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

Meeting notes

The State Administration of Taxation
and
The Hong Kong Institute of Certified Public Accountants

2013

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Foreword

The Hong Kong Institute of Certified Public Accountants ("Institute" or "HKICPA") was very pleased to hold its annual meeting with the State Administration of Taxation ("SAT") on 19 July 2013 to discuss and exchange views on various taxation issues.

The following is a translation of the meeting notes prepared, in Chinese, by the Institute. Please note that the meeting notes reflect the views of the SAT officials attending the meeting only and will not be binding on the relevant local tax bureaus. Please also note that some of the information in the notes about Value-added Tax ("VAT") reform will not be up-to-date as new circulars on the subject have been issued since the meeting took place. Relevant circulars should be referred to for the latest position of the VAT reform. Professional advice should be sought before applying the content of these notes to your particular situation. If there are differences in the interpretation between the English and Chinese versions, reference should be made to the Chinese version.

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Attendees

State Administration of Taxation ("SAT")

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Yu Shuchun	Deputy Counsel, HK, Macao and Taiwan Affair Office
Fu Yao	Director, Taiwan, HK and Macao Division, HK, Macao and Taiwan Affair Office
Fu Shulin	Director, Non-Resident Division, HK, Macao and Taiwan Affair Office
Huang Suhua	Director, Collection and Coordination Division, HK, Macao and Taiwan Affair Office
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He Daocheng	Consultant, Enterprise Income Tax Division, Income Tax Department
Yao Yuan	Deputy Director, Individual Income Tax Division, Income Tax Department
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Hong Kong Institute of Certified Public Accountants

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Discussion Matters

A. Corporate income tax ("CIT")

A1. Fluctuation of fair market value and deduction of depreciation charge for investment property

Article 3 of Caishui [2007] No.80 ("Circular 80") set out that for financial assets, financial liabilities and investment property which are measured at fair market value, any fluctuations in the fair market value will not be recorded such that taxable income/loss would result during the holding period. The resulting gain (loss) after deducting the historical cost from the sales proceeds is to be recorded as taxable income (loss) for CIT purposes when the applicable assets or liabilities are disposed of. However, Circular 80 was later abolished. Would the principle of Article 3, in practice, still be applied?

> The SAT representatives pointed out that although Circular 80 had been abolished, it did not conflict with the new tax law and thus the principle of the previous provision was still applicable. The fluctuation in fair market value was not an actual transaction activity. As non-actual transactions were generally not recognized, any resulting gains (losses) would not be included as taxable income/losses.

Investment property booked at fair market value is not recognized for depreciation charges for accounting purposes. However, investment property is often used to derive rental income, and such rental income is subject to CIT. Correspondingly, investment property should be allowed to claim depreciation deduction. In view of the inconsistencies in the implementation by local tax authorities in different locations, would the SAT issue any circulars to clarify depreciation deduction for investment property?

> The SAT representatives replied that, according to Article 8 of SAT Announcement [2012] No. 15 ("Announcement 15"), expenses that had been calculated and actually recognized according to the financial and accounting policies could be deductible for tax purposes, provided that such expenses did not exceed the deduction scope and threshold in accordance with the CIT law and its provisions. The objective of Announcement 15 was to reduce differences between tax and accounting treatments. At present, investment property measured at fair market value would not be subject to depreciation from an accounting point of view, therefore, the investment property should not be allowed to claim depreciation deduction under tax law based on the principle of reducing the differences between the tax and accounting treatments. Whether the policy would be changed in the future, it was now under study.

A2. Share incentive plan ("SIP")

SAT Announcement [2012] No. 18 ("Announcement 18") provides for the tax deductibility of SIP expenses incurred by resident corporations which set up SIPs. Could the expenses be tax deductible if employees of a group company in China join the group SIP? If yes, would such expenses be a deductible item of the listed company or of its group company, which is the entity enjoying the tax benefits?

Some multinational corporations allow employees of their mainland group companies to join the group SIPs of the parent company, which is incorporated and listed overseas. Where the overseas parent company allocates its SIP related expenses to mainland group companies, could such expenses be deductible in the calculation of income tax by the mainland group companies?

Where employees of mainland group companies have already paid individual income tax on what they earn from SIP, could tax authorities issue a tax paid certificate so that such group companies can pay their portion of relevant expenses to their overseas listed parent company?

The SAT representatives pointed out that Announcement 18 covered resident enterprises listed in domestic and overseas markets, as well as domestic non-listed enterprises, but it focused only on the SIPs of the enterprise itself. To be eligible for deduction of SIP expenses, enterprises should set up SIPs in accordance with the Administrative Measures regulations and adopt relevant accounting treatment in compliance with the Chinese accounting standards. As group companies, other than the specific enterprise that had physically set up the SIP, had not established any SIP, they were not allowed to deduct SIP expenses. Announcement 18 did not address SIP expenses allocation between domestic and overseas enterprises of multinational corporations. The SAT took the view that such allocation issue was complicated and tax authorities might find it difficult to fully understand in practice. Therefore, overseas enterprises for the time being were not allowed to allocate such expenses to its domestic member companies. The policy might be subject to change in future. Nevertheless, in order to avoid abuse, even if future policies allowed overseas enterprises to allocate SIP expenses to their domestic group companies, they would need to satisfy various prerequisites and conditions.

A3. Service fees and management fees

According to the relevant provisions in the CIT law, service fees are deductible if they are incurred in order to generate taxable income, while management fees paid between enterprises would not be deductible. In practice, as regards the definition of management fees, local tax authorities in different locations have different interpretations. Some simply treat the fees collected by overseas associates as

management fees and, therefore will not allow domestic enterprises to deduct such expenses in their tax calculation.

Would the SAT consider issuing guidelines to differentiate service fees from management fees and to explain the principle of deduction, in order to alleviate taxpayers' concerns?

The SAT representatives pointed out that these issues had become more prominent in recent years and they were in relation to two aspects. One was about erosion of tax base and the other was whether overseas parent companies should pay withholding tax. With regard to erosion of tax base, the SAT mainly assessed the expenses in accordance with CIT law, to see whether they were genuine, relevant and reasonable.

Supplementary question: With regard to services provided overseas, it was difficult in practice to substantiate that they were actually provided overseas. What documents should be submitted as proof that such services were indeed provided overseas?

The SAT representatives pointed out that, under the old tax law, parent companies could not allocate management fees to subsidiaries. The rationale was that expenses between two companies should be specific and not be abstract. Therefore, local-level tax authorities asked companies to provide evidence to substantiate that such expenses were genuine, relevant and reasonable expenses. In future, the SAT might consider providing more guidance and specifying the relevant operational procedures, so that companies could submit appropriate documentation to facilitate subsequent inspections by tax authorities. For example, assurance reports issued by intermediaries could provide evidence to substantiate that an expense was genuine and reasonable.

A4. Foreign income tax paid

Could prepaid foreign taxes, supported by the relevant vouchers, be claimed as deductible tax credit during the year? According to Article 77 of the Implementation Rules of the CIT law, foreign income tax paid could be credited against the CIT payable. "Foreign income tax paid" refers to taxes in the nature of income taxes that are payable and actually paid, on income derived outside the PRC, in accordance with the foreign tax laws and related regulations. The subsequent Circular 125 and Announcement 1 have reiterated the same principle that "the foreign income tax paid and credited against the CIT payable refers to taxes in the nature of CIT that are payable and actually paid, on income derived outside the PRC, in accordance with the foreign tax laws and related regulations". In this regard, can prepaid taxes be considered tax payable and actually paid? For example, an enterprise would not have received its Hong Kong final profit tax notice of assessment for 2012/13 at the time when it has completed the CIT tax filing (i.e. before 31 May 2013). However,

Hong Kong's prepaid tax system requires the enterprise to have paid provisional tax for 2012/13 in 2012, based on that year's assessable profit. Could the provisional tax, i.e., prepaid tax, be treated as foreign income tax paid and thus be credited against the CIT payment in 2012?

The SAT representatives pointed out that the tax credit practices for foreign income tax paid should be conducted annually. Prepaid tax was not the actual amount paid by an enterprise and thus could not be used for tax credit. Only the actual figure paid during the year could be taken into account. If the year of assessment in foreign countries was different from China, the enterprise should follow the relevant regulations in Article 11(3) of SAT Announcement [2010] No. 1.

Supplementary question: Assume that an enterprise was involved in litigation against its foreign income tax in a year and the amount was only determined three to four years later. It was known that Article 51 of the Law on the Administration of Tax Collection mentions, where taxpayers discovered a tax payment exceeding the amount of tax payable… within three years from the date the payment was made, the taxpayers could claim tax refunds from the tax authorities, together with the interests calculated according to the bank interest rates at the time. The tax authorities should immediately pay back the money upon examination…Was tax credit against foreign income tax paid subject to the same three-year limitation under the law?

The SAT representatives replied that this case would not be subject to the three-year limitation. As long as the actual amount was paid to foreign tax authorities, taxpayers could claim the relevant tax credits. Nevertheless, the SAT was studying whether tax payable adjustments should be made in the year in which the relevant applications were made or retrospective to the relevant years.

A5. Offsetting the profits of overseas branches with losses in China

Could profits of an overseas branch be used to offset against the prior year losses of a domestic enterprise? The old version of CIT tax filing form indicated in supplementary notes that overseas taxable income could be used to offset the prior year losses (i.e. in line 22: a line was to "add overseas taxable income to be set off by domestic tax losses"). According to the regulations under the provisional measures on managing overseas branches' CIT, when a taxpayer assesses its CIT, its profits from overseas branches can be offset by domestic enterprises' losses. However, the new version of tax filing form does not have clear indication to the above. Meanwhile, Circular 125 and Announcement 1 do not have specific explanation on it either. In practice, the design of tax filing system (e.g. in Beijing) does not allow foreign branches' earnings to be set off by prior year losses of domestic enterprises. Some enterprises have tried to file CIT returns manually but

have been requested to correct the returns. Could the SAT explain whether profits of overseas branches can be used to offset against the prior year losses of domestic enterprises?

The SAT representatives pointed out that Article 11 of the CIT law permits overseas profits to be used to offset against the domestic losses. Thus, prior years' losses fell into this scope as well. Tax filing system should not be considered as deliberately prohibiting current overseas profits from offsetting prior year losses of domestic enterprises. The concerned enterprises could communicate with the competent tax authorities for the above issue.

B. Taxation arrangement between Mainland China and Hong Kong

B1. Referral letter for issuing tax residency certificate of Hong Kong Special Administrative Region

According to Article 3 of Guoshuihan [2007] No. 403, when a Hong Kong resident applies for Hong Kong residency certificate from the Inland Revenue Department ("IRD") in accordance with the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion concerning Taxes on Income ("China-Hong Kong DTA"), the resident should provide a request letter issued by the relevant competent Mainland tax authorities; otherwise, the IRD will decline the application. This arrangement increases the administrative cost of the Hong Kong resident. Some Mainland tax authorities may even decline to issue a request letter for various reasons. Could the SAT consider deleting Article 3 of Guoshuihan [2007] No. 403, regarding the requirement for a request letter to be issued by the Mainland tax authorities? The IRD could then improve the processing of issuing residency certificate?

The SAT representatives pointed out that the need to determine the Hong Kong residency occurred frequently. The SAT recently discussed with the IRD about providing further clear and certain procedures in relation to this issue. The general principles were: (a) Not all taxpayers were required to submit residency certificates issued by the IRD. Only those whose residency status was in doubt would be required to substantiate their residency status by obtaining a residency certificate; (b) A request letter issued by mainland tax authorities was required for the IRD to accept the relevant applications. The IRD would then check applicants' identities before issuing certificates; (c) A strict process was imposed for taxpayers who wished to enjoy tax benefits. Based on the above criteria, the requirement was reasonable. It was understood that the IRD had devised different application forms to improve the workflow, by differentiating Hong Kong incorporated companies from those incorporated overseas.

B2. Exchange of information

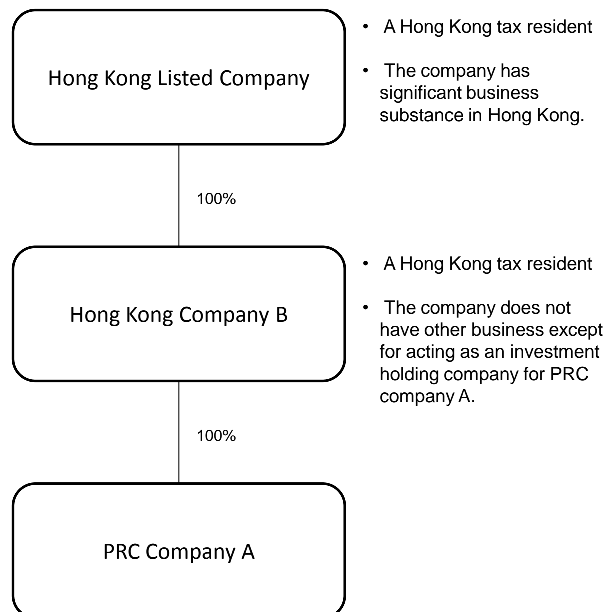
When the mainland tax authorities review applications under the China-Hong Kong DTA, they may ask the IRD to provide them with certain information about the Hong Kong resident applicants, in accordance with the procedures stipulated in Article 24 of China-Hong Kong DTA (Exchange of information).

What would be the workflow for implementing provisions in information exchange? Would the SAT notify the Hong Kong applicants or their payment remitter in the mainland?

The SAT representatives indicated that the SAT has formulated detailed internal procedures about the workflow for information exchanges. Local tax authorities were required to report the cases to the SAT and obtain its approval before sending requests to the IRD for information exchange. Currently, it took the IRD around three months to reply to each case. It was understood that the IRD would notify the relevant taxpayers and the SAT would respect the IRD's implementation guidelines.

B3. Application for tax refund under Circulars 30 and 124

The shareholding structure of Company A is illustrated as follows:



In the example, as Hong Kong Company B does not have significant business substance, PRC Company A did not apply for the preferential tax rate, i.e., 5% withholding tax on dividends when Company A distributed the year of 2010 dividends to Company B in 2011. In this respect, a 10% withholding tax rate has been applied.

Question: After Circular 30 has come into effect, could Company B apply for tax refunds in accordance with Circulars 30 and 124?

> The SAT representatives pointed out that enterprises could apply for tax benefits under China-Hong Kong DTA within three years according to Guoshuifa [2009] No. 124. The eligibility for preferential tax treatments under the China-Hong Kong DTA could be determined by the previously issued Guoshuihan [2009] No. 601. In addition, Circular 30 provided supplementary explanations to Circular 601 on the beneficiary. The effective date of Circular 30 should not affect the company to claim tax benefits under the China-Hong Kong DTA.

C. Cross-border reorganizations

C1. Criteria for special tax treatment

Articles 5 and 7 of Caishui [2009] No. 59 ("Circular 59"), issues concerning the corporate income tax treatment on corporate reorganizations, set out criteria applicable for special tax treatment on equity transfer transactions. Article 5(1) indicates that the reorganization should have a bona fide commercial purpose and the primary purpose is not to reduce, exempt, or defer any tax payments. In addition, Article 7(1) sets out another criterion in the case of a non-resident enterprise transferring a resident enterprise' shares to its 100% directly owned non-resident enterprise. Such transfer would not lead to a change in the withholding tax arising from any subsequent transfer of the enterprises' equities.

In practice, some local tax authorities have enlarged the applicability of Article 7(1) to include the change in withholding tax rate on dividends before and after the reorganization. What would be the SAT's views on such expanded interpretation?

> The SAT representatives pointed out that what Circular 59 specified in Article 7(1) was the withholding tax rate on equity transfers, rather than withholding tax rate on dividends. Therefore, a reorganization would not be questioned for objectively reducing tax rate simply because of any future decrease in the withholding tax rate on dividends under tax treaties. However, the SAT would not agree with a scenario in which a Chinese enterprise had accumulated a huge amount of undistributed profits but its BVI holding company did not distribute them. In order to reduce the withholding tax on distribution of this undistributed profit, a Hong Kong holding company was then formed and, after the BVI's equity interest in the

Chinese enterprise was transferred to its Hong Kong holding company, the relevant accumulated undistributed profits were immediately distributed. In this case, unless the enterprise chose to give up the benefit of 5% withholding tax rate for undistributed profits before the equity transfer, preferential tax treatments on the special reorganization would be denied.

C2. Definition of "equity" and "transfer" in the Guoshuihan [2009] No. 698

(a) Transfer of equity other than ordinary shares, such as preference shares

Is a transfer of equity other than ordinary shares, such as preference shares, subject to the reporting requirement under Circular 698? The differences between preference and ordinary shares are rights and the priority to share the companies' profits. Generally speaking, preference shareholders do not have rights to vote and stand for election. They cannot vote on the companies' major decisions, but they will receive companies' allocated profits prior to ordinary shareholders. If reporting is required, how is the holding proportion of these shares to be computed?

(b) Would distribution of shares as dividend in-species be considered as a "transfer"?

Where a foreign investor (the actual controller) distributes dividends in form of shares of a foreign holding company which indirectly holds a Chinese resident enterprise, is it a "transfer" and subject to the reporting requirement under Circular 698?

The SAT representatives pointed out that an equity transfer was not determined by what name was given to an equity interest or certain behaviours. The key determinant was whether there was a change of shareholders in a subject company. In the case of non-listed companies, the change of shareholders was a transfer of equity. In the case of listed companies, we should look at who was the purchaser (i.e., a public minority shareholder who purchased the shares through the stock exchange; or a strategic investor who purchased the shares in blocks), the number of shares, and whether the consideration was pre-determined (it was an equity transfer if the price was pre-determined). Preference shares were one of the equity types and their holders were shareholders, though the rights of various shareholders were different. Thus, a change of preference shareholders was considered an equity transfer and the ratio of a holding of preference shares should be in proportion to the investment cost.

C3. Would indirect transfer be substantively considered as direct transfer?

When a non-resident enterprise reports equity transfer cases in accordance with Guoshuihan [2009] No. 698, the tax authorities will look into the indirect transfer cases to determine if they are direct transfer in substance (by adopting the "looking through" approach). Could the SAT explain the following?

(a) Could a special purpose vehicle, which is formed purely for the purpose of an investment platform for its subsidiaries around the world, be considered as having a substantive business operation?

> The SAT representatives replied that the SAT was preparing a supplementary document to Circular 698 on indirect transfer. The proposed document would include general determinants in assessing anti-tax avoidance. In determining business substance, different factors would be taken into account. For example, were shell companies identified? Were substantive business operations present? Was income derived locally, according to the financial statements? Were local CIT returns filed?

(b) Fulfilling the requirements of substantive business operation

To satisfy the requirement of substantive business operations, should the special purpose vehicle hire employees for its operations? What is the SAT's view on an intellectual property holding company that engages in research activities (though actual activities may be sub-contracted to others), bears the relevant business risks, and receives royalties from its subsidiaries? It does not hire any employees while its directors are responsible for strategy planning.

> The SAT representatives pointed out that having employees was only a factor for consideration, and not an essential condition, to determine if a company had substantive business operations. The principle was whether the company had an actual operation. For example, some companies nominally hired employees, but they did not actually participate in the companies' operations. In this regard, the requirement of having substantive business operations could not be fulfilled.

C4. Determination of whether an equity transfer would recognize actual gains on transfer

When the SAT determines if actual gains are derived from an equity transfer, would it also consider how the equity transfer is settled financially? Assume that an overseas enterprise undertakes an Initial Public Offering ("IPO"). An investment gain will be recognized for accounting purposes based on the difference between the IPO price and the investment cost. However, the investment gain only carries a

book gain, and the enterprise does not receive any cash or actual gains. In this circumstance, would the SAT consider the accounting treatment as one of the factors to determine if an equity transfer involved an actual gain?

The SAT representatives pointed out that the key was on the substance, i.e., whether actual revenue was generated, rather than how it was recognized in accounting treatment. Therefore, when the investment income only carried a book gain, it would generally not be counted as actual revenue derived from an equity transfer.

C5. Questions on Caishui [2009] No. 59

(a) Relaxing the requirements of 75% of acquired entities' equities / assets

According to Article 7 of Circular 59, if equity or asset acquisitions take place between resident and non-resident companies, special tax treatments on reorganization could be applicable, provided that the requirements under Article 5 and the four conditions of Article 7 are satisfied. A strict application of the equity relationship between transferors and transferees is imposed under the first three conditions of Article 7, e.g., transferors must have 100% control over transferees. It is understood that the arrangement is to ensure the qualified equity or asset acquisitions are conducted within the same group, i.e., no asset or equity is transferred to a third party. We also understand that the rationale behind the treatment of equity or asset acquisitions is that, temporarily, the SAT will not impose tax on an internal reorganization until the group transfers the reorganized assets to a third party to realize profits. Would the SAT consider relaxing Articles 6(2) and 6(3), i.e., requiring at least 75% of assets and equities to be transferred? If one of the above mentioned conditions in Article 7 were satisfied, this would ensure the reorganization took place within the group and thus special tax treatments could be applied.

The SAT representatives replied that the SAT would not consider relaxing the conditions and all conditions under laws and regulations should be fulfilled.

(b) 100% direct and indirect holding

Article 7(1) of Circular 59 sets out the conditions for cross border transactions eligible for special reorganization treatments: A non-resident enterprise transfers the shares of a resident enterprise to its 100% directly owned non-resident enterprise. In addition, such transfer may not lead to a change in the withholding tax rate arising from any subsequent transfer of the enterprise shares. Moreover, the transferor (a non-resident enterprise) issues a written undertaking to the competent tax authority that it will not transfer the transferee's equity (a non-resident enterprise) within three years. Based on the

above, it is understood that the non-resident transferor must transfer its resident enterprises to another wholly owned non-resident company to enjoy special reorganization treatments. In this regard, what is the rationale of requiring 100% direct holding? Would the SAT consider 100% indirect holding when assessing the special tax treatments?

The SAT representatives replied that only direct holding would be considered and indirect holding would not be allowed. As it was difficult for PRC tax authorities to determine how many levels of controlling relationship there were among enterprises, indirect holdings would not be considered. Only direct holdings were applicable.

(c) The relationship between Circulars 698 and 59

Companies A, B and C are non-resident enterprises. Company A transfers shares in Company B, which in turn holds a resident enterprise, to Company C. Where the tax authority decides that Company B does not have substantive business operation by adopting "looking through" approach under Circular 698 as if the resident enterprise was disposed of, could the special tax treatment under Circular 59 be applied? In the circumstance where Company B was looked through, would applying for special reorganization be considered a cross-border reorganization and, therefore, the conditions of Article 7 in Circular 59 have to be satisfied? Or will fulfilment of the conditions in Article 5 be sufficient?

The SAT representatives pointed out that there would be a safe harbour provision in the proposed supplementary document on indirect transfer. The above illustration might fall into the scope of safe harbour and the issue could be resolved more easily when the document was released.

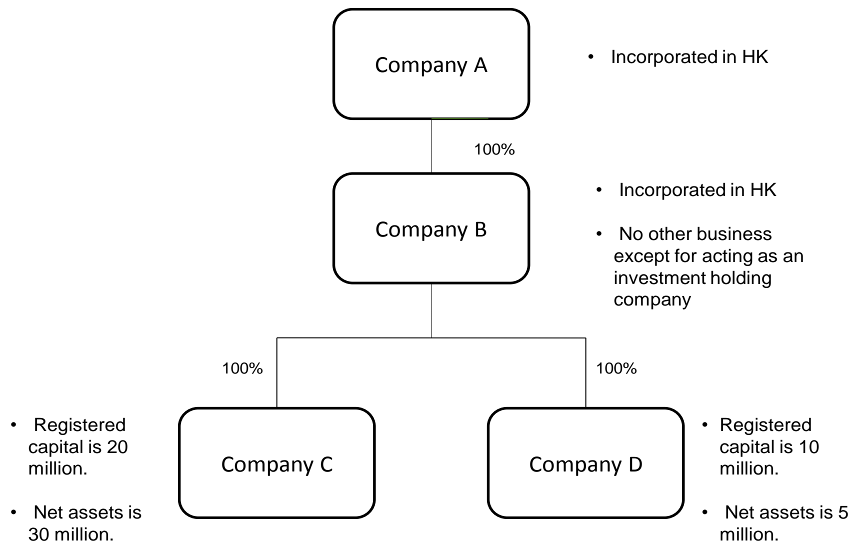
(d) Common control

Article 6(4) in Circular 59 indicates that special tax reorganization can be applied when no consideration is received for enterprises' merger under common control. According to Announcement 4, common control refers to enterprises that are subject to the same ultimate control from the same party or parties before and after the merger. However, no clear explanation is available as to whether the common control requires 100% direct or indirect control. Would indirect control cases also be applicable? If it is the case, would there be any limitations on levels of indirect ownership? In addition, concerning the merger of two non-resident enterprises, could this constitute equity transfer and be subject to the reporting requirement under Circular 698 if resident enterprises have been held by these non-resident enterprises?

The SAT representatives replied that the said common control should be held directly by the relevant enterprises. As it was difficult for PRC tax authorities to determine how many levels of controlling relationship there were between the enterprises, indirect holdings would not be considered in the common control requirement. Only direct holding would be considered.

C6. Calculation of withholding taxes arising from indirect transfer

Please refer to the following chart in relation to Circular 698:



Company A sold Company B to a third party at a consideration of $35 million, while Company C was indirectly transferred to Company D at the same time. Under this circumstance, how is the withholding tax computed? Is it the 10% of $5 million (i.e., $35 million – 30 million) or the 10% of $10 million (i.e., $30 million – 20 million)?

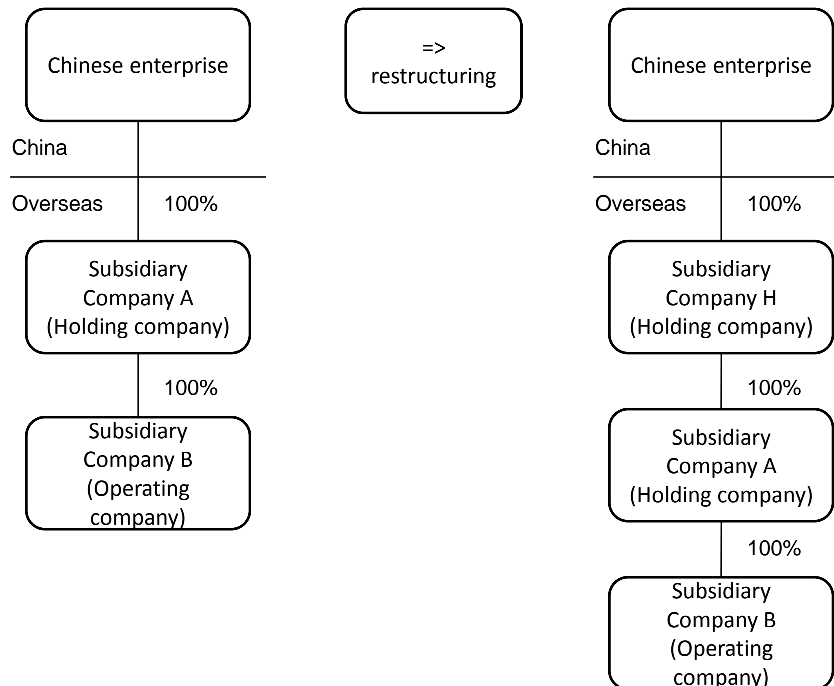
The SAT representatives replied that tax should not be levied in a bundle. Instead, each Chinese enterprise should compute its own tax payment separately while gains or losses between enterprises should not be credited against one another. The tax amount should be $1 million (i.e. ($30 million – 20 million) x 10% withholding tax). The WalMart case was treated in this manner even though not all the details were disclosed publicly as the case was complicated.

The Institute note: The details could be found in the reply from the SAT to Shenzhen municipal tax authority regarding the acquisition of TrustMart by WalMart (Shuizonghan [2013] No. 82). The reply set out that each Chinese enterprise computed its tax payment separately while gains and losses between

enterprises should not be offset against one another. The reply also illustrated how the proceeds were allocated and how tax amount was computed.

C7. Reorganization

A special holding company has been established by a Chinese enterprise for its investments in foreign enterprises due to business and tax planning. However, a reorganization may be conducted subsequently due to possible business and foreign tax planning. It is illustrated as follows:



The Chinese enterprise adopted a share exchange approach by contributing the equity of its subsidiary, Company A, to another wholly-owned subsidiary, Company H, and receiving the equity of Company H.

The illustrated reorganization should be able to satisfy the requirement of Circular 59. Thus, the special reorganization treatment would be applicable such that the gains could be deferred.

We would like to obtain the SAT's guidelines on two related issues.

(a) Special reorganization treatment

According to Article 5(1) of Circular 59, the applicable reorganization should have a bona fide commercial purpose and the primary purpose of the reorganization should not be to reduce, exempt, or defer any tax payments. We think such reorganization as illustrated above would lower the foreign

withholding tax on future dividends but should not have any impact on the China taxation. We hope that special reorganization treatment for such reorganizations would not be denied by the SAT because of a resulting decrease in the foreign withholding tax.

The SAT representatives pointed out that an unchanged tax burden as noted in Circular 59 refered to unchanged withholding tax arising from any future equity transfer, and had nothing to do with withholding tax on dividends. Please refer to its answer to Question C1, which would also be applicable to reorganizations of overseas subsidiaries of Chinese enterprises.

(b) Valuation report

A valuation report should be attached when submitting written documents to the competent tax authority. As Chinese valuers may have difficulties in assessing the market value of foreign companies, would the SAT consider valuation reports prepared by qualified overseas valuers?

The SAT representatives pointed out that it would be better to provide a valuation report when submitting written documents. As the valuation report would be taken as a reference only, the SAT would accept valuation reports prepared by overseas valuation professionals.

D. Permanent establishments

D1. Announcement 19

On 19 April 2013, the SAT issued Announcement 19 to provide guidance on circumstances under which a PRC taxable presence would be created on seconding foreign expatriates to China. However, Announcement 19 did not clarify all the relevant taxation issues. We hope the SAT would explain the following issues.

(a) Taxable presence issues arising from an overseas entity which also takes part in the appraisal of the job performance of its secondees who are working in mainland China

In Announcement 19, the “fundamental criterion” for determining if the secondees are employees of the overseas entity is whether the overseas entity normally reviews and appraises the performance of the secondees. In practice, for bona fide commercial reasons, some secondees have dual lines of reporting in performing their jobs, e.g., they report to both the CEO of the local entity and the business line managers of the overseas entity. The local CEO and the overseas business line managers will jointly review the secondees' job performance. Announcement 19 does not specifically address such a scenario,

and would seem to create a PE risk for the overseas entity if it has input into the performance review of the secondees.

(b) Inconsistencies between Announcement 19 and Circular 75

In practice, some secondees are directly compensated by the overseas entity, while the local entity fails to fully reimburse the overseas entity for the compensation costs. Announcement 19 and its accompanying interpretative guidance appear to imply that no Chinese taxable presence will be created, as long as individual income tax is paid on the full amount of the secondees' wages and salaries borne by the home entity. This position would appear to be inconsistent with Circular 75, which states that, if the overseas entity (foreign parent) bears the compensation cost for the secondees working in the local entity (Chinese subsidiary), this would demonstrate that the secondees are in fact working for the home entity, and the risk of creating a taxable presence of the overseas entity in China will be increased. Could this be interpreted as a scenario in which the local entity was not required to bear the full amount of the secondees' wages and salaries, and the fact that the overseas entity bore a part of the secondees' wages and salaries would not have an impact on determining if a taxable establishment or PE was constituted in China?

(c) Relationship between payment of Individual Income Tax ("IIT") and CIT

It is not precisely clear why the payment of IIT on the secondees' wages and salaries borne by the overseas entity is connected with the determination of whether the overseas entity has a taxable presence in China from a CIT perspective. It appears that Announcement 19 is making an inference that, if the secondees do not settle Chinese IIT on income received from the overseas entity, such a position implies that the secondees are not really the employees of the local entity. In practice, a secondee sometimes signs dual employment contracts with the local entity and the overseas entity during the secondment period and performs job duties associated with the two contracts, within (onshore duties) and outside China (offshore duties). In such a case, it is unclear whether the secondee must pay IIT on the compensation received for the offshore duties in order for the home entity to avoid a taxable presence in China. Announcement 19 does not explain it.

The SAT representatives gave a consolidated reply that Article 1(1) of Announcement 19 was a key provision on which the SAT placed a great emphasis. The SAT recognized employees with dual employment contracts. The determinant factors would be who reviewed the secondees' job performance and bore their job risks. While most companies were concerned that the fact of the secondees' reporting to headquarters would have an effect on determining the real employer defined in Announcement 19, there were boards of directors in Chinese subsidiaries too. As long as the secondees were accountable to the subsidiaries' board of directors, the "fundamental criterion" of Announcement No. 19 would not be affected, even if the

secondees reported to the headquarters as well. The other five factors were for reference only.

Announcement 19 was basically consistent with Circular 75. In determining secondees' real employers, we should take into account the determinants of real employer in the article on independent personal service, as stipulated in Circular 75. Salary was only one of the reference factors.

Supplementary question: Employees with dual employment contracts could have part of their income exempted from IIT according to IIT law. Would this partial tax exemption be considered a failure to pay taxes on the full amount in China under one of the five reference factors?

The SAT representatives replied "no" to this question. As long as the taxpayers filed their tax returns in China on all of their domestic and overseas wages and salaries, and made a correct payment on IIT in accordance with the relevant Chinese laws, they would be considered as having paid taxes on the full amount in China.

D2. Determination of six-month threshold in tax treaties

The six-month threshold has been adopted in a number of tax treaties between China and certain countries (e.g., the DTA with the US) to determine if a service permanent establishment is created. Although Guoshuihan [2007] No. 403 has given guidelines on how to calculate the six-month threshold, the Circular was abolished, following which the rule was replaced by the 183-day threshold in China-Hong Kong DTA. Moreover, the 183-day threshold is now applicable to China-Singapore DTA and Guoshuifa [2010] No. 75. In practice, is the six-month threshold still applicable in the cases such as the treaty with the US?

The SAT representatives replied that the general trend was to gradually revise the calculation period in bilateral tax treaties between China and other countries to 183 days from six months. For those countries still adopting the criterion of a six-month threshold, the concerned parties could negotiate with the competent tax authorities under different circumstances.

E. Funds and shares

E1. Qualified Foreign Institutional Investors, RMB Qualified Foreign Institutional Investors and RMB Funds (Qualified Foreign Limited Partner, "QFLP")

Since the launch of these programmes, foreign investors have been concerned about how and when the SAT will collect capital gains tax. Could the SAT clarify the related tax issues or when an announcement will be made?

Could the SAT confirm if the relevant tax treaties' reliefs will be applicable for the said programmes?

> The SAT representatives gave a consolidated reply that the tax levy was still under discussion. Director-general Liu of International Taxation Department had communicated with the relevant authorities, such as the China Securities Regulatory Commission. The issue might be clarified by the end of this year.
>
> Meanwhile, the SAT reiterated the need to avoid using the term "capital gains tax". The general public might have a misunderstanding that a new tax category would be introduced. Some developed countries differentiated capital gains tax from income tax, but it was not applicable in China. In practice, capital gains tax was included in corporate income tax. The different treatment was due to the fact that those countries gave preferential tax treatments on long-term investment while China did not follow suit. Therefore, differentiating "capital gain" from "income" was not necessary.

F. Individual income tax

F1. Announcement 16

(a) Extension of double taxation avoidance to include income from stock options

Announcement 16 is currently applicable to salaries and wages. Would the SAT consider extending the announcement's scope by including income derived from stock options?

> The SAT representatives pointed out that clear principles had been set out in Caishui [2005] No. 35 to classify the origin of income from stock options, whether it was derived domestically or overseas, in accordance to the relevant provisions of Guoshuihan [2000] No. 190. Therefore, the SAT would not consider extending the scope of Announcement 16 to include stock options.

(b) Application for foreign tax credit

According to Article 7 of the PRC IIT law, for a taxpayer who has derived income overseas, the corresponding amount of individual income tax already paid outside China could be deducted from the applicable IIT on this income. In practice, however, it seems that many tax authorities are not familiar with the relevant foreign tax credit policy. Although taxpayers may have successfully applied for a tax refund, it may take several years to receive the refund. Would the SAT consider providing more guidance on foreign tax credit applications?

The SAT representatives pointed out that the relevant provisions were in place for foreign tax credits. Taxpayers could send applications to the competent tax authorities in practice. Since the provisions were clear enough, the SAT would not consider giving further guidance.

G. Converting Business Tax ("BT") to VAT

G1. Royalties and rentals paid for cross-border transactions

China Customs may impose import duty and VAT on domestic enterprises for their payment of royalties on cross-border technology licensing and rentals of equipment leasing. Meanwhile, tax authorities in the areas under the VAT pilot scheme may also impose VAT on those enterprises. Would the SAT introduce new polices to prevent the same VAT being charged two times?

The SAT representatives pointed out that China Customs should not be an agent to collect VAT on such payments, according to the VAT provisional regulations. Companies could give their views to China Customs, while the SAT would communicate with them as well.

G2. Tax exemption application procedures for export of services

Application procedures for VAT zero-rating treatment have been issued for export services, but the application procedures for obtaining VAT exemption treatment have not been introduced. Taxpayers do not know what procedures to follow when applying for tax exemption. When would the relevant finance and taxation departments release the relevant regulations? It is hoped that the regulations will be easy to follow and operate and will not contain too many anti-tax avoidance provisions. The purpose is to encourage domestic and foreign enterprises to set up or retain modern service centres in China. We understand that some local tax authorities, in their review of tax exemption applications for export services, require the service to be provided overseas in addition to requiring the service recipients to

be located outside China. Would the finance and taxation departments clarify the issue?

The SAT representatives replied that the SAT was formulating the detailed rules and regulations, which would initially be released in August.

A domestic enterprise provides foreign companies with product quality inspection, procurement service and sales service. Would the enterprise be eligible to apply for tax exemption of these export services? Besides, would these services constitute business process management services or consulting services?

The SAT representatives replied that these services were not part of the export services eligible for tax exemption according to Article 7(8) of Annex 4 under Caishui [2013] No. 37. No tax exemption was applicable.

An export service company enters into an agreement with a foreign company, which keeps the receipts and makes the payments. If the ultimate beneficiaries of the services were domestic companies, would this affect the tax exemption application? As an illustration, the domestic company provides IT service to the foreign company, which will apply the results to other domestic companies.

The SAT representatives replied that in principle this would not affect the company's tax exemption application on export services.

G3. Scope of VAT pilot scheme

In day-to-day operations, we observe that there are different understandings and practices among local tax authorities as to whether or not certain businesses could be included in the VAT pilot scheme (e.g., agency services, legal and financial services provided by a group to its group members). In particular, when competent tax authorities of service providers and recipients apply different interpretations, VAT invoices issued by service providers may not be creditable by service recipients. This could weaken the effect of the VAT pilot scheme. Would the SAT issue any new policies to resolve the situation?

The SAT representatives pointed out that there were in fact some ambiguities about the scope of the pilot scheme but they would be gradually sorted out when the VAT was implemented countrywide in 2015. Therefore, no new policies would be issued.

G4. Taxable services fully consumed outside China

According to Caishui [2011] No. 111, no VAT will be imposed if foreign entities or individuals provide domestic entities or individuals with services to be fully consumed outside China or leases of tangible assets to be fully used outside China. In practice, how are "services to be fully consumed outside China or leases of tangible assets to be fully used outside China" to be defined? What kinds of supporting documents should be provided?

The SAT representatives pointed out that the problem of determining the place of taxation was a global problem. The OECD was now conducting research on this area and was drafting a VAT guideline. The OECD had determined two fundamental principles which were "neutrality" and "place of destination". Though the guideline was still at a preliminary stage, the SAT had actively driven the research.

G5. Transition policy for technology transfer

Under the VAT pilot scheme, VAT exemption is applicable for technology transfer. In the case of transferring the right to use the technology from overseas enterprises to domestic enterprises, different local tax authorities would have different interpretations as to whether overseas enterprises should be treated as "pilot taxpayers" and thus be exempt from VAT. Would the SAT clarify the issue?

The SAT representatives replied that overseas enterprises were also pilot taxpayers when they transferred technology to domestic enterprises. Therefore, they could enjoy the same tax benefits.

G6. Transfer out of input VAT on tax exempt items

According to the prevailing VAT provisions, there are two ways to transfer out the amounts of input VAT:

(a) Input VAT that cannot be accurately distinguished into taxable or tax exempt items should be transferred out pro-rata, based on sales volume.

(b) Input VAT that is independently assessed for taxable and tax exempt items should be transferred out based on actual tax amounts. Enterprises should apply to the competent tax authorities for independent assessment.

The existing national provisions do not indicate on how to distinguish taxable and tax exempt items or how to independently assess the input VAT. We communicated with some local tax authorities and noted that no specific guidelines have been

released for enterprises' reference. The tax authorities also had difficulty to give clear replies to the issue.

Meanwhile, the Shenzhen SAT issued an Announcement 2 in 2012 on independent assessment of input VAT on tax refunds and exemptions for export goods manufactured by production enterprises. The announcement could be taken as reference.

According to Announcement 2, the scope of the independent assessment of input VAT would include raw materials consumed for production, labour services purchased from third parties, or services and goods acquired for direct sales. The input VAT on utilities and consumables would be computed pro-rata, based on sales revenue, given the difficulties in allocating the corresponding input VAT. Taxpayers should independently check their purchases, stored goods, productions and relevant procedures, and establish detailed bookkeeping to calculate input VAT. Individual records on procedures of storage, requisitions and sales should be kept accurately, reasonably and completely.

Question: Could enterprises incorporated in other places follow Announcement 2, and apply for independent assessment?

The SAT representatives pointed out that it was required by law for the enterprises to independently assess their input VAT on taxable and tax exempt items. They were also required to apply to the local tax authorities for independent assessment. The input VAT transferred out on tax exempt items should be made in accordance with Articles 26 and 27 of VAT provisional implementation details. Distinguishable input VAT should be classified clearly. Those items that could not be distinguished, such as those arising from water, electricity and gas, should be divided pro-rata based on sales volume.

H. Others

H1. Application for Chinese tax resident status by foreign incorporated enterprises

Guoshuifa [2009] No. 82 ("Circular 82") sets out the guidelines to determine if a domestically-controlled enterprise that is incorporated overseas will be treated as a PRC resident enterprise, based on where the place of effective management is located. It has been observed that many overseas-incorporated corporations not controlled by Chinese enterprises apply for determination of Chinese resident status. Although these applicants can meet the requirements under Circular 82 in most of the cases, the relevant applications are not approved or they have been delayed. Could the SAT advise what would they consider during the assessment?

The SAT representatives indicated that the SAT had recognized some overseas-incorporated and domestically-controlled enterprises as PRC-resident companies since the promulgation of Circular 82 in April 2009. However, the progress had slowed down from last year. This was because the implementation of the current policy deviated from its original and legislative objective, which was primarily aimed at enlarging the CIT scope and protecting the tax base. In practice, however, many enterprises applied for the resident status in order to be exempt from withholding tax on dividends. The SAT was looking into revising and improving the relevant regulations. In addition, consideration needed to be given as to which authorities are responsible for examination and approval.

H2. Differences in implementation standards and judgments of tax authorities in different locations

(a) Various practices in the VAT pilot scheme

The VAT pilot scheme has been implemented for more than a year but official interpretations have not been clarified on certain details. VAT exemption on export services would be applicable on consulting, technical consulting, forensic, and software services. However, official and operational guidelines are not in place to explain the applicability of the relevant preferential tax treatments, and indicate which services should be included in the treatment. At present, different tax authorities may have different practices. Could the SAT publish clear guidelines to clarify and specify the above policies?

The SAT representatives replied that the SAT had been formulating the details, and was, initially, preparing to publish details by August.

The SAT hoped that, after communicating with its members, the Institute could provide the SAT with further questions about the tax law and possible ways of addressing these. This could help the SAT understand the members' industry backgrounds and other relevant information. If the SAT's participation would be helpful, the Institute could invite the SAT as early as possible to provide policy information and training to its members.

Hong Kong Institute of Certified Public Accountants
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