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

Meeting notes

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

2017

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Preface

It is a great honor for the Hong Kong Institute of Certified Public Accountants ("Institute" or "HKICPA") to hold the meeting with the Shenzhen Municipal Office of State Administration of Taxation ("SZSAT") on 5 December 2017 in Shenzhen. The purpose of the meeting is to have discussion on various taxation topics and to exchange opinions based on the discussion.

The following is a translation of the meeting notes prepared by the Institute. Please note that the meeting notes merely represented the views of SZSAT officials who attended the meetings and are not intended to be legally-binding or a definitive interpretation. You should seek professional advice before applying the content of these notes to your particular situation.

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

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Attendees:

SZSAT

Li Xianzhu	Chief Auditor, Member of the Leading Party Members' Group
Luo Guoxiu	Director of International Taxation Department
Feng Zhiguo	Deputy Director of Income Tax Department
Lin Hanyi	Deputy Director of Goods and Services Tax Department
He Naiping	Deputy Director of Large Business Taxation Department
Liu Jia	Deputy Director of International Taxation Department
Hu Yanfeng	International Taxation Department
Chen Yinyan	International Taxation Department
Liu Yang	International Taxation Department
Zhou Yanyuan	International Taxation Department

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
Leo Li	Member, China Taxation Subcommittee
Cecilia Lee	Observer, China Taxation Subcommittee
Shanice Siu	Member, China Taxation Subcommittee
Andy Leung	Tax Partner, EY
Travis Lee	China Tax Director, KPMG
Huang Xianping	Manager, PwC Shenzhen
Eric Chiang	Deputy Director, Advocacy and Practice Development
Wing Wong	Administrator, Advocacy and Practice Development

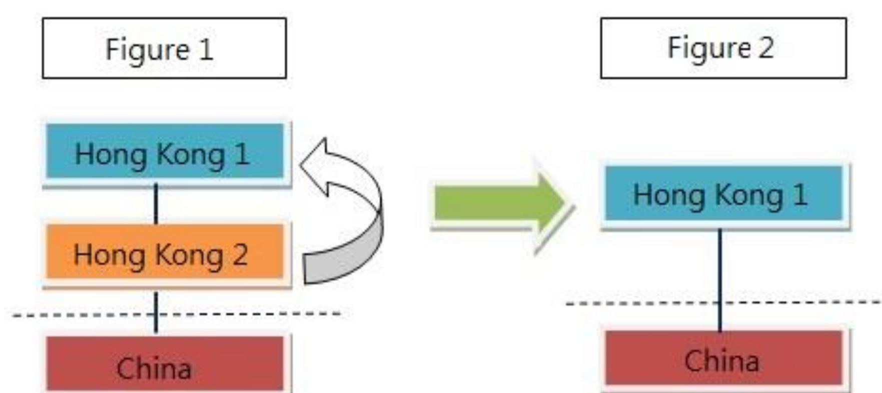
Agenda items

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?

SZSAT: According to Article 1 of Circular 72 and Article 7 in Circular 59, if a non-resident enterprise (i.e. the transferor) transfers its equity in a Chinese enterprise to another 100%-controlled non-resident enterprise (i.e. the transferee), where the equity transfer does not result in a change in the withholding tax due on the equity, and the transferor promises not to transfer its ownership in the transferee within 3 years , the equity transfer may be subject to special tax treatment. The equity transfer may include situations resulting from the separation and merger of the company. In the above example, Hong Kong 2 transferred its own equity to Hong Kong 1 and Hong Kong 2 did not control 100% equity of Hong Kong 1, so it is not a case where special taxation treatment applies. According to earlier court cases, it was noted that

special tax treatment is not applicable to the transfer of the domestic equity as a result of the merger of overseas company.

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 is the appropriate tax treatment on interest income and net gains received/ receivable by foreign enterprises under swap transactions?

SZSAT: According to item 2 and 3 of Circular 753, all kinds of receipts that are of the nature of interests should be treated as received by the overseas enterprise and sourced in the Mainland, according to the provisions of the tax code for source deduction; corporate income tax would not be deducted from the net amount of settlement paid by domestic enterprises to foreign enterprises due to swap transactions,.

Although the No. 753 document has been canceled, the contents of this document can still be referred to in actual operation. Invariable, interest income in related businesses is still deducted according to relevant tax laws.

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.

SZSAT: According to item 1 in Circular 18, the equity incentives referred to in this Public Announcement mean long-term incentives implemented by a listed company stipulated in the Administrative Measures for its directors, supervisors, senior management personnel and other employees, using its own shares. In the above example, since the domestic company does not use the company's own shares for the equity incentive, but instead uses the overseas parent company's shares, this does not comply with the basic requirements of Circular 18.

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?

SZSAT: There is no clear answer.

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 offices of the business. These offices can apply for preferential tax policies at their nearby tax bureaus. If an enterprise operates a shared service center which handles financial matters throughout the Mainland, its applications for preferential tax treatments are likely to be 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?

SZSAT: There is no definite answer.

5. Corporate restructuring: [2009] Circular 59

a. Special tax reorganization

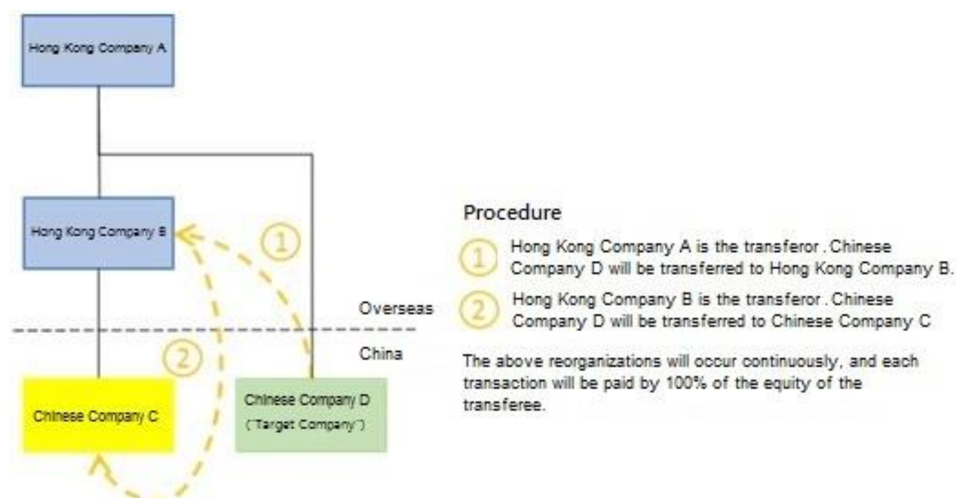
Special tax treatment should apply if a merger of PRC corporations satisfies the five conditions under Article 5 of Cai Shui (2009) No. 59 (Circular 59). Assuming that there is an absorption merger between PRC Corporation A and B (and Company B no longer exists after the transaction), would the special 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?

SZSAT: The treatment of foreign mergers has been a matter of controversy for many years. Item 7 of Circular 59 refers only to "equity and assets acquisition transactions", without mentioning mergers or demergers. In the above situation (i.e. two domestic companies are merged by overseas shareholders under the same control), the application of special tax treatment for restructuring is a matter of filing, and some local tax authorities will allow it by default.

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.

SZSAT: A requirement in special tax treatment is "The original key shareholders who obtain the equity in an enterprise restructuring shall not transfer the equity obtained within 12 consecutive months following the restructuring." For step-by-step reorganization transactions, the tax authorities can look through the

intermediate steps to judge whether the transaction can meet the specific tax treatment conditions. In this case, because the two steps that took place within 12 months, the merger would be judged by the results of the final reorganization. As the transferee was a subsidiary that was indirectly controlled by the transferor, this is not a situation of direct control so the special treatment for reorganizations would not apply.

On the contrary, if two separate reorganizations are carried out within 12 months, each of the individual reorganizations may not be eligible for special tax treatment. However, if such reorganizations are treated as a merger and meet the requirements of special tax reorganization, the tax authorities believe that special tax treatment should be applicable.

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

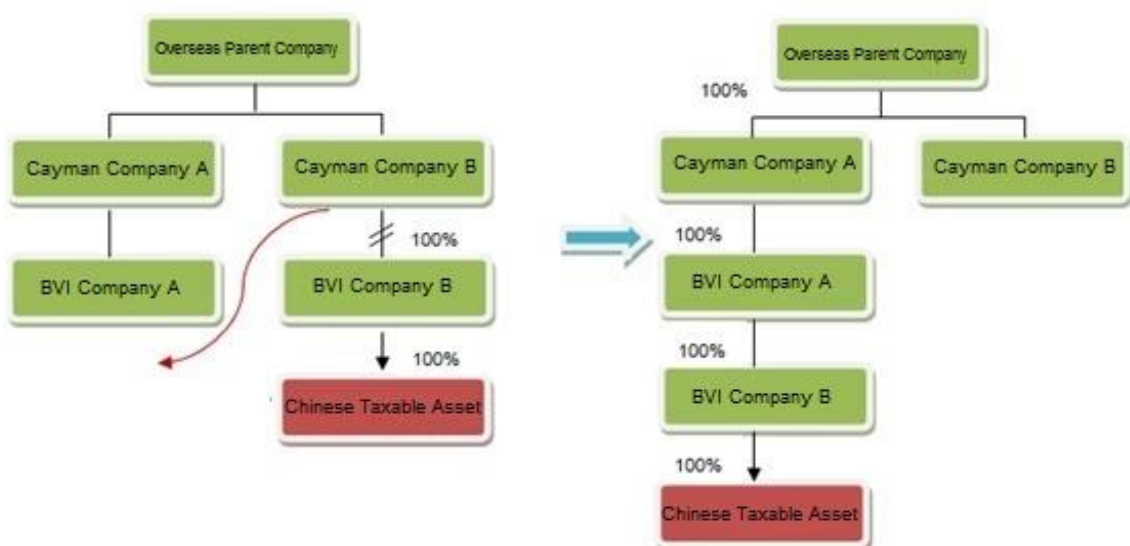
a. Equity-like interests

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?

SZSAT: There are no clear provisions dealing with this issue.

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?

SZSAT: Currently, there are no references for this question, and it will be further considered.

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				

A
100% ↓
B
100% ↓
C

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

SZSAT: There are currently no clear provisions on this issue. In practice, the assets and liabilities of middle-tier companies between overseas transferors and domestic indirect transferred subsidiaries are reviewed. When calculating the income derived from this indirect transfer of the equity of the Chinese company, consideration may be given to subtracting the assets and the liabilities of the middle layer company (excluding long-term equity investment) from the transfer consideration, , to obtain the value of the equity transfer in China The income minus the costs represent the equity transfer proceeds.

The actual calculation method of the State Administration of Taxation is as above. In handling this matter, the Shenzhen Tax Bureau refers to the guidelines of the State Administration of Taxation as the basis for reviewing the assets and liabilities of middle-tier companies.

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?

SZSAT: Firstly, it needs to be distinguished whether the payment situation relates to a staged payment or contingency; in the case of instalment payment, according to Article 37 of Circular 7, where income from an asset transfer subject to withholding at source is derived by a non-resident enterprise by way of instalments, the instalments may first be treated as recovery of costs of previous investments; upon recovery of all the costs, the taxable amount to be withheld should then be computed and withheld. It should be noted that Circular No. 37 does not apply to the payment collection activity of resident enterprises. Resident enterprises must recognize the income and costs of property transfer and calculate the enterprise income tax in accordance with the accounting standards.

There are no clear provisions for contingencies. In practice, the tax authority first analyses whether the contingent matter and the original transaction can be merged into the same transaction. If contingent events actually occur, the tax authority recognizes the corresponding income or loss. When a transaction occurs, the income from the transfer of equity should be recognized first; after the relevant conditions have been met and when a contingent event occurs, it is not clear whether the tax basis, i.e. the investment costs of an transferee should be used to adjust non-operating incomes or the underlying gains, if any, generated from contingencies should be treated as the transfer proceeds.

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)?

SZSAT: Before SAT is established, the principle of substance over form is accepted as the cost of future transfer.

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 overseas 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?

SZSAT: In the above case, the overseas parent of the borrower and the subsidiary using the funds in China are two independent legal entities. According to the provisions, the China resident company should withhold interest income tax and value added tax on interest paid. In addition, the policy of exempting unified borrowing and repaying from value-added tax is currently understood to be applicable only to domestic companies.

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?

SZSAT: The transfer price should be calculated in accordance with the actual value of the transferred company. If it is unreasonable, the taxation authority may refer to the present value of the assets of the transferred company, the composition of the assets, and the changes in the equity of the financial statements, to determine the transfer price. In the above case, although Company A transferred equity to Company D at the acquired price, Company A's rights over Company C exceeded the proportion of its actual shareholding. In this case, the tax authority may question the relationship between Company A and Company D. And whether the transfer of equity in company A has a reasonable commercial purpose.

According to the relevant provisions of the company law, under normal circumstances, corporate profits are distributed according to the proportion of shares held by shareholders. However, if there are special arrangements between shareholders, they may not distribute dividends according to the proportion of shares. The dividends paid to Company A can be subject in full to the policy of exemption from corporate income tax. It should be noted that in the

above cases, the tax authorities may challenge Company A as having undertaken the equity transfer arrangement for tax avoidance purposes.

For the second question, the relevant situation does not affect the tax exemption treatment.

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?

SZSAT: No timetable has been determined for the time being.

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?

SZSAT: According to the opinions of the tax authorities, the taxpayer can adjust the tax recovery plan based on the normal tax adjustment risk notification. The tax return declaration must be registered in the three-year gold tax system before tax payment can be made. In general, the taxpayer should communicate with a competent tax authorities and obtain advice before the taxpayer can make adjustments to the tax declaration.

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 SZSAT have similar plans? If not, does SZSAT have an internal assessment mechanism to rate the local files?

SZSAT: Currently, the tax authorities in Shenzhen have not established any rating system.

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?

SZSAT: There is no clear requirement for the content of corporate disclosure and the depth of its analysis. The failure to obtain relevant data from overseas affiliates may lead to incomplete analysis of the taxpayer's value chain and affect the taxpayer's defence in the face of transfer pricing adjustments.

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.

SZSAT: From the individual enterprise point of view, the test will not be used in insolation, and the test is quite difficult to apply and subjective. Regarding the profitability of enterprises receiving related labour services, it mainly refers to the changes in their profit levels before and after receiving related labour services.

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?

SZSAT: There is no rule or fixed ratio of this nature. The key is to look at the case and analyse it based on the specific facts and circumstances. There are cases where we try to use the method of profit margin for the service fees without using the cost-plus rate method, and consider methods such as the use of the sales profit rate to analyse the functions an enterprise undertakes in China.

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?

SZSAT: In respect of the above TPSM issues, the tax authorities give out the following principles: (1) to impose tax on the specific taxpayers in the regions where profits are generated; and (2) to apply the principle of fair and impartial trials. The value chain analysis will also be taken into account.

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?

SZSAT: For companies that have the intention to seek agreement on pre-determined pricing, the tax authorities are willing to accept applications, which can help alleviate contradictions and facilitate the work.

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), a 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?

SZSAT: The above provisions are currently applicable only to domestic financial institutions, and there is no provision to apply the regulations to the interbank interest income of overseas financial institutions.

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?

> SZSAT: According to Circular 13 of 2011, the transfer of all or part of the physical assets and associated claims, liabilities and labour force by taxpayers to other institutions or individuals during the asset restructuring process, by means of merger, separation, sale or replacement does not fall within the scope of VAT and the transfer of goods during the process shall not be subject to VAT.
>
> However, goodwill is not listed under Circular 13, i.e. not exempted under this circular. Therefore the transfer of goodwill, as in the question, is subject to VAT.

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 interest and net settlements paid to foreign enterprises?

> SZSAT: The nature of the business income referred to above is interest income, which should be calculated in accordance with the terms of the loan agreement.

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 whether the compensation encompasses compensation in the form of cash, new homes or equities?

> SZSAT: Complying strictly with the original words of Article 7 of Caishui [2016] No.140, the compensation for demolition and relocation does not take into consideration non-cash compensation such as payments in kind or equity.

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?

> SZSAT: It is advisable to communicate with the competent tax authorities in advance in order to obtain answers before proceeding with a particular case.

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?

SZSAT: At present, strict compliance with Circular 53 stipulates that the taxable income is mainly determined by the difference in the unit price per share after the listing date and date of the lifting of the restriction, regardless of the effect of a simple change in the number of shares (that is, if the stock price does not change); unless otherwise specified by the SAT.

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 doubled). 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 SZSAT?

SZSAT: In strict accordance with the understanding of Circular 53, the impact of changes in the number of shares is not currently considered, and taxable income is mainly determined by the difference in share prices; unless otherwise specified by the SAT.

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. However, the enterprise 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?

> SZSAT: According to the opinions of the tax authorities, whether or not to enjoy the three-half-half-three-half-rate [three-year exemption, three-year half rate??] corporate income tax benefit for the above-mentioned income should be considered from two angles: (1) the nature of the funding, as defined in the contract signed between the government and the enterprise; (2) the enterprise obtains the financial treatment when the funds are booked. If both the contract and the financing are considered to be a kind of financial subsidy, it should not be regarded as the "operating income" under Circular 80, and this kind of understanding will not affect the corporate income tax treatment. If the government pays the service fee to the company in the form of purchasing a service, it falls within “business income” under the Circular 80.

According to article 11 of Circular 32 from 2016, one of the criteria for the recognition of high-tech companies is that the ratio of research and development expenses to sales revenue in the company’s last three years must reach a certain proportion. If the company puts all the above government funds into R&D activities, can the funds be used as R&D expenses in assessing the criteria for high-tech enterprises?

> SZSAT: If the company reduces the cost of the funds when they enter the account, they are not used for R&D, and they cannot enjoy the deduction of R&D expenses. If an enterprise treats the funds as income and it is taxable income, its corresponding R&D expenses can be deducted. These R&D expenses can also be taken in account in meeting the test for a “high-tech enterprise”. If the company uses the funds as a government subsidy, it shall be accounted for in accordance with the non-taxable income, and the R&D expenses related to the funds may not be added or subtracted. As for whether the income can be counted in the calculation of the ratio of R&D expenses to sales of a high-tech enterprise, there is no clear provision in the regulations for the time being. .

2. Tax treatment of QFLP

At present, more and more foreign investors want to invest in China through QFLP (Qualified Foreign Limited Partner), but the relevant tax treatment is not clear. Please consult the SZSAT on the following issues:

Are overseas limited partners subject to income tax treatment on dividend income from QFLP funds? Is the overseas limited partner deemed to be a permanent establishment in China and subject to 25% corporate income tax, or is it subject to a 10% withholding income tax, based on the treatment for the distribution of dividends? How can overseas limited partners make tax returns?

SZSAT: SAT has made it clear, overseas limited partners pay the withholding income tax of 10% in accordance with the treatment on the distribution of dividends; while overseas general partners constitute a permanent establishment in the country, so the calculation is based their business profits, and they pay 25% corporate income tax.

If the withholding tax is levied on the basis of dividends, can overseas limited partners enjoy the preferential treatment of dividend income in the tax treaty?

SZSAT: It depends on the circumstances of the case. There is no definitive answer.

For Carried interest obtained by an overseas general partner, should it be regarded as "remuneration for performance" taxed on the basis of ordinary income or "passive income" (such as dividends)?

SZSAT: The overseas general partner engages in business activities and constitutes a permanent establishment in the country. Its operating profit is calculated and it pays 25% enterprise income tax.

Is there a tax preference policy for QFLP funds in Shenzhen?

SZSAT: No.

3. 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 SZSAT 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?

SZSAT: The statement of the "Tax Analysis of the Thousands of Households Programme" is not from the tax authorities, and the concept officially recognized by the tax authorities is only the "Thousands of Households." Initially, there were 1,069 groups that were short-listed for the “Thousands of Households” nationwide, and they were later adjusted to 1,062.

In 2017, SZSAT managed the registration of corporate names, collected business data, enhanced management and services, and provided diversified services to enterprises. At the macro level, the focus is on large enterprises. The tax authorities have formulated relevant measures to better serve taxpayers. Related measures include:

1. Visit large companies and remind corporate management to pay attention to internal control risks;
2. Set industry risk indicators;
3. Launching different types of events to provide training for corporate management;
4. Conduct internal control investigations and testing to test the effectiveness of the companies’ internal control management;
5. Personalized service.