January 2018

ICEbreakers: Unlocking China

Hot topics

- **Deferral of withholding tax on dividends:** On December 28, 2017, the Ministry of Finance, State Administration of Taxation (SAT), National Development and Reform Commission and Ministry of Commerce jointly issued new rules (Circular 88) that defer the imposition of withholding tax (10% under domestic law) on dividends distributed by Chinese enterprises to foreign investors, provided the funds are used to invest in domestic projects encouraged by China, and certain other requirements are met. The SAT then issued implementation guidance on the deferral rules on January 8, 2018. Investments qualifying for deferral include establishing new Chinese companies, increasing the capital (or capital surplus) of existing Chinese companies and acquiring Chinese companies from unrelated parties (excluding investments in publicly listed companies). There are requirements relating to the form of the investment, the source and routing of the funds and the scope of the reinvestment. Circular 88 applies retroactively to dividend distributions made on or after January 1, 2017. Qualifying foreign investors may request a refund of dividend withholding tax paid on such distributions.
- **Guidance on EIT withholding on China-source income derived by nonresident enterprises (NREs):** The SAT published guidance (Bulletin 37) on October 27, 2017 that revises the rules governing the administration of withholding tax on China-source income derived by NREs. Bulletin 37, which became effective on December 1, 2017, eliminates the requirement that NREs submit contracts to the SAT within 30 days after the contract was signed or amended. The bulletin clarifies that enterprise income tax on dividend payments may be withheld on the actual payment date rather than the date the distribution decision was made by the board of directors. It also stipulates the date an NRE is required to report and pay tax on its own, and specifies situations where a withholding agent will be deemed to have withheld tax but not to have paid the tax to the tax authorities.
- **Preferential EIT treatment of Technologically Advanced Service Enterprises (TASE):** Following the State Council's policy announcement that the EIT preferential treatment for TASEs would be expanded nationwide, on November 2, 2017, the government released detailed guidance on how such enterprises can qualify for the reduced enterprise income tax rate of 15% (rather than the standard 25% rate). The guidance, which applies retroactively as from January 1, 2017, clarifies that employee education expenses that do not exceed 8% of total wages and salaries may be deducted from taxable income, with the amount exceeding 8% available for carry forward and deducted in subsequent tax years.
- **Special tax audits and adjustments:** Regulations issued by the SAT in March 2017 and that apply as from May 1, 2017 largely complete the reform of China's transfer pricing regime. The regulations set out the methodology and procedures for special tax audits and adjustments and clarify transfer pricing issues, such as the monitoring of profit levels, audit processes, comparability analyses, methods, the treatment of services, royalties and losses, and the application of 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). With respect to transfer pricing audits, China is developing systems to better track profitability and risks, and will take a more systematic approach for selecting audit targets and encourage taxpayers to make self-adjustments before an audit is initiated.

Legislative updates

- **Catalogue of encouraged industries**: The government released the its new "negative list" approach nationwide on July 28, 2017 following a pilot program in the Shanghai Free Trade Zone. Under this approach, a foreign investor can apply to use simplified procedures (i.e. registration vs. pre-approval) to set up an entity, provided the investment is not included on the negative list.
- **VAT reform:** On December 1, 2017, the State Council abolished the provisional rules on business tax and officially amended the provisional rules on VAT to incorporate the provisions of the VAT reform.

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 to determine PE status of a foreign company under its domestic tax law.

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