

CHINA

IMPLEMENTING GAAR

On 3 July 2014, the State Administration of Taxation (SAT) published a discussion draft on Administrative Measures for General Anti Avoidance Rule (GAAR) (Draft Measures) for public comment. The public consultation closed on 1 August 2014.

The GAAR was introduced in the Corporate Income Tax (CIT) Law with effect from 1 January 2008, and some general guidelines were provided in the Implementation Measures on Special Tax Adjustments (Trial) issued by the SAT in early 2009 (Circular 2). Chinese tax authorities have been paying a lot of attention to tax avoidance and treaty shopping, especially on non-residents' business activities. In addition to the CIT Law and Circular 2, a series of steps, i.e. promulgations of various influential and controversial regulations (such as Guoshuihan [2009] No. 601 and Guoshuihan [2009] No. 698), increased information exchange and a growing number of tax audits have been put in place to show China's view on aggressive tax planning.

The Draft Measures serve as a procedural guideline on the application of GAAR, showing that the SAT has put a lot of effort into introducing international practices to combat abusive and aggressive tax planning. The following sections summarise the details in the Draft Report, as well as its impact from our point of view

Scope

Except for two scenarios, special measures are designed for tax authorities to apply a special tax adjustment to any tax avoidance arrangements which enterprises use to obtain tax benefits without a reasonable commercial purpose. The two exemptions are for:

- Arrangements between Chinese Tax Residents not involved in cross-border transactions or payments; and
- Illegal activities relating to avoidance of tax payments, avoidance of recovery of evaded taxes, tax fraud, resistance of paying tax and the issue of false invoices.

The applicable GAAR administrative measures on non-residents' indirect transfer of Chinese equity will be developed by the SAT on a separate basis.

Key principles provided by the Draft Measures

The following important principles in the application of a GAAR assessment are set out in the Draft Measures:

- A tax avoidance scheme that is intended to obtain a tax benefit and without reasonable commercial purpose is subject to GAAR adjustment.
- The main characteristics of a "tax avoidance scheme" are:
 - The sole or main purpose, or one of the main purpose of the tax arrangement is to obtain a tax benefit; and
 - The form of scheme is permitted in accordance with the tax rules, but the form is not consistent with its commercial substance.
- The definitions of certain crucial concepts such as "tax benefit".
- Tax authorities should assess GAAR cases based on both a purpose test and a substance test.
- Adjustment methods upon invoking GAAR.
- GAAR should be the last resort, i.e. it should not be invoked until the specific anti-avoidance rules such as transfer pricing and thin-capitalisation rules or tax treaty provisions for beneficial owners are exhausted.

Procedures for Chinese tax authorities when dealing with a GAAR case

The Draft Measures provide a set of comprehensive procedures for the life cycle of GAAR implementation, which can be identified into the following steps:

- 1) In-charge tax office to select potential cases
- 2) In-charge tax office to submit a case registration application to higher-level tax office
- 3) Higher-level tax office to submit the case to the SAT for approval
- 4) In-charge tax office to issue a formal tax investigation notice to launch a GAAR investigation
- 5) In-charge tax office to issue a tax information request letter to tax advisers, related parties, or other relevant parties or to the enterprise, for the provision of required information within 60 days from the receipt of the notice
- 6) In-charge tax office to review information and form an initial conclusion
- 7) Higher-level tax office to review the initial conclusion and submit to the SAT for their approval
- 8) Enterprises to apply for appeal systems regarding the Preliminary Conclusion Notice, as well as the Final Conclusion Notice.



Impact on taxpayers

It is a breakthrough for the Draft Measures to clarify how the Chinese tax authorities would apply GAAR to a tax avoidance scheme from a procedural perspective. With the increased standardisation and transparency of these procedures, we believe taxpayers can have a better sense of how the Chinese tax authorities would use this “last resort” to counter the avoidance of tax. However, the Draft Measures do not provide a timeline for the tax authorities to respond to taxpayers or a requirement for tax authorities to give taxpayers certainty on whether or not a case is subject to GAAR.

Notwithstanding the clarification of certain GAAR principles in the Draft Measures, GAAR has a broad spectrum, resulting in it possibly being interpreted in a more extensive manner. Under the current version, GAAR would be triggered if the sole or main purpose or one of the main purposes of a tax arrangement is to obtain a tax benefit. This appears to have broadened the scope for application of GAAR, as the Detailed Implementation Rules of the CIT Law only refer to the ‘main purpose’ and not ‘one of the main purposes’. It may be easy for taxpayers to fall within the scope unless they can prove that there was no intention at all of gaining a tax benefit.

The Draft Measures indicate that there would be a separate rule for offshore indirect equity transfers which could be subject to GAAR. We understand that GAAR implementation on offshore indirect equity transfers should still follow the basic procedures provided in the Draft Measures. The separate rule should set out additional guidelines specifically for handling offshore indirect equity transfer cases. We understand that many multinational companies are concerned about when the subsequent rules to Circular 698 will be released. We believe that it may not be too long after the GAAR Measures are finalised and promulgated.

Our view

Since publication of the OECD Base Erosion and Profit Shifting (BEPS) report, tax authorities throughout the world have been strengthening their anti-avoidance forces. The BEPS action plan may contain three tiers of actions: Strengthening multiparty cooperation, reviewing/(re)negotiating bilateral tax treaties, and amending domestic tax laws. Although China is not a member country of OECD, it is natural for China to follow international practice to secure its tax sovereignty.

The Draft Measures would be just one step, and the first step in China’s efforts to amend domestic laws to enhance the Chinese tax authorities’ legal basis to tackle tax avoidance arrangements. Other on-going developments may include amendments to the Tax Collection and Administrative Law, Individual Income Tax Law, and the supplementary rules for Circular 69. We will monitor developments and update you on the status of China’s anti-avoidance campaign.

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