Hong Kong Institute of
Certified Public Accountants
香港会计师公会

Meeting notes

The Shenzhen Municipal Office of the State Administration of Taxation and The Hong Kong Institute of Certified Public Accountants

2016

Foreword

It was a great pleasure for the Hong Kong Institute of Certified Public Accountants ("Institute" or "HKICPA") to hold a meeting with the Shenzhen Municipal Office of State Administration of Taxation ("SMOSAT") on 9th December 2016 in Shenzhen. The purpose of the meeting was to discuss various taxation topics and to exchange opinions based on the discussion.

The following is a translation of the meeting notes prepared, in Chinese, by the Institute. Please note that the meeting notes represent only the views of SMOSAT officials who attended the meetings and are not intended to be a legally-binding or definitive interpretation. Professional advice should be sought before applying the content of these notes to your particular situation.

HKICPA wishes to thank the delegates from EY for taking the meeting notes.

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Attendees

SMOSAT

He Jin	Chief Economist
Luo Guoxiu	Director, International Taxation Department
Liu Jia	Deputy Director, International Taxation Department
Wu Xiaodan	Director, Human Resources Department
Feng Zhiguo	Deputy Director, Corporate Income Tax Department
He Rongzhi	Tax Registration and Management Centre
Chen Yinyan	International Taxation Department
Lu Erbin	International Taxation Department
Zhou Yanyuan	International Taxation Department
Fang Yong Hao	International Taxation Department
Ou Yang Yuan Yi	Goods and Services Tax Department

HKICPA

Anthony Tam	Chairman, Taxation Faculty Executive Committee and Member, China Tax Subcommittee
So Kwok Kay	Deputy Chairman, Taxation Faculty Executive Committee and Member, China Tax Subcommittee
William Chan	Convenor, China Tax Subcommittee and Member, Taxation Faculty Executive Committee
Lorraine Cheung	Member, China Tax Subcommittee
Daniel Hui	Member, China Tax Subcommittee
Li Wen Huan	Member, China Tax Subcommittee
Shanice Siu	Member, China Tax Subcommittee
Rebecca Wong	Member, China Tax Subcommittee
Tang Ting	Manager, China Tax & Business Advisory Services, Ernst & Young (China) Advisory Limited
Eric Chiang	Deputy Director, Advocacy and Practice Development
Serena Fong	Associate Officer, Advocacy and Practice Development

Discussion items

A. Corporate Income Tax ("CIT")

1. SAT Public Notice [2015] No. 7 ("PN7")

a. Reasonable commercial purpose

There is no clear guideline on how to interpret "reasonable commercial purposes" in actual situations, such as the following:

- How do we determine "whether the main equity value of the overseas enterprise is derived directly or indirectly from Taxable Properties in China" in Article 3(1)? For example, should taxpayers provide relevant equity valuation reports to justify the equity value? Are there any other bases to determine "reasonable commercial purpose"?

> SMOSAT: 1. The "main equity value" of the equity of an overseas enterprise refers to greater than 50% of the actual enterprise value. 2. It is stipulated in Article 10 of PN7 that the enterprise is required to submit "an asset valuation report and other supporting evidences" as proofs for determining the value of equity transfer. Therefore, tax authorities would use the asset valuation reports that they receive and other supporting evidence as references for determining the equity value of the overseas enterprise.

- What are the specific criteria for determining "whether a majority of assets of the overseas enterprise is directly or indirectly comprised of investments in China, or whether a majority of its income is directly or indirectly derived from China" in Article 3(2)?

> SMOSAT: The same concepts as the above question apply, and a "majority of the assets" of an overseas enterprise can be inferred as being more than 50% of the enterprise's revenue derived within China. Gains derived from investments, dividends and bonuses are included as part of the enterprise's revenues. The tax authorities have not specified any criteria for how to determine the "majority of assets". The tax authorities need to consider various factors in estimating an enterprise's equity values.

Could the tax bureau share recent cases to help further explain the judging criterion of "reasonable commercial purposes" mentioned in PN7?

> SMOSAT: SMOSAT has in fact handled such cases; however, they cannot disclose any details due to confidentiality of taxpayers' information. Currently there are no specific standards or criteria in defining "reasonable commercial purposes". The tax authorities would mainly investigate the following areas: 1. whether the transaction is artificial and a tax benefit is obtained through

executing the transaction; 2. Determining the purpose of the transaction, i.e. whether obtaining tax benefit is the sole purpose of the transaction; 3. Besides considering domestic tax rules, the tax authorities will consider whether it is reasonable not to impose tax after reviewing the effective tax rate for the transaction from a global perspective.

With respect to the principal commercial substance ("PCS") mentioned in PN7, the principal activities of many Hong Kong intermediate holding companies are investment holding and financing. When a transfer transaction does not satisfy the safe habour rule on group internal reorganization, and the blacklist is not automatically applicable such that the transaction is subject to further analysis on confirming PCS of the intermediate holding company. In this particular example, will the tax authority estimate the value of the Chinese domestic company and demand CIT payment according to a calculated ratio?

SMOSAT: When determining PCS, one should not merely look at the holding and financing functions of the enterprise, other factors, such as who is responsible for making the management decisions and who bears the directors' fees, should also be part of the consideration. Tax authorities acknowledge that many intermediate companies merely take up investment holding and financing functions. However, this could be an indication that these companies are merely "conduits" in the group structures.

b. Transfer pricing consideration to be used for tax calculation purposes

When calculating the gains derived in an indirect transfer under PN7, should that be computed based on the enterprise value on the date of the transfer or another basis?

SMOSAT: Tax authorities will normally treat the gains from a transfer of equity as income, as stipulated in Guoshuihan [2009] No. 698. A gain from a transfer is the "value-added amount" of the transfer of equity, i.e. taking the transfer price as income and actual capital invested as investment cost. The tax authorities' primary focus is on the quantum of the income, and value of the equity transfer on the transaction date is not a major area that the tax authorities would look into. The tax authorities will make adjustments, if necessary.

If the transferor of an indirect equity transaction reported the case and made tax payments according to PN7, and the equity of the underlying Chinese entity is later transferred out under a direct transfer arrangement, can the value of the Chinese company used in the indirect transfer reported in the tax return be used as the base for the tax calculation of this subsequent transaction? (This question involves investment entity on different levels.)

SMOSAT: To avoid double taxation, tax authorities will consider the transfer reported in the tax returns as the consideration for the calculation base for future transfer. Further investigations are needed regarding different levels of investment entities.

- Example 1

  No tax had been paid in accordance with the rules in PN7 in the first indirect transfer transaction (the reasons for which could be, e.g., that the first indirect transfer took place before 2008 or the parties involved had not reported the case). Subsequently, the buyer indirectly disposed the equity of overseas company. How should the gains on this subsequent disposal be calculated? Can the cost incurred in the first indirect transfer be treated as deductible expenses in calculating the subsequent gains? (The corresponding payment document and equity agreement proof are available).

  SMOSAT: Taking the answer to the last question as the backdrop, the tax authorities will take the consideration for the transfer reported in the last tax returns as the tax base for computing the tax liability in order to avoid double taxation. Despite this, further detailed analysis may be required for certain cases.

- Example 2

  An overseas company indirectly obtained equity of a Chinese enterprise via acquiring the intermediate overseas holding company (special-purpose vehicle ("SPV")). The SPV had been "looked through" and tax had been paid on the gains arising from this indirect transfer. Subsequently, the overseas company directly transferred out the equity of the Chinese enterprise. As the actual acquisition cost of the overseas company is the amount it paid to purchase the SPV, which had been "looked through" by the tax authority, can the cost for acquiring the SPV rather than the paid up capital of the Chinese enterprise be used in calculating the gains in the subsequent transfer?

  SMOSAT: The tax authority considered that a detailed case-specific analysis is required before coming to a conclusion to this question.

c. Interests and late payment surcharges issues mentioned in PN7

Article 13 of PN7 stipulates that when a does not pay sufficient tax in a timely manner, interest will be imposed on a daily basis, based on the prime RMB lending rate published by the People's Bank of China in the year to which the unpaid tax is attributed. If the transferor fails to submit the required documents, or has not paid tax on a timely basis, the calculation for the applicable interest rate will be based on the RMB prime lending rate plus another 5%. In practice, we have encountered scenarios in which tax authorities imposed a late payment surcharge on the entire tax amount. How would you handle similar cases?

SMOSAT: SMOSAT advised that late payment surcharge is levied under the tax administration law and it could also be related to anti-tax avoidance matters. Whereas, interest is levied under the special tax adjustment regime. In practice, other provinces and cities may impose interest and overdue payments together. SSAT was of the view that one should first find out the nature of the adjustment before concluding if late payment surcharge or interest should be imposed. For example, parties involved in an indirect transfer are required to report the transaction to the tax authorities according to PN7. If taxpayer fails to report the transaction or pay the full amount of tax on time, a late payment surcharge should be levied. However, if there is special tax adjustment, interest should be levied. In general, we cannot jump to a conclusion without referring to the details of the case. For example, it is stipulated in PN7 that an enterprise shall file a report for an indirect transfer of equity. When an enterprise files the report but fails to report on time or pay tax in full amount, an overdue payment shall be applied. If there are other special situations, a late payment surcharge shall be applied. In short, a detailed analysis of the fact patterns of specific cases is required.

d. Looking through approach

Many overseas listed enterprises apply for delisting and prepare to return to the A-share market. This generally involves a privatization (i.e. the major shareholders acquire the equities of the small shareholders) or merger among overseas holding companies. In this circumstance, as the original group holding company is the listed company, could the group company be treated as if it has certain functions and risks (e.g. investment and financing)? Also, in case there is a transfer of equity, could the transfer be considered to have a reasonable commercial purpose, and the group company not be "looked through" under Circular 698 or PN7?

SMOSAT: The safe habour rule in the prevailing tax regulations is only applicable to dividends. There is no clear guideline on the “looking through” principle in PN7. Hence, SMOSAT will need to review details of the case before concluding what tax treatment should be applied.

e. Variable Interest Entity (“VIE”) structure

When a group is operating with a VIE structure in place, the group holds the equity interest of the wholly foreign-owned enterprise ("WFOE") and the group has entered into various agreements with the PRC domestic company. It is worth noting that a PRC individual (i.e. natural person) is still the legal owner of the domestic company under the VIE structure. Under the circumstances, should the WFOE or the VIE entity be the taxing entity when tax is required to be levied in an indirect transfer transaction? In other words, only the WFOE rather than the VIE will be considered as the company being indirectly transferred? The VIE is held by an individual in legal context and there is no shareholding relationship with the overseas group holding company. (The question involves source of tax and if the gains arising from the indirect transfer are required to be allocated between the WFOE and the VIE).

SMOSAT: We have not handled similar cases. In our opinion, we shall respect the legal structure of the arrangement, i.e. only working on the income from transfer incurred by WFOE. As natural persons are involved heavily in the management in the VIE structure and an individual income tax rate of 20% will be imposed, if the individuals are treated as the taxpayers, the tax authorities will need to find out who is controlling the VIE structure. Whether it is necessary, and how to allocate the asset value of WFOE and VIE, we need to study the details of the cases before drawing conclusions.

2. Corporate reorganization

a. Corporate income tax ("CIT") implications for non-resident enterprise in cross-border reorganization arrangement

The cross-border reorganization transactions entitled to special tax treatments are limited to the following three scenarios, as stipulated in Article 7 of Circular 59:

(1) A non-resident entity transfers its shareholding in a Chinese company to its wholly-owned non-resident subsidiary, where the non-resident company directly holds the equity of the transferee company. Moreover, the share transfer does not lead to a change of the withholding tax burden in relation to the gains derived from the subsequent transfer of the shares of the resident company. And the transferor issues a written commitment to the in-charge tax bureau that it will not sell shares of the transferee company (i.e. the shares of the wholly-owned subsidiary of transferor) within the following 3 years.

(2) A non-resident enterprise transfers the shares of a resident subsidiary enterprise to its another 100% directly-owned resident subsidiary enterprise.

(3) A resident enterprise invests in its 100% directly-subsidiary non-resident enterprise in the form of assets or equity interests.

The nature of many reorganization exercises is actually similar to the above, but enterprises that are involved in the similar arrangements cannot enjoy the special tax treatment. As stipulated in Article 7(4) of Circular 59, the Ministry of Finance and the State Administration of Taxation have the authority to approve other cross-border reorganizations. Is it possible to use this provision to approve special tax treatment applications in other reorganization arrangements? Are there any precedent cases in Shenzhen that we can make reference to?

Special considerations could be given to the following cases:

i. Special tax treatments in relation to cross-border reorganization as mentioned in Circular 59

Article 7(2) of Circular 59 mentions a situation where a non-resident enterprise transfers shares of a resident enterprise to its 100% directly-owned resident enterprise. May we know which type of 100% direct holding relationship is eligible for special tax treatments for reorganization under this provision? Is it (1) a non-resident enterprise to its 100% directly-owned Chinese resident enterprise or/and (2) a Chinese resident enterprise to its 100% directly-owned non-resident enterprise?

SMOSAT: There are different approaches to interpreting the rules by tax authorities in different locations. Some consider both parent-subsidiary and subsidiary-parent relationships are direct holding relationship. In addition, some consider the above three scenarios are applicable for both acquisition of equities and assets; whereas, other forms of restructuring transactions are not subject to the restrictions of the above three scenarios.

In addition to the three scenarios outlined in Circular 59, are there any other scenarios where the special reorganization tax treatments would apply (e.g. various scenarios illustrated in this paper)? SSAT advised that tax authorities of different areas have reported the problem to STA but STA had not issued any guidelines as of today. They will conduct research on this area and improve the tax regulations for the benefit of taxpayers.

ii. Special tax treatment application on cross-border merger transactions

If two Chinese resident enterprises, which are held by an overseas non-resident enterprise, merge, is it considered as a cross-border reorganization so that the above conditions are required to be fulfilled before enjoying special tax treatments? If yes, it appears that special tax treatments are not applicable as none of the above conditions has been satisfied. In fact, there will not be any non-equity payments as a result of the merger transaction, especially in the merger of resident enterprises which are controlled by the same non-resident enterprise. Also, there is no inflow of any other economic interest in this merger exercise. It would seem unreasonable that, under these circumstances, CIT would be ascertained and be payable based on the general tax treatment.

SMOSAT: SAT did not take the view that the merger of two Chinese resident enterprises controlled by an overseas holding company is a cross-border reorganization. In practice, there is inconsistency in applying the STA ruling in this kind of case. SSAT was of the view that further analysis of the cases is required before drawing any conclusion.

iii. Issues in relation to non-resident enterprises strike off as a result of cross-border reorganizations

If the overseas parent company is stuck off, the shareholding structure of the domestic company would need to be changed as well. Although this type of situation is not mentioned in Circular 59 as being eligible for tax deferral treatment in a group reorganization, can the tax deferral treatment be applied to this kind of case?

> SMOSAT: There is no a definitive view in this kind of case yet. The preliminary view is that the above scenario will be treated as transfer of shares.

iv. Issues in relation to where the business nature of the parent company changed

If an overseas parent company of a resident enterprise changes its business nature (e.g. from corporate to partnership), will the change trigger a deemed equity transfer of the resident enterprise?

> SMOSAT: There is no definitive view as yet. The preliminary view is that the above scenario will be treated as a transfer of shares.

b. Implementations of Caishui [2014] Circular 109 and SAT Public Notice [2015] No. 40

i. Has the SMOSAT handled any cases in which enterprises are eligible for the special tax treatments under Circular 109 on their equity transfers? Is Circular 109 also applicable to multinational companies regarding share transfer between their Chinese resident subsidiaries? Are the parties involved in the transaction required to inform the tax authorities in writing about the arrangements by reference to the requirements of Circular 59? (This does not seem to be a requirement in the Circular)

> SMOSAT: Circular 109 is aimed at sorting out issues relating to transformation of stated-owned enterprises. Purely by reading the circular, non-stated owned enterprises are not excluded from the regulations. Therefore, SMOSAT considered that non-stated owned enterprises can also refer to the requirements in Circular 109 and Public Announcement No. 40, i.e. reporting the case before filing the final settlement returns.

ii. Hypothetical Case 1: Parent company A (a resident enterprise) transfers the equity of subsidiary company B (a resident enterprise) to its 100% wholly-owned subsidiary C (a resident enterprise), will C be forbidden from transferring equity of B within 12 months? (This does not seem to be a requirement in the Circular)

> SMOSAT: Circular 109 was drafted based on the principles of Circular 59. Indeed, Circular 109 elaborates certain principles in Circular 59. Therefore, by referencing to the lockup period stipulated in Circular 59, Company C cannot transfer the shares of Company B within 12 months after the original transfer transaction is completed, if special tax treatments are applied by virtue of Circular 109.

Furthermore, will A be forbidden to transfer equities of C again within 12 months?

> SMOSAT: It is controversial in practice. There is no tax ruling specifying whether there is a lockup period for assets under the reorganization exercise. Apparently, the tax ruling only specifies lockup period for the transferor and transferee. We will look into it later. As there is no policy on it, enterprises are not encouraged to effect any transfer within 12 months after the original date of transfer in order to reduce their exposure.

iii. If B in the above case is a non-resident enterprise, is Circular 109 still applicable?

> SMOSAT: There are no specific regulations that could apply to this case. If enterprises encounter similar situations, they can inform SSTA such that it can seek instruction from STA.

B. Tax treaty benefits and overseas tax credits

1. Resident certificate and resident status confirmation

a. Tax treaty benefits

When a Hong Kong company claims any tax treaty benefits (e.g. preferential tax rate on dividends) under the tax arrangement between Hong Kong and China, the Hong Kong company is obliged to provide the in-charge Chinese tax authorities with a certificate of residence status issued by the Hong Kong Inland Revenue Department (IRD). According to SAT [2016] No. 25, the certificate is valid for 3 calendar years from the date of issue of the certificate. If the identity of the Hong Kong company changes during the stated 3 years, the certificate will become invalid.

We would like to share information regarding a few cases we have come across. For instance, a Hong Kong company applied for the tax treaty benefits from tax authority A in 2015 with its Hong Kong resident certificate for 2015 as a supporting document. The same company applied for similar tax treaty benefits from tax authority B for 2016 and was asked to provide its Hong Kong resident status certificate for 2016 to tax authority B. (It could be because tax authority B did not receive any copy of the certificate that was submitted to A, and authority B indicated that the company had to provide them with the 2016 certificate to substantiate that there was no change in its residence status). Are there any internal guidelines for the tax authorities such that the submission requirements of the residence certificate could be simplified, e.g. requesting the company to fill in a form to declare that there is no change (in these three years) in the residence status from the date of issue of the original certificate?

> SMOSAT: Because of STA's request, Hong Kong’s Inland Revenue Department has been increasingly stringent in issuing Hong Kong tax residence certificates

even though, in theory, a Hong Kong tax residence certificate can be issued within 21 days when all the required documents are submitted. In addition, taxpayers encounter another difficulty: Taxpayers only have one original copy of the tax residence certificate but the taxpayers may need to furnish the certificate to different tax authorities. SSAT advised that they have reported the issue to higher authority and hoped that the tax authorities at different locations can coordinate among themselves and eventually share information such that the problem for the taxpayers can be resolved.

If the company in Hong Kong is a holding company or a listed company (investment holding is the only business activity of the company), can the investment holding of the company be treated as the actual business of the company? Or can its Hong Kong listing status be treated as the substance for recognizing the listed holding company as a Hong Kong resident company?

SMOSAT: All relevant documents such as Guoshuihan [2009] No. 601 and SAT Announcement [2011] No. 24 should be considered before a conclusion could be reached.

b. Permanent Establishments

For non-resident enterprises that have business operations in China, how would SMOSAT determine whether the operations constitute permanent establishments in China? According to the prevailing tax regulations, income derived by non-resident enterprises outside of China (e.g. Hong Kong) is not taxable for CIT proposes. Would you specifically review the tax status of these non-resident enterprises from the perspective of their residence, permanent establishment or based on transfer pricing?

SMOSAT: Domestic laws and tax agreements will be taken into account before drawing a conclusion.

2. CIT credits

a. How should the indirect tax credit be applied to partnerships/ tax transparency entities?

SMOSAT: After preliminary discussions with tax authorities of different locations, in general, they did not think the “look through” rules should apply to partnerships/ tax transparent bodies. In other words, in a holding structure of resident enterprise – partnership– resident enterprise, the partnership cannot be looked through and tax-exemption of dividends between resident enterprises is not applicable. The rationale is that a partnership does not fall into the charging scope of the CIT Law. Under the law of China, a partnership is not an enterprise and should be subject to IIT instead of CIT. In respect of indirect tax credit, tax authorities consider that the general principle is to work down to the level of the partnership and not to continue to looking through for the sake of protecting the tax revenue of China.

b. Difference in calculating the overseas tax credit in relation to CIT between direct and indirect tax credit set off for partnerships

"The guidelines on overseas tax credit on CIT calculations" provide guidance on how to calculate the direct tax credits and indirect tax credits. The calculation of direct tax credit is covered in the guidelines, including taxes for CIT incurred on overseas business profits, withholding taxes on overseas dividends, interest, rentals, royalties and transfer of assets. Indirect tax credits cover tax credits related to the tax paid on the pre-dividend payment, profit attributable to shareholding by the Chinese entities. However, taxpayers may find the illustrations difficult to comprehend. Could you provide further examples of, for instance, dividend distributions in which the calculation of the direct and/ or indirect tax credit is considered? You may wish to consider an example where a China-incorporated company holds a Cayman/ British Virgin Islands partnership which holds a U.S. limited company (supposedly the CIT rate is 35% /withholding tax rate for dividends is 30%) which in turn owns a U.S. partnership. The in-charge tax authorities may allow credit only for a part of overseas tax payments in the actual situation, e.g. the payments of the overseas withholding taxes. Do you have any comments on the above?

SMOSAT: Need to further study.

c. The appropriate tax credit for partnership

When a Chinese partnership has overseas investments, is the underlying tax credit computed based on the entity or the number of partners? (We think that the latter should be used as the partnership is not a tax paying unit).

SMOSAT: Need to further study.

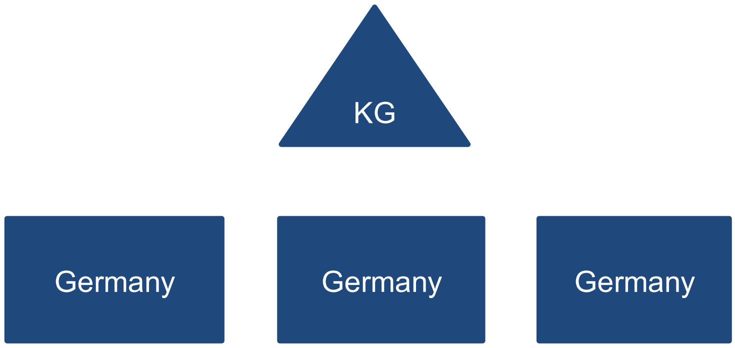
d. The appropriate tax credit for overseas partnership

Should the overseas partnership/tax transparent entities be deemed as a separate tier in calculating overseas indirect tax credit with reference of the "three-tier" scheme?

SMOSAT: Need to further study.

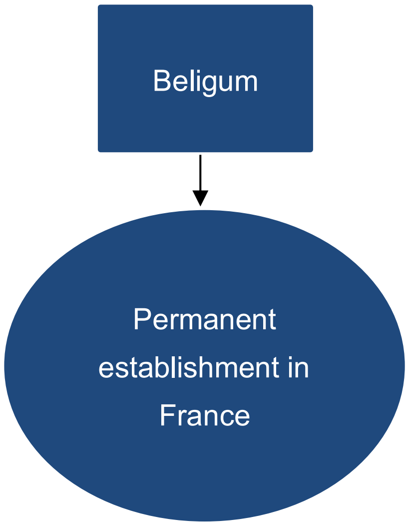
Similarly, will the partnership or the consolidated tax group/ tax entity or permanent establishment be deemed as a tier or having multiple tiers? The current prevailing laws and regulations are not clear on this issue. It is understood that the new regulations on foreign tax credits will soon be released; will the provisions on indirect tax credits, which are currently limited to three tiers of overseas subsidiaries, be relaxed?

Case 1: A German group company uses KG structure for consolidated tax filing basis (Note: KG-Kommanditgesellschaft is the German name for a limited partnership and is used in the German, Austrian and some other European legal systems).



SMOSAT: Need to further study.

Case 2: A Belgian company has a permanent establishment in France. Will the permanent establishment in France be considered as a tier? In this case, the permanent establishment is not an independent legal entity and is unlikely to distribute dividends to its parent company.



SMOSAT: Need to further study.

e. Consolidated tax filing

In many overseas jurisdictions, different group companies may be allowed to file their consolidated tax returns under foreign tax rules. For example, Chinese Company controls Hong Kong Co. 1 which controls Hong Kong Co. 2 that owns U.S. C-corp. which finally holds U.S. LLC. As U.S. LLC is a transparent entity in U.S., its revenue and expenditure will be consolidated into the business of U.S. C-corp for the purposes of tax filing; only one single tax payment receipt will be received after the payment. Will U.S. LLC be deemed as a tier-four entity or a tier-three company, i.e. combining U.S. C-corp. and U.S. LLC?

SMOSAT: Direct credit, rather than indirect credit, is applicable in this case. A permanent establishment is not a separate legal entity and therefore the tax treatment applicable to the permanent establishment should follow the company to which it is attached.

3. Chinese resident enterprises and foreign-controlled enterprises

It is common for a Chinese enterprise to set up a holding company in Hong Kong as an overseas investment platform. What is the risk of the Hong Kong company being considered a Chinese resident enterprise and/ or a foreign-controlled enterprise? Also, the in-charge tax authorities seldom approve applications for Chinese resident enterprise status certificates (especially when taxpayers take the initiative to apply for China resident status) and foreign-controlled enterprises. Could you explain the actual situation and advise the proper ways to deal with the tax risk and planning (especially for Chinese enterprises that set up companies in Hong Kong)?

SMOSAT: There has no such case in Shenzhen and there are only a few cases across the country. Most enterprises take the initiative to apply for the status of Chinese resident enterprises so that they can enjoy tax exemption on dividend income between resident enterprises.

In respect of foreign-controlled enterprises, what are your focus areas for review?

SMOSAT: Tax authorities mainly focus on whether the taxpayers comply with Chinese tax law and regulations, whether they have made proper disclosures, whether they are set up in low tax jurisdictions; whether they have allocated reasonable profit back to the Chinese entities. Tax authorities will also review the tax payment patterns of the group entities around the world. All the above are under close surveillance by the tax authorities.

4. Reimbursement of expenses paid by overseas enterprises

The Guidance for Foreign Exchange Management for Service Trade of Detailed Implementation Rules ("IDR") (SAFE [2013] Circular 30) states in Article 6(9) that domestic enterprises can apply to "reimbursements of expenses and cost sharing with domestic or foreign related companies." Also, SAT/SAFE Announcement of Issues concerning "Taxation Recording for Foreign Payments under Service Trade and Other Items" (SAT/SAFE [2013] Circular 40) expresses in Article 3 that domestic enterprises or individuals are not required to maintain(?) tax records and submit the Record Form when attributing following foreign exchange funds payments: (1) travel, conference, product exhibition, and other expenses incurred overseas by domestic enterprises, (2) office expenses incurred by the overseas representative offices of domestic enterprises, and project payments for projects contracted overseas by domestic enterprises. However, there are practical difficulties when enterprises are implementing above rules. Could the tax bureau advise us the procedures for domestic enterprises to reimburse overseas related companies for the expenses paid on their behalf? Are there any specific rules explaining the types of reimbursable expenses such as wages or travelling expenses? Does the tax bureau have unified internal processes when handling advanced expenses incurred by taxpayers; and what supporting documents that the taxpayers are required to submit?

If third party receipts can be provided to prove that the reimbursement is indeed only dollar to dollar matching, would the tax bureau agree the overseas related company should be exempt from paying Chinese tax on this reimbursement of expenses?

SMOSAT: Tax authorities will mainly examine the authenticity of the expenses. There are no standard procedures for handling these cases because banks and tax authorities do not handle the payment requests in the same way. There is a disconnect between the law and the procedures.

C. <u>Value-added taxes ("VAT")</u>

1. VAT liabilities on permanent representative offices of foreign enterprises

Representative offices of foreign enterprises are subject to CIT based on their operating expenses. How would VAT be imposed on them? Currently the in-charge tax authorities of some provinces and cities are inclined to impose VAT based on deemed income. However, the concerned taxpayers do not actually provide any of the services mentioned in Circular 36. How should the VAT liability be quantified, having regard to the service types, tax rates, tax credits, and general or small-scale taxpayers? A handful of representative offices are treated as the small-scale taxpayers who pay tax at 3%, while others pay tax at 6% as general taxpayers, without taking tax credit into account. Will you issue a guideline in this respect?

SMOSAT: Guidelines were released in May 2016 that representative offices ("ROs") of foreign enterprises must register for taxpaying purposes, verify their tax category and pay tax according to tax laws on a timely basis. It is a current practice in Shenzhen that income of the ROs would be calculated on a deemed basis by reference to the expenditure level. If the income levels of the ROs reach the standard of general VAT payers, they shall pay tax as general VAT payers. Otherwise, they shall pay tax as small-scale taxpayers.

2. VAT implications on cross-border activities under the business tax to value-added tax ("B2V") reform

a. Circular 36

Circular 36 stipulates that VAT liability arises when either the service seller or buyer, is located in the Mainland China. This is a typical people oriented tax administration basis. There are two special but ambiguous regulations on cross-border activities, namely:

- Appendix 1 stipulates that if foreign entities or individuals provide services that are performed completely outside China to domestic entities or individuals, the former parties are not subject to VAT. How would you interpret services that are performed outside China? This was originally defined in Circular 106 as services that are consumed completely overseas. What is the difference between "performed", as stated in the new regulation, and "consumed" in Circular 106? How should we infer these requirements in real life situations?

> SMOSAT: Our preliminary view is to change "consuming" to "occurring" so that we can determine where the taxpaying activities took place more accurately. Views on Circular 106 would not be taken into account.

b. Article 1 of SAT Public Notice [2016] No. 53

Article 1 of SAT Public Notice [2016] No. 53 stipulates that the following activities are not treated as provision of services nor sales of intangible assets in China by overseas entities or individuals:

- Postal, collections and delivery services provided for outbound mails and parcels
- Construction and project supervision services performed on overseas construction sites where domestic entities or individuals are located
- Engineering reconnaissance and exploration services provided for overseas mineral resources where domestic entities or individuals are engaged
- Conference and exhibition services provided for overseas conferences and exhibitions where domestic entities or individuals are engaged

Since the above four activities are not subject to VAT, does it mean that foreign entities or individuals providing domestic entities or individuals with other relevant services would be liable to pay VAT on the services provided?

> SMOSAT: Cases will be analysed individually and conclusions drawn based on the merits of individual cases.

In addition, Appendix 4 stipulates that where domestic entities or individuals provide foreign entities or individuals with services that are consumed completely overseas, VAT is exempted. Consumption occurring completely overseas means the service recipients have to be located outside of China and there is no association with any commodities and immovable properties within China. How should the phrase "no relation to domestic commodities and immovable properties" be interpreted?

> SMOSAT: Cases will be analysed individually and conclusions drawn based on the merits of individual cases.

3. Issues on import VAT credits

Recently, many enterprises have reported that their import VAT tax credits have been taken by other companies. As the system only acknowledges the underlying codes rather than the taxpayer names, the codes could easily be sold for illegal purposes. Under the circumstances, should the affected taxpayers inform the in-charge tax authorities of the details of the individual cases, letting the in-charge authorities to investigate the cases with the relevant tax authorities, and to deal with the parties that obtained tax credit? The number of such cases has been increasing significantly; hence, it is advisable for the tax authorities to give more attention to this issue in order to assist taxpayers to file their tax returns correctly.

SMOSAT: This became a real problem in practice, especially in foreign trade industry. The phenomenon is due to inaccuracy and non-timeliness of information exchange between tax and customs authorities. The tax authorities have made the best efforts to coordinate. It is advisable for enterprises to apply for the tax credits as soon as they obtain relevant documentary proof of credit in order to protect the tax information from leakage. If taxpayers cannot obtain the tax credit, they should report the cases to the tax authorities in a timely manner.

4. Inquiries on whether VAT should be imposed for transfer of shares listed in National Equities Exchange and Quotations ("NEEQ")

Public Notice 53 issued in late August 2016 stipulates that publicly traded shares are within the scope of VAT, and lays down rules for determining the purchase prices of three restricted share types. However, the Public Notice does not clarify whether transfers of shares listed in NEEQ should be subject to VAT and how tax should be levied. There are two schools of thoughts. Some people consider profit from trading of shares listed in NEEQ should be subject to VAT as the underlying shares, it could be argued, are publicly traded, even though there are differences between NEEQ and the main board. Others consider that the trading gains should be non-taxable as the entities listed in NEEQ are not listed companies under the definition of the relevant regulations issued by China Securities Regulatory Commission on provisional measures for the administration of NEEQ. Local tax authorities are reluctant to give a direct answer to this question. What is your opinion on the above?

SMOSAT: STA had not issued specific regulations in relation to this issue. Taking into account that B2V reform was quite recent and the tax treatments on financial businesses are relatively complicated, there was not specific comment on this question. The general principle is that income from securitization is subject to VAT. Otherwise, no VAT will be levied

5. VAT issues on centralized purchasing

Centralized procurement by a group company, e.g. purchase of materials, assets or services, is an effective means for overall cost reduction for the group. Under a group procurement arrangement, a group company signs a procurement agreement with the suppliers and shares its purchased materials, assets and services with other group companies. For example, a bank acquires a membership of an inter-organization lending platform, a securities company pays transaction fees for its various group companies, and a group company purchases the right to use software, etc.

As the suppliers may have strong bargaining power in the market, they can request an entity of a group of companies to sign a supply agreement and the VAT invoices will be issued to this group entity. The purchased assets/ services are in fact used by different group companies, thus the procurement cost will be shared among the group companies according to the underlying benefits they receive from an accounting perspective. Could the group company which is responsible for the group procurement issue VAT invoices to other group companies based on their allocated procurement expenses? Will there be any risk that the above group company could be accused of issuing fake VAT invoices?

SMOSAT: From a tax administration point of view, the tax authorities in general ask taxpayers to observe the outflow of three particular areas in issuing VAT invoices; and the three areas are "goods outflow", "service provision" and "cashflow". VAT invoices should be issued to the recipients of the outflow of the three particular areas. As a result of the B2V reform, the above-mentioned problem has become more apparent. The above-mentioned requirements for VAT invoice issuance by the tax authorities in general apply to the VAT invoice issuers; and the buying side may not need to comply with the "outflow" requirement before claiming the input VAT credits.

6. Issue on tax paying entities (VAT implications for foreign enterprises having permanent establishment in China)

As a result of sending its staff to China to provide services to related/ unrelated clients, a non-resident enterprise may have established a permanent establishment in China. Should the non-resident enterprise pay VAT for the income it derives from services provided in China (i.e. because the non-resident enterprise is considered a domestic service provider)?

SMOSAT: Circular 36 does not distinguish resident enterprises and non-resident enterprises. Our preliminary view is that the permanent establishment should be subject to VAT on its China secured income.

7. Are dividends from fund or wealth products (i.e. non-fixed income) taxable items for VAT?

SMOSAT: It is still unclear how the issue should be handled. STA require that capital preservation wealth products be subject to VAT, in accordance with the lending business. There is much considerable debatey about what the tax treatment should be for non-capital preservation wealth products. No definitive conclusion has been reached as yet.

D. Taxation of financial business

1. Tax implications on non-performing loan/non-performing asset acquisition

a. VAT issues

i. According to the latest trial implementation rules of B2V pilot scheme, taxpayers are liable to pay VAT on income derived from trading of financial products. We understand that financial products include transfer of foreign exchange, securities, non-commodities futures and other financial products on equities. Transfer of other financial products includes transfer of funds, trusts, wealth products, and all kinds of asset management products and various financial derivatives. Non-performing loans/ non-performing assets are not included in the definition. Does it mean that transfer of non-performing loans/ non-performing assets is not subject to VAT?

> SMOSAT: There is no corresponding item for non-performing loans/ transfer of non-performing loans in Circular 36. We have communicated with tax authorities of other locations and preliminarily concluded that they are not VAT taxable items.

ii. Having acquired non-performing loans/ assets, taxpayers may dispose of them at a price higher than the acquisition costs but below their carrying amounts. Will the underlying profit be treated as interest on loans and be subject to VAT?

> SMOSAT: Further study on the subject is required before a conclusion could be drawn.

iii. In case an enterprise transfers its shares through NEEQ, will it be defined as a transfer of financial products and be subject to VAT?

> SMOSAT: There is no consensus view whether transfers of corporate equities through NEEQ should be subject to VAT.

b. CIT issues

An enterprise acquires a portfolio of non-performing loans/ assets. From a CIT calculation perspective, should the enterprise assign the investment costs to each of the non-performing loans and calculate the profit of each disposal in the years concerned? Alternatively, could the underlying profit be taxed in a year in which the total disposal value of the portfolio was higher than its total original cost?

> SMOSAT: From a legal point of view, assets in a portfolio of non-performing loans/ assets will be booked into the ledger on an individual asset basis. Hence, we should follow the same principle when the individual asset is disposed of, i.e. profit on disposal of each individual asset should be calculated based on the

cost of acquisition of each individual asset. In short, we should follow the matching principle in calculating profit on the disposal of each individual asset. If the cost of the individual asset cannot be identified/ calculated in the portfolio. In practice, there is no clear guideline how to handle these kinds of cases and the tax authorities would tend to make reference to the accounting treatment in calculating the tax liabilities.

2. Transfer of financial products

VAT issues on cross-border financial products transfers

VAT regulations on cross-border transfer of financial products in Caishui [2016] (Circular 36) stated that:

- Transfer of financial products includes transfer of foreign exchange, securities, non-commodities futures and ownership of other financial products
- Transfer of other financial products includes funds, trusts, wealth products, all types of asset management products and various financial derivatives
- The transfer revenue of the financial products is the net balance between the selling price and purchase price
- Where there is profit or loss on the transfers of financial products, the revenue should be the net balance after offsetting profit or loss. If a loss results after offsetting, it can be carried forward to profit in the subsequent tax filing. However, an unrealized loss on the year-end revaluations cannot be carried forward to the next fiscal year.
- The purchase prices can be calculated based on weighted average method or moving weighted average method; however, once the computation method has been selected, such method shall not be changed within the following 36 months.

When overseas enterprises and domestic enterprises sign contracts, are the provisions of Circular 36 applicable? Should the domestic enterprise withhold and remit the tax after offsetting the loss against profit in the same tax filing period? Should the losses be carried forward to subsequent tax filing period? It is indeed difficult to implement the requirements in actual situations. Can the same treatment be given to both domestic and overseas enterprises?

SMOSAT: Circular 36 does not distinguish domestic and foreign enterprises. Therefore, domestic and foreign enterprises will be subject to the same treatment. Allowing netting off between profit and losses could be a problem in practice. The tax authorities will further study this topic.

3. VAT for interest receivables by non-financial enterprises

For financial companies that are not mentioned in Caishui [2016] Circular 36 (e.g. insurance companies), in case they derive interest from receivables, should they pay VAT during the contract period or when interest is received?

We understand that the interest income computed in accordance with the relevant contract is subject to VAT. When income is accrued, the income is also subject to VAT even if the amount is due over 90 days or above.

Caishui [2003] Circular 16 stipulates that where an insurance company has paid business tax on its premium receivable, the receivable can be deducted from its business revenue if it is not received during the accounting period.

SMOSAT: Insurance companies are not within the scope of financial enterprises mentioned in Circular 36, and the above regulation is not applicable to insurance companies.

4. Deemed sales of capital non-interest bearing loan and VAT implications for bank wealth products

There is a deemed sales concept in the VAT legislation. For example, where a group company with excess cash provides other group companies with interest-free short-term loans, would this lending activity be treated as deemed sales and therefore subject to VAT? If yes, what are the prevailing policies or implementation guidelines on the deemed interest income (including frequency, period, interest rate, etc.)? Besides, how should the nature of loans and deposits be differentiated from the perspective of deriving guaranteed/ fixed incomes on financial products? What should be the VAT treatments?

SMOSAT: In our opinion, interest free loans should be considered as deemed sales. Though enterprises have the right not to charge interest on advances, the tax authorities will review the detailed commercial arrangements in calculating the deemed interest income of the transactions. From a risk management point of view, it is not unreasonable for the tax authorities to make reference to the interest rate of banks on the same kind of products.

E. <u>Integrated question</u>

1. Compliance guidance

Will Shenzhen follow Jiangsu and Zhejiang in issuing international tax compliance guidance for the taxpayer's reference?

SMOSAT: We are making relevant arrangements, but the output may not necessarily be in the form of specific guidelines. Taxpayers will be informed no matter what format is adopted.

2. Guidance on partnership taxation

Does the Ministry of Finance or STA have any published guidelines on partnership taxation? How do you calculate the partnership tax involving Hong Kong enterprises or individuals?

SMOSAT: There is no specific written law and regulations on how to handle the tax matters of a partnership. When a Hong Kong enterprise/ individual invest in a partnership, the tax authorities tend to consider the partnership as an agency permanent establishment of the Hong Kong enterprise/ individual. CIT will be levied at 25%. However, this is only a preliminary view and the issue is subject to further discussion.