Hot topics

- **Preferential treatment for foreign investment:** The State Council of China held an executive meeting on July 28, 2017 to call for the promotion of foreign investment. Various financial, tax and other policies were issued after the meeting, with implementation rules expected to be released in the next few months. The main tax preferential treatment includes the following:
  - A deferral of withholding Enterprise Income Tax (EIT) on profits derived by foreign investors from Chinese resident companies and directly reinvested in encouraged investment projects;
  - Rolling out nationwide the EIT preferential treatment granted to Technologically Advanced Service Enterprises (i.e. a reduced EIT rate of 15%); and
  - Issuance of a new preferential tax policy for qualified foreign-source income derived by Chinese resident companies (including regional headquarters of multinational companies).

- **Special tax audits and adjustments:** Regulations issued by the State Administration of Taxation (SAT) in March 2017 largely complete the reform of China’s transfer pricing regime. The regulations, which apply as from May 1, 2017, set forth the methodology and procedures for special tax audits and adjustments and clarify certain transfer pricing issues, such as the monitoring of profit levels, audit processes, comparability analysis, methods, treatment of services, royalties, losses and the mutual agreement procedure. Although the regulations incorporate many of the OECD BEPS concepts, China continues to advance some of its own priority issues (location savings, local marketing intangibles). On the transfer pricing audit side, China is developing systems to better track profitability and risks. The SAT will take a more systematic approach for selecting audit targets and will encourage taxpayers to make self-adjustments before audit. There is a strong signal that the SAT will focus more on the management of prospective risk in tax administration, as opposed to the current focus at the audit stage.

- **Transfer pricing documentation:** The SAT issued the first tranche regulations for the transfer pricing reform in mid-2016 on the reporting of related party transactions and the contemporaneous documentation requirement. The rules, which apply retroactively as from January 1, 2016, include the formal templates and filing instructions for annual related party transaction reporting (including CbC reporting), and they introduce a three-tier documentation framework (master file, local file and special issue file), including a requirement that a value chain analysis and a location-specific advantage analysis be made.

- **R&D expense super deduction increased to 75% for small and medium-sized tech companies:** A company is eligible for a 50% super deduction in addition to the actual R&D expense deduction. The government has announced that the rate of the super deduction will be increased from 50% to 75% for qualified small and medium-sized tech companies for the period 2017 to 2019, and has issued guidance on how such companies can qualify to be recognized as such. A small and medium-sized tech company that employs no more than 500 employees, has annual sales revenue of no more than RMB 200 million; other requirements relating to technical personnel, IP rights, R&D expenses, etc. also must be met.

Legislative updates

- **Catalogue of encouraged industries for foreign investment 2017:** The government rolled out the negative list approach nationwide on July 28, 2017 following a pilot program in the Shanghai Free Trade Zone. Under this new approach, a foreign investor can apply to use simplified procedures (i.e. registration vs. pre-approval) to set up an entity, provided the type of investment is not on the negative list.

- **VAT reform:** The VAT reform was rolled out to all industries in China during 2016, but the tax authorities recently issued more measures: the number of VAT rate bands (17%, 13%, 11% and 6%) is reduced from four to three by replacing the 13% rate with the 11% rate as from July 1, 2017; and the time period for issuing a VAT special invoice is extended from 180 days to 360 days beginning on May 1, 2017.

Tax treaties

- **OECD multilateral instrument (MLI):** China was one of the countries that signed the MLI on June 7, 2017, and it is expected that the first modification of covered tax agreements will become effective in 2018. China has opted for the principal purpose test only minimum standard in the MLI. China has decided not to make the proposed changes to the permanent establishment (PE) threshold, so there will not be any changes to the PE provisions in China’s treaties. China will continue its practice under domestic tax law to determine the PE status of a foreign company in China.

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