for equity in another resident enterprise**
- (Being monitored) **Circular 59/Bulletin 4**
  - Further changes

# Overview of Recent Tax Developments

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### Special Tax Adjustments

### Tax Reform

### Corporate Reorganizations

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- (Issued) Circular 109
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# Offshore indirect transfer and reorganizations

# Offshore indirect transfer – new rules

## Scope and features

- Bulletin [2015] No. 7 issued on February 6, 2015
- Expanded scope to indirect transfer of equity interest or similar rights in offshore enterprise that directly/indirectly owns taxable Chinese properties (assets of Chinese PE, immovable properties and equity interests)
- Supersede Circular 698, reporting is now on a voluntary basis and no non-reporting penalty
- Re-emphasize the transferee's withholding obligation
  - Non-filing and non-withholding penalty for a taxable transaction unless report within 30 days of signing of transfer agreement
    - Transferee: Penalty of 50% to 300% of underpayment
    - Transferor: Additional punitive interest of 5% on underpayment
- Safe harbor rules and deeming provision on commercial purpose test
- Applicable to any open cases

# Offshore indirect transfer – new rules (cont'd)

## Safe harbor rules

- Safe harbor rules
  1. Listed company exception (buy and sell through open market)
  2. Treaty exception (capital gain exemption if it were a direct transfer)
  3. Internal reorganization exception
    - $\geq 80\%$  common ownership (must be 100% common ownership if more than 50% of value derives from Chinese immovable properties)
    - no China capital gain tax reduction after reorganization
    - Transferee uses solely its own shares or shares of affiliates that transferee has a “controlling relationship” (excluding public company shares) as considerations

# Offshore indirect transfer – new rules (cont'd)

## Deeming provision – no commercial purpose

Deemed to be of no commercial purposes if all of the following conditions apply:

- 1)  $\geq 75\%$  of total equity value derived from taxable Chinese Properties;
- 2) At any time during the one year before the indirect transfer,  $\geq 90\%$  of total assets (excluding monetary assets) derived from China, or  $\geq 90\%$  of income derived from China;
- 3) Limited economic substance in offshore enterprise; and
- 4) Overseas tax burden on indirect transfer  $<$  China tax burden in a direct transfer.

# Offshore indirect transfer – new rules (cont'd)

## Factors to determine commercial purpose

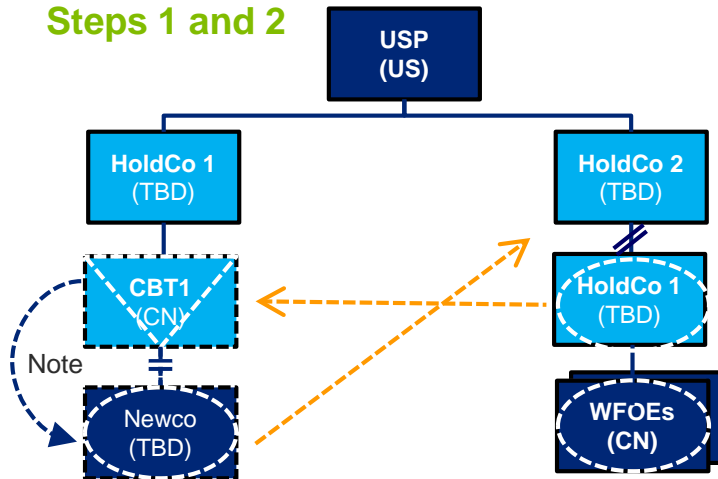
- If neither the Safe Harbor nor deeming provision applies, the following factors would be considered to determine if a transfer has commercial purposes
  - 1) Value of the shares attributable to taxable Chinese properties
  - 2) Holding mainly directly or indirectly Chinese investments, and deriving income mainly from China;=
  - 3) Functions and risks commensurate with economic substance of the structure
  - 4) Shareholders, business model and the duration of the structure
  - 5) Income tax position on the indirect transfer of taxable Chinese properties outside of China
  - 6) Substitutability of transferor investing indirectly and transferring taxable Chinese properties and directly investing and transferring taxable Chinese properties
  - 7) Applicability of tax treaty or arrangement with China on the gain derived from indirect transfer.

# Examples

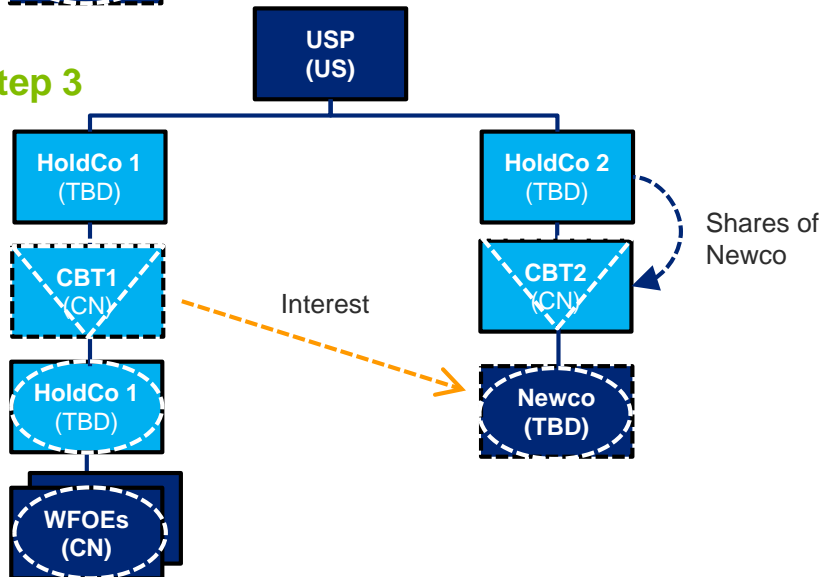
# Example I:

## Duo-China Business Trust for repatriation and FTC planning

### Steps 1 and 2



### Step 3



### Company profile

- U.S. companies having significant operations in China
- Substantial earnings accumulated in China and looking for tax-efficient repatriation

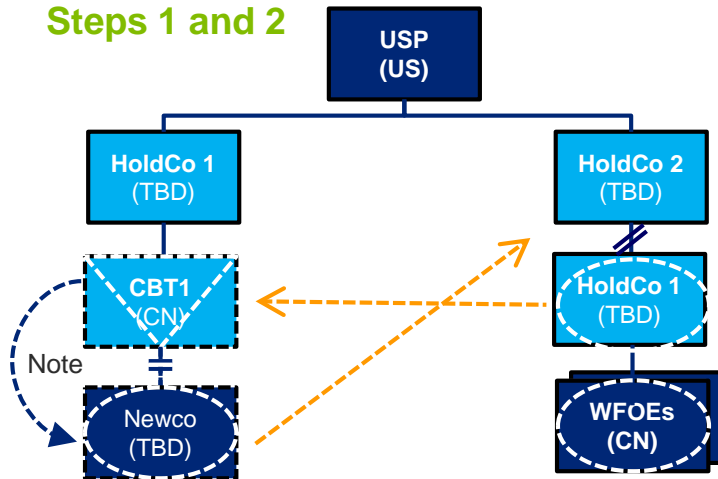
### Intended benefits

- Separate high/low tax earnings
- Same country exception on dividend from China

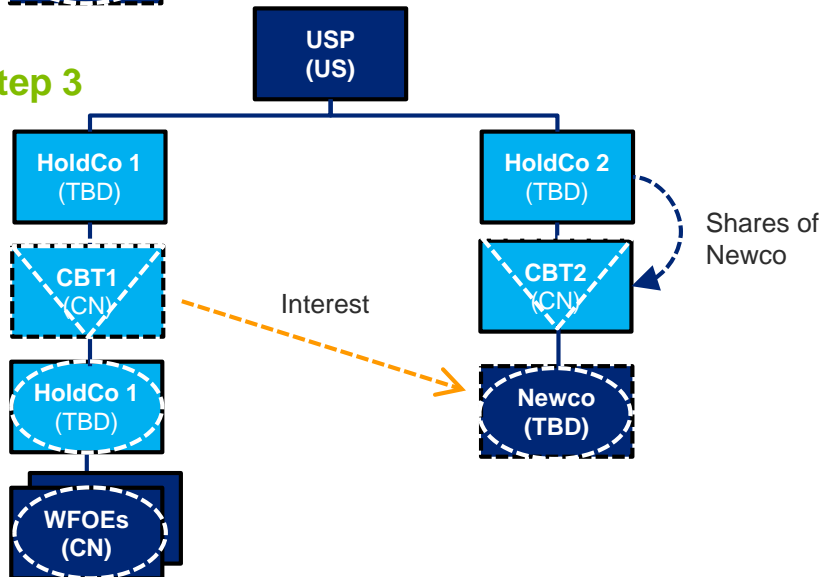
# Example I: (cont'd)

## Duo-China Business Trust for repatriation and FTC planning

### Steps 1 and 2



### Step 3



### Steps

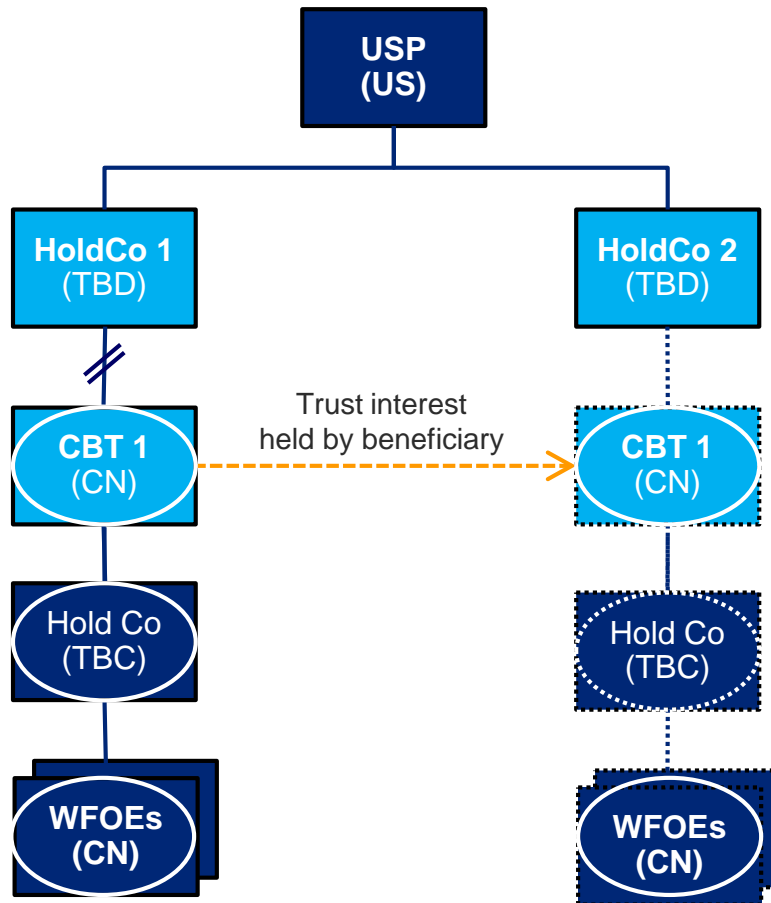
- Set up a duo-CBT financing structure, CBT1 would be set up with a Newco that holds a note from CBT1
- CBT1 would acquire the shares of the existing Chinese companies indirectly in exchange of shares of Newco
- The shares of Newco (holding the note from CBT1) would be subsequently contributed to CBT2

### Considerations

- US considerations (e.g., 901(m))
- Application of safe harbor rules on indirect transfer of WFOEs into CBT1

## Example II:

### Section 901(m) planning – use of a CBT



#### Company profile

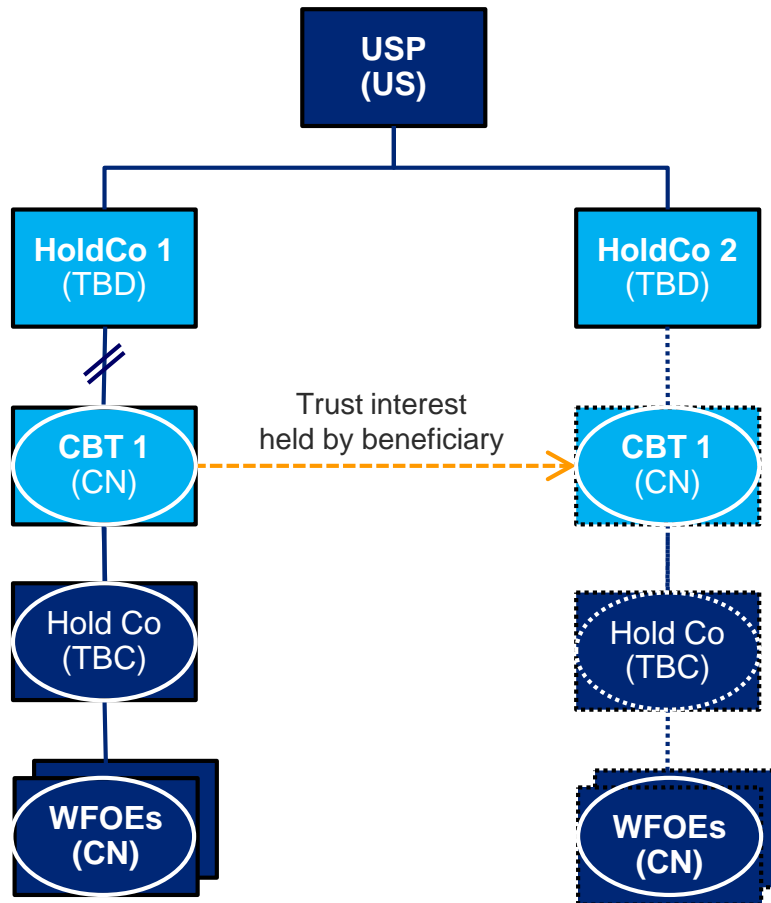
- U.S. companies that are contemplating an acquisition (internal or external) and would like to avoid the effects of §901(m) taint under a covered assets acquisition (“CAA”)

#### Intended benefits

- Avoiding CAAs: Transactions that result in a basis step-up for U.S. tax purposes and not treated as a CAA (Not treated as transfer of stocks or being disregarded for local tax purposes)

## Example II: (cont'd)

### Section 901(m) planning – use of a CBT



#### Steps

- Transfer the shares of Chinese companies indirectly into a CBT and then transfer the trust interest held by the beneficiary in CBT

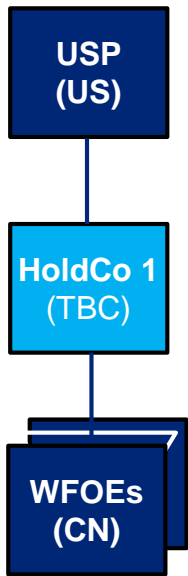
#### Considerations

- Transfer of trust interest not considered as transfer of stocks for U.S. tax purposes
- Application of safe harbor rules on indirect transfer of WFOEs to form CBT1

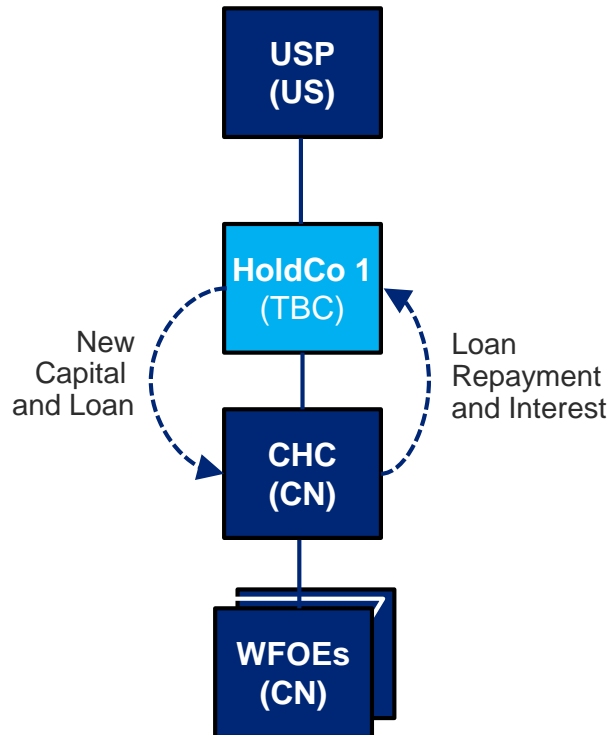
## Example III:

### Use of Chinese holding company

#### BEFORE



#### AFTER



#### Company profile

- U.S. companies having or planning to acquire significant operations in China

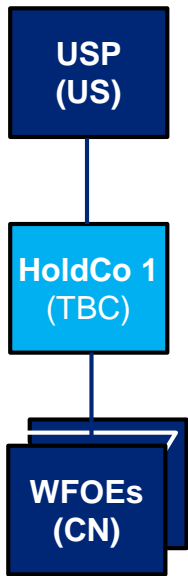
#### Intended benefits

- Create leverage by utilizing the foreign borrowing capacity (four to six times of registered capital) of the newly established Chinese Holding Company ("CHC") to acquire targets in China

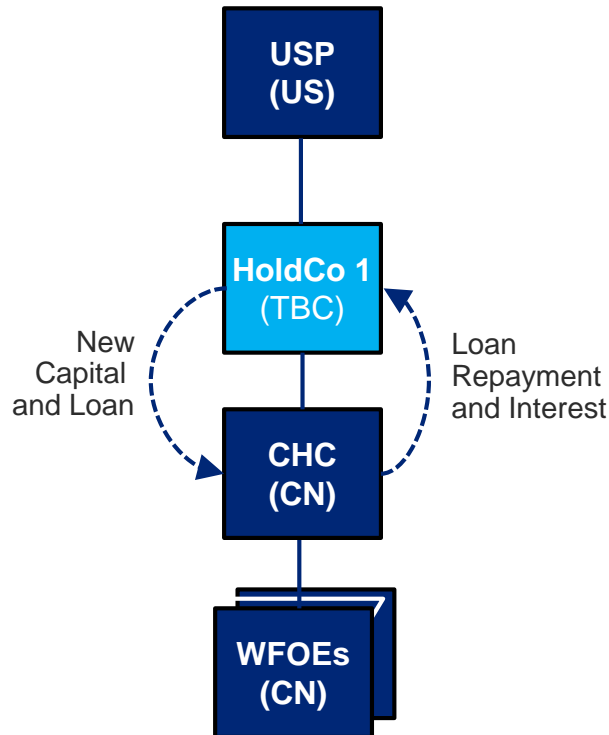
## Example III: (cont'd)

# Use of Chinese holding company

### BEFORE



### AFTER



### Steps

- Set up a CHC (as the Chinese principal company), CHC borrows money offshore to fund its acquisition of equity interests in other Chinese entities.

### Considerations

- Taxation on transfer of Chinese entities?
- Tax-deferred reorganizations under circular 109?
- US\$30 million of minimum newly injected cash to set up CHC
- Thin Cap Rules and GAAR

# BEPS and GAAR

# BEPS: Does China accept OECD recommendations?

- China has been closely involved in the discussions to date
- Many of the TP recommendations reflect positions of Chinese tax authorities
- In the meantime, SAT already taking action
  - Significantly more aggressive tax audit demands observed
  - Information concerning significant outbound tax payments requested (ten years)
  - “High risk transactions” and “15 Unacceptable Behaviours” identified and publicized
  - Six tests for tax deductibility of service charges articulated
  - Circular 2 (Special Tax Adjustments): being amended and such expected to reflect China’s position in relation to relevant BEPS matters
  - Administrative Measures concerning General Anti-Avoidance Rules (Trial) published
  - See Appendix 1 for summary of SAT actions

# BEPS: China's response to UN questionnaire

## **China recognized BEPS planning as a major threat**

- Respond by enacting GAAR legislation and carrying out TP audits

## **Common practices and structures used by MNCs in China**

- Adopt transfer pricing principles and methodologies in intra-group dealings (e.g., purchase & sale, financing, equity transfer, services) to lower profits in China
- Set up shell companies with no genuine economic substance in low-tax jurisdictions

## **China's priorities on OECD's Action points**

- TP-related actions as KEY
- MAP and digital economy are also important

# BEPS: China's response to UN questionnaire (cont'd)

## **China's obstacles/limitations to combat BEPS**

- Lack of comparable companies in China
- Unwillingness to co-operate from companies
- Lack of experienced tax personnel

## **China's wants**

- Establishment of the general anti-avoidance rules (GAAR) by developing countries
- Guidelines for developing countries on action plan and related staffing budget

# 15 “unacceptable” behaviors published by China SAT

- 1 Base erosion and profit shifting
- 2 Double or multiple non-taxation
- 3 Harmful tax planning
- 4 Opaque tax regime
- 5 Structures or arrangements without substantial commercial activities
- 6 Tax deduction for expenses that are not reasonable
- 7 Loss status for single function subsidiaries of foreign companies
- 8 Treaty abuse
- 9 Artificial high price of intangible assets
- 10 Mismatch of return with function undertaking and value contribution
- 11 Low return by "High-tech Company"
- 12 Lack of respect to the uniqueness of Chinese market
- 13 Transfer of foreign tax losses to China
- 14 Lack of cooperation by enterprises with respect to information collection by the tax authorities
- 15 Hybrid mismatch for tax avoidance purposes

Note: No specific examples provided as to what constitutes these behaviors.

# 13 examples of high Tax risk arrangements issued by Jiangsu office of SAT

(see appendix 2)

- 1 Establish offshore structure to avoid “Chinese tax resident enterprise” status
- 2 Tax base erosion through cross-border financing
- 3 Profit erosion through free use of intangible assets
- 4 Controlled Foreign Companies
- 5 Mismatch of function, economic substance and profit level
- 6 Profit shifting through cross-border related party payments
- 7 Reducing group effective tax rate by offsetting transactions
- 8 Profit shifting through purchase of foreign related party at non-arm’s length price
- 9 Transfer of mere legal ownership of intangibles to offshore company
- 10 Assuming “implicit cost” for the group without a proper compensation
- 11 Tax avoidance through shell company in tax haven and the use of offshore bank accounts
- 12 Unreported taxable gains during “start-up period”
- 13 Artificial avoidance of PE status

# Transactions on intangibles

# China Tax Authority focuses on intangibles

1

**China subsidiary positioned as “routine functions but not IP Owners”**

2

**The application of location saving and market premium**

3

**The pricing of IP owned by overseas company, and local entity’s contribution**

4

**Inspection of extraordinary non-trade outbound payment**

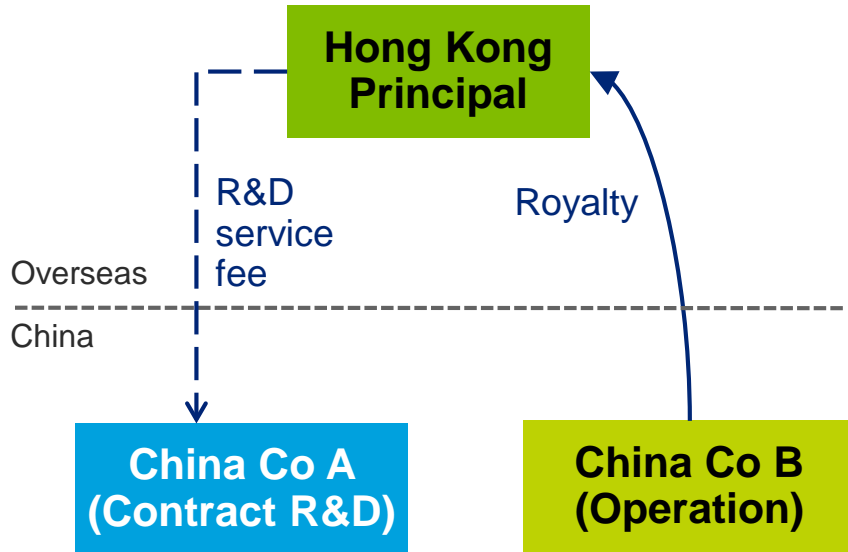
5

**China entities’ contribution from the aspect of global supply chain (disclosure requirement of country-by-country reporting in TP documentation)**

# Intangible transactions – what SAT looks for since BEPS

- Legal ownership  $\neq$  arm's length remuneration
- Whether legal owner satisfies **D**evelopment, **E**nhancement, **M**aintenance, **P**rotection and **E**xploitation (DEMPE) functions;
- Where are the people functions
- Explore profit split at early stage
- Is royalty payment recipient a conduit company or in tax heaven
- Any location specific advantage in China
- Proactively seek for information on potential CUP

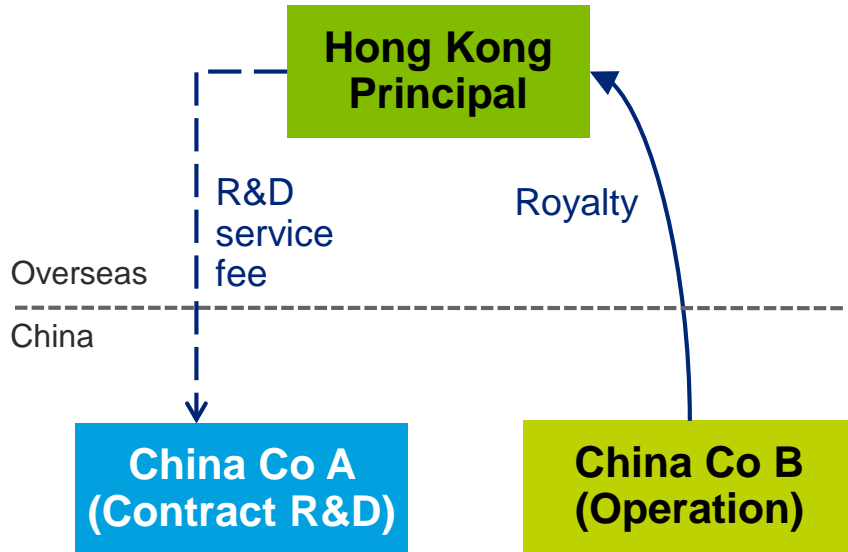
# Intangible transactions – case study



## Background

- China Co A provides contract R&D service to Hong Kong Principal and receives service fee on a cost-plus basis, while the contractual terms stipulate that Hong Kong Principal owns all R&D achievements
- As the principal company of the Group in Asia-Pacific region, Hong Kong maintains approximately 30 employees, but no professionals to oversee China Co A's R&D activities
- Hong Kong Principal obtains residual profit as the owner of intangible assets, while China Co B performs routine functions and earns routine return

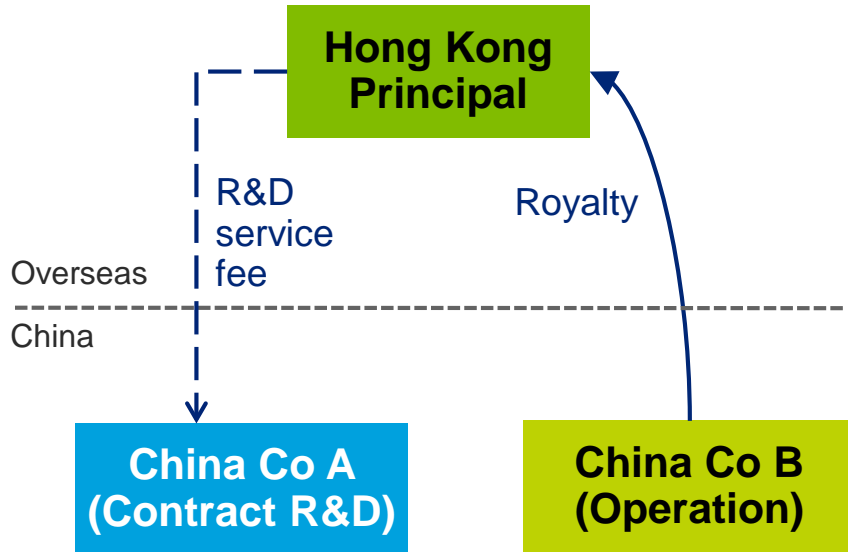
# Intangible transactions – case study (cont'd)



## Chinese Tax Authority's view

- In this case, Hong Kong Principal is being viewed without sufficient business substance in claiming the residual profit
- Tax authority's preliminary adjustment proposal:
  - Disregard the existence of Hong Kong Principal and attribute the residual profit to China Co; or
  - Hong Kong Principal only performs limited routine administrative services, but returns the residual profit to China Co after obtaining limited routine profit.

# Intangible transactions – case study



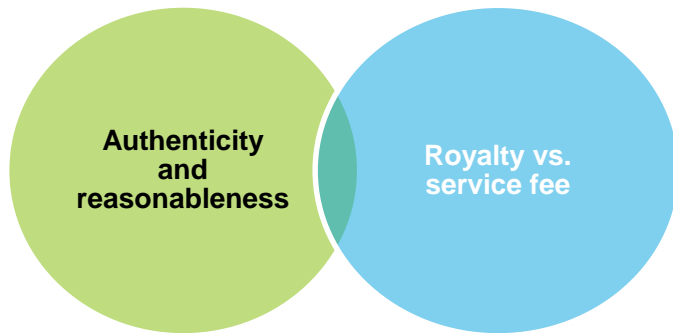
## Chinese Tax Authority's view (cont'd)

- Overuse of the “Special Measures” of OECD’s 2014 December Discussion Draft?
- Chinese tax authority’s common considerations in previous similar cases
  - Location savings of the R&D activities
  - China Company’s contribution to the intangible assets and profitability

# Intra-group payments

# SAT's view on cross-border intragroup service payments

- Two difficulties



- Four comments provided to UN

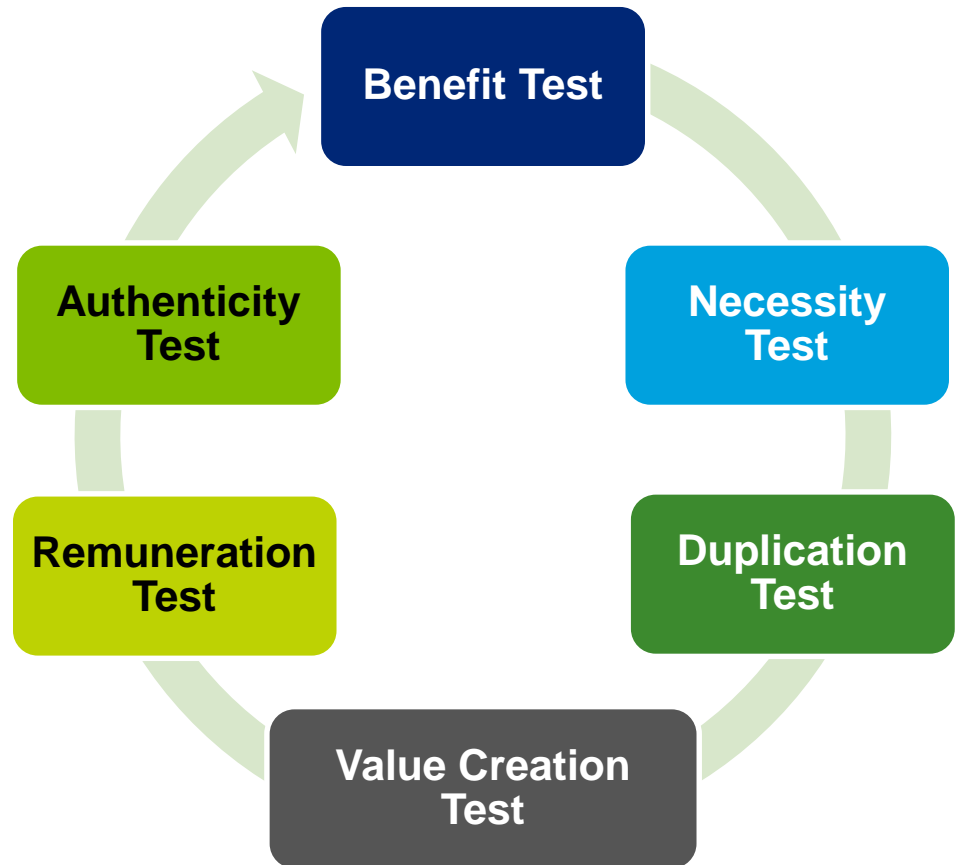
Benefit test – which entity derived the benefits from such services (parent/ subsidiary)

Benefit test – whether the services are necessarily needed by the PRC entity

Whether the services have already been compensated/ embedded in other fees/ transactions

Whether the services are duplicative, or considered to be shareholder activities

- Six tests



# SAT is inspecting on large cross-border payments

- Issued in July 2014, SAT is urging tax officers to strengthen anti-avoidance investigation on non-trading, cross-border payments (e.g., Circular 146)
- On a national basis, conduct inspection on the large amount of cross-border **service fees and royalty payments**, covering 2004-2013 (ten years)
- SAT's unilateral actions under BEPS initiatives

## Especially target on **service fees** as below


- ☐ Shareholders service
- ☐ Group management
- ☐ Duplicated service
- ☐ Fees not relevant to function and risk profile or operation arrangement
- ☐ Fees associated with other type of intercompany transactions

## Especially target **royalty payments** as below


- ☐ Paid to tax havens/jurisdictions with low tax rate
- ☐ Paid to overseas related party performing limited or no function
- ☐ Paid on outdated/depreciating IPs
- ☐ Value added by domestic enterprises

# Outlook of group service transaction regulations and consideration for taxpayers

## Anti-avoidance investigation

- Under Circular 146, more audits on cross-border service/royalty payments are expected
  - SAT will also likely examine whether service income received by a PRC entity meets the arm's length requirement
- 

## China is demanding a higher standard on visibility

- Following the revision OECD TP guidelines, China recommends the country-by-country report should disclose information on related party interest, royalty and service fee payments
  - Circular 2 is being revised to include a section on cross-border service fees
- 

## Consideration for taxpayers

- Documentation management: documentation to reflect transaction flow and support received by China is key
- Analysis on nature and reasonableness of transaction, meeting six tests
- TP documentation report should be specific on the nature of transaction(s) rather than on a collective/aggregated basis

# Agenda – India

Budget 2015

Updates on GAAR

Updates on APA and BEPS

GST roadmap

Repatriation strategies

Questions and answers

# Budget 2015

# Budget 2015

## Significant Policy Proposals

### **Infrastructure sector:**

- Appointment of Expert Committee to examine the possibility and prepare a draft legislation to replace multiple prior permissions with pre-existing regulatory mechanism – Aim towards ease of doing business in India
- Issuance of tax free infrastructure bonds for the projects in rail, road and irrigation sectors

### **Financial Markets:**

- Government to have control on capital flows as equity in consultation with RBI
- Indian Financial Code (IFC) to be introduced in Parliament

### **Banking and Investment:**

- Introducing comprehensive Bankruptcy Code in fiscal year 2015-16
- Allowing foreign investments in Alternative Investment Funds

# Budget 2015

## Significant Policy Proposals

### **Curbing Black Money:**

- To introduce a Bill to bring a comprehensive new law on Black Money

### **Resolution of Disputes:**

- Introduction of Public Contracts (Resolution of Disputes) Bill to streamline the institutional arrangements for resolution of disputes

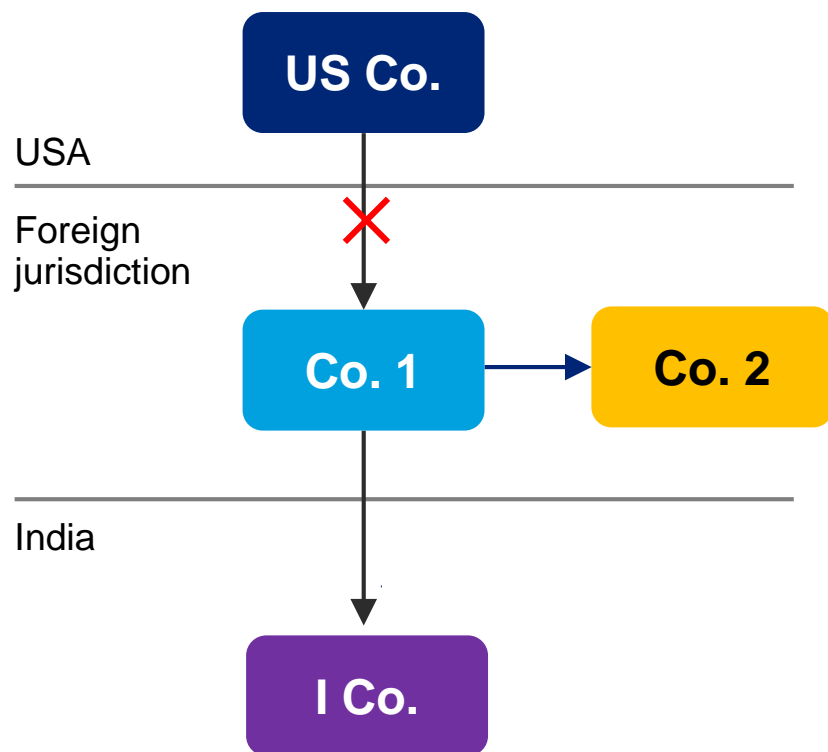
# Budget 2015

## Corporate Tax: Significant Amendments

- The Finance Minister has announced that corporate tax rate of an Indian company will be reduced from 30% to 25% over a period of 4 years
  - Reduction to be accompanied by rationalization and removal of various tax exemptions and incentives available to Indian companies.
- No change in corporate tax rate for financial year 2015-16
- Increase in the rate of surcharge by 2% for the Indian company having total income exceeding INR 10 million (Approx. USD 0.16 million)
  - Effective dividend distribution tax (DDT) rate: 20.36% (19.994%)

# Budget 2015

## Corporate Tax: Significant Amendments Indirect transfer



- Applicable provided on the specified date:
  - a) Value of Indian assets > 100 million (Approx. USD 1.6 million); **and**
  - b) Represents **at least 50%** of value of all assets owned by the company/entity.
- Value of asset = FMV of assets, without reduction of liabilities
- Determination of FMV of Indian assets vis-à-vis global assets would be prescribed in rules
- Taxation on proportionate basis. Method of determination of proportionality to be provided in rules
- Specified date – defined

# Budget 2015

## Corporate Tax: Significant Amendments Indirect transfer

- Exemption provided for holding of voting rights/share capital/interest of 5% or less – subject to conditions
- Exemption provided for transfer pursuant to amalgamation/demerger of foreign companies – subject to conditions
- Reporting obligation on the Indian entity
  - To furnish information relating to the off-shore transaction having the effect of directly/indirectly modifying the ownership structure/control of the Indian company/entity
  - Penalty leviable on failure to report

\* Plus applicable surcharge and cess

# Budget 2015

## Corporate Tax: Significant Amendments

- Amendment to definition of residence of companies - concept of PoEM introduced
- WHT rate on royalties and technical service fee reduced from 25%\* to 10%\*
- Fund Managers in India not to constitute business connection of offshore funds – subject to prescribed conditions
- Reduced withholding tax rate of 5% on interest paid to FII / QFI on rupee denominated debt will apply to interest paid till 31 May 2017
- Rationalization of MAT regime – FII would not be subject to MAT unless income qualifies as short term capital gains on which STT is not paid
- Abolition of wealth tax
- Favorable taxation regime for 'Business Trust' in India

\* Plus applicable surcharge and cess

# Updates on GAAR

# Updates on GAAR

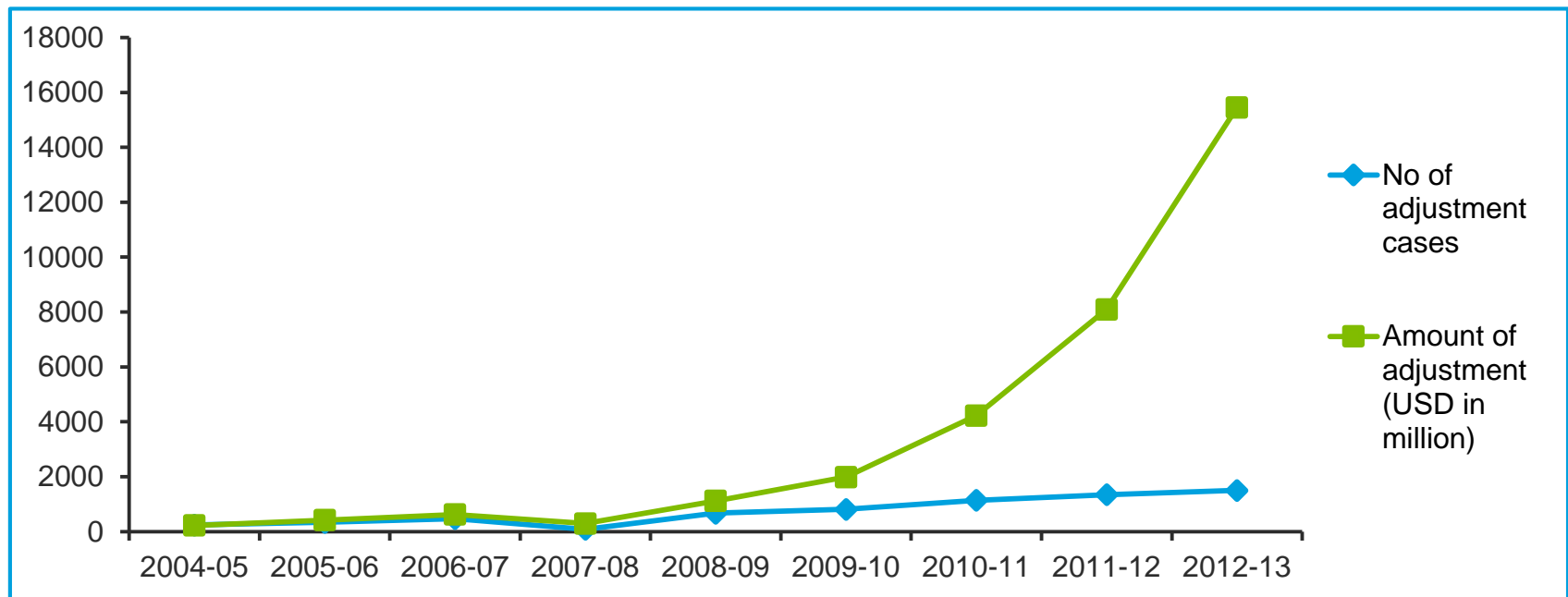
- Applicable prospectively from April 1, 2017
- GAAR provisions to be implemented as a part of comprehensive regime to deal with OECD's recommendations on BEPS and aggressive tax avoidance
- Investments made up to 31 March 2017 are proposed to be protected from applicability of GAAR (as per memorandum explaining Finance Bill 2015)

# Updates on Transfer Pricing, APA and BEPS

# India transfer pricing landscape – story so far

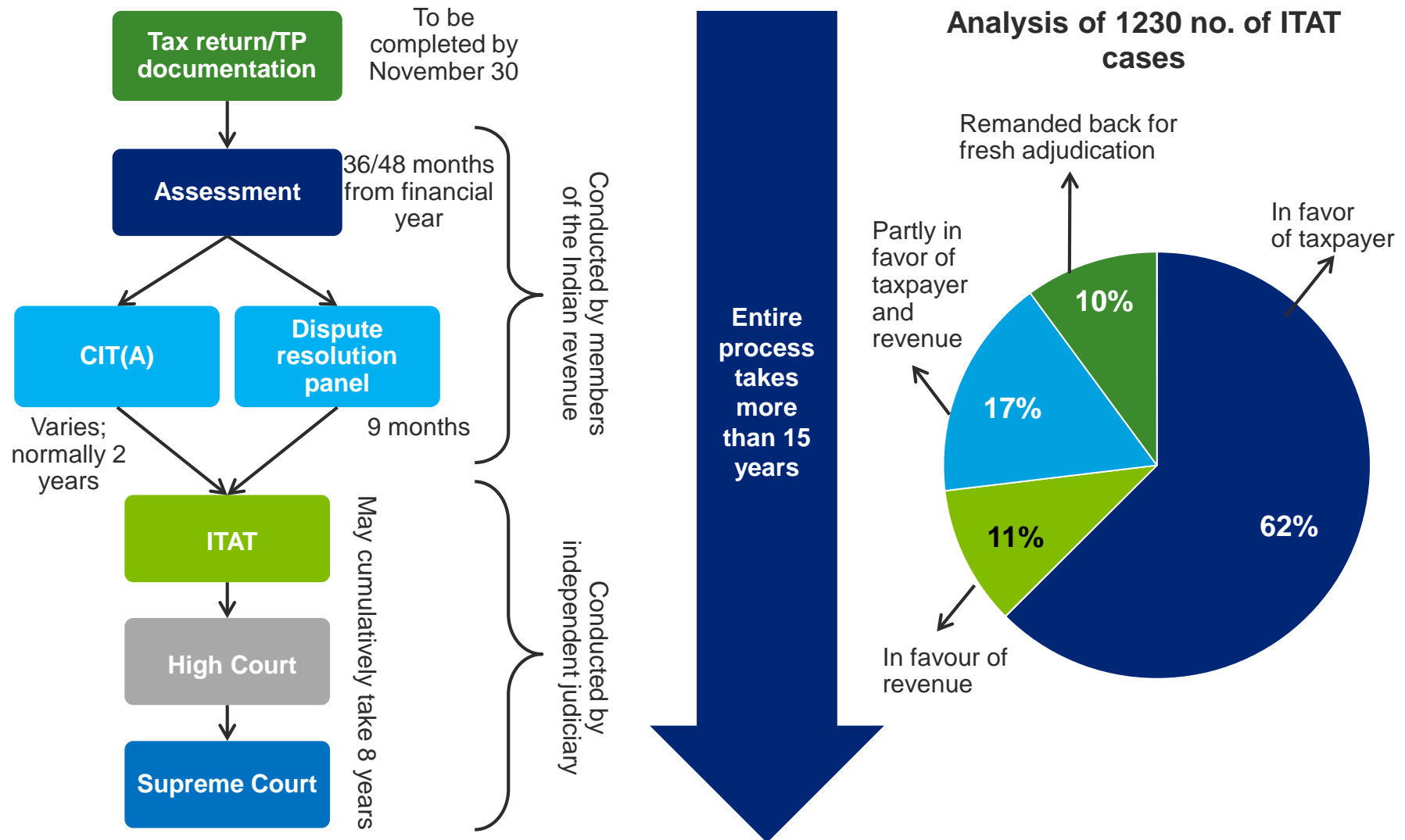
- Ten years of TP audit completed – trends indicate greater scrutiny, ever increasing adjustments and resultant litigation
- Approximately 50% of cases picked up for audit adjusted by tax department

## Trend of transfer pricing adjustment



- About 1,200 transfer pricing cases disposed of by various Tribunals
- In less than 30% of cases, department's position upheld by ITAT

# Traditional dispute resolution mechanism and outcome



# Transfer Pricing – in news....

## Obama in India: India, U.S. finalize framework to resolve transfer pricing cases

India and the US have finalized a framework to resolve transfer pricing cases, some of them pending for five years, in what could end tax trauma for more than 50 American MNCs such as Microsoft, IBM and Oracle by the fiscal year-end and send a strong signal to overseas investors that the Modi government is indeed committed to a non-adversarial tax regime. With President Barack Obama arriving in a few days, officials of the...



## Advance pricing agreements to draw investments from U.S. companies like Lockheed Martin, Google and others to India

US MNCs such as [Lockheed Martin](#), [Google](#) and [Dell](#) might soon be able to get a fix on their tax liability in advance, sans any fear of losing tax credits back home, with the American government agreeing to bilateral [advance pricing agreements](#) (APAs).....



# Alternate dispute resolution mechanism

## Mutual Agreement Procedure ('MAP')

- Negotiation/Compromise possible between two Competent Authorities (CA) avoiding double tax impact through correlative relief
- CAs agreeing on suspension of collection of tax demands (US, UK, Denmark)
- MAP depends on the meetings of CAs – time consuming, manning the cell and relationship between CAs
- India and U.S. reached agreement on January 15, 2015 to solve backlog of MAP cases to resolve double taxation arising from India-initiated TP adjustments

# Alternate dispute resolution mechanism

## Advance Pricing Agreement (APA)

- APA program introduced during 2012-13 – expected to provide certainty, removal of audit threat and substantial reduction in compliance cost
- Existing APA provisions apply prospectively, i.e. cover a maximum period of five consecutive years
- Effective October 1, 2014, roll back mechanism introduced – detailed framework awaited
- Roll back to be applied for a period not exceeding four previous years preceding first of the previous years for which APA applies
- For example, if the APA has been agreed from FY 2015-16 onwards, then the agreement may also cover prior four years – from FY 2011-12 to FY 2014-15
- APA to provide for determination of arm's length price or methodology of determination of arm's length price
- Proposal to strengthen the administrative set up to expedite disposal of applications

# Transfer Pricing – APA update

- Highest APA filing in the world during its first year
- Second rounds of APA application filing completed in March 2014 – overwhelming response with record number of APA applications filed: 232 in 2014; 146 in 2013
- Taxpayers with various business profiles opted for the APA program – primarily unilateral
- Positive response from APA authorities during pre-filing and post-filing meetings/discussions
- Despite being a forward looking agreement, it has the potential to resolve historical issues – likely to have persuasive value

**India signs first batch of 4-5 APAs on March 31, 2014**  
**Indian Competent Authority team has successfully signed first**  
**Bilateral APA in December 2014**

# BEPS Scorecard for India

<b>Current legislative position</b>	<ul style="list-style-type: none"> <li>• India part of G20 supporting BEPs initiative</li> <li>• There have been no changes in tax laws specifically related to BEPS so far –policymakers hinting at making such changes in near future</li> <li>• A notification issued on Cyprus as non-cooperative jurisdiction</li> <li>• GAAR may be introduced from April 1, 2015 or 2016 ?</li> <li>• Interesting to see how India deals with concept of GAAR, LOB and PPT</li> </ul>
<b>Perspective of the public</b>	<ul style="list-style-type: none"> <li>• There is definitely a sense of awareness with the public in general; all actions are being closely followed</li> </ul>
<b>India's response to UN questionnaire</b>	<ul style="list-style-type: none"> <li>• BEPs significant area of concern</li> <li>• Common practices/structures identified</li> <li>✓ Management/Service charges, royalties, technical fee, interest</li> <li>✓ Aggressive TP, including supply chain restructuring that allocates profits in low tax jurisdictions</li> <li>✓ Digital enterprises – zero/no taxation</li> <li>✓ Artificial avoidance of PE</li> <li>✓ Treaty shopping</li> <li>✓ Lack of information to address BEPs concerns – information exchange</li> </ul>
<b>Unilateral BEPS actions</b>	<ul style="list-style-type: none"> <li>• No clear signs of specific BEPS views during tax audits or litigation so far – though management charges, royalties, etc. area of focus in TP audits</li> </ul>

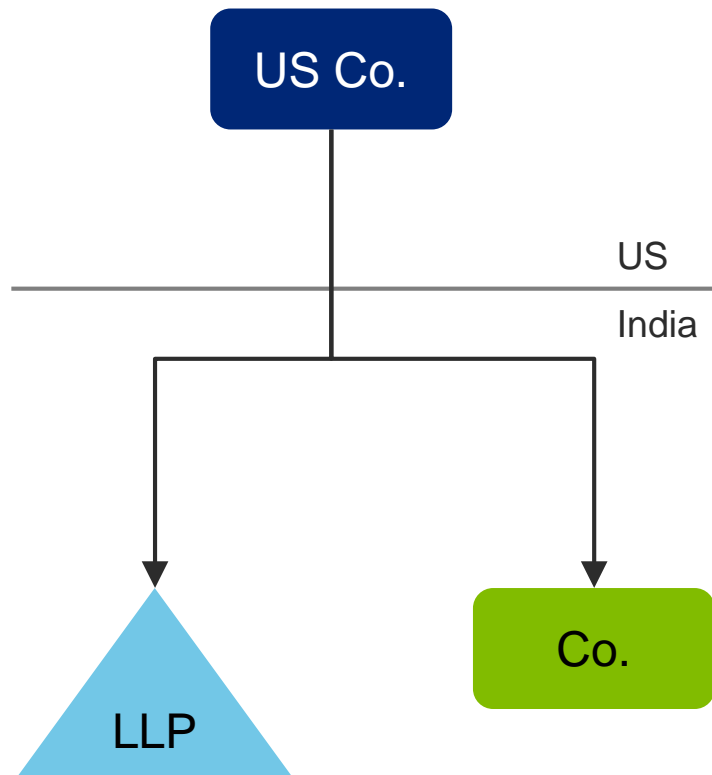
# GST roadmap

# GST roadmap

- Commitment towards introduction of GST by April 1, 2016
- GST is expected to be a State of the Art Indirect Tax system
- It will add buoyancy to the Indian economy by developing a common Indian market and reducing the cascading effect on the cost of goods and services
- Key takeaway: Proposed introduction of GST from 1 April 2016 is considered as a revolutionary shift towards more rational system of indirect tax and is expected to play a transformative role for the Indian economy.

# Repatriation strategies

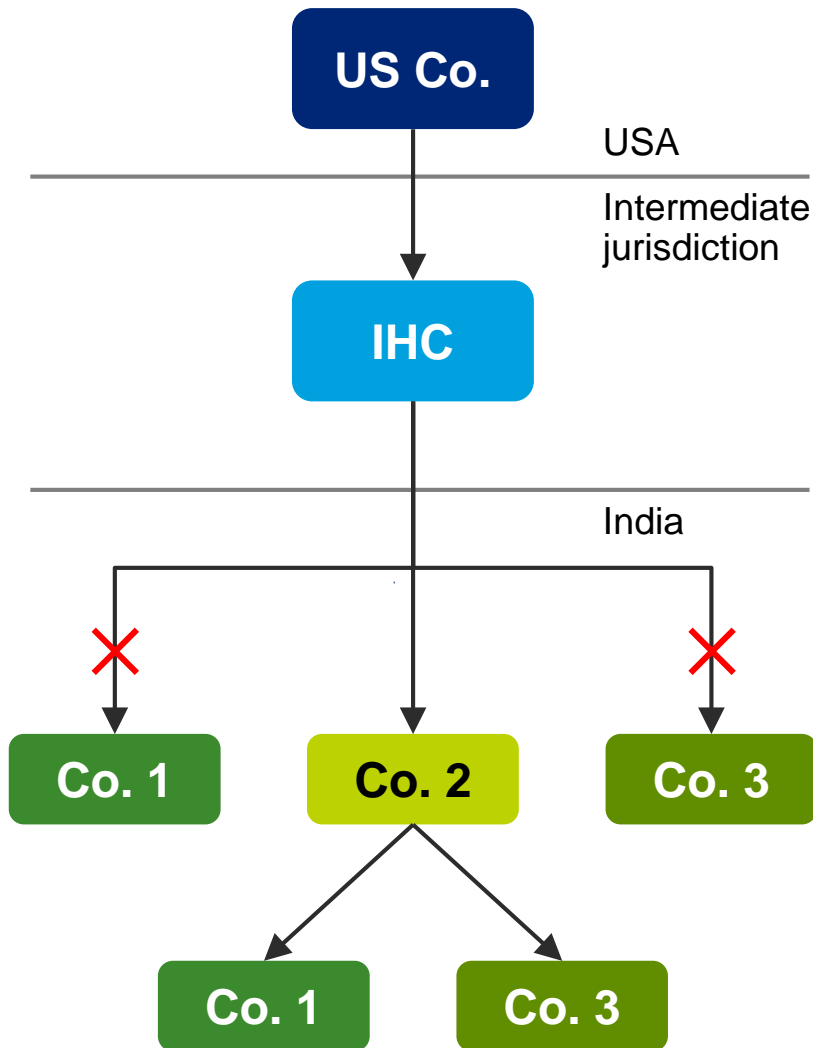
# LLP vs. Company as an investment vehicle



Key attributes	LLP	Company
Tax Rate	30%*	30%*
Dividend Distribution Tax	NA	15%*
AMT/MAT	18.5%*	18.5%*
Profits of Partners/ Dividends	Exempt	Exempt
Prior FIPB approval	Required	No, with exceptions
Requirement of local partner	Yes, can be minority	No, with exceptions
Ability to secure Offshore Borrowings	Not allowed	Allowed (subject to conditions)
Transition to a different form of entity	Possible	Possible

\*plus applicable surcharge and cess

# Internal restructuring



## Background/Mechanics

- IHC holds three Indian subsidiaries viz. Co.1, Co.2 and Co.3. All three Indian entities are operating companies
- IHC desires to consolidate Indian entities under Co. 2 for business and commercial reasons
- Co.2 to acquire shares of Co.1 and Co.3 at FMV

## Considerations

- Prior FIPB approval will be required prior to effecting the transfer
- No capital gains tax liability in India in the hands of IHC
- No MAT liability for IHC on transfer of shares
- Two tier dividend distribution tax liability will not exist with regard to dividends paid by Co. 1 and Co. 3.
- Valuation report to be obtained under exchange control regulations
- Subsequent dilution in Co.1 and Co.3 by Co. 2 will entail capital gains tax liability in India

# Questions and answers

# Appendix 1:

# Summary of China BEPS actions

# BEPS: China SAT positions and actions

Action 1: Digital economy		
<ul style="list-style-type: none"><li>• Data has value because collecting data incurs costs and data can be traded</li><li>• Supply and demand interact to complete a behavior</li></ul>		
“Gaps”	“Frictions”	“Transparency”
i. Establishing international coherence of corporate income taxation	ii. Restoring the full effects and benefits of international standards	iii. Ensuring transparency while promoting increased certainty and predictability
Action 2: Hybrid mismatch	<b>Action 6: Prevent treaty abuse</b> <ul style="list-style-type: none"><li>• SAT’s view on PPT vs. LOB options not clear</li></ul>	<b>Action 11: Data collection for BEPS</b> <ul style="list-style-type: none"><li>• Income and assets hidden overseas by wealthy Chinese will be discovered</li></ul>
<b>Action 3: CFC rules</b> <ul style="list-style-type: none"><li>• SAT to strengthen scrutiny of CFCs</li></ul>	<b>Action 7:</b> Prevent the artificial avoidance of PE status	<b>Action 12: Disclosure of aggressive tax planning arrangements</b> <ul style="list-style-type: none"><li>• China will not lag behind the world</li></ul>
<b>Action 4: Limit base erosion via financial payments</b> <ul style="list-style-type: none"><li>• Examples of high-risk transaction provided (<i>refer following slides</i>)</li></ul>	<b>Transfer pricing (Action 8, 9, 10)</b> <ul style="list-style-type: none"><li>• IP to be a focus<ul style="list-style-type: none"><li>– Emphasis on value creation</li><li>– Downplay legal ownership</li></ul></li><li>• Marketing intangibles – cost-plus likely not acceptable for marketing function</li><li>• Contract R&amp;D – cost-plus likely not acceptable</li></ul>	<b>Action 13:</b> Re-examine transfer pricing documentation
<b>Action 5: Harmful tax practices</b> <ul style="list-style-type: none"><li>• China has almost no harmful tax practices</li></ul>		<b>Action 14:</b> Make dispute resolution mechanisms more effective
<b>Action 15: Develop a multilateral instrument</b>		

Source: China SAT' BEPS Conference, Beijing, September 25, 2014

# BEPS — China perspective

## Environment before BEPS

- **Transfer Pricing - many BEPS concepts and arguments already applied in audits and APAs**
- **Outbound payments**
  - compliance -- contract registration, reporting and withholding
  - Treaty benefits claims
  - deductibility -- not "management fees", "benefit to payer"
- **Treaty abuse - "beneficial owner" and capital gain tax exemption claims**
- **Taxation on business carried on by non-residents**
  - tax on payments "made to ..."
  - "deemed profit" basis
  - "PE", but result in taxation on a "deemed profit" basis ... relatively "benign"
- **Indirect Transfers**

## Since BEPS

- **Transfer Pricing**
  - Formalization of BEPS concepts and arguments already applied in audits and APAs
  - CbC reporting - to be made available through foreign jurisdiction tax authority? (China unlikely to favor)
  - Chinese tendency to enlarge demands made in relation to Local Files ... to include what is recommended for Master file and CbC
  - Moving away from "cost plus" -- towards "profit splits" favoring China, or even further, "China entitled to residual profits, and principal to the cost plus"
- **Outbound payments**
  - more reporting, more scrutiny and more challenges
  - deductibility -- "six tests" formalized
- **Treaty abuse - "beneficial owner" and Article 13 claims**
- **Taxation of offshore businesses**
  - still tax on "payments made to ..."
  - move away from "deemed profit" basis?
  - "PE" high on agenda, and result may no longer be taxation on a "deemed profit" basis
- **Indirect Transfers - some relaxation per New Bulletin**
- **Focus might now move to "Chinese tax resident enterprise"**
  - Location of "management organization"? Not merely "location of management activities"
- **Digital economy**
- **Chinese HQ MNEs (Outbound)**
  - Chinese CFCs in focus?

# Appendix 2:

International tax compliance  
administrative plan and  
published high risk examples  
by Jiangsu Province

# Jiangsu Provincial State Tax Bureau's (STB) administration plan for international taxation compliance in 2014-15

## Background of the administration plan

- To respond to OECD's Base Erosion and Profit Shifting Report (BEPS) and the corresponding action plan

## Aims of plan

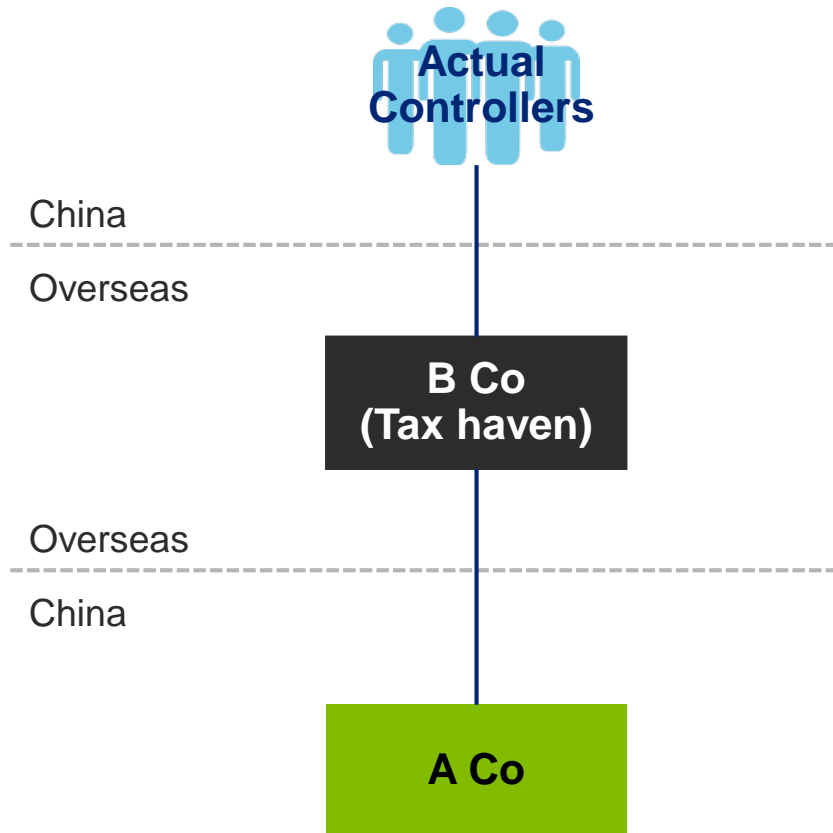
- To inform taxpayers of the major **1) position and opinions;** and **2) strategies and methodologies** adopted by the tax authorities
- To facilitate the communication between tax authorities and taxpayers
- To improve taxpayer's voluntary compliance

## Actions will be taken from several aspects

# Position and opinions on BEPS projects

- Consider fully the role of **market** in value creation – recognize value of China as an emerging market
- The taxing rights are to be aligned with the **substance** of economic activities
- The **tax filing** location should be in line with the location of its enterprise's business activities
- Improve the transparency of **transfer pricing** documentation
- Revisit taxing rights of the source country in the **digital economy**
- Pay attention to the application of **safe harbor** rules in transfer pricing
- Enterprises should strengthen their tax governance and **internal control**

# Establish offshore structure to avoid “Chinese tax resident enterprise” status



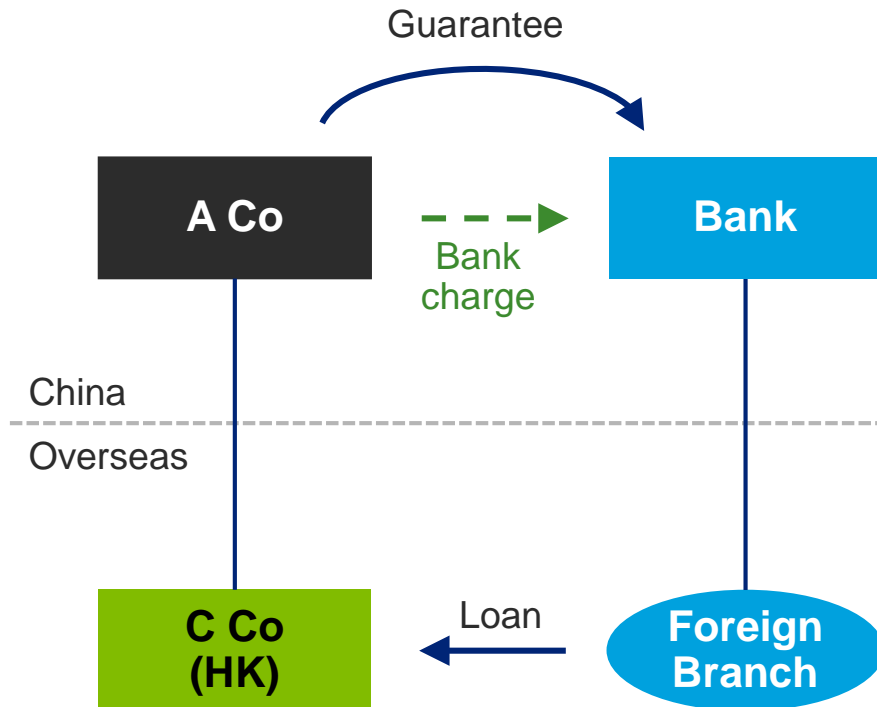
- Key management of B Co performs duties in China
- Important decisions (e.g., financial and HR of B Co are made in China
- Directors and management staffs of B Co who have decision and controlling power habitually reside in China

## Tax authority's view

- B Co is a Chinese tax resident

Source: 《China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

# Tax base erosion through cross-border financing



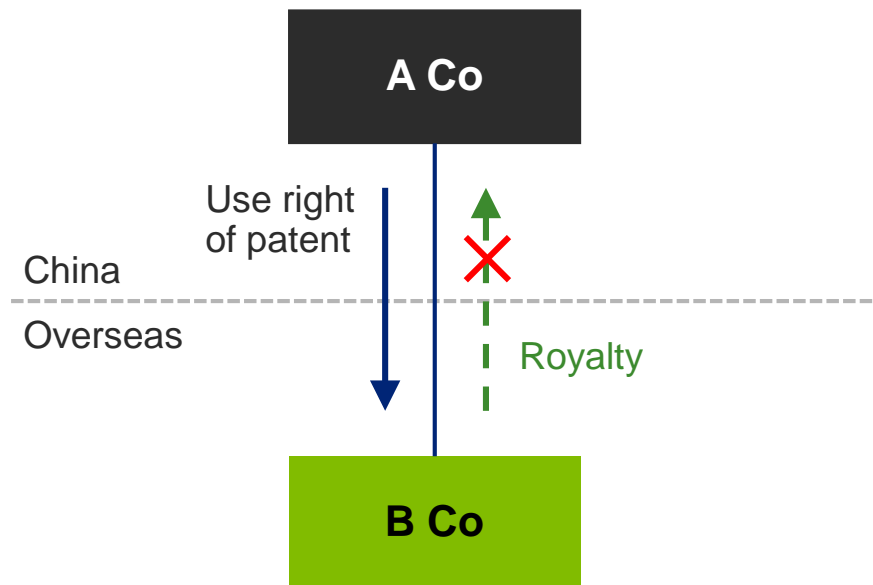
- Foreign branch of a Chinese bank provides a three-year loan to C Co, which is guaranteed by A Co
- A Co deposits cash in the bank in relation to the guarantee provided
- A Co pays applicable bank's charges
- A Co is not compensated by C Co for guarantee given

## Tax authority's view

- **Substance:** Capital of A Co used by C Co without due compensation to A Co
- To make adjustments according to the **principle of substance over form**

Source: 《China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

# Profit erosion through free use of intangible assets



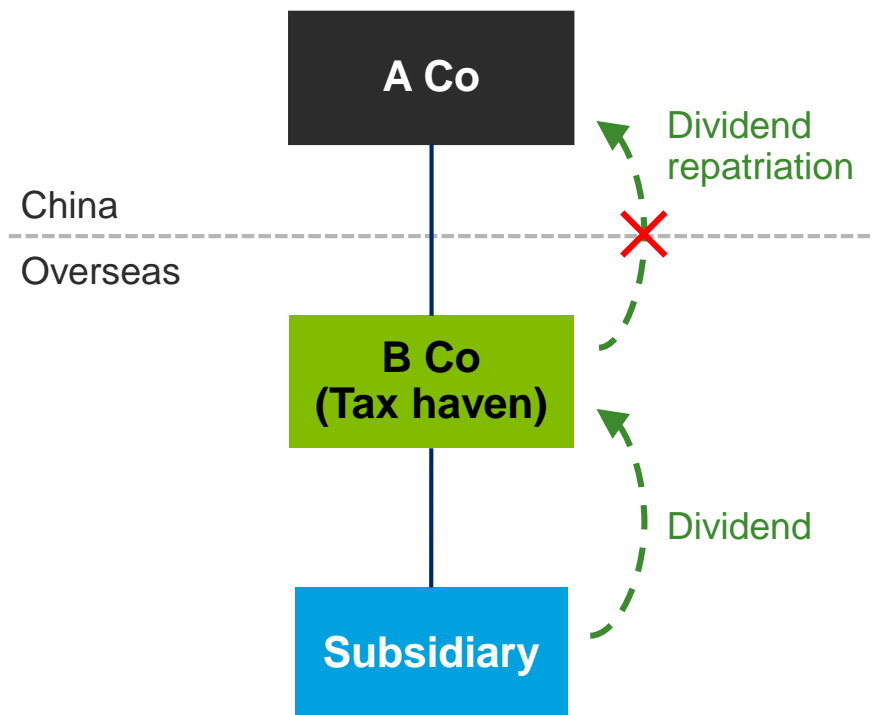
- A Co (a high technology company) sets up an overseas manufacturing company B Co
- B Co uses the patented technology of A Co for manufacturing
- B Co pays no royalty to A Co

## Tax authority's view

- Royalty fee should be charged based on arm's length principle.
- To assess additional tax on royalty income and impose late payment surcharges.

Source: 《China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

# Controlled Foreign companies



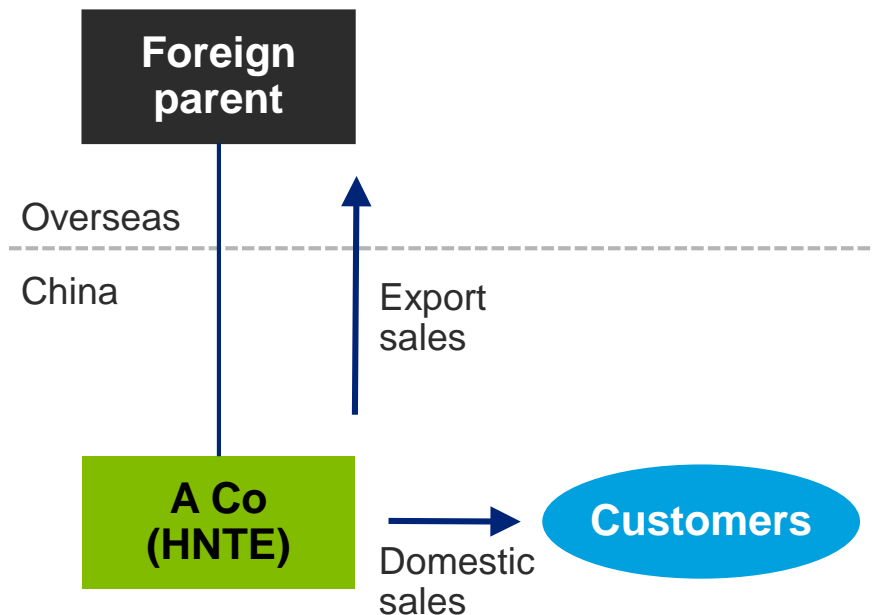
- A Co sets up B Co in a tax haven for investment holding
- Income of B Co are mainly dividends received from subsidiaries
- Profits of B Co are retained in B Co for a long time without distribution to A Co

## Tax authority's view (after investigation)

- No bona-fide business reason for not distributing profits to A Co
- Profits of B Co, to the extent attributable to A Co, should be deemed to be distributed and included in the current-year taxable income of A Co

Source: 《China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

# Mismatch of function, economic substance and profit level



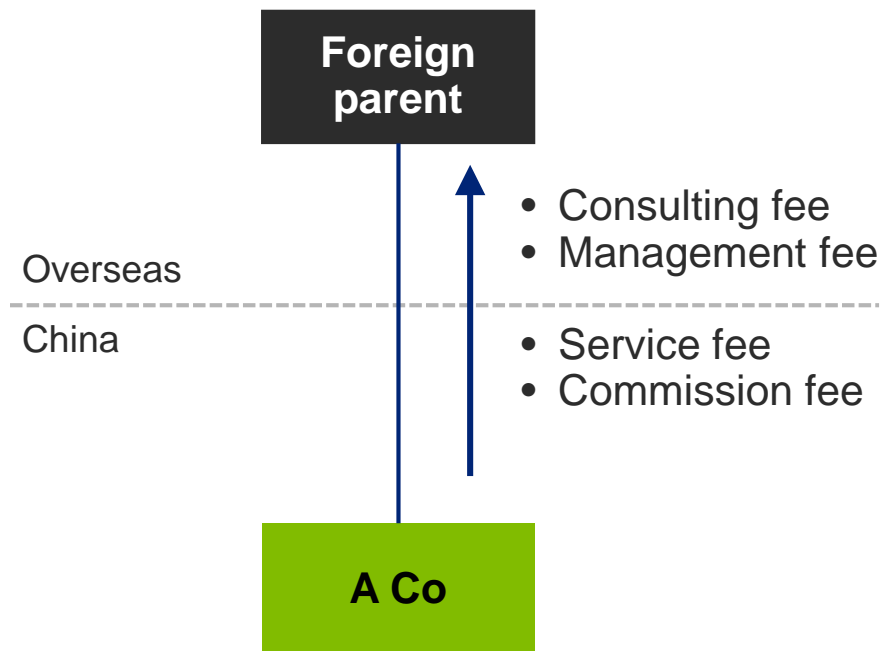
- A Co is a high and new technology enterprise and enjoys
- 15% enterprise income tax rate
- R&D expense super deduction
- A Co's **functions** include R&D, manufacturing, and sales to Chinese domestic customers and exports
- A Co's **transfer pricing position:** Voncontract manufacturer (thus low profit level)

## Tax authority's view

- Appropriateness of the transfer pricing position is highly questionable
- A Co proactively communicated with tax authority and made self-assessment (additional taxable income: RMB 80m)

Source: 《China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

# Profit shifting through cross-border related party payments



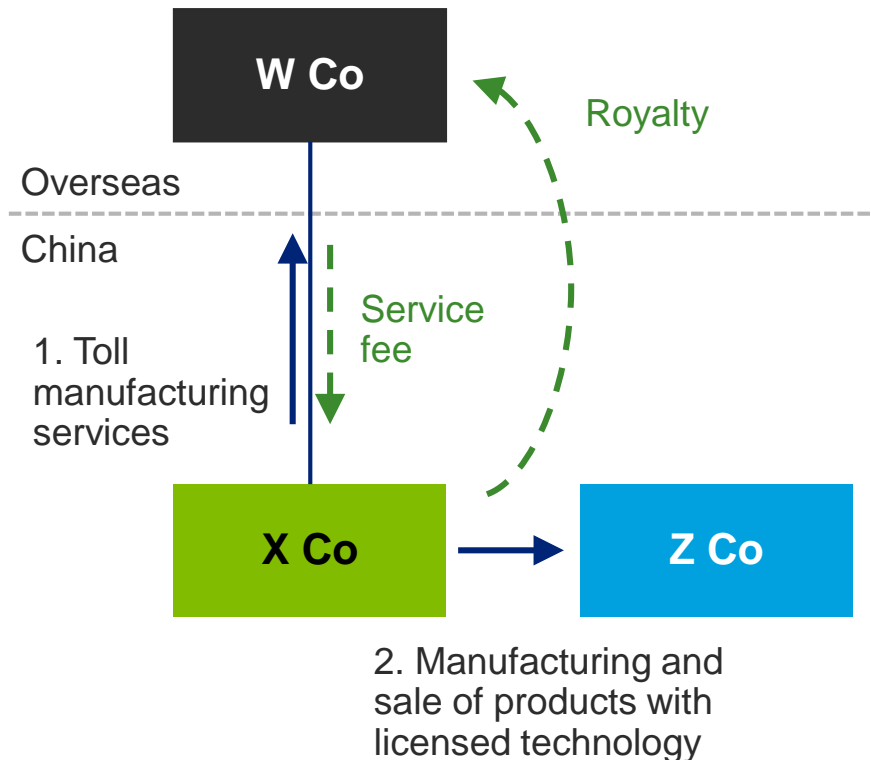
- Related-party sales/purchases of A Co accounts for less than 10% of total sales/purchases of A Co, and this ratio is in decline
- Payments offshore to related parties, including consulting fees, management fees, service fees, commissions, etc, are on the increase

## Tax authority's view (after investigation)

- RMB 5.5m expenses are non-deductible: Additional tax and penalties should be imposed
- RMB 6.7m other related-party transactions: subject to further investigation

Source: 《China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

# Reducing group effective tax rate by offsetting transactions



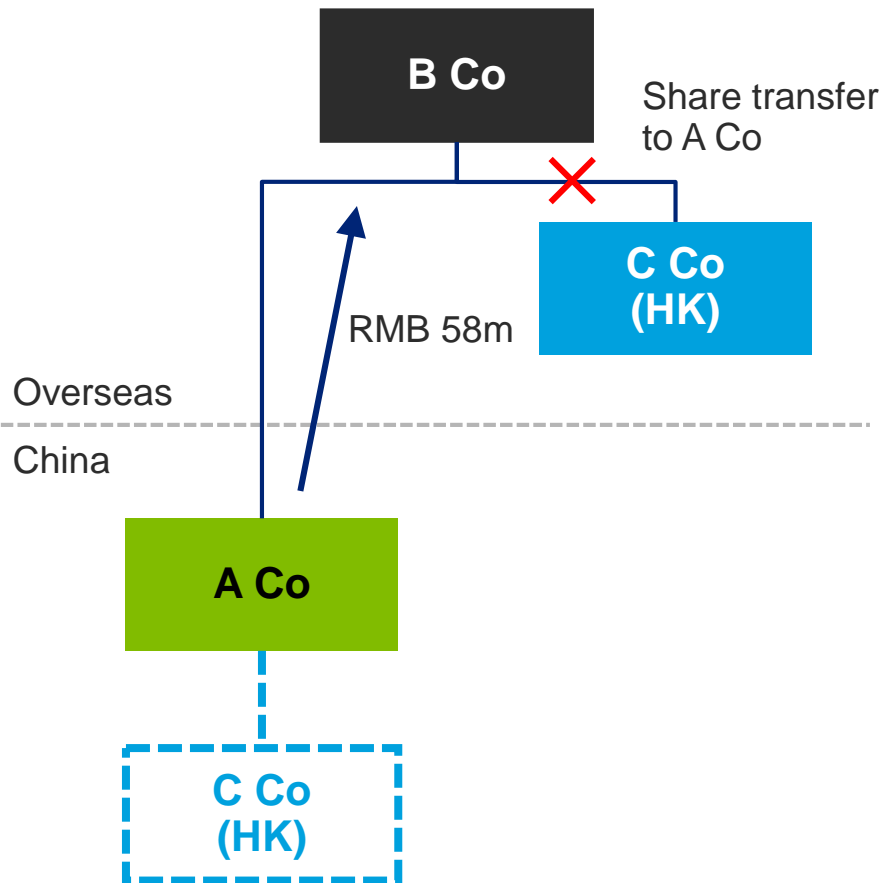
- X Co provides toll manufacturing services to W Co and should receive a service fee
- X Co manufactures and sells products with the licensed technology provided by W Co and should **pay** W Co a royalty
- X Co and W Co **offset** the service fee and royalty without changing the overall profitability of X Co

## Tax authority's view

- The offsetting of the transactions results in a reduction of withholding tax on royalty
- The two transactions, i.e. service and licensing, should be taxed separately and withholding tax should be imposed on the original amount of royalty before offsetting

Source: 《China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

# Profit shifting through purchase of foreign related party at non-arm's length price



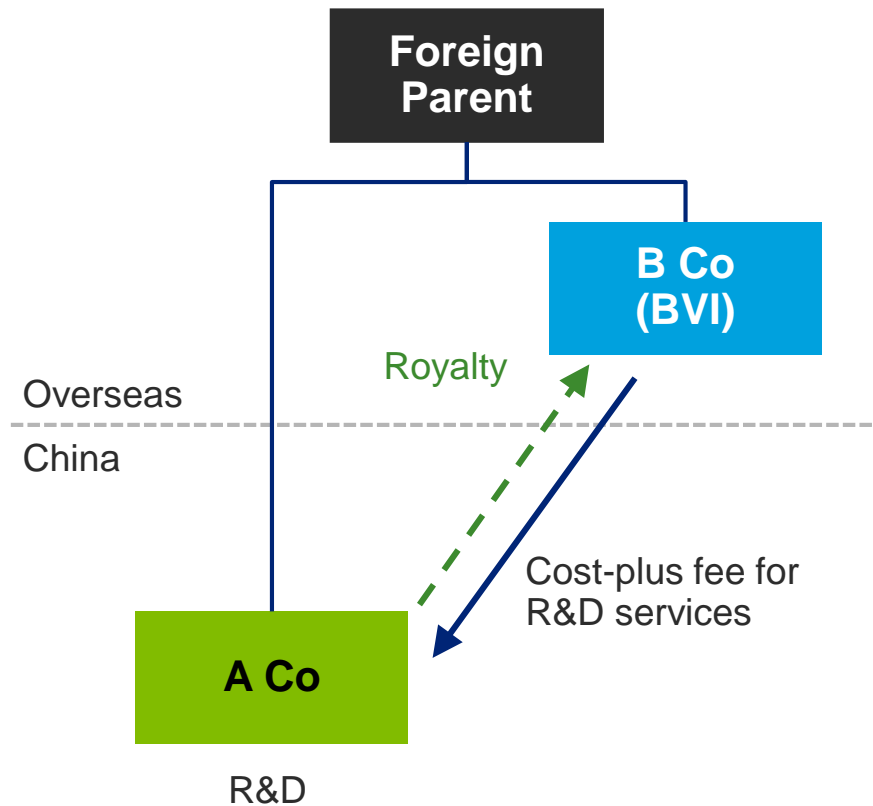
- A Co acquired C Co with **RMB 58m** in 2010
- The net book value of C Co was only **RMB 10m** upon acquisition
- A Co booked a “loss” arising from the acquisition: offset against retained earnings

## Tax authority's view

- The payment to B Co, to the extent attributable to A Co's undistributed profits, should be deemed as dividend distribution and subject to withholding tax in China

Source: China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

# Transfer of mere legal ownership of intangibles to offshore company



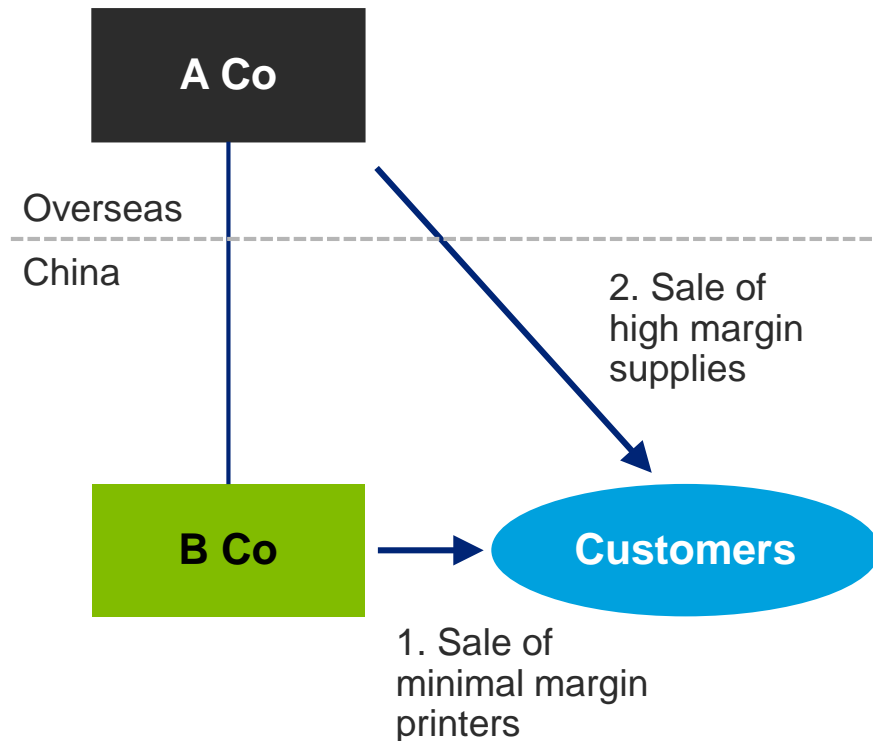
- A Co is a manufacturing company and started R&D activities in recent years
- Foreign Parent set up B Co in BVI to engage A Co to perform the R&D service that A was carrying out, and paid A Co for the service on a limited cost-plus basis. B Co is the legal owner of the intangibles resulting from the R&D being carried out
- A Co pays royalty to B Co for the use of intangible arising from the results of the R&D

## Tax authority's view

- A Co owned valuable intangibles developed before the incorporation of B Co
- There is no substantial change in the R&D arrangement (e.g., the personnel) and the simple legal agreement should not change the ownership of intangible by A Co
- It is not appropriate for A Co to pay royalty to B Co

Source: 《China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

# Assuming “implicit cost” for the group without a proper compensation



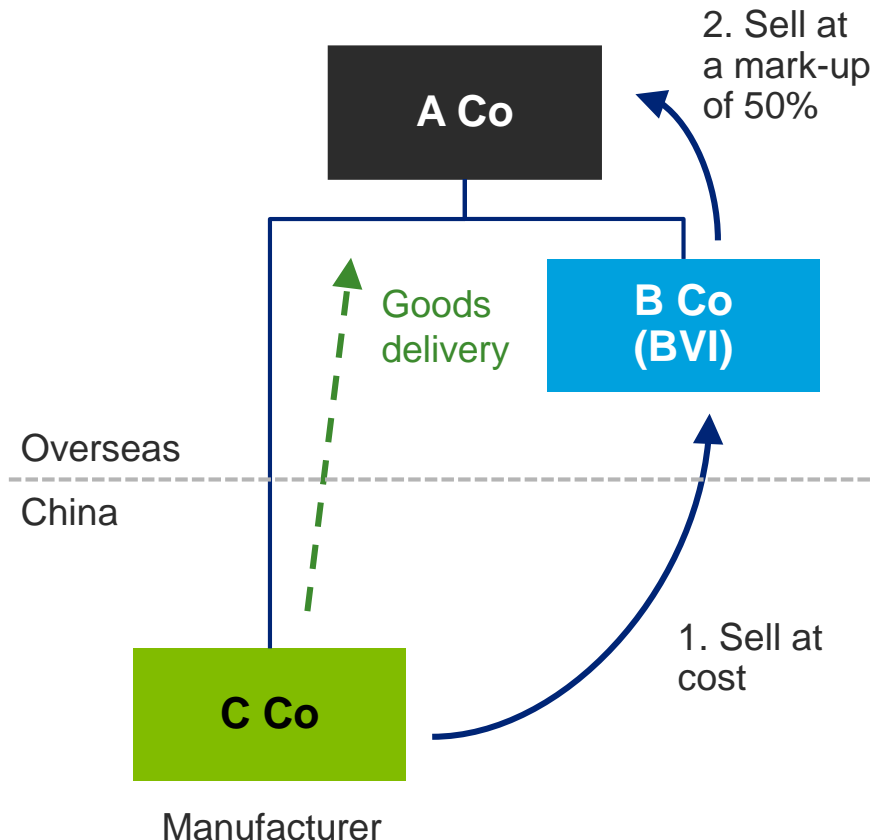
- A Co Group globally manufactures and sells printers and printer supplies
- B Co, a Chinese subsidiary of A Co, sells printers to Chinese domestic customers at cost to facilitate A Group selling printer supplies to those customers
- Selling of printer supplies generates a very high profit margin for A Co Group
- B Co is loss making

## Tax authority's view

- B Co incurs losses in order to benefit the group of A Co Group as a whole
- B Co should be compensated for the sale of printers at low prices and pay tax in China

Source: 《China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

# Tax avoidance through shell company in tax haven and the use of offshore bank accounts



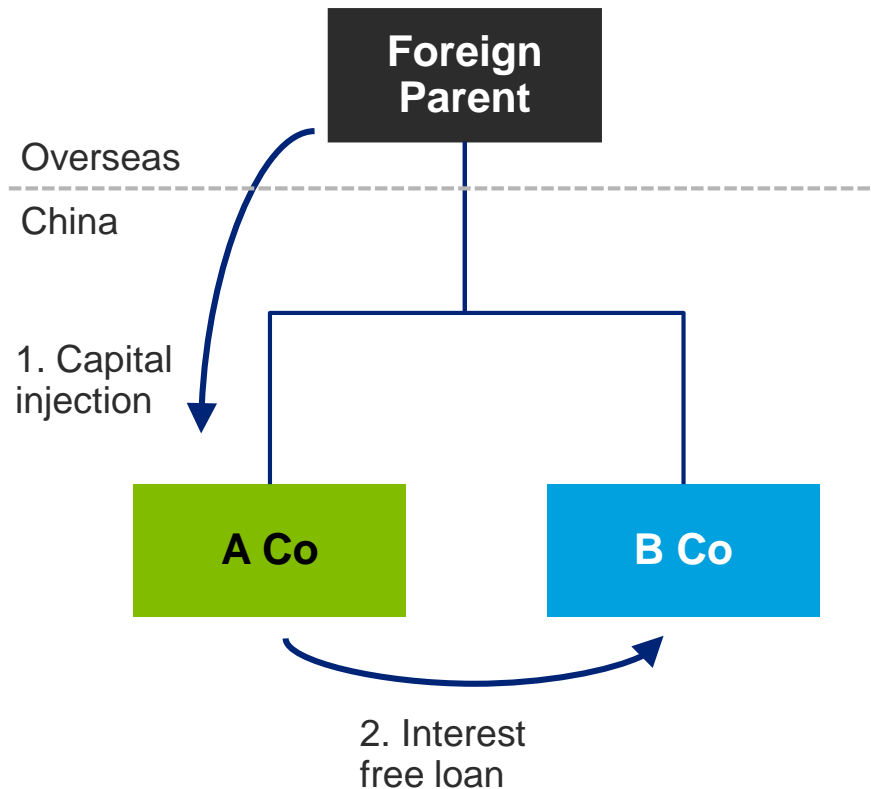
- A Co's Chinese subsidiary C Co is a manufacturing company
- C Co sells the products it manufactures to B Co at cost (or with a minimal mark-up)
- B Co subsequently sells the products to A Co with a 50% mark-up on its cost
- Cash payment flows are consistent with contract flows
- Goods are physically delivered directly from C Co to A Co
- B Co is a shell company with no employees

## Tax authority's view

- The transfer pricing adopted by C Co is questionable and should be subject to audit

Source: 《China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

# Unreported taxable gains during “start-up period”



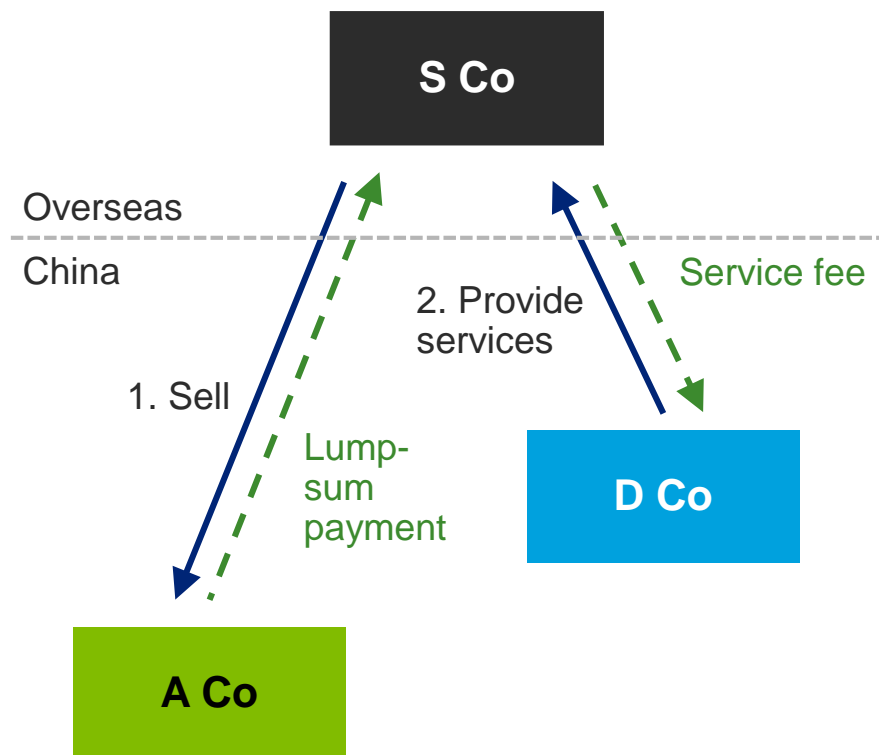
- The capital of A Co was converted to RMB in 2009 immediately after its incorporation
- A Co has been dormant since its incorporation, and therefore, is still in its “start-up period” for enterprise income tax purposes
- A Co provided the cash to a related-party B Co interest free

## Tax authority’s view

- A Co should charge interest
- The interest income is taxable in the hands of A Co
- A Co should pay tax thereon, notwithstanding it is still in its “start-up period” for enterprise income tax purposes

Source: 《China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

# Artificial avoidance of PE status



- S Co sells a large equipment to A Co in exchange for a lump-sum price
  - The lump-sum price covers installation and commissioning services which will last for one year
- S Co subcontracts the installation and commissioning services to a third-party D Co in China and pays D Co for those services
  - D Co performs the services according to the requirement and standard provided by S Co

## Tax authority's view

- D Co constitutes a PE of S Co in China
- Relevant factor emphasized: The legal obligations and risks in respect of the services provided by D Co are assumed by S Co

Source: 《China Taxation News》, August 1, 2014; also published on the official website of Jiangsu Provincial Office of SAT

Please remember  
to complete your  
evaluation

# Speaker bios

**Ryan Chang** is the Co-Leader of Asia Pacific International Core of Excellence (“ICE”) program for Deloitte Touche Tohmatsu in Hong Kong and the China National Leader for Business Model Optimization Services. He assists clients in numerous industries including, financial, manufacturing, consumer products, pharmaceutical, high-tech and real estate.

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