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SAT issues regulations on the application of the GAAR

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On 2 December 2014, China's State Administration of Taxation (SAT) issued regulations on the application of the general anti-avoidance rule (GAAR) (Administrative Regulations for the General Anti-Avoidance Rule (Trial Implementation)). The regulations will apply from 1 February 2015.

The GAAR was introduced in article 47 of the PRC Enterprise Income Tax Law (EIT law) in 2008. In 2009, the SAT issued Circular 2 (Special Adjustments Implementation Measures (Trial Implementation)), providing some general principles on the implementation of the GAAR (which is considered one type of special adjustment). The new regulations are designed to operate in conjunction with the EIT Law and Circular 2 to provide a more comprehensive and transparent legal framework for the administration of the GAAR.

The key points of the new regulations are summarized below.

Scope of the new regulations

According to Article 2 of the new regulations, they will apply when tax officials make special adjustments pursuant to article 47 of the EIT law to address a "tax avoidance arrangement." A tax avoidance arrangement is defined as an arrangement having the following two features:

- The sole purpose or the main purpose of the arrangement is to obtain a tax benefit; and
- A form of arrangement permitted under the tax law is used to obtain tax benefits, but its use is inconsistent with the economic substance of the arrangement.

A "tax benefit" means a reduction, exemption or deferral of an amount of EIT that otherwise would be payable.

Article 2 also provides that the new regulations will not apply to the following:

- Arrangements that do not involve a cross-border transaction or payment (i.e. purely domestic transactions or payments); and
- Illegal acts, such as avoidance of the payment of tax, fraud in obtaining a tax refund, other tax fraud or refusal to pay tax.

Further, Article 6 clarifies that, where the tax authorities can apply a more specific rule to make a special adjustment, such as the rules on transfer pricing, cost sharing, controlled foreign companies and thin capitalization, the more specific rule should be applied first. Similarly, according to article 6, where a tax treaty provision or a domestic rule on the application of a treaty is applicable (such as the rule on beneficial ownership or the limitation of benefits provision), such treaty provision or domestic rule should be applied first.

Lastly, in a recent question and answer session with reporters, the SAT also clarified that an adjustment made to an indirect transfer under Circular 698 also is considered an application of the GAAR.

Methods of adjustments

The tax authorities may use any of the following methods to deny tax benefits obtained through a tax avoidance arrangement:

- Recharacterizing the arrangement in whole or in part;
- Disregarding the existence of a party to the transaction for tax purposes, or treating parties to a transaction as a single entity;
- Recharacterizing the relevant income, deductions, tax incentives, foreign tax credits, etc., or reallocating these items among parties to the transaction; or
- Other reasonable methods.

Life cycle of an investigation

The new regulations delineate the life cycle of an investigation and clearly set out the rights and obligations of the tax authorities and the taxpayers in each major stage:

- 1) Case selection:** The primary responsibility for identifying cases for audit will rest with the in-charge tax authorities; however, given the complexity of GAAR cases, audits may be carried out only with the approval of the provincial tax authorities and the SAT.
- 2) Investigation:** The regulations also have a chapter on how an investigation will be conducted, which specifies that the primary responsibility for conducting a GAAR audit also rests with the in-charge tax authorities.

The tax authorities have broad powers to require a taxpayer to produce extensive documentation, including information on the background of the arrangement, its commercial purposes, internal and external documents related to the arrangement, etc. The taxpayer must submit the documentation to the tax authorities within 60 days after receipt of a tax examination notice (with a potential extension of 30 days in certain cases). If the taxpayer fails to provide the information, the in-charge tax authorities can levy the EIT by assessment.

The tax authorities specifically are empowered to request information that is maintained offshore, either through an exchange of information procedure or through other means, and to request information from persons who advised the taxpayer in respect of the particular arrangement.

- 3) Issuance of special tax investigation adjustment notice:** The responsible tax authorities must conduct a GAAR investigation within nine months after receiving case selection approval from the SAT. All aspects of a GAAR case will have to be reported to the provincial-level tax authorities for their review and consensus, and then to the SAT for final determination and assessment.

The responsible tax authorities will first need to issue a special tax investigation initial adjustment notice to the taxpayer. The taxpayer will have seven days from receipt of the notice to appeal to the tax authorities for review by the provincial-level tax authorities and, ultimately, by the SAT. If no objection is received from the taxpayer or if the taxpayer's appeal is unsuccessful, the in-charge tax authorities will issue a final special tax investigation adjustment notice.

- 4) Dispute resolution:** As is the case for general tax audits, a taxpayer will be permitted to appeal the issuance of a special tax investigation adjustment notice, in accordance with the applicable tax law. If the adjustment is believed to result in "domestic" double taxation, the SAT will be responsible for coordinating and resolving the dispute. If the adjustment is believed to result in "international" double taxation, the taxpayer will be able to apply to initiate a mutual agreement procedure.

Comments

Overall, the GAAR regulations are welcome in that they provide more clarity on how and when the Chinese tax authorities will invoke the GAAR. Considering the increasing importance of GAARs in the current environment of the base erosion and profit shifting (BEPS) initiative, it is timely for the SAT to issue GAAR regulations.

The fact that approvals from the SAT are required for both the case selection and the issuance of the special tax investigation adjustment notice indicates cautiousness on the part of the SAT regarding application of the GAAR; the SAT likely does not want the local tax authorities to be so aggressive in applying the GAAR that commercial activities could be negatively affected.

The regulations also set a nine-month deadline for the responsible tax authorities to finalize an examination after obtaining the approval of the SAT to investigate a particular case, which may make the process more efficient and should provide more certainty to the taxpayer. However, since a taxpayer will have only 60 days to respond to a tax examination notice (with a possible extension of 30 days), taxpayers should try to maintain contemporaneous documentation of their transactions that can be used later (if needed) to demonstrate the commercial purpose and the economic substance of these transactions.

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