SiATP Singapore Institute of ACCREDITED TAX PROFESSIONALS

Technical Excellence Decoded

Essence of China Tax

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Mr Kenny's no-holds barred insights on China tax delivered a fruitful session for participants.

Since China's new leadership came onboard in 2012, many reforms have been implemented to transform its economy. Over the years, Value-Added Tax (VAT) changes, mergers and acquisitions, and funds repatriation continue to be top issues many corporations have had to grapple with, in addition to the usual foreign exchange matters in any cross-border investments.

VAT Changes as China Transforms

China currently administers two sets of Indirect Tax systems. Broadly, services are taxed based on Business Tax (BT) and the VAT is applied on goods. If a service provider (who pays BT) buys goods, the service provider will have to incur VAT which it cannot claim tax credit on as it is a BT payer.

For greater efficiencies and to mirror international standards, progressive steps are already in place to transform the current two-system tax regime into one system by 2016. Some services such as transportation, telecommunications, cultural and creative services, logistics and ancillary services are already taxed via the VAT pilot scheme.

A company with RMB5 million sales turnover has an obligation to register the business as a VAT general taxpayer. This in turn allows the company to enjoy the tax credits where applicable. Smaller businesses can also enjoy these benefits if they choose to register as temporary VAT taxpayers and be subjected to supervision from the tax authorities.

Alternatively, small companies may pay VAT based on 3% of turnover. These companies will however not be able to enjoy the tax credits mechanism applicable for general VAT taxpayers. This was just one of many intricacies of the China tax regime that was explained by Kenny Chiu, Senior Manager, China Tax Desk, KPMG in Singapore, at a *Tax Excellence Decoded* session by ISCA's subsidiary, the Singapore Institute of Accredited Tax Professionals.

In China, other than taking the tax credits available into consideration for general VAT taxpayers when they switch from being a BT taxpayer to a VAT-registered entity, it should be noted also that BT returns are filed with the Local Tax Bureau but VAT returns are filed with the State Tax Bureau.

Besides this, tax rates differ. China's BT is mainly 3% and 5% depending on various circumstances while VAT rates vary according to the type of services and even the size of the businesses. For example, small businesses may choose to pay 3% VAT based on turnover, and while transportation companies charge 11% VAT, a 6% VAT applies for companies offering logistics services. In addition, BT affects the profit

and loss statement while VAT is reflected in the balance sheet. These administrative issues and tax impact are considerations businesses need to take into account as part of their investments in China.

MNC Implications

One significant impact is the tax treatment on cross-border services. In the past, businesses paying BT pay 5% on most services which were either exported from or imported into China. Currently, VAT-registered companies whose services are exported may be taxable, zero-rated or exempted altogether and imports subjected to value-added withholding tax though the China taxpayer recipient may claim an input VAT credit. For example, a Singapore company which charges management fees to its China subsidiary which is VAT-registered, will have a portion of the fees withheld as a tax credit.

The VAT regime will continue to expand across other sectors. The lifestyle services, including the hospitality sector, will be subjected to VAT and this will cover the Food and Beverage sector too. Companies currently paying 5% BT will need to be VAT-registered and change its tax administration. The VAT reform will continue to be expanded to the real estate and construction sector and thereafter, the financial services and insurance sectors.

Tax on Indirect Transfers

Another major issue that many companies grapple with when investing in China is the indirect transfer of China enterprises. In December 2009, China issued Circular 698 which, subject to some conditions, requires foreign entities to disclose the indirect sale of China enterprises – that is, when a holding company that owns a China enterprise is sold. Notice of such transfers must be given to the China tax authorities within 30 days of the agreement being signed. If the China tax authority considers the holding structure of the investment not to have reasonable commercial purpose, they will categorise the transaction as one that is subject to a 10% withholding tax.

This means, an offshore seller indirectly transferring the China equity through transferring the offshore intermediate holding company established in a low/no tax jurisdiction where no tax would be imposed on such a transfer, would still be subject to withholding tax on the gains derived provided that there is no sound commercial reasons for having such a intermediate holding company.

If the holding company has various offices across China, it may choose any one location to file this report to determine whether the transaction would be taxed or not. If the transaction is taxable, the holding company will then submit tax returns to the respective cities' tax office.

In July 2014, another circular on tax administration of equity transfer was issued. One of the key pointers was that the China authorities will be leveraging on technology and other secondary sources to gather information on equity transfers, in addition to information from the taxpayer. This was illustrated in an announcement by the authorities in August 2014, where the authorities collected information on an offshore indirect transfer by a listed company from the Internet.

Another area where the China authorities will be making changes would be to formalise a structure that ensures a consistent application of tax treatment across various circumstances of equity transfers. A third aspect of the circular was a clarification on the key transactions the authorities will be taking note of when applying the regulations stipulated in Circular 698.

A detail to highlight in the July 2014's circular is the consideration on pricing. Instead of simply using net asset value, the market approach or the discounted cash flow method will be used for valuation purposes. It is advisable to supplement decisions with further analysis such as transfer pricing reports.

To sum up this matter, Circular 698 is not something to be taken lightly. It is not simply a reporting requirement. Companies would be wise to invest time and resources to plan and be clear on how to present its position to the authorities and report accordingly. If a tax treaty is in place, tax treaty protection would be applicable.

Tax on Profit Repatriation

Singapore companies seeking to repatriate the profits from China will need to prove it is a tax resident of Singapore by providing a certificate of residence as an example. Another criterion is that the Singapore entity must be the beneficial owner of the income; this means the Singapore entity has a control of the income received. Some of the red flags that signal otherwise to the Chinese

authorities would be the commercial presence in terms of assets, staff and business activities and its control over income and assets from which the income is derived.

To illustrate, in 2013, the Qingdao tax authority was presented with a case where profits were being repatriated to a Mauritian company. The Mauritian company however only had passive income such as dividends and interest; there was no active business / trading income. It was noted that no tax obligation is applicable for such dividends in Mauritius. In addition, the application for the repatriation was by a small scale taxpayer with little asset and staff relative to its investment, and based on the reduced tax treaty rate of 5% withholding tax. The tax authority concluded that the Mauritian company was not the beneficial owner and clawed back the tax payable. The company was made to pay the full 10% withholding tax.

Tax on Cross-border Service Fee

To determine the tax applicable for service fees in China, a permanent establishment (PE) must be present. For example, one criterion, as stated in the tax treaty, is that the Singapore employee must be in China for at least 183 days within a 12-month period. If there is a PE, Corporate Income Tax will apply. In addition to Corporate Income Tax, VAT or BT will apply.

Foreign Exchange Issues

Chinese companies may lend money to offshore companies as long as there is equity relationship between both entities. For dividends remittance, in addition to yearly dividends, there is a gradual simplification of rules to allow for the remittance of interim dividends.

In short, the China tax landscape will continue to evolve and that is the Essence of China. Investors, take heed.

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About SIATP's Technical Discussions

SIATP's technical discussions have continually been very well received by accredited tax professionals. Unlike the run-of-mill Continuing Professional Educational courses which typically cover tax fundamentals, SIATP's interactive technical discussions are designed to cover tax issues that do not have clear-cut solutions or situations that may have different interpretations. Over time, these discussions contribute in boosting the overall tax standards in Singapore.

About Mr Kenny Chiu

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Kenny who specialises in China corporate taxation was seconded to KPMG in Singapore from KPMG in China in May 2012 to support the China Tax Desk in Singapore and provide assistance on China taxation matters to companies based in Singapore. He has advised multinational clients on China taxation, foreign exchange and business matters. His extensive experience includes advice on a number of substantial group restructurings in China, mergers and acquisitions and pre-IPO listing advisory.

Being specialised in the Consumer, Industrial and Infrastructure markets, Kenny has assisted a number of multinational clients in their restructurings and business expansions in China. He has also advised clients on cross-border transactions and the repatriation of funds to China in a tax efficient manner.

Throughout the years in KPMG, he has been a member of the Global Transfer Pricing Services and International Executive Services teams. He has participated in several Transfer Pricing investigation cases and personal tax review projects. Kenny is also a frequent speaker in seminars and workshops which include 'China and set-up issues' organised by the IE Singapore in 2013.

This technical event commentary is written by SIATP's Assistant Director, Joanna Wong.