2016

China and BEPS: From Norm-Taker to Norm-Shaker

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OECD / International / China (People's Rep.)

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Issue: Bulletin for International Taxation, 2015 (Volume 69), No. 6/7
Published online: 12 June 2015

In this article, the author considers the implications for China of the G20/OECD Base Erosion and Profit Shifting (BEPS) initiative and the international implications of China's BEPS measures.

1. Introduction: BEPS as a Global Issue

"BEPS" refers to the phenomenon of base erosion and profit shifting. This abbreviation has already found a prominent place in the tax lexicon, and often requires no translation in non-English publications.[1] BEPS also refers to the projects addressing the phenomenon of artificial shifting of profit. The most notable project is that initiated by the G20 and led by the OECD (the "BEPS initiative"). Since the initial BEPS report of 13 February 2013,[2] the OECD has released a detailed Action Plan,[3] public discussion drafts and deliverables related to the various Actions at a speed unprecedented in the history of international taxation. The project of the UN Subcommittee on BEPS Issues for Developing Countries (the "UN Subcommittee") is parallel to, and coordinated with, the OECD's work, and is intended to complement from a capacity development angle the BEPS initiative by focusing on the needs and priorities of developing countries. The UN Subcommittee has sought responses from developing nations on how BEPS affects them, what prevents them from protecting their tax bases and their views on the issues raised in the BEPS initiative.[4] The UN is in the process of producing a collection of papers on tax base protection in developing countries.[5] Many national governments have also introduced measures to counter BEPS.[6]

The problem of BEPS is described in the Action Plan as follows:

> No or low taxation is not per se a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.[7]

From the perspective of national governments, a country's tax base is eroded when profits that should be taxable in that country are shifted elsewhere. From the perspective of multinational enterprises (MNEs) that adopt BEPS strategies, there is nothing illegal about this. BEPS highlights two conflicts: (1) a government-to-government conflict regarding sharing the international tax resources or tax base arising from cross-border activities; and (2) a government-to-taxpayer conflict in the sense that taxpayers want to minimize their tax liability in a country, whereas the governments want the opposite.

The problems addressed by the BEPS initiative are not new. They are inevitable because of the design of the international tax system. International tax rules primarily originate from domestic tax laws and a network of bilateral tax

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* **Professor, Osgoode Hall Law School of York University, Canada. This article is part of a research project on tax transplants supported by a grant from the Social Sciences and Humanities Research Council of Canada (SHHRC). The author wishes to thank her co-investigator, Professor Thaddeus Hwong, for his collaboration and her students, Stephen Ji and Huaning (Christina) Li for their research assistance. She is indebted to Professor Wei Cui for his comments on the draft of this paper. She is solely responsible for any remaining errors. She can be contacted at JinyanLi@osgoode.yorku.ca.**

1. *See*, for example, SAT, State Administration of Taxation Regulates the Administration of the General Anti-Avoidance Rule, available at www.chinatax.gov.cn/n810214/n810641/n810697/n813233/c1395201/content.html (in Chinese).
2. OECD, *Addressing Base Erosion and Profit Shifting* p. 15 (OECD 2013), International Organizations' Documentation IBFD.
3. OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013), International Organizations' Documentation IBFD.
4. *See* www.un.org/esa/ffd/tax-committee/tc-beps.html.
5. At the time of the writing of this article, the UN Handbook on Tax Base Protection for Developing Countries was expected to be issued in spring 2015. The project was led by Brian Arnold and Hugh Ault, and contributed to by a number of scholars worldwide, including the author. *See* www.un.org/esa/ffd/topics/capacity-development/capacity-development-tax-cooperation/cd-tbp.html.
6. Examples include the UK diverted profits tax proposal in UK: Finance Bill (2015).
7. OECD, *supra* n. 3, at p. 10.

treaties. There is no international tax organization that oversees tax matters. Consequently, there are gaps and overlaps between national tax laws that cannot be adequately addressed by tax treaties. For example, tax jurisdictional rules are based on the residence of taxpayers or the source of income, both of which leave MNEs with room for self-selection. Transfer pricing rules regard members of an economically integrated firm, i.e. an MNE, as separate and independent entities and respect intra-group contracts and other legal arrangements in allocating profits for national tax purposes. The primary objective of current international tax rules is to prevent double taxation, but there is no agreement that preventing double non-taxation is a purpose of tax treaties. These problems are exacerbated by the globalization of national economies, integrated cross-border business structures adopted by MNEs and the digital economy. MNEs can take advantage of these to minimize their global tax burdens.

BEPS became a global political issue in the past few years primarily due to the global financial crisis of 2007-09, public outcry regarding the aggressive tax planning of some MNEs and growing frustration about the increasing inequality between the wealthy 1% and the rest of the world. The G20/OECD partnership, to some extent supported by the UN, combines political influence with technical expertise and has the potential to implement fundamental international tax reforms. Perhaps, for the first time in history, international tax reform is a global political issue that is important to both the public and policymakers, taxpayers and tax practitioners. Countries that had no say in the past may now partake in the BEPS initiative. For countries such as China and other emerging economies, the stakes are high and the opportunity precious.

This article discusses what BEPS means for China and recent Chinese actions in this regard. It suggests that China's involvement in the BEPS initiative and its unilateral BEPS measures indicate a transformation of China from a norm-taker to a norm-shaker. China's actions are likely to have significant implications for the development of international tax system.

2. Implications of BEPS for China

2.1. BEPS is real

China is believed by some to be one of the major victims of BEPS.[8] This belief is not officially shared by the Chinese State Administration of Taxes (SAT), although the SAT acknowledged the existence of BEPS in China in its response to the UN Subcommittee's question "How does base erosion and profit shifting affect your country":

> China currently does not have a system which quantitatively analyzes the base erosion in our country. Yet, we do find, and it is obvious, that the major threat China faces is that many MNE groups have shifted their profits by means of tax planning and transfer pricing.[9]

There are several reasons for suspecting that China is a victim of BEPS. Given that BEPS concerns shifting profits from countries where business activities take place, i.e. production and sales, to low-tax jurisdictions and that China is a major producer of goods and market for goods and services and has a corporate income tax rate of 25%, BEPS is a real issue for China. In addition, more than 50% of the foreign direct investment into China originated from low-tax jurisdictions, including the British Virgin Islands and Cayman Islands, and many Chinese companies making outbound investments use holding vehicles in tax havens.[10]

China identifies the most common BEPS practices and structures as being:[11]

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8. For instance, Mr Jiang Yuesheng of Jiangsu Provincial State Tax Bureau has stated that China is "the largest victim of BEPS in the world" on the basis of a research report conducted by an international expert without disclosing the name of the expert or the source of the report. *See* The Nature of BEPS and Our Response Strategy (5 June 2014), available at www.wendangwang.com/doc/c2b322abc3b8dfa8e90f4110 (in Chinese) [hereinafter: "Jiang Speech"]. More research is needed to establish the extent of BEPS in China. BEPS practices in China are presumably different from those in the OECD countries. For example, China's capital control regime and exchange control regime probably limit the use of debt to shift profits from China.
9. *See* China's reply to the BEPS Questionnaire of the UN Subcommittee, available at www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-BEPS-CommentsChina.pdf [hereinafter: "UN Response re BEPS"].
10. D. Qiu, *Collecting Unpaid Tax Offshore: Caribbean Tax Havens and Foreign Direct Investment in China*, 68 Bull. Intl. Taxn. 12 (2014), Journals IBFD.
11. UN Response re BEPS, *supra* n. 9.

- MNE groups adopt transfer pricing principles and methodologies in intra-group dealings to reduce the profits of their Chinese subsidiaries; and
- MNE groups establish shell companies with no genuine economic substance in the low-tax jurisdictions and tax havens to shift profits.

Specifically, BEPS practices include using arrangements or structures to: (1) avoid Chinese-source rules; (2) make tax-deductible payments to non-resident related parties; (3) use transfer pricing methodologies to shift value to offshore risks and intangible properties; and (4) use intermediaries in treaty states to benefit from Chinese tax treaties.

Recently, the SAT has publicly noted how MNEs conduct themselves in China, resulting in avoidance of Chinese taxes. For example, Chinese subsidiaries of MNEs are often treated as contract manufacturers and receive low-profit margins for their contract manufacturing function, while at the same time they claim tax incentives for “high and new technology enterprises” under the Enterprise Income Tax Law (the “EIT Law”).[12] The MNE has healthy profits but the Chinese subsidiaries of the MNE report losses in spite of the fact that they are major manufacturing centres and China is a major market for MNE products. Foreign-based MNEs have often implemented transfer pricing policies “that are sensitive to developed countries’ transfer pricing rules and nuances”[13] as opposed to those in China.

BEPS is not limited to foreign-based MNEs. Chinese enterprises and individuals have engaged in BEPS to transfer Chinese profit offshore, often to holding entities in tax havens.

2.2. BEPS is unfair

China regards BEPS as being fundamentally unfair. The unfairness lies in the mismatch between the location of taxation rights and the substantive economic activities. The right to tax business profits should belong to the jurisdiction where the government creates the necessary business and investment environment for MNEs and business activities are conducted, i.e.:

> For many years, China has consistently been one of the world’s largest recipients of foreign direct investment, played the role of a “factory of the world”; in recent years, with the rapid economic development and consistent increase in people’s purchasing power, China has also become the “market of the world”. As a base for production and consumption, China has created and contributed enormous value for the world, and China’s value-contribution should be reflected in the allocation of profits arising from cross-border economic activities.[14]

Specifically, BEPS highlights the unfairness in sharing the tax base between developed countries and developing countries, i.e.:

> For a long time, in their competition with developing countries for more tax resources (tax base), developed countries have obtained most of the benefits generated by MNEs by relying on their dominant position in formulating the rules and superiority in technology and intangible property, while developing countries have obtained a very small share of the profits even though they have paid a price [for such profits] through providing huge market, cheap labour, using energy resources and damaging the environment.[15]

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12. CN: Enterprise Income Tax Law of the People’s Republic of China, promulgated by the 5th Session of the Tenth National People’s Congress, 16 March, 2007, art. 30 [hereinafter: “EIT Law”]. Detailed Rules for the Implementation of the EIT Law were promulgated by the State Council on 6 December 2007 [hereinafter: “EIT Regulations”]. *See China Country Practice*, *United Nations Practical Manual on Transfer Pricing* sec. 10.3, available at www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf [hereinafter: “UN TP Manual”].
13. UN TP Manual, *supra* n. 12, at para. 10.3.8.3.
14. Interview with Deputy Commissioner Zhang Zhiyong, Strengthening Global Tax Cooperation and Combating International Tax Avoidance and Tax Evasion (8 Dec. 2014), available at http://www.chinatax.gov.cn/n810219/n810724/c1353155/content.html (in Chinese) [hereinafter: “Interview with Deputy Commissioner”].
15. Jiangsu Provincial Office of SAT, Administration Plan for International Taxation Compliance in 2014-2015 and Jiangsu State Tax Bureau, Prevention of Three Mismatches and Guarding against Four Matches (13 August 2014), available at http://www.shui5.cn/article/13/73408.html (in Chinese) [hereinafter: “Jiangsu STB Paper”].

2.3. BEPS is an opportunity for reform

The problems in the current international tax system were transplanted into China when China created its income tax system.[16] China could not create an international tax system that deviated from the international norm. By default, China was a norm-taker. As in other countries, the system has proven to be fertile ground for BEPS.

As the international tax rules were developed largely for an industrial economy, their defects were revealed when, in a short time, the Chinese economy rapidly transformed from an agricultural one to a mixed agricultural, industrial and information economy. The frustration with these flawed rules is perhaps intensified by the fact that their underlying values are not necessarily compatible with the Chinese ones.

BEPS provides an opportunity for reforming the international tax rules.[17] China regards the BEPS initiative as an opportunity to improve basic fairness in the international tax system, i.e. the "G20 Tax Reform".[18]

2.4. BEPS brings China to the table

The BEPS initiative brought China to the table where international tax rules are debated and their future direction is mapped. China had previously aired its views, but primarily through the United Nations.[19] China has played a role in developing international tax rules through the UN Committee of Experts on Tax Matters (the "UN Committee") and its non-member country status as regards the OECD Model.[20] It is the BEPS initiative that enables China to have a seat at the table.

As a member of the G20, China presumably played an important role in putting BEPS on the global agenda. According to the SAT, as a partner of the OECD, China has played a significant role in developing the BEPS initiative. By the end of 2014, SAT representatives had attended 42 BEPS meetings, submitted 52 position papers to the OECD and made "important contributions" to the completion of several BEPS 2014 Deliverables.[21] President Xi Jinping raised the BEPS issue during the G20 Summit on 16 November 2014 and regarded BEPS as a risk to global economic recovery.[22]

2.5. BEPS means action

Given the changes brought about by BEPS, China is leveraging off the BEPS outcomes to solidify its thinking on international tax rules and to introduce new enforcement measures. The SAT has developed a plan to translate the outcomes of the Action Plan into measures in China.[23] Notable BEPS measures include: (1) the General Anti-Avoidance Rule (GAAR);[24] (2), the Offshore Indirect Transfers Circular (2015);[25] (3) Beneficial Ownership Circulars;[26] (4) the Outbound Payments Notice (2015);[27] and (5) Special Tax Adjustment Measures (2009),[28] i.e. transfer pricing and other anti-avoidance rules.

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16. *See* J. Li, *Tax Transplants and the Critical Role of Processes: A Case Study of China*, Osgoode Leg. Stud. Research Paper Series, Paper 84 (2015), available at http://digitalcommons.osgoode.yorku.ca/olsrps/84/, originally published in 3 J. Chinese Tax & Policy, Special issue, pp. 85-139 (2013).
17. Jiangsu STB Paper, *supra* n. 15.
18. SAT, Tax System Reform, Through Strategizing One Area to Mobilize the Entire System (31 Dec. 2014), available at www.chinatax.gov.cn/n840303/c1440429/content.html (in Chinese) [hereinafter: "Strategizing One Area to Mobilize the Entire System"].
19. For instance, in 2013, China published its views on transfer pricing in UN TP Manual, *supra* n. 12.
20. Most recently, *OECD Model Tax Convention on Income and on Capital: Commentaries* (15 July 2014), Models IBFD.
21. Strategizing One Area to Mobilize the Entire System, *supra* n. 18.
22. President Xi urged strengthening global tax cooperation, combating international tax avoidance and evasion and assisting developing countries and low-income countries to increase their capacity to collect taxes (*see* Interview with Deputy Commissioner, *supra* n. 14).
23. Strategizing One Area to Mobilize the Entire System, *supra* n. 18.
24. SAT, Administrative Measures on the General Anti-Avoidance Rules (Trial), SAT Order No. 32 (2 Dec. 2014) [hereinafter: "GAAR Measures"]. *See* further replies to questions from the press regarding Administrative Measures for the GAAR (Trial) by in-charge SAT officials (SAT GAAR Q&A), posted on the SAT website on 12 December 2014 and Discussion draft of Administrative Measures on the General Anti-Avoidance Rules (Draft GAAR administrative measures) issued for public comment by the SAT on 3 July 2014.
25. SAT, Notice on Several Issues Related to Enterprise Income Tax Application to Indirect Transfers of Property between Non-resident Enterprises, Gong Gao [2015] No. 7 (3 Feb. 2015) [hereinafter: "Offshore Indirect Transfers Circular (2015)"].
26. *See infra* ns. 51-54.
27. SAT, Notice on Enterprise Income Tax Issues related to Payments of Expenses by Enterprises to Offshore Related Parties, Gong Gao [2015] No. 16 (18 Mar. 2015) [hereinafter: "Outbound Payments Notice (2015)"]. Before the publication of this document, *see* SAT, Notice of Anti-Avoidance Examination on Significant Outbound Payments, Shuifabanfa [2014] No. 146, Circular [2014] No. 146 (29 July 2014) [hereinafter: "Notice [2014] No. 146"].
28. SAT, Measures for the Implementation of the Special Tax Adjustment (trial)], Guo Shui Fa [2009] No. 2, (10 Jan. 2009, effective 1 Jan. 2009 [hereinafter: "Special Tax Adjustment Measures (2009)"].

The above measures are based on the GAAR[29] and the transfer pricing rules[30] in the EIT Law. They guide the audit and assessment practices of the SAT. Under Chinese law, the SAT enjoys a wide range of delegated authority to introduce rules and measures for the implementation of provisions in the EIT Law and EIT Regulations. There is no judicial oversight in this area. The doctrine of “substance over form” in applying statutory provisions also has a long history in China and has been incorporated into the Chinese anti-avoidance legislation. Consequently, local tax authorities have acted on the directions of the SAT.

3. BEPS Measures in China

3.1. The GAAR

3.1.1. Overview

The GAAR is the first set of rules introduced by the SAT following President Xi’s remarks at the 2014 G20 Summit. The timing of the official introduction of these measures indicates the importance of the GAAR as an anti-BEPS instrument. The accompanying news release was entitled “Implementing G20 Tax Reform and Forcefully Attacking International Tax Avoidance: State Administration of Taxation Standardises the Administration of the GAAR”.[31] The GAAR is believed to be the right instrument to counter BEPS, as it shares the same objective as the BEPS initiative, i.e. that of ensuring that the tax reporting of business profits is not artificially segregated from the location of business activities. The reasonable business purpose test and the concept of substance over form or economic substance underlie the GAAR.

Under Chinese law, the GAAR is a measure of last resort in addressing tax avoidance transactions. If a transaction is subject to any of the specific anti-avoidance rules (SAARs), such as transfer pricing, thin capitalization or controlled foreign corporation (CFC) rules, the SAAR is applied first.[32] The SAT has applied the GAAR to address perceived base erosion problems arising from realization of economic values accrued in China through offshore transfers and the improper use of tax treaties.

3.1.2. The provision

Article 47 of the EIT Law states that:

> [i]f an enterprise enters into any business arrangement without a reasonable business purpose that results in a reduction of taxable revenue or income, the tax authority has the power to make adjustments based on reasonable methods (author’s unofficial translation).[33]

The phrase “business arrangements without a reasonable business purpose” is defined in article 120 of the EIT Regulations to mean “arrangements whose main purpose is to reduce, avoid or defer tax payments”.

There is no case law interpreting the meaning of the GAAR. According to the SAT’s GAAR Measures, the GAAR applies only to cross-border transactions. It does not apply to transactions that are purely domestic or to non-compliance behaviour amounting to tax evasion or tax fraud. However, certain offshore transactions between non-resident enterprises are potentially subject to the GAAR if the transactions involve the transfer of taxable Chinese property (*see* section 3.2.2.).[34] The GAAR may apply to cross-border transactions covered by tax treaties. Generally, the GAAR can be invoked to prevent arrangements or transactions that result in: (1) the abuse of tax preferences; (2) the abuse of tax treaties; (3) the abuse of corporate forms; (4) tax avoidance using tax havens; and (5) other arrangements without reasonable business purposes.[35]

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29. Art. 47 EIT Law.
30. Id., at art. 41.
31. *See* www.gov.cn/xinwen/2014-12/14/content_2790846.htm (in Chinese).
32. Art. 6 GAAR Measures, *supra* n. 24.
33. If the GAAR is applied, in addition to unpaid taxes, there is an additional interest charge in respect of the underpaid tax. This charge is computed on a daily basis from 1 June following the tax year to which the tax is attributed, through the date of tax payment. The interest charges cannot be deducted in computing taxable income.
34. Art. 2 GAAR Measures, *supra* n. 24.
35. Art. 92 Special Tax Adjustment Measures (2009), *supra* n. 28.

3.1.3. Business purpose and economic substance tests

The GAAR applies to a transaction or arrangement if it is undertaken to obtain a tax benefit and has no reasonable business purpose.

The term “tax benefit” is interpreted by the SAT as meaning a reduction, exemption or deferral of tax payable by an enterprise.[36]

According to the GAAR Measures, if the sole or main purpose of an arrangement is to obtain a tax benefit, the arrangement is not undertaken for a reasonable business purpose. The GAAR provisions in the EIT Law and the EIT Regulations do not specify whether the purpose of obtaining a tax benefit must be the sole or primary purpose of the transaction or arrangement. Article 4 of the GAAR Measures clarifies the purpose test to mean the “sole”（唯一）“”or “primary” （主要）purpose.[37] In making the determination, all relevant circumstances in a specific case, including the economic substance of an arrangement, must be considered.

The concept of “economic substance” plays a key role in applying the GAAR, even though its meaning remains undefined. Without explicitly stating that tax law provisions are intended to apply to transactions with economic substance, the SAT appears to assume the existence of such an intention.[38] Artificial transactions and entities lacking economic substance are, therefore, considered to be abusive. In applying the economic substance doctrine, the SAT regards the following to be relevant: (1) the form and substance; (2) the creation time and implementation period; (3) the implementation method; (4) the relationship between each of the steps or components; (5) the changes in each party’s financial situation; and (6) the tax consequences, in respect of an arrangement.[39]

3.1.4. GAAR adjustments

When the GAAR applies to a transaction, the tax consequences of the transaction are determined according to the substance-over-form principle using similar arrangements with reasonable business purposes and economic substance as the benchmark.[40] Specific methods of adjustments include: (1) recharacterizing all or part of the transaction; (2) disregarding the counterparty of the transaction for tax purposes or to deem a specific counterparty and other counterparties as one single entity; (3) recharacterizing the income, deduction, tax incentive or foreign tax credit or the reallocation of the impugned amount among the relevant parties to the transaction; and (4) applying another reasonable method. These methods provide tax officials with specific guidance. Once the GAAR is invoked, the tax benefit arising from the avoidance arrangement is thereby denied.[41]

3.2. Offshore indirect transfers

3.2.1. Overview

Erosion of the source country’s tax base through offshore indirect transfers is not among the issues addressed by the BEPS initiative. For many developing countries, however, this is an important issue. It is the subject of a study commissioned by the UN subcommittee.[42] Examples of such transactions are described as follows:

> Mauritania: A Canadian company effectively acquired an interest in a large gold mining project [in Mauritania] from another Canadian company via a transaction in the Bahamas in 2010, with a potential capital gain of US$4 billion. No tax was collected on the transaction in Mauritania.
>
> Mozambique: In 2011 a change in ownership of mining projects in Mozambique was achieved through the sale, on the Australian stock market, of shares in the mining company holding interests in the projects. The value of the transaction was around US$4 billion. No tax was collected on the transaction in Mozambique. In the case of the

36. Art. 3 GAAR Measures, *supra* n. 24. Presumably, any increase in a tax refund would also be treated as a tax benefit.
37. *Supra* n. 24.
38. The principle of economic substance is widely supported in the Chinese tax literature. *See*, for example, Liu Yingchun, *Relevant Legal Issues regarding Taxation according to the Principle of Substance*”, 113 Rev. Inst. Pol. China Youth 1, (2012), available at www.cesruc.org/uploads/soft/130320/1-1303201Z019.pdf (in Chinese).
39. Art. 93 Special Tax Adjustment Measures, *supra* n. 28.
40. Article 93 of the Special Tax Adjustment Measures, *supra* n. 28, and article 5 of the GAAR Measures, *supra* n. 24.
41. Art. 94 Special Tax Adjustment Measures, *supra* n. 28.
42. *See* W. Cui, *Taxation of Capital Gains*, Papers on Selected Topics in Protecting the Tax Base of Developing Countries (Sept. 2014), available at www.un.org/esa/ffd/wp-content/uploads/2014/09/20140923_Paper_TaxationCapitalGains.pdf.

> sales of shares in the exploration concessions in the Rovuma basin, the authorities have collected US$1.1 billion in capital gains taxes in 2013-14. Changes were made to the tax code, on January 1, 2014, to ensure taxation of capital gains resulting from a direct or indirect transfer between non-residents of assets located in Mozambique (International Monetary Fund, 2014).[43]

In China, offshore indirect transfers generally refer to transfers of shares of a non-resident holding company by its shareholders where the holding company owns equity investments in Chinese enterprises. Gains from such transfers are technically not taxable in China, but are economically sourced in China and are believed to fall within the Chinese tax base.

3.2.2. Source rules for capital gains

Under the EIT Law, capital gains are subject to withholding taxes which apply to passive investment income.[44] In contrast to passive investment income that is taxed on a gross basis, capital gains are taxed on a net basis. The source of the capital gain is defined in article 7 of the EIT Regulations as follows:

- for immovable property, the source is the place where the property is located;
- for movable property, the source is where the enterprise or the establishment or site of the non-resident that transfers the property is located; and
- for equity investments, the source is where the enterprise invested is located.

According to these rules, the source of gains from the transfer of shares of a Chinese company is China. There are no “look-through” rules in the EIT Law. Consequently, for offshore indirect transfers, the shares sold are not those of a Chinese company, but an offshore holding company. Technically, the gains from the sale of such shares are not sourced in China. Economically, however, the value of the shares of may be derived solely or principally from the underlying shares of the Chinese company. The Chinese tax base is, therefore, eroded in the sense that the economic gain accrued in China is realized by a non-resident investor without paying taxes in China on the gain.

The SAT has relied on the domestic GAAR to attribute capital gains to a Chinese source in the Offshore Indirect Transfer Circular (2009)[45] and Offshore Indirect Transfer Circular (2015).[46] The latter introduces the new concept of “taxable Chinese property” to convey the scope of Chinese source-based taxation on capital gains.[47] Taxable Chinese property refers to: (1) assets of an establishment or site through which business is carried on in China; (2) immovable property in China; and (3) equity investments in resident enterprises.[48] The SAT circular has the effect of clarifying and modifying the legislative source rules in article 7 of the EIT Regulations.

3.2.3. Abusive transactions

Offshore indirect transfers may take place where the original investor in China wants to dispose of its investment in China, there is a cross-border merger and/or acquisition, and an intra-group restructuring. In this regard, the SAT circulars provide guidance on abusive transfers and safe harbours.

The targeted transactions are indirect transfers that lack a reasonable business purpose and economic substance and result in the avoidance of Chinese tax. Specifically, the relevant transactions are where: (1) the transferor is a non-resident enterprise, i.e. the transferee can be a resident or non-resident of China; (2) the company whose shares are transferred, i.e. the “intermediary”, holds “taxable Chinese properties”; (3) the effective transaction is the same as, or similar to, a direct transfer of the taxable Chinese property; and (4) the transaction has no reasonable business purpose.

Whether a transaction has a reasonable business purpose is assessed by considering all related arrangements and conducting a comprehensive analysis of the circumstances, including the following: (1) whether the value of equity

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43. OECD, *Part 2 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries* p. 16 (OECD 2014, available at www.oecd.org/ctp/tax-global/part-2-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf [hereinafter: “Part 2 of a Report to G20 Development Working Group”].
44. Arts. 3 and 19 EIT Law.
45. SAT, Notice on Strengthening the Administration of Enterprise income Tax on Income From Transfers of Equity Interests by Non-resident Enterprises, Guoshuihan [2009] No. 698 (10 Dec. 2009), retroactively effective from 1 January 2008.
46. Offshore Indirect Transfers Circular (2015), *supra* n. 25.
47. Id.
48. Id., at art.1.

interests in the intermediary is principally derived, directly or indirectly, from taxable Chinese properties; (2) whether the assets of the intermediary mainly consist, directly or indirectly, of investments in China, or whether the income of the intermediary mainly consists, directly or indirectly, of income sourced from China; (3) what are the functions performed and risks assumed by the intermediary and its subsidiaries that hold, directly or indirectly, taxable Chinese properties; (4) how long have the shareholders, business model and relevant organizational structure of the intermediary existed; (5) what is the foreign income tax on the gains from the indirect transfers of taxable Chinese properties; (6) whether the transferor's indirect investment in, and indirect transfers of, taxable Chinese properties is an alternative of a direct investment or direct transfers of taxable Chinese properties; (7) whether a tax treaty applies to the indirect transfers of taxable Chinese properties; and (8) other related factors.

A transaction is deemed to lack a reasonable business purpose in the following circumstances:

- more than 75% of the value of the equity in the intermediary is derived, directly or indirectly, from taxable Chinese properties;
- at any time in the year immediately before the indirect transfer of a taxable Chinese property takes place, more than 90% of the total investment, excluding cash, comprises, directly or indirectly, investments in China, or in the year before the indirect transfer of a taxable Chinese property takes place, more than 90% of the income of the intermediary is derived, directly or indirect, from Chinese sources;
- the functions performed and risks assumed by the intermediary and any of its subsidiaries that, directly or indirectly, hold taxable Chinese properties are limited and are insufficient to provide their economic substance, despite the fact that they are registered in their resident jurisdiction and meet the required legal form; and
- the foreign tax payable on the gain from the indirect transfer of taxable Chinese properties is less than the Chinese tax otherwise payable on the gains from a direct transfer of such properties.

In practice, three types of factors are important in determining if there is sufficient economic substance in the intermediary or transaction. The first is whether the intermediary is capable of performing functions and assuming risks on the basis of analysing the intermediary's personnel, assets and revenue relative to those of its related parties. If the intermediary has USD 100 of paid-up capital, no personnel and no other assets, while holding valuable shares of Chinese companies, the intermediary is considered to have no economic substance. The second is the time of the existence of the intermediary. If the intermediary has existed for a brief period of time before its shares are transferred, this can be considered to be evidence of the lack of economic substance. The third factor is whether or not the impugned indirect transfer is an alternative to a direct transfer of taxable Chinese properties. Market conditions, regulatory approval of the transactions, as well as the objectives and framework of the transactions are also relevant factors in determining if an indirect transfer is an alternative to a direct transfer.[49]

Given that the offshore indirect transfer rules are anti-avoidance provisions, if the impugned indirect transfer does not result in a reduction or avoidance of Chinese tax, it is not abusive. The SAT lists the following as relevant to determining whether avoiding Chinese tax is a main purpose:

- Whether the tax payable in a foreign jurisdiction is less than the Chinese tax otherwise payable. If so, the indirect transfer is presumed to be undertaken to avoid Chinese tax.
- Whether the gains, if realized through a direct transfer, would have been protected from Chinese taxation by a tax treaty. If the gains were not to be taxed in China, the avoidance of Chinese tax is presumably not a purpose of the indirect transfer.
- Whether the shares of the intermediary are publicly traded. Buying and selling publicly traded shares in companies that hold taxable Chinese properties are presumed to have a business purpose and not to avoid Chinese tax.
- Whether the indirect transfers are part of an intra-group reorganization that does not result in any change in the economic ownership or divestment of the non-resident investors. Eighty percent equity ownership is required to qualify for an intra-group reorganization or 100% for companies holding immovable properties in China.

49. SAT, Concerning the interpretation of "Announcement of the State Administration of Taxation on Several Issues Relating to Corporate Income Tax on Gains from Indirect Transfer of Assets by Non-resident Enterprises (3 Feb. 2015).

- Whether a non-resident investor's equity interests in Chinese taxable properties remain unchanged after the impugned transfer.

3.2.4. Effective look-through rules

The SAT adopted three tests for tracing the value of gains from offshore indirect transfers to a Chinese source. These are: (1) the share value test; (2) the asset test; and (3) the revenue test. They function as look-through rules.

Under the share value test, if more than 75% of the value of the shares of the intermediary is derived from taxable Chinese properties, any indirect transfer of the shares is deemed to lack a reasonable commercial purpose, thereby resulting in the gains being taxed in China. This has the same effect as defining "taxable Chinese property" to include shares of a non-resident company that holds shares of Chinese companies. If a lesser percentage of the value of the shares transferred is derived from taxable Chinese properties, an indirect transfer of the shares may still be deemed to have no reasonable commercial purpose after a consideration of all relevant factors.

Under the asset test, the source of gains from an indirect transfer is deemed to be in China if more than 90% of the intermediary's assets are investments in China, i.e. not limited to equity investments, or if more than 90% of the intermediary's revenues are derived from Chinese sources. The 90% threshold may be tested at any time in the year preceding the transfer. In effect, for the indirect transfer of shares of an intermediary that holds licences in respect of Chinese companies or debt investments in Chinese companies, any gain from the transfer is taxable in China. That is, the source of the gain accrued to the shares of the holding company is deemed to be the same as royalties or interest income earned by the company. There is, therefore, symmetry between the source rule for royalties and interest paid by Chinese companies, and the source rule for the capital gains arising from the shares of the holding company that holds the licences or debts.

3.2.5. Safe harbours

Safe harbours are provided where non-Chinese tax is avoided as a result of an offshore indirect transfer. Conditions for safe harbours include:

- For "intra-group" reorganizations, the shareholding relationship of the transferor and transferee meets any of the following tests: (1) the transferor holds, directly or indirectly, more than 80% of the equity of the transferee; (2) the transferee holds, directly or indirectly, more than 80% of the equity of the non-resident transferor; or (3) the same party holds, directly or indirectly, more than 80% of the equity of the non-resident transferor and transferee.[50]
- For non-Chinese tax leakage scenarios, the Chinese tax payable on any subsequent indirect transfer undertaken after the indirect transfer in issue is not less than the Chinese tax payable on the same or a similar indirect transfer if it were undertaken before the indirect transfer in issue.
- For share-for-share exchanges, the transferee pays all consideration in equities, excluding equities in listed enterprises, of the transferee itself or its controlled enterprises.

The anti-avoidance rules also do not apply where: (1) the shares transferred indirectly are publicly listed shares acquired by the transferor from the open market; and (2) the gains would be exempt from Chinese tax under a tax treaty had the gains been realized from a direct transfer.

3.3. Improper use of tax treaties

3.3.1. Overview

The SAT has dealt with the issue of treaty abuse in several ways. These include: (1) interpreting the meaning of the beneficial ownership test according to a purposive interpretation of tax treaties; (2) including an anti-abuse provision in a tax treaty, i.e. a principal purpose rule or a limitations on benefits (LOB) rule; and (3) relying on the domestic GAAR.

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50. For the purpose of the safe harbour, the shareholding percentage must be 100% if more than 50% of the value of the intermediary's equity is derived, directly or indirectly, from immovable property situated in China. The indirect shareholding percentage should be calculated by multiplying the shareholding percentages of each enterprise in the share chain (*see* art. 6 Offshore Indirect Transfers Circular (2015), *supra* n. 25).

3.3.2. Beneficial ownership

The SAT's interpretation of beneficial ownership is published in the following circulars: (1) the BO Circular 601 (2009);[51] (2) the BO Announcement 30 (2012);[52] (3) the BO Hong Kong Letter (2013);[53] and (4) the BO Announcement 24 (2014).[54] The first two documents provide general guidelines, the third relaxes the standard for residents in Hong Kong and the fourth deals with entrusted investments or collective investment entities. A later document generally supplements, but does not replace, an earlier document.

A "beneficial owner" is a person who has the right of ownership and disposal over the dividend, interest and royalty income received from China or the associated properties and rights.[55] Generally, a beneficial owner is supposed to conduct substantive business operations. Agents and conduit entities, therefore, do not qualify as beneficial owners.

"Conduit entities" are defined as companies that are established in the residence jurisdiction for the purpose of evading or reducing tax, or transferring profits. These entities do not perform manufacturing, distribution or management functions and possess barely enough substance to meet the minimum legal requirements imposed by the residence state. In addition to a technical legal analysis, the circular emphasizes the determination of substance on the basis of the facts of the situation.

Adverse factors are listed in BO Circular 601 as relevant to determining if a recipient of China-source income is a beneficial owner. These are:[56]

- the recipient is under an obligation to distribute all or the most of the China-source income to a resident of a third jurisdiction within a specified period;
- other than holding the properties or rights that generate the income received, the recipient conducts little or no business activities;
- if the recipient is a corporation or another business entity, the assets, the size of operations and the human resources of the recipient are disproportionately small relative to the income received from China;
- the recipient does not, or almost does not, have rights to control or dispose of the income or the properties or rights giving rise to the income, and bears little or no risks;
- the recipient is exempt from, or is not subject to, tax in the residence state with regard to the income received from China, or the recipient pays tax in the residence state but at a very low effective tax rate; and
- for interest income from a loan agreement, the recipient has a loan or deposit agreement with another party with terms resembling those in the primary loan agreement.

None of the above factors is decisive. According to the circular, a determination must be based on a comprehensive analysis of all relevant factors and cannot be based solely on the existence of a specific negative factor or the absence of the tax avoidance purpose:[57]

- Where the recipient is an agent or nominee of another party, i.e. the principal, factors associated with the principal should be considered in making the beneficial ownership assessment.

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51. SAT, Circular on how to understand and recognize the "Beneficial Owner" in tax treaties, Guoshuihan (2009) No. 601 (27 Oct. 2009) [hereinafter: "BO Circular 601"]. The SAT had previously released the following two circulars dealing with access to treaty benefits: (1) Guoshuihan (2009) No. 81 (20 Feb. 2009), setting out guidance relating to the implementation of dividend clauses in tax treaties; and (2) Guoshuifa (2009) No. 124, providing guidance and clarifying procedures and documentation requirements for non-residents seeking to take advantage of treaty benefits on their Chinese-source income.
52. SAT, Announcement on Determining Beneficial Ownership in the context of Qualifying for PRC Treaty Benefits, Gonggao (2012) No. 30 (29 June 2012) [hereinafter: "BO Announcement 30"].
53. SAT, Opinion Letter on the determination of beneficial ownership cases under the dividend article of the PRC-HK double tax arrangement, Shuizonghan [2013] No. 165 (Circular 165) (12 Apr. 2013) [hereinafter: "BO Hong Kong Letter"].
54. SAT, Announcement on the Definition of "Beneficial Owner" under Entrusted Investments, Gonggao 2014 No. 24 (21 Apr. 2014) [hereinafter: "BO Announcement 24"].
55. Art. 1 BO Circular 601, *supra* n. 51.
56. Id., at art. 2.
57. Art. 1 BO Announcement 30, *supra* n. 52.

- A safe harbour is where an overseas listed company or its same-country subsidiaries receive dividends from China. If the recipient company is a resident in a treaty state and listed in that jurisdiction, it is automatically regarded as a beneficial owner.

The substantive business activities and assets test disqualifies most, if not all, holding companies as beneficial owners. This has significant implications for investors who use Hong Kong as a base for investments in China. In order to address the uncertainties and anxieties, the BO Hong Kong Circular extends a preferential approach to assessing beneficial ownership to treaty relief claims by Hong Kong companies through the following clarifications:

- Under the China-Hong Kong Income Tax Arrangement (2006),[58] the beneficial owner status of the recipient should not be adversely affected if the recipient does not make any distributions to a non-HK resident.
- For the purpose of adverse factor 2, "investment activities" are considered to be "business activities" and treaty relief cannot be denied solely on the basis that the recipient only holds one investment. That is, a holding company should not be denied any treaty benefits simply because it has only one investment. Other factors should also be taken into account.
- For the purposes of adverse factor 3, the SAT is not to draw negative inference from the fact that the recipient is thinly capitalized. No negative inference is to be drawn if the capitalization level is commercially justifiable and the interest payments on the recipient's debt do not result in a failure of the income retention test in adverse factor 1. If the registered capital of the recipient is very low, whether or not its income is commensurate with its assets, this should be assessed in light of the sources of its capital investment risk. In assessing whether or not the staffing is commensurate with the income earned, the responsibilities and nature of work of the staff should be considered, and not solely the number of staff and the size of staff costs of the recipient.
- For purpose of adverse factor 4, in examining whether or not the recipient has legal capacity and right of control and disposal over the income or investments and bears risks, the following three specific issues must be analysed: (1) do the articles of association and other legal documents of the recipient grant such rights of control and disposal; (2) has the recipient exercised such rights before; and (3) is the exercise of such rights voluntary, as evidenced by the resolutions of the general meetings or board meetings, etc? The mere fact that the applicant's shares are controlled by a higher-level corporation should not negate the existence of rights of control or disposal of the applicant.
- For the purpose of adverse factor 5, the fact that the offshore dividend income of a Hong Kong resident falls outside the scope of the Hong Kong profits tax under the territorial tax system should have no negative implications in determining the beneficial ownership of the income. Tax filing should also be taken into account.

Under BO Announcement 24, an investor in a collective investment scheme[59] can be treated as a beneficial owner where: (1) the overseas professional institution that manages the investment must maintain separate accounts for their own funding and the entrustment funding during the entrustment period, and collect service fees or commissions under the entrustment agreement; and (2) the investor obtains investment income and bears the relevant investment risks.

Overall, the SAT has interpreted the beneficial ownership test on the basis of the substance-over-form principle, which may elevate the test to a broader anti-treaty abuse rule.

3.3.3. Principal purpose test

Some Chinese tax treaties contain a principal purpose provision.[60] Some recently amended tax treaties also contain a similar principal purpose test in the dividends, interest and royalties articles.[61]

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58. *H.K.-P.R.C. Income Tax Arrangement* (unofficial translation) (21 Aug. 2006) (as amended through 2010), Treaties IBFD.
59. BO Announcement 24, *supra* n. 54 defines "entrusted investment" as equity or debt investments made by a non-resident with its own capital through an overseas professional institution and "overseas professional institution" as a financial institution approved by the home jurisdiction to conduct business in securities brokerage, asset management, capital and securities trust, etc.
60. For instance, *Austl.-P.R.C. Income Tax Treaty* art. 4(5) (17 Nov. 1988), Treaties IBFD.
61. For instance, *P.R.C.-Sing. Income* (11 July 2007) (as amended through 2010), *Fin-P.R.C. Income* (25 May 2010), *Malta-P.R.C. Income* (23 Oct. 2010), *Den.-P.R.C. Income* (16 June 2012), *Neth.-P.R.C. Income* (31 May 2013), *P.R.C-Swit. Income and Capital* (25 Sept. 2013), *Fr.-P.R.C. Income* (unofficial translation) (26 Nov. 2013) and *Ger.-P.R.C. Income and Capital* (28 Mar. 2014) *Tax Treaties*, Treaties IBFD. *See also P.R.C.-U.K. Income Tax Treaty* art. 10(7) (27 June 2011) (as amended through 2013), Treaties IBFD

3.3.4. LOB

An LOB article can be found in the China-United States (1986)[62] and the China-Mexico (2005) Income Tax Treaties.[63] The LOB clause in these tax treaties is substantially similar. According to the China-Mexico Income Tax Treaty (2005), a resident of Mexico does not qualify for treaty relief in China, unless it is a publicly traded company or a subsidiary of resident individual or publicly traded company, or it is not a "conduit".

Under the LOB provision of the US Treaty, a corporation which is a resident of a contracting state is denied treaty benefits unless: (1) its shares are publicly traded; or (2) more than 50% of the shares of each class of the company's shares are owned, directly or indirectly, by any combination of one or more of: (i) individuals who are residents of one of the Contracting States and (ii) a publicly traded company. For relief under the dividends, interest and royalties provisions, a recipient of such income is entitled to treaty benefits if not more than 50% of the gross income of such person is used to make relevant payments to persons who are not entitled to treaty benefits. The LOB provision also states that these limitations should not apply:

> if the establishment, acquisition and maintenance of such person and the conduct of its operations did not have as a principal purpose the purpose of obtaining benefits under the Agreement.

3.3.5. Domestic GAAR

China's tax treaties concluded before 2006 do not contain any provision that allows the use of a domestic GAAR to counter treaty abuse. The domestic GAAR was enacted in 2007 and became effective on 1 January 2008.[64] Since 2007, the domestic GAAR has been incorporated into an increasing number of tax treaties. For instance, article 23 of the China-Netherlands Income Tax Treaty (2013) states that:

> Nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax evasion and avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to this Agreement.

In practice, it appears to be clear that an explicit GAAR article in a tax treaty is included for the purposes of greater certainty. The absence of such a provision in a tax treaty does not mean that the GAAR is not relied on by the SAT.

Applying domestic GAAR to deny treaty benefits may result in double taxation of the income if the treaty partner state does not agree with China's approach. For instance, where a resident of the United States sells shares of a US company that owns nothing but shares of a Chinese corporation, China may invoke its GAAR and tax the capital gains as Chinese-source income. The United States may not grant foreign tax credit for the Chinese taxes, as the gains are not taxable in China under the tax treaty.[65] This kind of dispute is likely more common if the treaty partner is a common law country that adheres more to the form-over-substance doctrine and emphasizes textual interpretation of treaty provisions.

3.4. Improper use of corporate forms

3.4.1. Empty shells

A corporation is a legal fiction. The law recognizes the separate identity of a corporation and the limited liability of its owners for the purpose of promoting production and business activities.[66] A corporation is, by nature, a business entity. Avoiding taxes is not a business activity per se. When a corporation is created for the main purpose of avoiding taxes and has no capacity to conduct any substantive activities, it is considered to be an abuse of the corporate form. Such holding

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62. *Protocol 2, P.R.C.-U.S. Income Tax Treaty* (30 Apr. 1984) (as amended through 1986), Treaties IBFD [hereinafter: "LOB Provision of US Treaty"].
63. *Mex.-P.R.C. Income Tax Treaty* (12 Sept. 2005), Treaties IBFD.
64. Art. 47 EIT Law and art. 120 EIT Regulations. For more on this topic, *see* J. Li, *Tax Transplants and Local Culture: A Comparative Study of the Chinese and Canadian GAAR*, 11 Theoretical Inquiries in Law 2, p. 75 (2009) and W. Xiong & C. Evans, *Towards an Improved Design of the Chinese General Anti-Avoidance Rule: A Comparative Analysis*, 68 Bull. Intl. Taxn. 12 (2014), Journals IBFD.
65. Q. Zhou, *The Relationship between China's Tax Treaties and Indirect Transfer Antiavoidance Rules*, Tax Notes Intl. p. 543 (12 May 2014) and C. Xing, C. Ho & R. Di, *New Landscape of Chinese Tax Treaties*, in *China: Looking Ahead* 2nd ed. Intl. Tax Rev. p. 21 (2013).
66. *See*, for example, F.H. Easterbrook & D.R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89 (1985).

companies are regarded to be shell companies if they do not carry on any production, distribution, sales, management and other substantive activities.

Empty shells are used by both foreign-based and China-based MNEs, and wealthy individuals.[67] Chinese resident taxpayers use holding companies in tax havens, typically the British Virgin Islands and the Cayman Islands, for purposes of raising capital overseas to invest in China or move ownership offshore. It is suspected that offshore entities are also used by corrupt officials in China to hide or launder money.[68] MNEs may use holding companies to hold intangible property, equity interest or debts in subsidiaries, including those in China.

3.4.2. Anti-abuse measures

Using empty shells to avoid Chinese taxes is counter to the substance-over-form principle that underlies the Chinese anti-avoidance measures. The SAT has relied on the GAAR and transfer pricing rules to deny tax benefits arising from such use. For instance, payments made by Chinese enterprises to a related shell company are not deductible for EIT purposes if the shell company undertakes no functions, bears no risks or has no substantial operations or activities.[69] If the shell company is located in a treaty state, dividend, interest or royalty payments may be denied treaty benefits on the ground that the shell company is not a beneficial owner (*see* section 3.3.2.). Indirect transfers of equity interest in Chinese companies through the sale of shares in the shell company may be subject to the GAAR (*see* section 3.2.3.).

3.5. Profit shifting through transfer pricing

3.5.1. Overview

Transfer pricing issues occupy a prominent place in the BEPS initiative. Action 8, i.e. Intangibles, Action 9, i.e. Risks/capital, Action 10, i.e. Other high-risk transactions, and Action 13, i.e. Transfer pricing documentation, are directly related to transfer pricing. In addition, Action 1, i.e. Digital economy, and Action 4, i.e. Interest deductions/other financial payments, involve some transfer pricing issues.

Transfer pricing is a major form of BEPS in China.[70] According to the SAT, intra-group payments of service fees and royalties are of particular significance. Service fees account for a major share of outbound payments. The range of services is very broad and the potential leakage from the Chinese tax base is significant. Royalties and intangibles have also been a major issue. The Outbound Payments Notice (2015)[71] standardizes and strengthens the administration of transfer pricing in respect of outbound payments of service fees and royalties. In its press release, the SAT stated this notice is another BEPS measure, following the introduction of the GAAR and the Offshore Indirect Transfers Measures.[72] Instead of attempting to determine the arm's length price for the intra-group service transactions, the Outbound Payments Notice (2015) denies the existence of transactions if they provide no economic benefit to the Chinese affiliate. It builds on the SAT previous views on the arm's length principle and practices in applying the transfer pricing methods.[73]

3.5.2. China's approach to transfer pricing

Chinese law includes the arm's length principle[74] and the SAT has incorporated the OECD Transfer Pricing Guidelines (the "OECD Guidelines")[75] into its administrative practices.[76] China's position on the challenges in applying the arm's

67. Jiangsu STB Paper, *supra* n. 15.
68. Y. Sun, *Escalating Anti-Tax Evasion Tactics in Mainland China* , available at www.ifengweekly.com/detil.php?id=1589 (in Chinese).
69. Art. 3 Outbound Payments Notice (2015), *supra* n. 27.
70. UN Response re BEPS, *supra* n. 9.
71. Outbound Payments Notice (2015), *supra* n. 27.
72. SAT, Attacking Cross-Border Tax Avoidance and Plugging Taxation Loopholes: SAT Strengthens the Administration of Transfer Pricing related to Outbound Payments of Expenses (20 Mar. 2015), available at www.chinatax.gov.cn/n810341/n810755/c1519231/content.html (in Chinese).
73. Inter alia, SAT: (1) Notice [2014] No. 146, *supra* n. 27; (2) Public Announcement about Issues Related to Monitoring and Administration of Special Tax Adjustments, Gonggao [2014] No. 54; (3) Panel Review Rules for Significant Special Tax Adjustment Cases (Trial), Guoshuifa [2012] No. 16; (4) Internal Work Rules of Special Tax Adjustments (Trial), Guoshuifa [2012] No. 13; (5) Notice on Conducting Examinations of Contemporaneous Documentation, Guoshuihan [2010] No. 323; (6) Circular on Strengthening Supervision and Investigation of Cross-Border Related-Party Transactions, Guoshuihan [2009] No. 363; (7) Notice Regarding the Status of Anti-tax Avoidance Efforts in 2009, Guoshuihan [2010] No. 84; and (8) EIT Treatment Related to Payment for Provision of Services between Parent Company and Its Subsidiary Company, Guoshui Fa [2008] No. 86; and (9) Ministry of Finance & SAT, Notice on the Tax Deductibility of Interest Expense Paid to Related Parties, Caishui [2008] No. 121.
74. Art. 41 EIT Law.
75. OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 1995 & 2010), International Organizations' Documentation IBFD, also available at www.oecd.org/dataoecd/23/12/45763692.pdf [hereinafter: "OECD Guidelines (1995 & 2010)"].
76. Special Tax Adjustment Measures (2009), *supra* n. 28.

length principle and the transfer pricing methodologies is officially stated in the UN TP Manual. China has identified some major challenges in transfer pricing and expressed approaches that deviate from the OECD Guidelines. Some of these are noted subsequently in this section.

A major challenge in transfer pricing is a lack of reliable, public information on comparables, i.e.:

> comparable sets are often dominated by companies in developed countries, simply because there are usually a much larger number of public companies in these countries.[77]

The SAT must make comparability adjustments to bridge the material differences between the Chinese market and foreign markets to account for differences in China and foreign countries when applying profit-based methods, i.e. geographical markets comparability adjustments. China regards location specific advantages (LSA), such as location savings[78] and market premium,[79] as relevant factors, as they represent advantages for production arising from assets, resource endowments, and government industry policies and incentives that exist in specific localities.

Another major challenge in applying the transfer pricing rules is related to intangibles. MNEs often provide intangibles to their Chinese affiliates in return for royalties and other payments. Over time, the Chinese affiliates contribute to the improvement of the original intangibles or create additional value of global brand name through effective marketing in the Chinese markets. Even if accepting the original royalties were reasonable, China questions:

> whether the Chinese affiliate should continue to pay a royalty to the parent company for the manufacturing process, or whether the Chinese affiliates should be entitled to a return on the intangibles that they have developed and shared with the group companies.[80]

China prefers profit-based method to address these challenges. It has also expressed different approaches to the transfer pricing issue:

- A holistic view of functions and risks may have to be adopted.[81] A risk-based approach may have insufficient regard for the fact that there are sizeable assets located in China.
- A contribution-based approach may be more suitable than a transactional or profits-based approach. This is particularly the case where the majority of the work force and tangible assets of foreign-based MNEs are in China. An example is the electronic manufacturing services (EMS) sector, where the entire, or nearly the entire, manufacturing and assembly activities of an MNE have been outsourced to a Chinese affiliate. Under a contribution based approach, the remuneration to each party involved would be commensurate with its role and contribution to the value chain in the MNE, i.e. "[i]n this case, the assets and the people should largely dictate where the group's profits should stay".[82] The technical legal ownership of intangibles or contractually assigned assumption of risks is not among important, or even relevant, factors.
- China is open to use alternative methods. For instance, global formulary approach "should be a realistic and appropriate method".[83] In allocating profit to a Chinese affiliate of an MNE, the SAT may "determine the property return for the headquarters, with the Chinese manufacturer earning the residual profits"[84] or "to evaluate the

77. UN TP Manual, *supra* n. 12, at para. 10.3.2.2.
78. Id., where the concept is explained as follows: "Location savings are the net cost savings derived by a multinational company when it sets up its operations in a low-cost jurisdiction. Net cost savings are commonly realized through lower expenditure on items such as raw materials, labour, rent, transportation and infrastructure even though additional expenses (so-called dis-savings) may be incurred due to the relocation, such as increased training costs in return for hiring less skilled labour".
79. Id., where it is stated that: "Market premium relates to the additional profit derived by a multinational company by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product".
80. Id., at para. 380.
81. Id., at para. 10.3.5.2.
82. Id., at para. 10.3.6.3.
83. Id.
84. Id., at para. 10.3.6.4.

> Chinese manufacturer on the return on its assets or capital employed, using the group's results as a comparable for the Chinese manufacturer".[85]

China's emphasis on contribution analysis and value creation is consistent with the BEPS initiative as the Action Plan is intended to ensure that taxation is aligned with substance and transfer pricing outcomes are in line with value creation.[86]

Notable issues from the Chinese position on transfer pricing include LSAs, value creation to intangibles by local subsidiaries, applying an economic benefit test in denying deduction for intra-group services and holistic examinations of the MNE activities as opposed to those limited to Chinese affiliates.

3.5.3. LSAs

The term "location specific advantages" was used by China probably for the first time in the context of transfer pricing in the UN TP Manual. This term is not found in the 1995[87] or the 2010 OECD Transfer Pricing Guidelines.[88]

The concept "local specific advantages" is defined in the UN TP Manual as "advantages for production arising from assets, resource endowments, government industry policies and incentives, etc., which exist in specific localities".[89] It includes location savings and market premium. Location savings capture the supply-side advantages in running operations in low-cost jurisdictions and market premium refers to demand-side advantages that correspond to other advantages that the market structure offers.[90]

Location savings are net cost savings, i.e. the savings realized by MNEs relocating from a high-cost jurisdiction to a low-cost jurisdiction are offset by dis-savings or disadvantages associated with the cost of training, lower competitiveness and a higher cost of business. Location savings are among the main reasons why MNEs invest in developing countries.[91] According to data from the US Bureau of Labor Statistics,[92] the average hourly compensation cost in manufacturing in 2009 was estimated at USD 1.74 in China, higher than that of USD 1.70 in the Philippines and USD 1.24 in India,[93] but still lower than that of USD 15.06 in Korea (Rep.) and USD 30.03 in Japan. The electronics manufacturers also enjoy a "well-developed network of suppliers",[94] as another cost saving factor that allows easier access to parts and other resources.

Market premium refers to:

> the additional profit derived by a multinational company by operating in a jurisdiction with unique qualities impacting on the sale and demand of a service or product.[95]

Such unique qualities or advantages include the existence of legal, regulatory or administrative restrictions, which limit the number of competitors and induce an artificial scarcity in the relevant market, consumer preference for foreign brands and inelastic demand for certain luxury products. In essence, the market premium concept seeks to capture the additional profit realized by an MNE through higher sales or sales at higher prices.

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85. Id.
86. OECD, *Public Discussion Draft: BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains* para. 34 (OECD 2015) [hereinafter: "Public Discussion Draft: BEPS Action 10"].
87. OECD Guidelines (1995 & 2010), *supra* n. 75. The closest concept in the *OECD Guidelines* (1995), *supra* n. 75, at para. 1.30 would be "economic circumstances" as factors in comparability adjustments, i.e.: "[e]conomic circumstances that may be relevant to determining market comparability include the *geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers*; the availability (risk thereof) of substitute goods and services; *the levels of supply and demand in the market as a whole and in particular regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production*, including the costs of land, labour, and capital; transport costs; the level of the market (e.g. retail or wholesale); the date and time of transactions; and so forth." (Emphasis added).
88. OECD Guidelines (2010, *supra* n. 75, at para. 1.57, which elaborates further on the factor of geographic markets which can affect comparability as follows: "The identification of the relevant market is a factual question. For a number of industries, large regional markets encompassing more than one country may prove to be reasonably homogeneous, while for others, differences among domestic markets (or even within domestic markets) are very significant".
89. UN TP Manual, *supra* n. 12, at para. 10.3.3.1.
90. S. Gonnet, P. Fris & T. Coriano, *Location Specific Advantages – Principles*, Transfer Pricing Intl. J., pp. 6-7 (Special Issue: November 2011).
91. *See*, for example, UN TP Manual, *supra* n. 12, at para. 10.3.3.1.
92. *See* www.bls.gov/opub/mlr/2010/05/art1full.pdf; www.bls.gov/fls/china_method.pdf; and www.bls.gov/news.release/archives/ichcc_12212011.pdf.
93. Gonnet, Fris & Coriano, *supra* n. 90, at p. 23.
94. UN TP Manual, *supra* n. 12, at para. 10.3.3.1.
95. Id., at para. 10.3.3.3.

Market premium is an important issue for China, as the country is becoming the “market of the world”. The Chinese market also has certain distinct features in terms of its size and growth, as well as consumer preferences.[96] One of the idiosyncratic features is the strong consumer preference for foreign brands:

> Chinese consumers’ general preference for foreign brands and imported products – this general preference, as opposed to loyalty to a specific brand, creates opportunities for MNEs to charge higher prices and earn additional profits on automotive products sold in China.[97]

Recognizing the value of LSAs in transfer pricing assessment is new. The SAT has adopted a four-step approach: (1) identifying if an LSA exists; (2) determining if the LSA generates additional profit; (3) quantifying and measuring the additional profits arising from the LSA; and (4) determining the transfer pricing method to allocate the profits arising from the LSA.[98]

In the UN TP Manual, China states that industry analysis and quantitative analysis are critical in applying this approach. Chinese LSAs are expected to result in profit allocations to Chinese affiliates because many LSAs have led to extraordinarily high profits that are rightly earned by Chinese taxpayers.[99]

In practice, the SAT has attempted to use profit split methods where there are significant marketing intangibles or LSAs. Alternatively, it has used LSAs in performing comparability adjustments where the Transactional Net Margin Method (TNMM) is used:

> For example, if the median operating expense to sales ratio for the comparable set is only 7 per cent, and the same ratio for the taxpayer is 40 per cent. To the extent that there are location savings, cost base is adjusted first. The Chinese tax administration would then calculate the additional return required for the extra efforts made by the Chinese taxpayer to derive the total return for the Chinese taxpayer.[100]

3.5.4. Intra-group royalties and value creation

Payments of royalties by a Chinese affiliate of an MNE are viewed as suspicious with regard to BEPS where (1) the recipient is an entity in tax haven jurisdictions; or (2) the recipient performs no functions or assumes simple functions when a Chinese affiliate has made “special contributions” to the value of the proprietary right or when the proprietary right has decreased in value. In July 2014, local tax authorities were instructed to monitor intra-group payments of royalties with a view of strengthening the audit and enforcement of transfer pricing rules.[101]

In assessing whether the royalties are deductible for a Chinese payer, a contribution-based value creation analysis must be undertaken. The Outbound Payments Notice (2015) states that royalties paid to a non-resident related party that merely has legal ownership of the intangible property but does not contribute to value creation in respect of the property, and are not in compliance with the arm’s length principle, are not deductible in computing taxable income.[102]

In other cases, the royalties should reflect the contributions by the relevant parties and the benefits to be derived. Article 5 of the Outbound Payments Notice (2015) states that:

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96. Gonnet, Fris & Coriano, *supra* n. 90, at pp. 25-27.
97. UN TP Manual, *supra* n. 12, at para. 10.3.3.6.
98. Id., at para. 10.3.3.4.
99. Id. The LSAs include the “market-for-technology” industry policy of the Chinese government, Chinese consumers’ general preference for foreign brands and imported products, inelastic demand for automotive vehicles in China, capacity constraints on the supply of domestically assembled vehicles and duty savings from the lower duty rates on automotive parts, and a large supply of high quality, low costs parts manufactured by suppliers in China.
100. Id., at para. 10.3.5.11.
101. Notice [2014] No.146, *supra* n. 27.
102. Article 6 of the Outbound Payments Notice (2015), *supra* n. 27 refers to royalty payments to overseas related parties in compensation for incidental benefits arising from financial or listing activities, where a holding or financing company is established offshore for the main purpose of financing or listing.

> the extent of contributions by each related party to the value-creation of such intangible property should be considered in order to determine each party's entitlement to the economic benefit arising from the value creation.

It provides the following guidance on how to determine the contributions to value creation in respect of intangibles and the respective economic benefits arising from the contribution:

> Enterprises which are required to make royalty payments to overseas related parties about technology, brand and other intangible assets should determine the contributions made by each party to the value creation of the intangible assets in order to confirm the economic benefits that each party is entitled on the basis of analysing each party's functions performed, assets employed and risks assumed in the development, enhancement, maintenance, protection, application and promotion of the intangible assets. Furthermore, the enterprises should comply with the arm's length principle in determining whether it is necessary to make royalty payments to the overseas related parties and how much payment should be made.
>
> Royalty payments to an overseas related party which only owns the legal rights of the intangible asset but having no contribution to its value creation are not in compliance with the arm's length principle [and] are not deductible for tax purposes. For example, where a Chinese real estate enterprise utilizes the brand or trademark of an overseas related party in its real estate development, if the trademark or brand is gradually being recognized through the process of real estate development by the enterprise and the value of the trademark or brand is increased as the result of the domestic enterprise's promotion and maintenance, the royalties payment should be regarded as not in compliance with the arm's length principle, and are thus not deductible for EIT purposes.[103]

Erosion of the Chinese tax base through intra-group royalties is not limited to foreign-based MNEs. Some China-based MNEs transfer intangibles developed in China to offshore holding companies and license the intangibles back to Chinese operating companies in return for royalties.[104]

The SAT approach to royalties reflects its emphasis on economic substance and contributions to value creation as opposed to a mere legal entitlement. One of the practical difficulties for the SAT is how to distinguish between royalties and technical service fees.[105]

3.5.5. Intra-group services

Intra-group services are not addressed in detail in the "China Country Practice" section of the UN TP Manual. In April 2014, in response to the UN's request for comments on intra-group service and management fees, the SAT submitted an official response to express its views and provide recommendations to be included in the next update of the UN TP Manual. [106] The SAT reaffirmed its view that service fees paid between related parties must be in compliance with the arm's length principle. In this regard, the SAT agrees with the OECD Guidelines[107] that:

> whether intra-group services comply with the arm's length principle should mainly be analyzed from the following two aspects: firstly, to determine whether intra-group services have been rendered; and secondly, to determine an arm's length price that an independent third party would have been willing to pay for the services rendered under the same circumstances.[108]

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103. SAT, Commentary, Offshore Payments Notice, *supra* n. 27, available at www.chinatax.gov.cn/n810341/n810760/c1519250/content.html (in Chinese).
104. D. Li & Y. Yang, *China Deals a Heavy Blow on International Tax Avoidance: "General Anti-Avoidance Rule Measures"*, Nashuiren Bao (28 Jan. 2015), available at http://db.zgnsrb.com.cn/pdf/disishibaqi.pdf (in Chinese).
105. SAT, People's Republic of China Views on Service Fees and Management Fees pp. 1-2, available at www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-tp-CommentsPRC.pdf [hereinafter: "UN Response re Services]. In its Response to the UN, the SAT provides the following example: "a proprietary technology licensing contract containing service terms may provide the rights to use the proprietary technology as well as the provision of technical assistance services". It recommends that the UN TP Manual, *supra* n. 12, provides additional guidance on how to differentiate royalties from technical service fees.
106. Id.
107. OECD Guidelines (2010), *supra* n. 75, at ch. VII, Special Consideration for Intra-group Services.
108. UN Response re Services, *supra* n. 105.

China also agrees with the OECD Guidelines that the benefit test applies in determining whether services have been rendered.[109] In China's view, an activity provides a "benefit" if it directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position or that may be reasonably anticipated to do so.

On the basis of the Response to the UN and Outbound Payments Notice (2015), The SAT's interpretation of the benefit test requires the consideration of the following:

- A two-sided perspective: when applying the benefit test, it should not only be considered from the service recipient's perspective. The analysis should also be performed from the perspective of both the service provider and the service recipient. An example is services provided by a parent company that are associated with its own strategic management, but not classified as "shareholder activities". Although the subsidiary may benefit from such services, the parent company benefits more. Consequently, the parent company should not charge service fees to the subsidiary merely because the subsidiary may benefit from the services.
- Necessity: if the services are not necessarily needed by the Chinese subsidiary, there is most likely no economic benefit to the subsidiary. For instance, various advisory and legal services provided by a parent company may confer some benefit to a manufacturing subsidiary in China. However, these high-end services may not be needed from the perspective of the subsidiary given its functions and a cost-benefit analysis. Similarly, if the intra-group services are already purchased by the Chinese subsidiary from a third party or already performed by the Chinese subsidiary, they are likely to have some benefit for the subsidiary.
- Double remuneration: in applying the best analysis, it is necessary to consider whether the provision of various services from a parent or related company to the Chinese subsidiary have already been remunerated through other transactions. For instance, when the parent company provides intangibles to the subsidiary and shares the associated residual profit, i.e. the royalties from its subsidiary, the parent company should not separately charge the subsidiary additional management fees regarding the management or control activities related to the use of the intangible property.
- Incidental or passive benefit from the MNE group: negative inferences may be drawn in making the benefit analysis if the services in issue benefit the Chinese subsidiary solely for being a member of an MNE and are not specifically provided to a Chinese subsidiary.[110]
- Shareholder activities: the definition of shareholder services in the OECD Guidelines is too narrow by excluding management or stewardship activities.[111] Consequently, the parent company can charge its subsidiary service fees relating to managing and controlling the subsidiaries and the subsidiaries can deduct these expenses in calculating their taxable incomes. That is: "[i]n fact, most of the subsidiaries in developing countries have their own management teams, and they only need management decision approvals from the parent companies due to authorisation requirements. In this situation, we believe that these types of management services are likely to be duplicative activities or shareholder activities and, therefore, should not be charged".[112]
- Management fees: article 49 of the EIT Regulations prohibits the deduction of management fees paid by a Chinese company to other companies. Non-deductible management fees generally "relate to shareholder activities, which are charged on the basis of an associated relationship between investors and investees, therefore not deductible in calculating taxable income".[113]

Intra-group services that fail the benefit test are deemed not to have been rendered to the Chinese affiliate and payments for such services are inconsistent with the arm's length principle, as independent enterprises would not make such payments. The payments are not deductible for EIT purpose. There is, therefore, no need to establish an arm's length price for the transactions.

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109. Id.
110. This is different from the OECD Guidelines (2010), *supra* n. 75, which state at para. 7.12: "Examples could be analysing the question whether to reorganise the group, to acquire new members, or to terminate a division. These activities could constitute intragroup services to the particular group members involved, for example those members who will make the acquisition or terminate one of their divisions, but they may also produce economic benefits for other group members not involved in the object of the decision by increasing efficiencies, economies of scale, or other synergies."
111. UN Response re Services, *supra* n. 105, at paras. 4-5.
112. Id.
113. Id., at paras. 1-2.

Where intra-group services satisfy the benefit test, the transfer pricing methodologies, especially comparable uncontrolled price (CUP) and cost plus methods, would presumably apply to determine if any portion of a payment were not deductible. The SAT's position is broadly consistent with Public Discussion Draft on Action 10 with regard to the determination of whether or not intra-group services have been provided.

In China's experience with transfer pricing investigations relating to intra-group services, a major challenge is validating the authenticity of the services provided and the reasonableness of the associated allocation mechanisms. The SAT states in the Response to the UN:

> In comparison with related party buy/sale transactions, intra-group services have a wider variety of arrangements and are undertaken in many different forms. Therefore, the breadth of potential information regarding service fees could be very large (from thousands to tens of thousands pieces of information). In this regard, the tax administrations of developing countries find it difficult to verify the authenticity of these fees. Furthermore, determining whether the allocation method applied is in accordance with the arm's length principle is another practical difficulty since intra-group services are mostly charged applying an indirect charge method utilising various allocation keys. Due to the fact that most of the parent companies or service centres of multinational enterprises are located overseas, the local taxpayers can often only provide information regarding their own operations instead of an overall understanding of the entire intra-group services structure. Potential issues could comprise whether the subsidiaries in other countries that similarly benefit from the services follow the same methodology to pay the service fees and the service fees charged to the various subsidiaries.[114]

The SAT recommends that the UN TP Manual require MNEs to provide more relevant transfer pricing documentation along the line of the country-by-country (CbC) reporting requirement in the BEPS initiative to help resolve this difficulty.

3.6. Documentation and information gathering

In the UN TP Manual and the Response to the UN re Services, China highlights the importance of, and difficulty in, obtaining information on the Chinese members of an MNE, as well as on the MNE. Asymmetry in information handicaps tax officials in their investigation of transfer pricing cases. The SAT has, therefore, taken some unilateral and international steps to address this issue.

Domestically, the SAT has introduced a "carrot and stick" strategy to improve tax compliance. For instance, with regard to offshore indirect transfers, the gains from the transfer are taxable. Although the transferor is the taxpayer, the transferee is liable to withhold Chinese taxes from the payments to the transferor, i.e. it acts as the "withholding agent". If the withholding agent fails to withhold the taxes in part or in full, the transferor is required to file and pay the taxes and submit documents relating to the calculation of the taxable gain and taxes payable.[115] If neither the withholding agent nor the taxpayer complies, the in-charge tax authority may impose penalties on the withholding agent. However, if the withholding agent has submitted the required documents within 30 days from the date when the equity transfer contract or agreement is signed, the withholding agent may be exempted from or receive reduced penalties.[116] The Chinese enterprise whose equity interest was indirectly transferred offshore must report the transaction to the in-charge tax authorities.

The SAT has strengthened the requirement for providing information to avoid GAAR assessment or to obtain treaty relief. For instance, the GAAR Measures (2015) require taxpayers who are subject to a GAAR investigation to provide the following material: (1) background materials for the avoidance arrangement; (2) explanatory documentation regarding the business purpose of the arrangement; (3) materials related to internal strategic decisions and administration; (4) detailed transactional information related to the arrangement; (5) communications with counterparties; (6) other material supporting the claim that the arrangement is not a tax avoidance arrangement; and (7) other material deemed necessary by the in-charge tax authorities.[117] If the taxpayer refuses to provide this information, the in-charge tax authorities assess

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114. Id.
115. The in-charge tax authority should report the offshore transfer to the tax authorities within 30 days of the taxes being paid to the state treasury.
116. Article 9 of the Offshore Indirect Transfers Circular (2015), *supra* n. 25, lists the following documents: (1) an equity transfer contract or agreement; (2) corporate ownership structure charts before and after the equity transfer; (3) the prior two years of financial and accounting statements for the offshore enterprise and its underlying affiliates that directly or indirectly hold Chinese taxable property; and (4) a statement of the reason why the first paragraph of article 1 does not apply to the indirect Chinese taxable property transfer. Chinese translations are required, together with the original foreign language version, of all this documentation.
117. Art. 11 GAAR Measures, *supra* n. 24.

the tax liability using any reasonable method.[118] The in-charge tax authorities also have the power to request any entity or individual who has planned the tax arrangement for the taxpayer under investigation to provide relevant material and documentation.[119]

In order to receive treaty relief for beneficial owners of dividends, interest or royalties, the recipient must provide documentation, including bylaws of the company, financial statements, records of cash flows, minutes of meetings of the board of directors, resolutions of the board of directors, the assignment of human resources and assets, related expenses, functions and assumption of risk, loan agreements, licence agreements, transfer contracts, certificate of registration of patents, evidence of ownership, agency agreements, designated agents for receiving payments, and similar material.[120] This evidentiary burden is reduced in applying the China-Hong Kong Income Tax Arrangement (2006).[121]

Internationally, China supports Action 13 on Transfer Pricing Documentation and CbC reporting. The annual CbC reporting by MNEs would provide the SAT with data for conducting transfer pricing assessments. China could also obtain information filed by the ultimate parents of MNEs through the government-to-government exchanges of CbC reports. In addition, by the end of 2014, China has concluded nine tax information exchange agreements (TIEAs) with tax haven jurisdictions.

On 27 August 2013, China signed the Convention on Mutual Administrative Assistance in Tax Matters (the "Multilateral Convention"). This is the first time China has signed a multilateral tax instrument. China has also participated in the development of a new global standard for automatic exchange of financial information, covering bank accounts and other financial assets held offshore. In 2014, China reached an "in substance" intergovernmental agreement with the United States on cooperation with the Foreign Account Tax Compliance Act (FATCA).[122]

4. International implications of China's BEPS Measures

4.1. China as a norm-shaker

China's BEPS measures are expected to have some international implications. There is evidence to suggest that China is becoming important in the international tax system. From the 1980s to the present, China has transformed itself from a norm-taker to a norm-shaker and may become one of the norm-makers in the near future.

With regard to the BEPS initiative, China not only participated, but also contributed. China is expected to use the opportunity of hosting the 2016 G20 Summit to address tax matters. China's influence on BEPS outcomes is presumably evidenced by inclusion of location savings and specific market advantages in the Action 8 Deliverable (2014). The Action 8 Deliverable recognizes that features of the geographic market in which business operations occur, i.e. location savings and other local market advantages or disadvantages can affect comparability and arm's length prices.[123] Market-specific characteristics are not, however, recognized as intangibles as they cannot be owned or controlled.[124] The following statements in the Public Discussion Draft on Actions 8, 9 and 10 are generally in line with the Chinese position on location savings:

> [I]n determining how location savings are to be shared between two or more associated enterprises, it is necessary to consider (i) whether location savings exist; (ii) the amount of any location savings; (iii) the extent to which location savings are either retained by a member or members of the MNE group or are passed on to independent customers

118. Id., at art. 12.
119. Id., at art. 13.
120. Art. 2 BO Announcement 30, *supra* n. 52.
121. BO Hong Kong Letter, *supra* n. 53.
122. *P.R.C.-U.S. FATCA Agreement* (26 June 2014), Treaties IBFD. *See also* US Treasury FATCA Resource Centre, U.S. Treasury Department, available at www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA-Archive.aspx.
123. OECD, *Actions 8, 9 and 10: Discussion Draft on Revisions to Chapter I of the Transfer Pricing Guidelines (including Risk, Recharacterization, and Special Measures)* paras. 104-116 (OECD 2015) [hereinafter; "Public Discussion Draft: BEPS Actions 8, 9 and 10"]; G20/OECD, *Base Erosion and Profit Shifting Project, Guidance on Transfer Pricing Aspects of Intangibles, BEPS Action 8 2014 Deliverable*, D.6 [hereinafter: "BEPS Action 8 2014 Deliverable"], where it is stated that: "Paragraphs 1.55, 1.57 and 6.31 indicate that features of the geographic market in which business operations occur can affect comparability and arm's length prices. Difficult issues can arise in evaluating differences between geographic markets and in determining appropriate comparability adjustments. Such issues may arise in connection with the consideration of cost savings attributable to operating in a particular market. Such savings are sometimes referred to as location savings. In other situations comparability issues can arise in connection with the consideration of local market advantages or disadvantages that may not be directly related to location savings."
124. OECD, BEPS Action 8 2014 Deliverable, *supra* n. 123, at para. 6.31.

or suppliers; and (iv) where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar circumstances would allocate any retained net location savings.[125]

China's emphasis on value creation is also consistent with the BEPS initiative as the Action Plan is intended to ensure that taxation is aligned with substance and transfer pricing outcomes are in line with value creation.[126] The BEPS initiative already recognizes that: (1) the "actual contributions, capabilities, and other features of the parties" should be considered in conducting functional analysis;[127] and (2) in applying profit splits to the value creation by highly integrated MNEs, the three allocation keys are "production capacity", "headcount" and "value of production".[128]

Finally, China's experience with base erosion issues that are more important to developing and low-income countries appears to be directly relevant to the work of the G20 and OECD Development Working Group (DWG) in developing solutions for BEPS problems in these countries. In its two-part report to the DWG,[129] the OECD recognizes the special concerns and experiences of developing countries, identifies BEPS issues that are of particular importance to these countries and suggests specific actions to assist developing countries in countering BEPS.

China's influence on the development of the UN TP Manual is more direct, as a SAT representative has served on the UN Committee[130] and the transfer pricing subcommittee.[131] Section 10.3 of the UN TP Manual now includes China's views on transfer pricing. The forthcoming update, most likely in 2016, is expected to pay attention to China's recommendations that the UN TP Manual: (1) refers the relevant requirements in relation to transfer pricing documentation contained in the Action Plan and requires that the parent company discloses in the Master File the transfer pricing policies for global intra-group services, the method and the service fees allocated to each subsidiary; and (2) provides additional guidance on how to differentiate royalties from technical service fees.

4.2. Implications for developing countries

China's position on intra-group payments is likely to influence other developing countries in strengthening their domestic anti-avoidance rules to counter BEPS. Since BEPS outcomes may not lead to any immediate measures that can address the specific needs of developing countries, denying a tax deduction to the payer of service fees or royalties is an easier and arguably more effective way of protecting the tax base of developing countries. The deduction method is more suitable to developing counties because:

- It helps overcome the technical issues of establishing an arm's length price for the intra-group services and the licensing of intangibles.
- It is arguably superior in protecting the tax base than imposing a withholding tax on intra-group payments. Under the existing system, withholding taxes are imposed only on royalties. Payments for intra-group services are generally tax deductible for domestic taxpayers, but not subject to withholding tax. Unless the non-resident company provides the services through a permanent establishment (PE) in the developing country, profit from the services is free from tax in that country.
- It is arguably easier than trying to tax the non-resident service provider by revising the PE test.[132]
- It may help to address payments regarding digital transactions without the need to introducing a special PE threshold for digital transactions.[133]

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125. OECD, Public Discussion Draft: BEPS Actions 8, 9 and 10, *supra* n. 123, at para. 107.
126. OECD, Public Discussion Draft: BEPS Action 10, *supra* n. 86, at para. 34.
127. OECD, Public Discussion Draft: BEPS Actions 8, 9 and 10, *supra* n. 123, at para. 17.
128. OECD, Public Discussion Draft: BEPS Action 10, *supra* n. 86, at para. 37.
129. OECD, *Part 1 of a Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries* (OECD 2014) and *Part 2 of a Report to G20 Development Working Group*, *supra* n. 43, available at www.oecd.org/ctp/tax-global/part-2-of-report-to-g20-dwg-on-the-impact-of-beps-in-low-income-countries.pdf.
130. Mr Tizhong Liao served as First Vice Chairperson of the UN Committee when the *UN Model Tax Convention on Income and on Capital* p. viii (1 Jan. 2011), Models IBFD was published.
131. Shanwu Yuan was a member of the transfer pricing subcommittee which drafted the UN TP Manual, *supra* n. 12, at p. vii.
132. *See* B.J. Arnold, *The Taxation of Income from Services*, *UN Papers on Selected Topics, in Protecting the Tax Base of Developing Countries* Draft Paper No. 2 (2013), available at www.un.org/esa/ffd/wp-content/uploads/2014/10/20140604_Paper2_Arnold.pdf.
133. OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 2014 Deliverable* (OECD 2014), International Organizations' Documentation IBFD. For further discussions on the digital economy and developing countries, *see* J. Li, *Protecting the Tax Base in the Digital Economy* (2014), available at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/20140604_Paper9_Li.pdf.

5. Conclusions

China's BEPS measures go beyond the scope of the BEPS initiative. The primary legal instrument is the domestic GAAR.[134] The SAT relies on the GAAR in addressing base erosion issues relating to the improper use of tax treaties, the improper use of corporate forms, especially empty shells in tax haven jurisdictions, and indirect transfers of taxable Chinese property. The SAT also relies on its understanding of the arm's length principle in dealing with intra-group service fees, royalties and other forms of transfer pricing practices.[135]

China has high hopes on the outcomes of the BEPS initiative. At the same time, China appears to be realistic regarding what can be achieved at a global level. The BEPS initiative is not about redesigning the basic international tax rules and the system continues to be biased in favour of capital exporting countries (CEN), i.e. residence countries. The BEPS initiative is not designed to rethink the arm's length principle to assign more value to productive activities and markets in both developing countries and developed countries. Instead, the BEPS initiative pursues the objective of attributing more profits to the jurisdiction where intangibles are generated, which are predominantly developed countries.[136]

China has a high stake in the future of the international tax system, as it is both a major recipient of foreign direct investment (FDI) and a major source of outbound FDI. The BEPS initiative marks the beginning of a process that involves China. It is uncertain if the G20 and OECD member countries will be able to agree on the recommendations of the BEPS initiative and introduce the necessary legislative changes to initiate the reforms. It is even more uncertain as to the effect of the BEPS initiative on developing countries, in spite of the efforts of the UN Subcommittee and the DWG. However, to the extent that BEPS is shaking up the international tax norm, China is surely an active norm-shaker.

134. The SAT reported this strategy in UN Response re BEPS, *supra* n. 9.
135. The SAT is expected to update the Special Tax Adjustment Measures, *supra* n. 28, most of which deals with transfer pricing, in 2015 to incorporate China's approaches to LSAs and profit-based methods.
136. The views expressed here are not the "official" views of the SAT. Instead, they are based on discussions in Chinese websites, including Jiang Speech, *supra* n. 8.