

Administration Plan for International Taxation Compliance in 2014-2015, Jiangsu Provincial Office of SAT

This Plan manifests the tax authorities' understanding and views concerning the key risks involving international taxation described in OECD's *Addressing Base Erosion and Profit Shifting* (OECD, 2013) (BEPS Report). The cross-border taxpayers should pay attention to the typical risks which have been identified in the tax authorities' administration practice in recent years and summarized in this Plan. This Plan informs taxpayers of those major strategies and methodologies adopted by the tax authorities in the administration of international taxation. This Plan aims to facilitate the communication between the tax authorities and taxpayers and to improve taxpayer's voluntary compliance on the basis of open and transparency.

I. The tax authorities' attention to and views on the problems raised in BEPS Report

In recent years, as requested by political leaders of G20, OECD published BEPS Report and Action Plan on BEPS, which have invoked intense attention and hot discussion among governments, international

organizations and multinational corporations. BEPS Report and Action Plan on BEPS will not only bring about significant changes to international taxation rules, but also present great challenges to the business models, tax planning and tax compliance of multinational enterprises, which the tax authorities have been paying close attention to by taking into consideration at the same time of the tax authorities' analysis and study of administration practice in Jiangsu Province. Taxpayers should pay their attention to the following:

- Consider fully the role of market in value creation

BEPS Report suggests that transfer pricing outcomes should be in line with value creation, and measures of the allocation of income across jurisdictions should be looked at relative to measures of value creating activities.

The tax authorities are of the opinion that domestic market in China has its unique significance and effect concerning enterprise's value creation and profit. With this in mind, firstly, the tax authorities adhere to the concepts of location savings and market premium put forward by UN *Practical Manual on Transfer Pricing for Developing Countries*, and incarnate these concepts when allocating the global profits of multinational corporations. Secondly, in the course of transfer pricing investigation, APA negotiation and enterprise's contemporaneous

document preparation, in case the profit methods are to be used to split profits, the role of market is to be taken into consideration as an important factor for the profit splitting so that the corresponding profit will be reflected. Thirdly, for those multinational corporations for which China represents a substantial portion of their global market, they should take into consideration not only the role of domestic market in China when allocating group profits throughout their value chain, but in particular take into consideration the specific contribution of China's emerging economy — namely its huge market and fast growing demand — so that special key factors are incorporated in the allocation of profits.

- The rights to tax are to be aligned with the substance of economic activities

As indicated by BEPS Report, the rights to tax should be aligned with the substance of economic activities. It is the tax authorities' opinion that enterprises should not segregate the taxable income from the business activities generating the income by means of establishing shell company or entity without economic substance for the purpose to avoid the tax jurisdiction of China or erode China's tax base. By fully applying current tax rules concerning the location of effective management and general anti-avoidance and measures of information exchange related to tax heavens, the tax authorities will exercise resident jurisdiction on

enterprises registered in foreign country but effectively managed in China, look through those shell companies without economic substance, deny the treaty benefits for the taxpayers without the beneficiary ownership, strengthen administration on double non-taxation, under-taxation, deferred taxation caused by mismatch arrangements. Furthermore, the tax authorities will actively make suggestions to SAT Headquarters in order to improve the reporting and disclosing requirements of our country's taxpayers.

- The location of enterprise's business activities is to be in conformity with the location of its report for tax purpose

BEPS Report indicates that the location of enterprise's actual business activities shall be in conformity with the location of its report for tax purpose. The Report says that the actual business activities are generally identified through elements such as sales, workforce, payroll and fixed assets. The tax authorities hold the opinion that the identification of the location of enterprise's business activities signifies not only the identification of the location of its report for tax purpose, but also the attribution of its profits. As to any multinational group mainly acting as a consigned manufacturer and owning no significant intangible assets, in case the workforce, payroll and fixed assets of its subsidiary in China accounts for a major proportion of the global group, the profit

attribution to this subsidiary should match with and correspond to this proportion. If functions such as R&D, marketing and management are further added to the subsidiary in China by the multinational corporation, the profit of this subsidiary should be increased correspondingly, and this subsidiary should not be treated as simple processor any more and should not be attributed with lower level of profit. Conversely, if related functions of such subsidiary are removed and transferred to a foreign country, corresponding compensation should be considered. Multinational corporation should pay attention to the fact that the tax authorities are highly concerned with the profit proportion of Chinese enterprise in the global group.

- Improve the transparency of transfer pricing documentation

BEPS Report suggests that a key issue in the administration of transfer pricing rules is the asymmetry of information between taxpayers and tax administrations. Tax administrations have difficulties in understanding multinational corporation's value chain. Taxpayers have to prepare transfer pricing documentation in different countries, which increases compliance costs for the enterprises. In this respect, the tax authorities agree with OECD on its judgment and proposal. When carrying out associated transactions, enterprises are encouraged not only to get ready real time information related to itself according to China's

tax rules, but also to actively strengthen its communication with its parent company and the tax authorities to provide information concerning the global group's organization, business activities, profit allocation and its tax payment in various countries for the purpose to improve the trust and cooperation between the taxpayer and the tax authorities.

- Revisit the right to tax of the source in the digital economy

The development of information technology has made it possible for multinational corporation to provide digital service or products via the internet without having any entity or substantial presence in the related country to obtain cross-border income, which poses challenges for the application of traditional source principle and the allocation of the right to tax. In the tax authorities' practice of administration, the tax authorities have noticed that certain design, consultancy and technology services are provided through the internet or remote control, which makes it difficult to determine whether there is any non-resident permanent establishment and thus makes it hard to effect the original source taxing right. The tax authorities think that new concepts are needed to identify the source of income in order that the allocation of taxing rights between source and residence states in digital economy will remain its fairness, and that the enterprises should pay their attention to the risks of compliance related to the above-mentioned problems.

- Pay attention to the application of safe harbor rules in transfer pricing

BEPS Report advocates that the global tax avoidance shall be tackled in an internationally coordinated approach. The Report does not deny the possibility that jurisdictions may also provide more stringent unilateral actions to prevent profit shifting. The tax authorities have noticed that Indian government issued last year safe harbor rules, which explicitly states quantitative safe harbors concerning 13 types of cross-border associated transactions. There are same or similar cross-border associated transactions in Jiangsu Province. The tax authorities do not deny the differences between China and India, but the similarities of these two countries both as major developing ones should be asserted. Although presently there is no corresponding safe harbor legislation in China, the safe harbor rules of other developing countries will be taken as reference when the tax authorities are monitoring the risks related to cross-border associated transactions. Enterprises should have a global view and understanding when arranging their business.

- Enterprises should strengthen their tax governance and internal control

BEPS Report suggests that enterprises should treat tax governance and tax compliance as important elements of their oversight and broader

risk management systems. It is the tax authorities' opinion that internal control is an enterprise's foremost stage to prevent itself from transfer pricing risks. Multinational companies should comply with the tax rules and other stipulations of the places where they are carrying out their business, and their board of directors should establish and implement strategies concerning tax risk management, especially those risks related to cross-border transactions and associated transactions. The tax authorities have attached great importance to enterprise's internal control concerning associated transactions, which the tax authorities are trying ways to test and assess. Enterprises should pay attention to that and give their cooperation.

II. Tips on risks of cross-border taxation

Based on the typical risks identified in recent years, the tax authorities remind the enterprises of the following scenarios and the enterprises should deal with these scenarios in compliance with the law:

1. Establish off-shore structure to avoid tax jurisdiction

A domestic enterprise sets up multi-tier holding company, which by means of round tripping purchases the stock equity of the domestic enterprise with the result that the group holding company or the listed entity being the foreign registered enterprise but effective management of operation, personnel, finance and assets still carried out domestically. As

the offshore holding (listed) company is located in tax heaven or place which does not tax offshore income, double non-taxation occurs with such company paying no tax to jurisdiction where it is registered or where the effective management happens.

According to the tax laws of China, companies registered outside of China but with their effective management in China shall be deemed as Chinese residents and taxed accordingly. Enterprises should avoid aggressive tax planning. Enterprises with its effective management in China should voluntarily apply for resident status to avoid the risk of being adjusted afterwards.

2. Base erosion by cross-border investment or financing

Domestic enterprise reinvests the loan it gets to its overseas associated enterprise, which transfers the cost of loan to be borne by the overseas enterprise to the domestic enterprise. Domestic enterprise deposits its fund from its after-tax profit with domestic financial institute, which is to be frozen as guarantee for the loan of its overseas associated enterprise, and the profit is transferred to overseas enterprise in disguised forms. In terms of this kind of arrangements, the domestic enterprise obtains no guarantee fee and interest of loan from its overseas associated enterprise, but needs to pay for the bank business. Thus, the income tax base of the domestic enterprise is eroded in multiple ways. At the same

time, the withholding tax of dividend is avoided because the financial instrument conceals the substance of profit distribution.

In accordance with the principle of substance over form, the tax authorities will analyze the substance of the enterprise's cross-border investment and financing in terms of the source, channel and purpose of the fund and with the enterprise's business taken into consideration, and make adjustment accordingly to offset the benefit of the tax planning.

3. Erosion of the profit of domestic enterprise by overseas output of intangible assets

At the same time of fund output by “go global” enterprises, technology output is becoming popular. During the course of providing their overseas subsidiaries or associated enterprises with such intangible assets as goodwill, trademarks, technological knowhow and client lists, no related fees and other considerations are charged and received, and the taxable income of the domestic enterprises are decreased, which harms the taxation interests of China.

“Go global” enterprises should pay proper attention to their cross-border transactions and related issues of transfer pricing. Related fees must be charged when there is overseas output of intangible assets to secure the income of domestic enterprises and the taxation interests of China.

4. No report or under-report of overseas income by overseas investing enterprises

Some enterprises with significant overseas investment over long period of time have rarely reported overseas business income and distributed related profit. Some other enterprises have engaged in passive business activities (such as investing and financing) or transit trading by establishing companies in tax heaven, and they have distributed little or no profit of the companies in the tax heaven to the domestic shareholders and have not reported to the tax authorities their *Form 12-8 of Overseas Investment* attached to their annual tax returns.

Resident enterprises should pay tax on their income from both within and outside of China. When filing their annual income tax returns, resident enterprises should report their overseas income including business profit, dividend, bonus, royalty and property transfer income for the purpose of tax credit. Shareholders of resident enterprises with investment in controlled foreign companies should submit *Form of Overseas Investment* for the purpose of tax credit or tax exemption to avoid the afterwards investigation and adjustment by tax authorities.

5. Functional restructure and mismatch of economic substance and profit level

Multinational companies implement in their group trans-regional restructure concerning management and decision making, manufacture and trade, R&D and technology and other factors when integrating and updating their supply chain. But when the enterprises' function changes, the profit level of the enterprise carrying out the function and bearing the risk is not adjusted accordingly from the perspective of economic substance, which leads to the mismatch of the enterprise's function, economic substance and profit level, or the enterprise not compensated properly. For example, the function of R&D is added to an enterprise, and the enterprise becomes the regional R&D center, but its profit level does not change or the change does not match its function. Or the function of sales and R&D is striped from an enterprise, and the related intangible assets are transferred, but the enterprise is not compensated accordingly.

As to those enterprises with mismatch of function, economic substance and profit level, the tax authorities will promote voluntary compliance by means of risk reminder and specific enquiry and will carry out special tax investigation to those enterprises with severe tax avoidance.

6. Profit transfer by means of associated outbound payment

There are frequent intra-group services within multinational companies. And there are more and more situations such as fake service

expenses, unreasonable allocation of service expense, mistaking taxable item as non-taxable one. Expenses have been repeatedly charged by the name of various payments of support fee, consultant expense, service fee, etc. Shareholder expenses which should be borne by parent company or expenses which should be borne by other company of the group are allocated to domestic company. Royalty is turned into overseas technology service expenses. Taxable item is turned into non-taxable one. All of these not only increases the deduction before tax of domestic enterprises and erodes the income tax base of resident enterprises, but also avoids the withholding tax for non-resident enterprises.

The tax authorities are paying more attention to assessing the associated service and understanding the details of the service provider and receiver. The tax authorities may also review the authenticity of the overseas service and the reasonableness of the charge by way of international tax information exchange. The enterprises should reasonably define the occurrence of overseas services to avoid the investigation and initiation of the measures of international assistance on tax matters by tax authority.

7. Lowering the tax burden of the whole group by off-setting transactions

Intentional set-off refers to the arrangement included in the terms and conditions of their associated transactions by the associated enterprises with purpose. Off-setting transactions occur when the benefit provided by one associated enterprise to another associated enterprise within the group that is deliberately balanced to some degree by different benefit received from that enterprise in return. In reality, the common off-setting transactions are the off-setting between purchase/sales transactions and payment of expenses with the taxation effects of avoiding withholding tax on non-residents and lowering the tax burden of the group as a whole.

As to the off-setting transactions between associated enterprises, the tax authorities will restore the actual situation on the basis of arm's length principle to abrogate the taxation effects of off-setting transactions. Enterprises are advised not to carry out arrangements of tax planning through off-setting transactions.

8. Profit transfer by means of purchasing overseas associated enterprise with unreasonable price

The headquarters of a multinational group sets up in a third country an associated company with low net assets and simple function, which is to be purchased by the domestic enterprise with high price. In this way, the undistributed profit of the domestic enterprise is transferred in

disguised forms to the headquarters of a multinational group, and the overseas investor thus withdraws indirectly the retained gains of the domestic enterprise and avoids the withholding tax on dividend.

In case any enterprise avoids the Chinese taxation by means of unreasonable business arrangement, it is possible that the tax authorities will re-characterize such arrangement according to its economic substance, and adjust the unreasonable purchase behavior and purchase price to safeguard the taxation interest of China.

9. Provide associated R&D service without responding gains or returns

Multinational groups set up R&D project in the name of its subsidiary based in tax heaven and contract the project to its domestic associated company. The returns of R&D service are determined on the basis of relatively lower rate of cost plus. When using the results of the R&D service, the company providing the service will still have to pay royalty to the subsidiary in tax heaven without considering the economic ownership of intangible assets, and the profit level of this company does not increase because of providing the R&D service.

The tax authorities will examine the make-up of the R&D personnel of the domestic company, the input and output of the R&D and its application within the group for the purpose to assess whether the

domestic R&D service has been reasonably compensated and whether the outbound payment of royalty is appropriate. Arrangements which are not in conformity with arm's length principle might be subject to tax adjustment.

10. Benefit the whole group by assuming implicit cost without corresponding compensation

For the purpose of its overall strategy, certain group may tie up some transactions into a package and sell some products with no profit or even at loss to create the demand for other products or services, so that the group as a whole will make profit. In practice, some domestic subsidiary companies manufacture and sell those products which incur loss on long term basis and assume implicit cost for the group without corresponding compensation.

The tax authorities will, from the perspective of independent enterprises, examine the operation and profit level of domestic subsidiary companies. As to those companies involved in strategy of package transactions and assuming implicit cost for the group with lasting loss, the tax authorities will claim reasonable profit compensation and make tax adjustment.

11. Tax avoiding transactions by means of shell company in tax heaven or offshore account

Some companies set up shell companies or offshore accounts in tax heaven or offshore financial center, which meet the local legal requirements on the forms of such organizations without carrying out any substantial business activities such as manufacturing, sales and management. These companies are used as means of equity investment, debt investment, licensing of trademark and patented technology. In this way, profits are transferred to areas of low tax burden for the purpose of tax avoidance.

The tax authorities pay much attention to the authenticity and reasonableness of transactions with tax heavens and offshore financial centers. Presently, China has signed agreements of tax information exchange with 9 tax heavens including BVI. In the process of investigation of the authenticity and reasonableness of transactions with enterprises in tax heavens, the procedure of information exchange may be initiated to examine the business substance and dealings of fund. General anti-avoidance rules would be applied to deal with the behaviors without reasonable business purpose, such as abuse of tax preferential, tax treaty and forms of incorporation.

12. Not report capital gains obtained by taking advantage of start-up period

Some foreign invested enterprises fail to report capital gains obtained through capital related business activities by taking advantage of start-up period. For example, interest income from depositing fund after exchange settlement is not reported by start-up enterprises. Start-up enterprises change the use of fund after exchange settlement to provide it to associated enterprise as interest-free loan or for other uses without consideration. Start-up enterprises purchase land or factory building, which is then rented to obtain income without reporting. Start-up enterprises fail to report exchange gains by hoarding fund. Start-up enterprises fail to report income of financial subsidy.

By establishing coordinated mechanism with foreign exchange administration authorities, the tax authorities have put start-up foreign invested enterprises under special control. The fund after exchange settlement is monitored through bank account, and the capital gains of start-up enterprises are under coordinated supervision. Enterprises are advised to voluntarily report their capital gains in the start-up period.

13. Avoid non-resident tax obligation through three-party contract

Having won the bidding for a domestic project, the overseas company signs a three-party contract with its domestic subsidiary and the proprietor of the project, which tends to state that the overseas company

will provide major part of service abroad and a minor part of service will be provided by the domestic subsidiary. Judging by the form of the contract, non-resident permanent establish is not involved in the process of implementing the contract. But in fact, the overseas company still sends its employees to provide service in China. The three-party contract formally turns taxable income of the overseas company with domestic source into non-taxable income with overseas source, thus avoids its tax obligation.

The tax authorities will verify the actual implementation of the contract and check the receipts and payment concerning the service actually provided by the overseas company domestically. Tax adjustment might be made according to the fact instead of the form of the contract.

III. Tax authorities' risk treatment measures in 2014-2015

Aimed at above-mentioned cross-border taxation risks, comprehensive treatment will be carried out through integrating administrative resources, focusing on key enterprises and projects and adopting various approaches. Under the international administrative framework, high level communication mechanism with the overseas group will be set up to solve the problem of information asymmetry, cooperation with foreign tax authorities will be strengthened to make full use of measures of international administrative cooperation, the

communication and cooperation with accounting and tax intermediaries will be smoothed to bring into full play their active roles in their tax-related practice.

1. Screen risks with the support of data warehouse

Tax administration information platform of Jiangsu Province has been set up, which integrates information from within and outside of tax authorities, including various tax filing information, information from business databases and information from third parties such as customs offices, commerce administrations, industry and business administrations, and other government departments. With the support of the data mart thus established and by means of data warehouse technology, the tax authorities will screen cross-border taxation risks thoroughly, assess potential tax loss of the risks and identify the key risks to be dealt with.

2. Establish risk differentiation framework to determine risk level

Based on the risk screening of data warehouse, the tax authorities will determine the risk level of the enterprises by taking into consideration their internal control on associated transactions, the quality of their contemporaneous documents and their compliance willingness embodied in their awareness of the communication with the tax authorities and the transparency of information concerning their overseas

parent companies. As to those enterprises identified as enterprises with high level risks, the tax authorities will make them known to certain stakeholders, including the group headquarters of the related enterprises. The managements of the enterprises should pay attention to this and to lower their risk level by strengthening their internal control on tax risks of cross-border transactions and continually improve their voluntary compliance.

3. Establish integrated administrative mechanism by starting from associated transaction reporting

As required by SAT Headquarters' "administration, service and investigation—three in one" and based on risk screening of data warehouse and risk level determination, after the associated transaction reporting by the enterprises, the tax authorities will carry out work including review of associated transaction reporting, selective examination of contemporaneous documents, testing of internal control on tax risks of associated transactions, monitoring of enterprise's function and risk, assessment of APA and investigation of anti-avoidance. In order to improve the quality and effectiveness of the tax authorities' administration, the integrated and progressive administrative mechanism will be adopted to focus the administrative resources on those enterprises with low compliance willingness and high tax risks.

4. Upgrade the level of anti-avoidance investigation and strengthen anti-avoidance investigation

In order to upgrade the level of anti-avoidance investigation and strengthen anti-avoidance investigation, a specific anti-avoidance investigation organization has been established on the Provincial Office level, which is responsible for the anti-avoidance investigation and APA administration for the whole Province. The professional resources of the Province has been concentrated to improve the professional level of anti-avoidance and to strengthen the administration on transfer pricing investigation, controlled foreign company, thin capitalization, associated service, profit transfer through intangible asset and financial instrument, general anti-avoidance and other fields.

5. Strengthen the monitoring on cross-border tax sources by making full use of international cooperation of tax administration.

After the G20 summit in 2009, countries have strengthened their work against aggressive tax planning and double non-taxation in a coordinated way. Presently, China has signed 99 tax treaties (arrangements) and signed agreements of information exchange with 9 tax heavens and offshore financial centers, and specific personnel has been dispatched to work in Joint International Tax Shelter Information Center (JITSIC). In 2013, China officially signed *Multilateral Convention*

on Mutual Administrative Assistance in Tax Matters. The tax authorities will further strengthen the monitoring on cross-border tax sources by making full use of international cooperation of tax administration such as information exchange with tax heaven, JITSIC, simultaneous examination and visit of authorized representative and so on.

6. Solve the problem of information asymmetry by establishing mechanism of high level communication

Most of the foreign invested enterprises in China are factories with limited function and no power to make decision and set price, and little information concerning the group's value chain. The tax authorities will change the way of thinking under the international administration framework. In the areas of transfer pricing, APA and general anti-avoidance investigation, the tax authorities will try to solve the problem of information asymmetry by actively establishing channel of communication with overseas headquarters of enterprises with foreign investments. The tax authorities will define the function and profit contribution of domestic subsidiaries on the basis of global value chain to safeguard and win over our fair share in international taxation.

7. Improve the communication with tax intermediaries to give full play of their active roles

Accounting and tax intermediaries play important roles in such aspects as multinational companies' internal control, tax planning, associated transaction reporting, contemporaneous document preparation, anti-avoidance investigation, and so on. These intermediaries are strong at professional skills, and are the source of aggressive tax planning as well. As a result, the tax authorities will strengthen communication with these intermediaries, and let them know tax authorities' requirements, views and position concerning the administration of international taxation. The tax authorities encourage the tax intermediaries to give full play of their professional skills to help enterprises comply with their tax obligation and suppress those intermediaries involved in aggressive tax planning

8. Strengthen cooperation of government departments to establish tax assistance network

The cooperation of government departments are getting stronger. The regular information exchange mechanism with foreign exchange administrations, customs offices, commerce administrations and other departments has made it possible to collect, check and analyze information from other parties, which greatly increases the tax authorities' capability to identify potential tax risks. As to the doubts identified, such as outbound investment, outbound payment, associated

relationship and fund flow, the tax authorities may have them further checked with related departments, which leads to a solid tax assistance network.