

Executive Editors: Khoonming Ho and Yuesheng Jiang

Authors: Conrad Turley, David Chamberlain and Mario Petriccione

# A New Dawn for the International Tax System Evolution from past to future and what role will China play?





# A New Dawn for the International Tax System: Evolution from past to future and what role will China play?

## Why this book?

The global tax system is currently in a period of flux, with the BEPS Project driving a significant overhaul of international tax rules. At the same time, China's growing economic sophistication has prompted radical changes in Chinese cross-border tax rules and a shift in China's engagement with global tax rule-setting bodies. This book provides a long-run perspective on the development of the global taxation framework and analyses China's rules against developments elsewhere in the world.

A New Dawn for the International Tax System is a collaboration led by executive editors Khoonming Ho and Yuesheng Jiang, of KPMG China and the Jiangsu Provincial Office of the SAT, respectively.

"This book is both informative and sophisticated, its perspective both broad and unique. It is a powerful weapon in the armoury of ambitious readers in the field of international tax research, daily corporate tax practice and fiscal tax administration."

Dr Liao Tizhong, Director-General, Department of International Tax,  
State Administration of Taxation (SAT)

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**Sample Chapter**

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## **Foreword – Dr Liao Tizhong, Director-General, Department of International Tax, SAT**

*As A New Dawn for the International Tax System – Evolution from past to future and what role will China play?* goes to press at IBFD, I wish to take this opportunity to extend my sincere congratulations to the two executive editors of the book, Mr Khoonming Ho, Vice Chairman and Head of Tax at KPMG China, as well as Head of Tax for KPMG Asia Pacific, and Mr Yuesheng Jiang, Deputy Director-General of the Jiangsu Provincial Office of the State Administration of Taxation (SAT).

A friend of mine for years, Mr Jiang is a veteran fighting at the frontier of Chinese international taxation. Mr Ho is a renowned tax advisor who enjoys a good reputation across mainland China. In April 2013, to face up to challenges brought about by BEPS, the Jiangsu Provincial Office of the SAT, together with KPMG and the other three “Big Four” international accounting firms, held a conference on the latest developments in the field of international taxation. After heated discussions, it was agreed that the reform of the international tax norms exemplified by BEPS poses challenges for both MNE tax compliance and for government tax administration. For corporate finance staff, tax professionals and tax officials in China, it has to be admitted that, on key topics such as the history of the international tax system, contemporary tax theoretical frameworks, international tax norms, comparison among domestic tax legislative systems, tax administration measures and the future evolution of the international tax system, there is a lack of knowledge. There is a need for greater understanding, analysis and thinking that combine past and present, theory and practice, and micro and macro views.

Consequently, there is a dire need for a book that provides, as a study and reference guide in the field of international taxation, a comprehensive introduction to the topic, theoretical discussion, practically oriented instruction and referential authority. As a result of careful consideration, Mr Ho and Mr Jiang were chosen to take the lead in editing the book. After 3 years of arduous work with their team, the book finally went to press at a time when the BEPS final deliverables had also been released.

The book is comprised of three parts, which deal with MNEs and international taxation, key topics in international tax rules, and practices in international tax administration, respectively. There are four distinctive highlights in this book:

- Firstly, the book caters to the needs of Chinese readers by addressing key tax-related issues, structured around the practical needs of the contemporary Chinese tax environment. Nonetheless, readers from other tax jurisdictions may also find the approach beneficial to their own understanding of the international tax system.
- Secondly, starting with the discussion on the interplay between economic globalization, MNEs and international taxation, the book presents a comprehensive narrative of the historical trajectory and internal dynamics of, and a macroscopic picture of, the evolution of the international tax system.
- Thirdly, in its detailed discussion of key international tax issues such as tax jurisdiction, transfer pricing, advance pricing arrangements, cost sharing arrangements, CFC rules, thin capitalization, GAARs, tax treaties, e-commerce and harmful tax competition, the book dissects these topics into past development, present-day jurisdictional comparison and future evolution. Throughout these topics, the book reveals to its readers the historical and recent development of the international tax system with both a macroscopic and a microcosmic perspective that overviews the global tax system and at the same time examines the differences across various jurisdictions. Looking through the multifaceted analytical lens of international norms, major jurisdictions' regulations, academic discussions and the latest BEPS deliverables, the book offers its readers a source for reference and an opportunity for better thinking in respect of both theoretical research and professional practice.
- Last but not least, this book is also built upon the rock of the BEPS deliverables, which are discussed in conjunction with the key topics explored in the book. The relevant discussion helps readers to see in perspective the essence of the anti-BEPS initiatives and the impact of these on existing international tax norms and domestic legislation.

In brief, this book is both informative and sophisticated, its perspective both broad and unique. It is a powerful weapon in the armoury of ambitious readers in the field of international tax research, daily corporate tax practice and fiscal tax administration. This book not only traces the developments in the history of the international tax system but also measures the vast tax

landscape across the globe. Furthermore, it helps to reveal the rationale underlying the anti-BEPS initiatives and to foresee their future evolution. For these reasons, I am more than delighted to recommend this book to readers.

Tizhong Liao

Director-General

Department of International Taxation, State Administration of Taxation

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## **Foreword – Raffaele Russo, Head of BEPS Project, OECD**

China's economic growth in recent decades has transformed the country into an industrial powerhouse at the centre of global supply chains. The move from basic processing to high-end services and advanced manufacturing is well under way. The year 2015 witnessed China's shift from a net capital importer to a net capital exporter, and in 2016 China has assumed the presidency of the G20, the political engine behind global structural reforms in several areas, including that of international taxation, in particular via the BEPS Project.

China's increasing economic and political role is reflected in a number of important initiatives in the area of taxation, such as the modernization of its tax administration, its major domestic tax reform and its increased leadership role in the global dialogue on tax issues. In the context of the BEPS Project, China has played an active role in the global effort to build a fair, efficient and sustainable international tax system, along with other OECD and G20 countries and a number of least developed countries. As the significance of its economy to the world system continues to grow, China has a defining role in working with global partners to ensure that international tax principles remain responsive and relevant to the ever-changing dynamics of the global economy.

Transparency and clarity of tax rules are key to fostering investment and sustainable growth. I am convinced that a relationship based on trust between the tax administration, on the one hand, and taxpayers and advisors, on the other, always brings mutual benefits. For this reason, I very much enjoyed reading this book, a collaboration between leaders of KPMG China and the Jiangsu Provincial Office of the SAT. It is an incredibly valuable resource for understanding Chinese tax law and gaining further insight into the key policy questions in today's global economy. I do hope you will enjoy reading it as much as I did.

Raffaele Russo  
Head of BEPS Project (2013-2015)  
OECD



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## Preface

*What is the purpose of this book, and for whom is it written?*

This book was designed by two prominent thought leaders, Mr Yuesheng Jiang and Mr Khoonming Ho, from the Jiangsu Provincial Office of the SAT and KPMG China (KPMG), respectively.

It has been drafted with the primary intent of informing the Chinese community of tax professionals and officials, as well as interested members of the wider business community, about the origins of and challenges accompanying the existing global tax framework.

Going further than this, the book explores China's role in the present and the future of the international tax order, comparing and contrasting Chinese tax law and administrative practice with practices in other countries. As such, the book should equally be of interest to readers outside China who are looking for insight into the future direction of Chinese tax policy.

The book aims to reach a broad audience of financially and economically literate readers, as well as tax administrators and professionals. As such, it is written in a – hopefully – accessible and understandable manner for the non-tax specialist.

*Why is there a need for this book at this time?*

China's economy has undergone profound structural changes over the course of recent years. Private enterprise has been steadily supplanting state-owned enterprise, consumption and services have been replacing investment and manufacturing as leading growth drivers, and Chinese enterprises have exhibited a rising sophistication as China has moved from being a capital importer to being a capital exporter. This has led to extensive retooling of the Chinese tax system, particularly as regards cross-border activity.

China's confidence as a global tax policy leader has been clearly shown in the innovations it has made in cross-border tax rules and in the key contributing role it has played in the G20/OECD Base Erosion and Profit Shifting (BEPS) international tax reform project. As China has taken the helm in hosting the G20 and Forum on Tax Administration (FTA) meetings in 2016, and is pushing ahead with the implementation of BEPS and other international tax measures, it is timely and instructive to consider the Chinese approach in the light of comparative tax practice elsewhere and over time.

It is intended that this book will be the first of two volumes. A second volume, focusing on China tax administrative developments and trends, is currently being drafted.

We hope that you find this book informative and interesting.

Executive Editors – Khoonming Ho and Yuesheng Jiang.

Authors – Conrad Turley, David Chamberlain and Mario Petriccione.

### *About the executive editors*

Mr Khoonming Ho is the Vice Chairman and Head of Tax at KPMG China, as well as the Head of Tax for KPMG Asia Pacific. Since 1993, Mr Ho has been actively involved in advising foreign investors on their investments and operations in China, working in Beijing, Shanghai and southern China and building strong relationships with tax officials at both the local and state levels. He has advised the Budgetary Affairs Committee under the National People's Congress of China on post-WTO tax reform and been an active participant in various government consultation projects, including the recently concluded VAT reforms. Mr Ho is a frequent speaker at tax seminars and workshops for clients and the public, and an active contributor to thought leadership on tax issues. He is a fellow of the Institute of Chartered Accountants in England and Wales (ICAEW), a member of the Chartered Institute of Taxation (CIOT) in the United Kingdom and a fellow of the Hong Kong Institute of Certified Public Accountants (HKICPA).

Mr Yuesheng Jiang is the Deputy Director-General of the Jiangsu Provincial Office of the State Administration of Taxation (SAT) and has more than 20 years of experience in international tax administration. He is one of the supervisors of the SAT's Guiding Group for Leadership in International Tax Affairs, as well as a member of the Jiangsu Provincial Government's Expert Group on the Internationalization of Jiangsu Enterprises. He is also a member of the International Tax Study Committee at the Central University of Finance and Economics (Beijing) and is further affiliated with several other institutions of higher education. Mr Jiang directed the work on the official translation of the OECD Transfer Pricing Guidelines into Chinese and presided over the compilation of a book entitled *Practical Guidance on the Application of the Chinese International Anti-Avoidance Rules*. He has, in

addition, published more than 20 expert treatises on Chinese taxation, both domestically and overseas.

### *About the authors*

Conrad Turley is a director with KPMG, specializing in international tax and based in Beijing. He has previously worked with KPMG in Hong Kong, Dublin and Amsterdam, and with the European Commission Tax Directorate in Brussels. Mr Turley works closely with Chinese tax policy-setting bodies, makes regular contributions to international tax journals and frequently lectures before tax authorities, business associations and Chinese and overseas university audiences. He is a chartered accountant and a registered tax consultant, and he is a graduate of Trinity College, Dublin.

David Chamberlain is an international corporate tax advisor specializing in transfer pricing and is currently located in China. Previously, he has worked in the high-technology sector, based in California's Silicon Valley, and as a team leader in the advance pricing agreement programme of the US Internal Revenue Service. Mr Chamberlain publishes regularly in international tax and transfer pricing journals and has taught courses at several prominent Chinese universities. He holds a JD from Columbia University and an LLM in taxation from New York University.

Mario Petriccione is a director with KPMG, specializing in international tax and based in London. He was educated first in Italy and then as an overseas student at Cambridge University, graduating with a degree in economics in 1979. He has extensive experience working on structuring Chinese investments. Mario is a co-author of *Fundamentals of International Tax Planning* and *The Attribution of Profits to Permanent Establishments* (IBFD). He is a visiting lecturer in international tax law at the University of Leiden (the Netherlands), at UNIL in Lausanne (Switzerland) and at the Instituto Brasileiro de Direito Tributario in São Paulo (Brazil).

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From KPMG China: Chi Cheng (partner), Mimi Wang (partner), Chris Xing (partner), Vincent Pang (partner) and Carol Cheng (senior manager).

From the Jiangsu Provincial Office of the SAT: Ms Yin Xiao Yu, Director in the International Tax Division.



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## Introduction

This book examines the evolution of the key components of the global tax system, in terms of law and administration, across countries and over time. In light of this understanding, the book considers how the future evolution of the international tax system may proceed, particularly in light of the reforms under the G20/OECD base erosion and profit shifting (BEPS) programme and allied initiatives throughout the world. It sets out China's position along the spectrum of global tax practices, with a particular focus on how China's policy positions and Chinese tax innovations may contribute to shaping the global tax consensus.

The book's three parts deal with separate but interconnected subject matters:

- Part 1 sets out how the multinational enterprise (MNE) form of business model has evolved over time in response to economic globalization and technological advances. The purpose of Part 1 is to provide a context for the detailed overview of tax rules in Part 2 by explaining how global tax conventions and rules, set for a particular phase of economic development, became outdated and prone to tax planning when fundamental changes occurred in MNE business models, structures and strategies.
- Part 2 provides an overview of ten thematic areas in international taxation. It draws on the Part 1 analysis of continuously changing MNE business models, and on the tax legislative history of individual countries, to explain why countries took different approaches to crafting the cross-border taxing provisions in their domestic tax law. Part 2 extensively considers how the OECD and UN sought to modify their instruments to maintain coherence between the multiple domestic tax systems, including the shortcomings of these efforts and the new BEPS measures to repair these defects. Throughout, Chinese tax rules, past and present, are compared to rules used in other countries, as well as to the global standards.
- Part 3 looks at improvements over time in tax administration and the development of mechanisms for inter-jurisdictional cooperation. Particular attention is paid to the integration, by tax authorities, of new global measures that will assist tax administration in the post-BEPS era and the challenges of administering the new BEPS rules outlined in Part 2. Part 3 also focuses attention on the remarkable advances in Chinese tax administration in recent years.

Very broadly speaking, then, the three parts of this book might be characterized as International Business Theory (Part 1), Tax Law (Part 2), and Tax Administration (Part 3). Each chapter within each part follows precisely the same structure, namely “Past Development”, followed by “Present State of Play”, followed by “Future Evolution”. Within each of these past, present and future sections, the content is further subdivided into “Principles and policies”, “Regulations” and “Practice”. Consequently, each chapter consists of nine separate sections. A brief overview of the contents of the parts and chapters is set out below:

### **Part 1 – MNEs and International Tax**

#### *Chapter 1 Globalization and Development of MNEs*

This chapter charts the historic development of the MNE business model from the second to the third industrial revolutions. Understanding how the pre-1970s MNE operated and was structured provides insights into the shape and form of the still-existing global tax rules, as they were set for the MNEs of that era. The chapter proceeds to explain the business and technological trends from the 1970s onwards that have ultimately come to define the shape of modern MNEs and have simultaneously undermined the effectiveness of the original international tax consensus. These include (i) the extension of MNE supply chains, which rendered much of global trade internal to MNEs; (ii) the increasing importance of unique intellectual property (IP) and global synergies to the value of MNEs; and (iii) the tentative moves towards business models which are freed from dependence on a physical presence in target markets.

#### *Chapter 2 Global Strategic Planning of MNEs and International Tax*

This chapter draws on the analysis conducted in chapter 1 to consider specifically how the interrelationship between MNE business strategies/models and international tax planning developed over time, with a particular focus on how MNE group legal structures were influenced by tax considerations. Themes examined include (i) the embedding of entities in offshore and tax-preferred jurisdictions in MNE group structures; (ii) the restructuring of MNE group legal structures around rapidly changing MNE global value chains, facilitating tax optimization; and (iii) the gradual detachment of MNEs from any specific “home” country, including the phenomenon of “corporate inversions”.

### *Chapter 3 Approaches of MNEs towards International Tax*

This chapter considers how MNE attitudes and approaches to tax planning are affected by a range of factors. These include (i) MNE culture; (ii) internal organizational dynamics, such as the role and operation of the MNE tax department; and (iii) external pressures, such as attention from the media and social action by non-governmental organizations (NGOs).

## **Part 2 – International Tax Rules**

### *Chapter 4 Tax Jurisdiction*

This chapter explains how the division of taxing rights between countries reflected the nature of cross-border investment and MNE operations in the pre-1970s world. Consideration is given to the manner in which changes in MNE business models, and inherent weaknesses in the international tax rules, undermined effective taxation. The chapter goes on to consider the new global tax jurisdictional compromise embodied in BEPS and how China's policy positions on tax jurisdictional matters compare to the new global standards.

### *Chapter 5 Transfer Pricing*

This chapter provides a comprehensive overview of the origins of the arm's length principle as the foundation for transfer pricing (TP) rules worldwide. It highlights the developments, particularly in US TP practice, over time and the influence of the US approach on the OECD standards and on TP practices in other countries. The chapter goes on to analyse the significance of the changes in the BEPS TP work and how these changes compare with the latest draft Chinese TP guidance.

### *Chapter 6 Advance Pricing Agreements*

This chapter considers how the use of unilateral, bilateral and multilateral advance pricing agreements (APAs) has grown in the recent past and considers their prospects for the future.

### *Chapter 7 TP for Intangible Assets and Cost Sharing Arrangements*

This chapter looks in detail at the challenges of dealing with intangible assets under TP rules and considers how, in particular, US practice has evolved in relation to cost sharing arrangements (CSAs) over time. CSA approaches in other countries are outlined. The chapter also examines the

BEPS TP work on intangibles and draws comparisons to China's TP approach to intangibles.

### *Chapter 8 Controlled Foreign Corporation Rules*

This chapter considers the range of approaches countries have taken to the design of controlled foreign corporation (CFC) rules. The weaknesses of CFC rules, in terms of liberal exclusions, hybrid-based planning and the digital economy, are examined. The chapter further considers the future direction of CFC rules and sets out and analyses BEPS, EU and Chinese CFC developments.

### *Chapter 9 Interest Deductions*

This chapter documents the wide variety of approaches taken by countries to limiting debt-based tax planning, including thin capitalization rules, interest barriers, debt-equity rules and special measures. It sets out recent innovations in leading jurisdictions and the BEPS recommendations.

### *Chapter 10 General Anti-Avoidance Rules*

This chapter documents the variety of judicial and statutory general anti-avoidance rules (GAARs) used across jurisdictions and compares their underlying mechanics and relative efficacies. It examines in detail the interaction of GAARs with treaty obligations, the interaction of GAARs with specific anti-avoidance legislation and the convergence in GAAR approaches across countries, along with the key elements of China's approach to GAARs.

### *Chapter 11 Tax Treaties*

This chapter looks at a number of key thematic areas in tax treaty practice. These include (i) ensuring access to tax treaties in the context of increasing complexity in the cross-border attribution of income; (ii) the rapid evolution of the permanent establishment (PE) concept with BEPS; and (iii) the evolution of approaches to countering treaty abuse. The Chinese approach to dealing with these matters is also outlined in detail.

### *Chapter 12 E-Commerce*

This chapter explains the unique set of challenges created for international tax rules by digital economy businesses. It considers how the efforts of the early 2000s to adapt international tax rules proved inadequate and looks at the types of tax planning arrangements that were put in place and



subsequently highly publicized in various noted governmental inquiries. The BEPS work on the digital economy is examined, along with the unique digital economy tax issues arising in a China context.

### *Chapter 13 Harmful Tax Competition*

This chapter considers the efforts at a global level, since the 1990s, to discourage jurisdictions from offering themselves up as platforms to facilitate tax avoidance and evasion. It examines the history of efforts to improve transparency and exchange of information, in particular the rapid progress achieved since 2009, and outlines initiatives targeting preferential regimes and the EU State aid cases.

## **Part 3 – MNEs and International Tax**

### *Chapter 14 Status and Trends in International Tax Cooperation*

This chapter details the roles of the various international organizations in the maintenance and development of the global tax system. It outlines the roles of the various international forums and taskforces through which global tax policy setting is increasingly coordinated and tax administrative experience is shared. China's growing role in these forums and groupings is also discussed.

### *Chapter 15 Principal Forms of International Tax Cooperation*

This chapter looks at the mechanics of tax cooperation between national tax authorities, including (i) the revolution, since the 2008 financial crisis, in tax authorities' approaches to cooperation on exchange of information (EOI); (ii) tax administrative cooperation initiatives such as mutual assistance in tax collection and simultaneous and joint audits; and (iii) China's strong engagement in global EOI initiatives and other forms of administrative cooperation.

### *Chapter 16 International Tax Administration Solutions in Major Countries*

This chapter considers how domestic tax administration and enforcement have advanced since the financial crisis of 2008. This includes (i) the great efforts made in the recent past by emerging economy tax administrations to reform tax institutional and administrative arrangements; (ii) efforts in advanced economies in reorganizing tax authorities, making better use of technology to target audits and compelling greater disclosure by taxpayers

through mandatory reporting regimes; and (iii) efforts to foster collaboration with taxpayers through cooperative compliance arrangements. These international changes are set against the significant reform and upgrades which China has made to its tax administrative practices in the course of recent years. As China has placed itself at the forefront of tax administrative innovation in many areas, details of these initiatives are provided.



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