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

Meeting notes

The Guangdong Provincial State Taxation Bureau
and
The Hong Kong Institute of Certified Public Accountants

2017

Preface

The Hong Kong Institute of Certified Public Accountants ("Institute" or "HKICPA") appreciates the opportunity to meet the Guangdong Provincial Office of State Administration of Taxation ("GPOSAT") on 8 December 2017 in Guangzhou. 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 merely represent the views of GPOSAT officials who attended the meetings and are not intended to be a legally-binding or a 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 Deloitte for taking the meeting notes.

Summary Note

Agenda items

A. Enterprise Income Taxes ("EIT")

1. Special tax treatment
2. Income derived from swap transactions
3. Share base incentive payment
4. Record filing on EIT Preferential Tax matters
5. Corporate restructuring: [2009] Circular 59
    a. Special tax reorganization
    b. Group reorganization
6. [2015] Public Notice 7 ("PN7")
    a. Equity-like interests
    b. Equity payment
    c. Share subscription of equity of overseas enterprises
        i. Calculation for income attributable to China taxable property
        ii. Ascertaining the consideration
        iii. Ascertaining the costs
7. Chinese subsidiary pays interests to offshore debt issuer
8. Tax exemption on dividends received by domestic resident enterprises
9. Administrative adjustment on EIT

B. Transfer Pricing

1. Self-adjustments by taxpayers
2. Scoring systems for local files
3. Requirements for value chain analysis
4. Benefit Test
5. Mark-up ratios for service fees
6. Practical operations of Transactional Profit Split Method
7. Application of Advance Pricing Arrangements (APA)

C. Value-added tax ("VAT")

1. Whether VAT exemption is available for interest on inter-bank transactions derived by overseas financial institutions
2. Whether VAT is levied on the transfer of goodwill
3. VAT treatment of interest and net income paid to foreign enterprises
4. Article 7 of Caishui [2016] No. 40
    a. Resettlement compensation expenses
    b. Assignment of land for a real estate development enterprise
5. Restricted shares

D. Others

1. Three years of EIT exemption followed by three years at a 50% reduction of EIT
2. Tax Analysis of the Thousands of Households Programme
    a. Work plan and the related impact
    b. Taxation services for large enterprises

Attendees

GPOSAT

Liu Li	Director, Department of International Tax Management
Yang Pei Ling	Deputy Staff Member, Department of Income Tax
Chu Wei Yan	Deputy Director, Department of Commodity and Service Tax
Zhuang Bo	Principal Staff Member, Department of International Tax Management
Chen Weidi	Deputy Principal Staff Member, Department of Commodity and Service Tax
Chen Liexin	Deputy Principal Staff Member, Department of International Tax Management
Chen Gaohua	Staff Member, Department of International Tax Management

HKICPA

Anthony Tam	Chairman, Taxation Faculty Executive Committee and Member, Mainland Taxation Subcommittee
Kwok Kay So	Deputy Chairman, Taxation Faculty Executive Committee and Member, Mainland Taxation Subcommittee
William Chan	Convenor, China Taxation Subcommittee and Member, Taxation Faculty Executive Committee
Stephen Lee	Member, China Taxation Subcommittee
Daniel Hui	Member, China Taxation Subcommittee
Leo Li	Member, China Taxation Subcommittee
Ho Sing Mak	Member, China Taxation Subcommittee
Rebecca Wong	Member, China Taxation Subcommittee
Cecilia Lee	Observer, China Taxation Subcommittee
Shanice Siu	Member, China Taxation Subcommittee
Maggie Huang	Manager, Taxation, Deloitte
Eric Chiang	Deputy Director, Advocacy and Practice Development
Wing Wong	Administrator, Advocacy and Practice Development

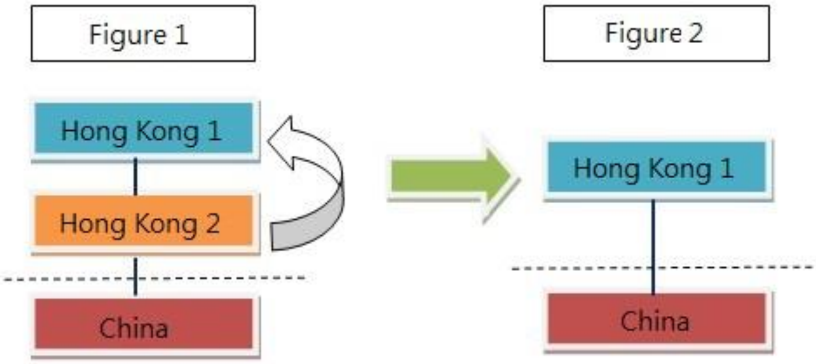
Discussion items

A. Enterprise Income Tax ("EIT")

1. Special tax treatment

According to Article 1 of Public Notice [2013] No.72 ("PN72") of the State Administration of Taxation (SAT), "equity transfer" by non-resident enterprises, relates to transfer arrangements that match the scenarios set out in Items 1 and 2 of Article 7 of Cai Shui [2009] No.59 ("Circular 59"). The circumstances set out in Item 1 of Article 7 of Circular 59 include the transfer of the equity of a Chinese enterprise due to the merger or demerger of an overseas enterprise.

How should this regulation be interpreted? Would Item 1 of Article 7 of Circular 59 be satisfied when there is a change of equity of a Chinese enterprise resulting from a merger or demerger of an overseas enterprise? Please refer to the following diagram for illustration.



Assuming Hong Kong 2 merges with Hong Kong 1 and Hong Kong 1 becomes the shareholder of the Chinese company. Would this transaction satisfy the requirement under Article 1 of PN72 such that special tax treatment would apply?

GPOSAT: The above scenario does not meet the requirements for special tax treatment under Article 7 of Circular 59.

2. Income derived from swap transactions

According to Guoshuihan [2004] No. 753, the relevant tax treatments as per the prevailing tax regulations would apply on interest income and net settlements paid to foreign enterprises under swap transactions.

As Circular 753 has expired, what are the appropriate tax treatments on interest income and net gains received/ receivable by foreign enterprises under swap transactions?

GPOSAT: We will still rely on Circular 753 before new rules are introduced.

3. Share base incentive payment

Assuming employees of a non-listed domestic company have participated in an equity incentive plan devised by an overseas listed group company. These employees are then granted shares/ stock options by the overseas company. The costs in relation to the stock option are paid by the domestic company to the overseas company.

According to SAT [2012] Public Notice No.18 relating to the handling of EIT for share-based payment incentive plans implemented by resident enterprises in China, the underlying costs of the incentive plan could be deducted as wages and remuneration.

These expenses should be computed based on the difference between:

- The fair market value of the shares at the time of actual exercise of the options; and
- The price actually paid by the employees for exercise of the options.

This circular applies to both resident enterprises listed overseas and non-listed companies.

Regarding the situation where domestic employees of a non-listed domestic enterprise are granted shares/ stock options of an overseas listed group company, would the underlying costs be deductible by virtue of Circular 18? Some tax officials believe that if the non-listed domestic company meets the following requirements, the relevant equity costs could be deductible:

- The cost payable aims to settle the liabilities owed to the overseas company by the domestic company. This should not affect the deductibility of the relevant expenses.
- The corresponding individual income taxes have been withheld by the non-listed domestic company.

We would like to clarify:

- In view of the above situation, would there be a consistent treatment to allow deductions for share option expenses?
- What kind of information does a domestic non-listed domestic company need to submit to claim the deduction?
- Will there be any detailed guidance?

GPOSAT: The circular states clearly that its application scope is limited to the equity incentive policy of the taxpayer. Therefore, the Circular does not apply to local employees participating in the stock option plans of overseas related companies.

4. Record filing on EIT Preferential Tax matters

According to SAT Public Announcement relating to enterprises with cross-province businesses (Shuizongfa [2017] Circular 102), EIT preferential tax policies (e.g. super deductions for research and development expenses, regional tax incentives, etc.) can be handled by local branches. These branches can apply for preferential tax policies at their nearby tax bureaus. If an enterprise operates a shared service center which handles financial matters across the Mainland, its applications for preferential tax treatments are likely handled by the tax bureau at the place where the center is situated.

No specific section is available in the form for EIT preferential tax treatments for taxpayers to put down the information of the in-charge tax authorities. Would taxpayers be required to submit another form for applying preferential tax treatments at a different location? Is there a standard format for the relevant authorization letter?

GPOSAT: There is no definitive answer to this question for the time being. We need more time to study this question.

5. Corporate restructuring: [2009] Circular 59

a. Special tax reorganization

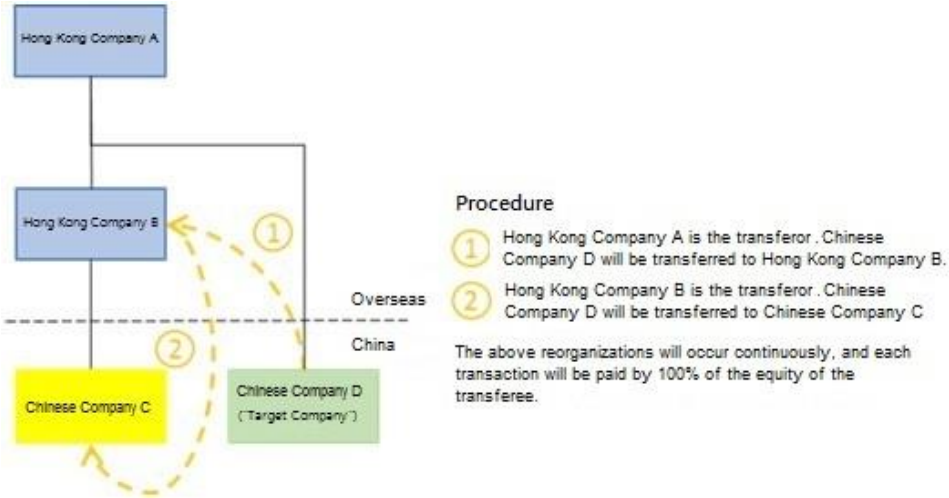
Special tax treatment should apply if a merger of PRC corporations satisfies the five conditions under Article 5 of Cai Shui (2009) No. 59 (Circular 59). Assuming that there is an absorption merger between PRC Corporation A and B (and Company B no longer exists after the transaction), would the special tax treatment under Circular 59 still apply if these PRC corporations are wholly-owned subsidiaries of an overseas company? Alternatively, would the special tax treatment apply if an overseas parent company splits its wholly foreign-owned enterprise (e.g. PRC Corporation C) into two separate entities in China?

On the other hand, if a vertical absorption takes place between a PRC holding company and its wholly-owned PRC company and this does not involve any consideration, would the special treatment apply under this circumstance?

GPOSAT: Article 5 of Circular 59 is applicable to the above situations.

b. Group reorganization

Assuming that a group is under reorganization, which is expected to be completed in two separate steps within 12 months. The group would like to apply for special tax treatment under Cai Shui (2009) Circular 59. Please refer to the detailed steps below:



Hong Kong Company A transferred its shareholding in Chinese Company D to its Chinese Company C by two separate steps within 12 months as indicated above.

Some tax bureaus may treat the above transactions as a single transaction from an anti-tax avoidance perspective under Article 10 of Circular 59. It states that where an enterprise has carried out transactions for transferring its assets and equity progressively within 12 consecutive months before and after the reorganization, all these transactions will be treated as one single transaction based on the principle of "substance over form".

In the present case, Hong Kong Company A would be considered as transferring its shareholding in Chinese company D directly to the Chinese company C, which is not a wholly-owned subsidiary directly held by Hong Kong Company A. In this regard, the conditions under Article 7 of Circular 59 are not satisfied, i.e. the transferee must be a wholly-owned subsidiary of the transferor directly.

We consider that Article 10 of Circular 59 should aim to benefit taxpayers rather than for tax anti-avoidance purposes. It also provides authority to the relevant tax bureaus to reach a final outcome of multiple step transfers in reorganization. Accordingly, special tax treatment could arguably be allowed after the first transaction is completed (refer to the note below), on a case-by-case basis. If local tax bureaus intend to interpret Article 10 strictly, this may lead to unnecessary tax burdens to taxpayers on their internal reorganizations. Could the tax bureau shed some further light on this issue?

Note:

According to the State Administration of Taxation (SAT) Public Notice (2015) No. 48 ("PN48"), Article 10 of Circular 59 should be interpreted as follow:

Where:

- A restructuring involves multiple steps within 12 consecutive months and straddles across two tax years; and

- The parties in the restructuring negotiated and agreed to opt for special tax treatment when the entire restructuring is expected to satisfy the conditions under the special tax treatment, upon completion of the transaction in the first tax year,

Special tax treatment may apply temporarily.

Written declaration materials must be submitted at the time of filing of tax returns for EIT for that year.

GPOSAT: According to Article 10 of Circular 59, restructuring by stages within twelve consecutive months will be treated as a single transaction. Additional tax may be payable as a result. We will relay the concern to SAT for consideration.

6. [2015] Public Notice 7 ("PN7")

a. Equity-like interests

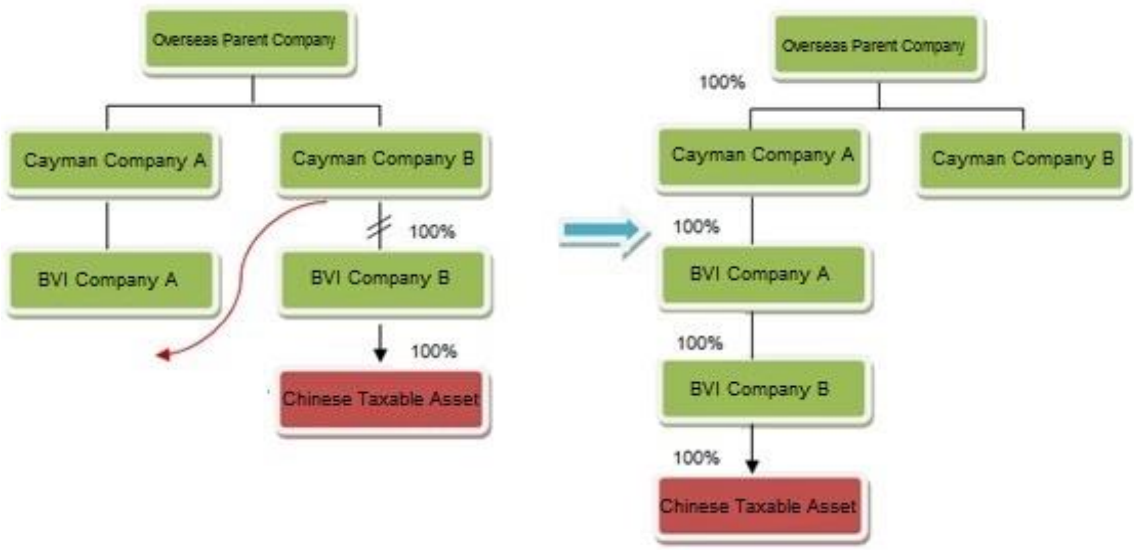
What are interests in equity-like instruments? These interests are mentioned under Item 3 of Article 1 of PN7. It is about transfer of equity and other similar interests in overseas enterprises, which directly or indirectly holds taxable properties in China, by a non-resident enterprise.

In practice, would transfers of preference shares, interests in partnership, stock options, convertible bonds, and issues of new shares, fall within the reporting scope under PN7? Have there been any cases that you can share with us?

GPOSAT: The definition of equity-like interests is still unclear under the prevailing regulations. There is no precedent case for the time being. The matter will be handled on a case-by-case basis.

b. Equity payment

The 3rd condition of Article 6, PN7 stipulates that the underlying considerations must be equities/ shares. Therefore, considerations should not contain a cash element. In addition, equities/ shares of listed companies cannot be included in the considerations because these equities/ shares are highly liquid assets. Assuming that Cayman Company B transfers its interests in BVI Company B, where company B owns China taxable properties, to BVI Company A at "nil" consideration such that cash is not involved. Does this transaction meet the "equity payment" requirement under the 3rd condition of Article 6, PN7?



GPOSAT: The said transfer is controversial and may give rise to problems. PN7 in general does not apply.

c. Share subscription of equity of overseas enterprises

i. Calculation for income attributable to China taxable property

According to PN7, in a transfer of the equity of an overseas enterprise, which owns both China and overseas taxable properties, a reasonable basis should be adopted to attribute values to these properties. Taxes should be levied only on the China taxable properties. However, different bases have been used by tax authorities in different regions as there is no clear guidance on what bases are considered acceptable. Would the tax bureau consider issuing clear guidelines in this regard?

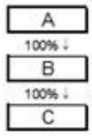
According to some cases in certain locations, the in-charge tax authorities have made adjustments to the consideration in the calculation basis. The adjustments are to exclude the assets and liabilities of the overseas intermediate holding companies. After the adjustments, the registered capital of a Chinese company becomes the cost of the investment.

In the following example, Overseas Company A originally held 100% equity of a Chinese Company C through its wholly-owned overseas subsidiary, i.e. Overseas Intermediate Holding Company B. In this transaction, equity interest in Overseas Company A was transferred out. The consideration for the transfer is RMB 51, which is the amount of net asset shown under the consolidated financial statements of Company A.

To calculate the value of Chinese Company C, the in-charge tax bureaus made an adjustment to the consideration i.e. RMB 51 by adding (or subtracting) the net liabilities (net assets) of the intermediate holding company (i.e. Overseas Company B). RMB 150 is then computed as the value of Chinese Taxable properties (i.e. Chinese Company C).

Do you agree with the above calculation basis? Could you please share with us the work practices of Guangdong tax bureaus on this issue?

	A (Transferred Overseas Company)	B (Overseas Intermediate Holding Company)	C (Chinese Company)	A+B+C (Consolidated Financial Statements)
Assets:				
Cash	200	141	110	451
Long-term equity investment	1	100	0	
Intercompany receivables	100	60	0	
Investment property	0	0	100	100
Liabilities				
Intercompany receivables	-100	-100	-60	-100
Payable	-400	0	0	-400
Total net assets	-199	201	150	51
Registered capital	100	1	100	100
Undistributed profit	-299	200	50	-49
Equity of shareholders	-199	201	150	51
Net assets which excluded long-term equity investment				



Tax calculation method	51
Original transfer price (Net assets under the consolidated Financial Statements)	-99
Net assets of the Intermediate holding company but excluding long term equity investment	150
Adjusted transfer price (equal to the net assets of Chinese companies)	100
Transfer costs (registered capital of Chinese companies)	50
Transfer Income	
Tax payable (10%)	5

GPOSAT: In principle, we agree with the above calculation method.

ii. Ascertaining the consideration

If a consideration includes an amount of contingency fee payable to the seller (e.g. an additional amount will be paid by a buyer to a seller depending on the profitability of a property development project in China), should this contingency fee be treated as part of the consideration? If so, as the fee of this nature could not be estimated accurately in advance, and would not be settled at the time of the transfer, would it be acceptable to make additional tax payment when the fee is paid?

GPOSAT: Taxable income is ascertained based on the actual receipts derived by taxpayers. As contracts could be implemented differently in practice, if payments are made in instalments, the corresponding income should be recognized in instalments as well.

iii. Ascertaining the costs

PN7 is not applicable to individuals who conduct indirect transfers of Chinese taxable properties. Could an enterprise use the amount paid to an individual seller as the cost of investment for calculating gains/ losses in future disposal (assuming the individual has not reported the transaction nor made any tax payment)?

GPOSAT: The actual payment incurred should, in general, be treated as the cost of future assignment. However, payments made between related parties may be subject to challenge.

7. Chinese subsidiary pays interests to offshore debt issuer

Interest expenses paid by domestic enterprises to overseas parties should, in general, be subject to withholding tax. Assuming that an overseas enterprise (e.g. a Hong Kong listed company) issued Renminbi Bonds (e.g. panda bonds) in a public market. The overseas enterprise has obtained the underlying receipt via an overseas bank account (e.g. a Hong Kong bank account). Subsequently, the oversea enterprise has lent the entire fund raised in the bond issuance to its wholly-owned subsidiary in China at the same interest rate as under the bond. Under this arrangement, both the bondholders and payer of the bond interest are within China. Would the interest payment be subject to withholding tax and VAT?

GPOSAT: Although the overseas enterprise in the question did not make any gains/ losses from the on-lending arrangement, in principle, interest paid by the subsidiary would still be subject to withholding tax under the prevailing regulations. Corresponding VAT exemption would be given on a case-by-case basis, on the merits of each case. VAT exemptions on-such lending arrangements are not limited to resident enterprises.

8. Tax exemption on dividends received by domestic resident enterprises

Assuming that Chinese Company A and Chinese Company B invest RMB 8 million (80% of the share) and RMB 2 million (20% of the share) in Chinese Company C respectively. Chinese Company A then sold 60% (i.e. three quarters of its shares) to Company D at RMB 6 million. After this transfer, Chinese Company A and Chinese Company B will each hold 20% of Chinese Company C. The remaining 60% is held by Company D. However, it was agreed that Chinese Company A still holds 40% of dividend entitlement and voting rights of Chinese Company C after the transfer.

With that, we would like to ask:

- Would the consideration of transferring 60% of Company C from Company A to Company D be subject to adjustments?
- Would tax exemption be available to the dividends received by Company A from Company C?
- Capital subscription system is generally adopted in China. If the shareholders have only partially paid or not paid for the subscribed capital, could the shareholders still enjoy tax exemption on the dividends?

GPOSAT: This question is related to how the policy is actually implemented. According to the prevailing rules and regulations, "look through" of intermediate entities is not applicable to direct investment. This is a key issue that one should bear in mind in this question.

9. Administrative adjustment on EIT

According to a circular on the reform of state and local tax administrations, the division of duties and responsibilities between them should be streamlined. EIT is currently administrated by both state and local tax bureaus in Guangdong. Would there be any change to this arrangement and, if so, what would be the likely timeline?

GPOSAT: There is no scheduled timetable at the moment. The existing mechanism is still in place.

B. Transfer Pricing

1. Self-adjustments by taxpayers

On 17 March 2017, SAT published a public notice on promulgation of the administrative measures on special tax investigations, adjustments and mutual agreement procedures (PN6). When monitoring the profit levels of enterprises, the tax authorities may identify certain tax risks of enterprises. Under PN6, the tax authorities may issue a note to taxpayers on their findings. If the taxpayers agree to the risk areas so identified, they may put through adjustments and pay additional taxes on a voluntary basis.

If the taxpayers proceed with the self-adjustments and additional tax payments, can the taxpayers make the adjustments and pay tax according to their own calculations? Or do they need to reach mutual agreement with the tax authority on the tax payment, interest and late payment surcharge at the outset? If taxpayers can make tax payment based on their own view first, what would be the consequence if the tax authorities' final determination differs from the taxpayers' proposals?

GPOSAT: It depends. If the tax authority has not opened a case for a taxpayer, the taxpayer can make arrangements to settle the case on its own. However, if a case has already been opened, the taxpayer should discuss the position with the tax authority first and, if the taxpayer's proposal does not accord with the tax authority's estimate, interest and a late payment surcharge, if any, will be calculated based on the additional tax payable.

2. Scoring systems for local files

We understand that some local tax bureaus have established rating systems for contemporaneous documentation of local files. It seems that a similar arrangement is being put in place by SAT. Does GPOSAT have similar plans? If not, does GPOSAT have an internal assessment mechanism to rate the local files?

GPOSAT: GPOSAT plans to put in place a similar system but there is no specific timeline or standard. In addition, we are finalizing guidance for the preparation of local files, which will be published soon.

3. Requirements for value chain analysis

In respect of additional requests, e.g. value chain analyses and analyses of special geographical factors, imposed on local files in 2016, are there any particular requirements for the information filed by enterprises, and the depth and breadth of their analysis?

Circular 42 indicates that enterprises should file financial statements for the latest accounting year of the businesses that have assisted the enterprises to deliver valuable products or services to the market. Also, the information about the distribution principle and results of enterprises' group profits in the global value chain should be provided. However, it could be practically difficult to obtain the said information. What is the administrative consequence if the information cannot be provided? Would the enterprises be required to provide supplementary information, and resubmit the local files?

GPOSAT: The above analyses should be filed but there is no specific requirement on the depth and the breadth of the analyses. If taxpayers do not provide the analyses, they could be subject to tax on a deemed basis, by virtue of the tax administration law. In general, taxpayers would not be required to file their local files again. If local files are not complete, in-charge tax authorities may question the quality of the underlying information.

4. Benefit Test

According to Article 35 of PN 6, enterprises receiving services from overseas related companies can demonstrate benefits of the services in terms of 6 aspects. What should the enterprises do to demonstrate the benefits that they have received from the related parties? For example, do the enterprises need to show that their turnover, profit margin, general and administrative expenses changed as a result of using the services from the overseas related parties? But, as the operating statistics of the enterprises as stated above are affected by multiple internal and external factors, it would be difficult if not impossible for enterprises to provide proof of direct correlation between the usage of the services from the overseas related parties and the operating statistics.

Would the tax authorities use other indirect indicators to verify that enterprises obtain benefits from usage of the services from their overseas related companies? If yes, what are these indirect indicators?

GPOSAT: The benefits of using services from overseas related companies should be actualized in the profitability of the enterprises, i.e., leading to improvement in profitability. Therefore, an increase in the income level or reduction of expenses would be a direct method to validate the assumption that the enterprises have obtain benefits from using the services from the overseas related companies. In other words, there should be evidence showing a correlation between benefits obtained by enterprises and usage of the services from the overseas related companies.

5. Mark-up ratios for service fees

According to the past transfer pricing cases, tax bureaus, in general, consider the following mark-up percentages for services as reasonable:

- 10% for common services; and
- 15% for contract research and development services

With that, we would like to ask:

- Whether the above percentages are the findings of analyses of relevant information collected from enterprises, or the result of big data analysis of service fee mark ups of enterprises?

- If the underlying services are considered low value-added, such that the markup percentage is lower than that stated above, would the mark ups be considered as reasonable?

GPOSAT: The relevant ranges of percentages are determined and adjusted based on past cases. It is not necessary for a ratio to fall within the relevant ranges. The mark-up in individual cases should be analyzed based on their merits before concluding whether or not they are reasonable.

6. Practical operations of Transactional Profit Split Method

OECD has published a draft discussion guideline on the Transactional Profit Split Method (TPSM) recently. It suggested situations where TPSM should be used, and it also summarizes practical difficulties that may be faced when using TPSM. We note that a lot of tax authorities prefer TPSM on transactions involving intangible assets. Taxpayers, however, have the following observations and uncertainties when using TPSM:

1. How to determine both parties of a transaction have unique contributions?

2. The reasons for being required to use TPSM if a transaction price for using intangible assets is shown to be reasonable under the Comparable Uncontrolled Pricing method?

3. The operation of an enterprise not only relies on the intangible assets used, but is also affected by the overall market and business environment at a specific place and time. It is unreasonable to disregard the value of intangible assets because a relevant enterprise has performed poorly in a local market?

4. An enterprise may find it difficult to ascertain future profit levels based on the current financial data. In short, it seems that it can be difficult to apply TPSM in practice.

Would the tax bureaus share with us their views on the practical considerations in relation to applying TPSM?

GPOSAT:

i. Each case should be analyzed individually even though there is no universal way to do so. In general, one should look at the levels of contribution to the relevant intangible assets to ascertain the value contribution.

ii. According to PN6, if a Chinese enterprise has made a significant contribution to an intangible asset, which could be more than that of the asset owner, the enterprise should share revenues in relation to the intangible asset. TPSM should therefore be applied.

iii. In general, an intangible asset would give rise to a revenue stream. Without this revenue, it would be difficult to justify the existence of the intangible asset.

iv. If more data can be provided, the tax authorities can perform comprehensive analyses and come to fair and equitable conclusions. Taxpayers' co-operation is important in the entire process.

7. Application of Advance Pricing Arrangements (APA)

As a result of the issuance of PN64, has the workload on case validation prior to accepting APA applications increased as compared with before? Have the verification requirements become stricter? We note that the number of unilateral APAs has increased. Does this mean that more taxpayers are encouraged to apply for unilateral APAs?

GPOSAT: The validation process has become stricter. For example, taxpayers are now required to provide a value chain analysis and location specific factors. GPOSAT welcomes more applications for unilateral APAs. Applications with location specific factors are likely to be given a higher priority for case handling. If quantitative solutions and value chain analyses are provided, there will be a higher chance of the tax authorities accepting the APA application.

C. Value-added tax (“VAT”)

1. Whether VAT exemption is available for interest on inter-bank transactions derived by overseas financial institutions

According to Item 23 of Article 1 of Caishui [2016] No. 36 (Circular 36), VAT exemption is available for interest on inter-bank transactions. The same exemption is also available under Caishui [2016] No. 46 and Caishui [2016] No. 70.

Would the above regulations be applicable to the inter-bank transactions between overseas and Chinese financial institutions? Do overseas financial institutions fall within the scope?

GPOSAT: VAT exemption is only available to the financial institutions approved by People's Bank of China, China Banking Regulatory Commission, China Securities Regulatory Commission and China Insurance Regulatory Commission.

2. Whether VAT is levied on the transfer of goodwill

Appendix 1 of Caishui [2016] Circular 36 indicates that intangible assets do not have a physical form but they can bring economic benefits. These assets include technology, trademarks, copyright, goodwill, rights to use natural resources and other equity intangible assets. Therefore, VAT should be imposed on transfers of goodwill.

For example, in a merger and acquisition transaction by means of asset transfer, the underlying items could include client lists, distribution channels, branding, etc. Assuming the consideration of the transaction is RMB 100. The corresponding value of tangible and intangible assets (excluding goodwill, which is not shown in the financial statements), in total, is RMB 80.

There has been no transfer of goodwill from the seller's perspective as no such intangible asset exists in its financial statements. However, from the buyer's perspective, the value of goodwill would be RMB 20. Hence, RMB 20 has been reflected in the financial statements of the buyer. As the value of goodwill has been recognized, should VAT be imposed?

Assuming that VAT is levied on goodwill. If a seller meets the relevant requirements under SAT Announcement [2011] No.13 and the transfer in question is treated as an overall transfer of assets, the transfer should be excluded from the scope VAT. With that, should the value of goodwill be exempted from VAT?

GPOSAT: Intangible assets do not fall within the scope of the VAT exemption. Hence, value of goodwill is irrelevant in this case.

3. VAT treatment of interest and net income paid to foreign enterprises

In respect of swap transactions between domestic and foreign enterprises, what is the VAT treatment of interests and net settlements paid to foreign enterprises?

GPOSAT: No regulation is in place to address this question. We will analyze actual cases as and when we receive information on relevant cases.

4. Article 7 of Caishui [2016] No. 40

a. Resettlement compensation expenses

According to Article 7 of Caishui [2016] No.140, compensation paid by the developers that are general VAT payers to other enterprises or individuals, as compensation for acquiring land, is deductible for calculating VAT payable when the developers sell property units. The calculation does not apply to developers that opted for a simplified basis for the calculation of taxation, basis on their old projects.

We would like to confirm if the compensation encompasses compensation in the form of cash, new homes or equities?

GPOSAT: There is no clear written guidance on the matter. We have checked with SAT and have been advised that compensation is limited to payment in the form of cash.

b. Assignment of land for a real estate development enterprise

According to Caishui [2016] No 140, upon fulfilling certain conditions, a special purpose vehicle (“SPV”) to hold land for a property development created by the developer can claim a tax deduction on the payment made by the developer to the government for acquiring the land. One of the conditions is that the developer should hold all the equity interest in the SPV. Is there any time limitation for this requirement? If strategic partners are introduced and become shareholders of the SPV later to co-develop the project, can the SPV claim the said tax deduction by virtue of Circular 140?

GPOSAT: It is preferable that the shareholding structure remain the same at all relevant times in order to meet the deduction requirement under Circular 140. However, this may not be practical in real life situation. Therefore, reference will be made to the shareholding structure at each tax filing. As long as there is no change in the shareholding structure, the SPV can claim tax deduction. The SPV can no longer claim tax deduction once there is change in the shareholding structure. However, no tax adjustment will be made in relation to the tax deduction made in the prior periods.

5. Restricted Shares

The VAT treatment on restricted shares is regulated under SAT Announcement [2016] No. 53 which is related to tax collection for the pilot scheme of imposing VAT in place of business tax.

For the transfer of restricted shares held by an organization to an external party after the restriction is lifted, the purchase price will be determined pursuant to the following provisions:

1. The purchase price of the following restricted shares will be the opening price on the date of resumption of listing, following a restricted share reform:

   a. Shares which were acquired between the date on which the reform was implemented and the date of resumption of listing; and

   b. Rights issues from the shares in (a) which were derived between the date of resumption of listing and the date of lifting the restriction.

2. The purchase price of the following restricted shares will be the issue price of the initial public offering (IPO) shares of a listed company:

   a. Restricted shares formed after the IPO; and

   b. Rights issues from the shares in (a) which were derived between the date of resumption of listing and the date of lifting the restriction

3. The purchase price of the following restricted shares will be the closing price on the trading day, immediately preceding the date of the listing suspension of a relevant listed company's shares due to its significant asset restructuring

   a. Restricted shares derived from significant asset restructuring of a listed company; and

   b. Right issues from the shares in (a) which were derived between the date of resumption of listing and the date of lifting the restriction

Circular 53 has only addressed a few scenarios where restricted shares are formed and sold. In practice, the following issues have not been dealt with:

Listed companies may arrange placements or bonus issues from time to time. Shares issued in placements and bonus issues may subject to sales restrictions. It is possible that, when the sales restrictions are relaxed, the price of the shares under the placements and right issues may be below the market price. Disposal of these shares are exempt from VAT by virtue of Circular 53. How would the tax authorities deal with this issue in practice?

Assuming Shareholder A holds 10,000 shares of Company B before the latter has been listed. When Company B is listed, its IPO price is HK$10 per share. During the restricted stock trade period, Company B issues bonus shares. Each shareholder is allotted 10 extra shares for every 10 shares it holds. The number of shares held by Shareholder A will therefore be 20,000, while the average purchase price has dropped to HK$5 per share. Subsequently, Shareholder A disposes of its shares in Company B at HK$8 per share after the sales restriction has been relaxed.

According to Circular 53, the price of the right issues, derived between the first listing day and the day when the trading restriction is lifted, will be the IPO price. When calculating VAT, even if the number of shares has increased from 10,000 to 20,000 shares, the cost per share should still be HK$10. With the shares being disposed at HK$8 per share, Shareholder A will incur a loss of HK$2 per share. This loss could be used to set off against the gains from trading of other financial products.

Assuming that listed Company B places its shares at HK$4 per share to the existing shareholders, which will be allotted an additional 10 shares for every 10 shares they hold.

The number of shares held by Shareholder A will become 20,000. The average cost of each share will then fall to HK$7.5 per share. After the sales restriction is relaxed, Shareholder A disposes of its shares in Company B at a price of HK$8 per share (but the number of shares has increased by a double). Would the placement of shares fall within the category of rights issues stipulated under Circular 53? If so, VAT should not be imposed, given that the IPO price is HK$10 per share while the disposal price is HK$8 per share.

How should the purchase prices be determined in view of the activities in relation to the shares, as mentioned above? What are the views of GPOSAT?

GPOSAT: From the legislative perspective, if we consider taxpayers' interests, the price of additional 10,000 shares should be their original price. Also, it seems that the prevailing regulations are not applicable to placement of shares.

D. Others

1. Three years of EIT exemption followed by three years at a 50% reduction of EIT

According to Guoshuifa [2009] No. 80, an enterprise can enjoy three years of EIT exemption followed by three years of 50% EIT reduction in the year during which the enterprise derived its revenues. The enterprise, however, has to conduct its business within the catalogue of EIT preferential incentives for public infrastructure projects, and to meet the relevant conditions and criteria.

In practice, an increasing number of enterprises have derived income from the government. For instance, for an enterprise that engages in sewage treatment, its source of income comes from the sewage treatment, which is paid by the government, and the immediate refund of VAT. Would the income derived from the government be counted as production income? Would the enterprise be entitled to claim the benefit under the CIT benefit package?

GPOSAT: Certain requirements need to be fulfilled before treating income from the government as non-taxable receipts.

2. Tax Analysis of the Thousands of Households Programme

In 2015, SAT launched a programme, namely tax risk management for group enterprises, listed under the “Thousand Enterprises Initiative”. This programme takes into account operating data, profit indicators and the tax status of central government enterprises, state-owned enterprises, private enterprises and multinational corporations. In 2016, SAT issued the requirements under a notice about registering the thousand group enterprises for the programme.

a. Work plan and the related impact

Could GPOSAT brief us its work plan in 2018 and how it will impact enterprises?

b. Taxation services for large enterprises

What kind of measures will be undertaken by tax bureaus to help large enterprises avoid their tax risks, after obtaining the relevant information?

GPOSAT: At present, many large enterprises are adopting an intensive management module. The EIT administration is being upgraded. Tax returns and related issues are being analyzed. The underlying findings will be shared with the local tax bureaus. In 2018, state and local tax bureaus will continue to cooperate with each other on:

- Managing the tax risks of large enterprises
- Avoiding duplication of work, particularly tax investigations
- Reviewing the tax status of large enterprises to identify their tax risks, aiming to assist these enterprises to establish their own risk management systems. The following measures will be adopted to assist large enterprises:

The following measures will be adopted to assist large enterprises

- Setting up an enterprise risk management system
- Reorganizing ERP systems to take into account tax factors and individual recommendations
- Facilitating an online platform for taxpayers and tax bureaus to exchange their information
- Arranging for electronic tax filing, and enhancing the corresponding information system
- Implementing credit ratings for large enterprises
- Analyzing the relevant data based on industry indicators.