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

2014

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Preface

The Hong Kong Institute of Certified Public Accountants ("Institute" or "HKICPA") held its annual meeting with the State Administration of Taxation ("SAT") at No.5 Yangfangdian West Road of Haidian District, Beijing on 25 July 2014. Yu Shuchun, Deputy Counsel of the SAT and leaders of relevant Divisions and Offices welcomed the HKICPA delegates. Clement Chan, the president of HKICPA, expressed gratitude to the SAT for taking time to attend this meeting, and shared his belief that it would improve the development of mutual communication between HKICPA and the SAT.

The following is a translation of the meeting notes prepared, in Chinese, by the Institute. Please note that the notes represent the understanding of the Institute's delegates with respect to the responses from the SAT and do not necessarily represent the SAT's official opinion. Therefore, the notes are not intended to be a legally-binding or a definitive interpretation. Professional opinion should be sought before applying the content of these notes to your specific situations. If there are differences in the interpretation between the English and Chinese versions, reference should be made to the Chinese version.

HKICPA wishes to thank the delegate from PwC for taking the meeting notes.

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Attendees

SAT

Yu Shuchun	Deputy Counsel, Hong Kong, Macau and Taiwan Affair Office
Mei Hong	Director, the Second Division, Property and Behaviour Tax Department
Wang Rui	Deputy Researcher, Record and Review Division of Policies and Laws Department
Zhang Ying	Principal Staff Member, Value-added Tax Division of Goods and Services Tax Department
Wu Xiaoqiang	Principal Staff Member, the Second Division, Corporate Income Tax Department
Zhang Jin	Principal Staff Member, Macau and Taiwan Affair Office
Zheng Xiaoyong	Principal Staff Member, Non-Resident Division, Hong Kong, Macau and Taiwan Affair Office
Liu Xiaomeng	Principal Staff Member, Tax Treaty Division, Hong Kong, Macau and Taiwan Affair Office
Zeng Wencong	Principal Staff Member, Anti-Tax Avoidance Division, Hong Kong, Macau and Taiwan Affair Office

HKICPA

Clement Chan	President
Anthony Tam	Deputy Chair, Taxation Faculty Executive Committee and Convenor, Mainland Taxation Subcommittee
William Chan	Member, Taxation Faculty Executive Committee and Mainland Taxation Subcommittee
Daisy Kwun	Member, Mainland Taxation Subcommittee
Mak Ho Sing	Member, Mainland Taxation Subcommittee
Shanice Siu	Member, Mainland Taxation Subcommittee
Michael To	Member, Mainland Taxation Subcommittee
Chris Xing	Member, Mainland Taxation Subcommittee
Yan Hai	Manager, Tax, PricewaterhouseCoopers
Mary Lam	Director, Member Support
Wallace Wong	Manager, Advocacy and Practice Development

Discussions

A. Transformation from BT regime to B2V

A1. Intangible asset

Caishui [2002] No.191 makes it clear that there is a BT exemption for investment in the form of intangible assets or real estate when the investor participates in profits distribution, and jointly bears the investment risks.

After the transformation from B2V, what is the VAT treatment for investment of capital in the form of intangible assets (such as know-how and intellectual property rights)? Would the SAT issue relevant guidance?

> The SAT pointed out that B2V transformation was now in the intermediate stage. During this process, there were still uncertainties for taxpayers and tax authorities on some issues. After the transformation, there should be no difference between the investment of capital in the form of intangible assets and other VAT taxable items. Therefore, VAT should be levied on this arrangement according to the relevant VAT regulations. There would be a difference between this treatment and previous regulations, which allowed such arrangements to be exempted from BT.
>
> Many BT exemption policies would be retained during the B2V transformation, such that VAT exemption would apply to items originally exempted from BT. Nonetheless, there was difference in the taxable scope for BT and VAT. In respect of the VAT on investment of capital in the form of intangible assets and real estate, there was no special regulation.

A2. Circular No.52

The SAT Public Notice [2013] No.52 clarifies the required procedures for applying VAT exemption on cross-border services. Nonetheless, there are still difficulties in practice. For example:

(a) VAT issues on collection and payment on behalf of related companies

For taxpayers providing cross-border services for overseas enterprises with compensation, they may be exempted from VAT only when all income from such services are received from abroad; otherwise, VAT may not be exempted. A common arrangement for services between intra-group companies is that the overseas headquarters pay its regional headquarters in China a fee that is in turn allocated and paid by the regional headquarters to their branches in China, which provide the services. Since it is the branches in China that actually provide the cross-border services, while the regional headquarters in China collects the service fee from the oversees headquarters on behalf of the branches, could such service fee received by the branches in China be exempted from VAT?

> The SAT pointed out that since providing services was different from importing and exporting tangible goods, the administration of the import and export of services was much more difficult than the administration of import and export of goods. This created difficulties in the collection and administration of the

corresponding tax. Therefore, having taken into consideration of advice from all parties, the SAT issued Measure for Administration ("Circular No.52") last year, for the better application of these policies by taxpayers and better execution by tax authorities. Circular No.52 specified the requirements for the administration of tax exemptions on cross-border services. For example, cross-border service contracts should be provided, and all income should be proved to have been received from abroad. These requirements aimed at better determining whether a service could be defined as a cross-border service.

Where not all income was directly received from abroad, the SAT was aware of the situation raised by HKICPA when preparing Circular No.52, i.e., though the service was cross-border in nature, the service fee might not be collected directly from overseas, which would mean that the service did not meet the requirements mentioned in Circular No.52. In addition, there were also other issues pending for discussion. Presently, the SAT was collecting information on the problems encountered in the implementation, and would make further supplementary terms to certain administrative requirements in Circular No.52. All these situations would be taken into consideration in enhancing Circular No.52.

(b) Calculation of VAT on different services in a single contract

When multiple services are agreed in a single contract, among which some services are subject to VAT exemption while others are not, could taxpayers apply for VAT exemption on partial cross-border services covered in that contract?

The SAT pointed out that under such conditions, relevant tax regulations should apply to different services if they could be separately accounted for. In practice, if the contract distinguished the scope of different services, and the services subject to VAT exemption could be separated in accounting, VAT might be exempted on the qualified cross-border services, after the tax authorities had reviewed and approved the record filing application submitted as required.

A3. Circular No.43

Caishui [2014] No.43 ("Circular No.43") points out that the transmission and application services of electronic data and information should belong to taxable services, subject to 6% VAT. This definition seems to include digital services, such as providing music, video or e-book downloading, and on-line games, even, questionably, including cloud computation and storage services. Therefore, the income derived from the above services by Chinese providers should be subject to VAT.

Nonetheless, in practice, the VAT treatment for the foreign service providers is not clear. Should income of the aforesaid services provided by the foreign service providers be subject to VAT? If so, should VAT be withheld by service buyers?

The SAT pointed out that there were two categories of telecommunication services pursuant to Circular No.43, including basic telecommunication services and value-added telecommunication services. Services mentioned in the aforesaid question, such as providing music and video downloading and e-book services, were not

included in telecommunication services so far. These services were more likely to be defined as the provision of a right to use certain properties. The SAT welcomed further discussion over how to determine the nature of these services.

Circular No.43 specially states that taxpayers shall separately account for the service charge, free goods (e.g. mobile phone) and free telecommunication services. This regulation might lead to difficulties in policy interpretation. For instance, when a user signs a telecommunication contract that includes a minimum monthly consumption fee and a free mobile phone, the corresponding problems are:

(a) Calculation of VAT on telecommunication services

Should the total price of the telecommunication service be allocated (at fair value) between the different goods and services, and should different VAT rates be applied on the different components? Or

(b) Whether the market price of the free of charge goods included in telecommunication service should be considered

Except for the VAT on telecommunication service based on the purchasing price, should the free mobile phone given to the service recipient be deemed as sales and subject to VAT calculated based on its fair value?

The SAT pointed out that, as stipulated in Circular No.43, the revenue of telecommunication services and that of selling of goods should be separately accounted when they were provided simultaneously. Exact accounting treatments should depend on actual situations. Tax authorities would not interfere the accounting treatment adopted by the enterprises, but would reserve the right to exercise supervision and to make tax adjustments if the accounting treatments were found to be unreasonable.

A4. VAT exemption on cross-border services

According to Caishui [2013] No.106 and the SAT Public Notice [2013] No.52*, specified types of cross-border services provided by enterprises and individuals within China may be exempted from VAT. Nonetheless, the following questions have yet to be clarified:

(a) Inconsistency between the service recipient and the service beneficiary

In case the service recipient and the service beneficiary are not the same person, would a VAT exemption be applicable? For example, a management and consulting company established within China was engaged by the overseas parent company of a client group to provide management and consulting services to its subsidiaries or related enterprises within China. (The service recipient is the overseas parent but the service beneficiary are the subsidiaries in China.)

* The SAT Public Notice [2013] No.52 has been replaced by the SAT Public Notice [2014] No. 49, with effective from 1 October 2014.

(b) The objects of assurance and consulting services

How to determine whether the objects of assurance and consulting services are physical goods or others? For example, when a professional firm within China, engaged by a foreign enterprise, audits the enterprise's investment entity (a factory) in China, should the factory itself or the relevant financial information of the factory be the object of audit?

(c) How to define the term "physical goods within China"

How to determine the assurance and consulting services being provided for physical goods within China? For example, where a domestic company was engaged by a foreign enterprise to conduct market research, market planning, advertising, etc. for the latter's products and goods to be sold in China, would such products and goods be considered to exist physically within China? Many local tax authorities consider the assurance and consulting services were being provided for products and goods sold in China, or to be imported to China, thus the said services were not qualified for a VAT exemption.

(d) Definition of "assurance and consulting" services

How to define "assurance and consulting services"? Would consulting and management services related to daily finance, taxation, law, IT and human resources, provided by the group's shared service centre, meet the definition of such consulting services? Would the consultancy service provider be required to possess relevant qualifications (from professional consulting institutions)? Would the services be required to be delivered in form of professional reports?

> The SAT pointed out that all aforesaid questions were related to assurance and consulting services. As clarified in the Appendix IV of Circular No.106, assurance and consulting services for goods or real estate within China were not exempted from VAT. Assurance and consulting services were also defined in Notes of taxable items of Circular No.106.

(e) Review of intra-group consulting and management service

Would cross-border consulting and management services between subsidiaries and related enterprises face a more stringent process of review and approval?

> The SAT pointed out that the tax administration on cross-border consulting services would not be more stringent due to the relationships between affiliated enterprises. The administrative requirements for taxable services and tax-free services were consistent, whether the services were between related or unrelated entities. The requirements would not be stricter due to the form or nature of the relevant taxpayer.

(f) Tax exemption on cross-border services and outsourcing services

How to solve the problem of applicability of tax exemption on some cross-border services as well as on outsourcing services? For example, should an enterprise in

China, providing IT support services to a foreign enterprise, be exempted from tax pursuant to the B2V transformation regulations or based on the favourable tax treatment on offshore IT outsourcing services?

The SAT pointed out that taxpayers had the right to apply for a more favourable tax treatment if they were eligible to obtain both the tax exemption on cross-border services and offshore outsourcing services.

A5. Deemed sales on cosmetics samples

Often, in the cosmetics industry, free samples are provided, their packages and volumes being different from the products for sale, and these samples are not for sale. In general, in terms of VAT, such free samples are deemed as goods for sale. How should the taxable income of such free samples be determined? Should it be calculated based on the price estimated according to the ratio of volume between the samples and the products, or calculated based on the mark up on cost pricing method? Samples are provided for customers to try out, aiming at helping them to better understand the products, while such samples value and application are totally different from the products for sale. Therefore, the sales of samples and products should not belong to the same category of goods. According to Article 16 of Detailed Rules for Implementation of Provisional Regulations on Value-Added Tax, should the composite assessable price be used to determine the value of samples, instead of the price calculated based on the ratio of volume between samples and the products?

The SAT confirmed that free cosmetics samples provided to customers should be deemed as goods for sale for VAT purposes. Pursuant to Detailed Rules for Implementation of Provisional Regulations on Value-Added Tax, the tax basis on deemed sales should follow the following three principles: firstly, the sales amount should be determined based on the average price of similar types of goods sold by the taxpayer during the latest period. Though samples were different from the products from the packaging perspective, they were under the same category of products. It should also be noted that VAT was collected on products; secondly, the sales amount should be determined based on the average price of similar types of goods sold by other taxpayers during the latest period; thirdly, the sales amount should be determined pursuant to the composite assessable price. In general, the revenue from the deemed sales should be firstly determined by the taxpayer. During tax filings, if tax authorities considered the price was too high or too low without adequate reasons, tax authorities had the right to adjust the taxable income. In relation to these adjustments, the aforesaid three principles would be applicable. Local tax authorities' practices might differ based on different situations.

A6. VAT exemption on international transportation agency

Caishui [2013] No.106 (Circular No.106) introduces the policies of taxation on the net basis method and the VAT exemption on international transportation agency services. Circular No.106 allows the deduction of transportation fees paid to international transportation enterprises only when calculating the corresponding VAT payable, which implies that this net basis method applies only to international transportation agencies that directly have transactions with international transportation enterprises (such as airlines and shipping companies). Therefore, this preferential policy applies

only to “the principal agent” enterprises, but leaving an additional tax burden on the second agent or the third agent enterprises. Firstly, since the principal agent enterprises are exempted from VAT and VAT invoices cannot be issued, the subsequent transportation agents are unable to claim input VAT from their output VAT; secondly, since the second agent and the third agent do not directly pay international transportation fees to international transportation enterprises (but only pay transportation agency fees to the principal agent), the net basis method does not apply to the VAT calculation for them; thirdly, since the second agent and the third agent enterprises do not directly pay international transportation fees to international transportation enterprises, the transitional policy of VAT exemption does not apply in this case. In light of the aforesaid regulations, the full amount of the income of the second agent and the third agent enterprises will be subject to VAT, while their actual income are only transportation agency income. Therefore, this leads to serious double taxation. Would the SAT issue provisions to reduce the tax burden on “the second agent” and “the third agent” enterprises?

> The SAT has issued the SAT Public Notice [2014] No.42 (Public Notice No.42) to solve this problem. According to Public Notice No.42, VAT could also be exempted on indirect agents providing international transportation agency services. Public Notice No. 42 has been effective since 1 September 2014.

B. CIT

B1. Equity transfer of domestic enterprises by non-resident enterprises

In accordance with Guo Shui Fa [2009] No.3, when a non-resident enterprise transfers a Chinese enterprise (“the target enterprise”)'s equities to the buyer (assuming the buyer is a Chinese resident enterprise), the buyer is the withholding agent for the relevant PRC taxes. If the buyer and the target enterprise are not under the supervision by the same in-charge tax bureau, the in-charge tax bureau of the buyer should have the priority of tax collection. If tax has not been reported to the buyer’s in-charge tax bureau, it should send a letter to the in-charge tax bureau of the target enterprise, which will then be the party to collect tax. Thus, the following issues are to be considered:

(a) Tax settlement issue

Many enterprises reflect that, if CIT is not reported to the buyer’s in-charge tax bureau, the in-charge State Administration of Foreign Exchange (“SAFE”) of the buyer will not allow the buyer to remit the equity transfer consideration. Moreover, in practice, many tax bureaux of the target enterprises also consider that the buyer’s in-charge tax bureau should not enjoy the priority of tax collection. Therefore, the remittance of consideration has usually been delayed due to these debates. Would the SAT consider reaching an agreement on this matter with SAFE?

> The SAT indicated that they were not aware of the situation mentioned above. If it existed, the SAT would communicate with SAFE.

(b) Public Notice No.40

The SAT Public Notice [2013] No.40 ("Public Notice No.40"), in principle, allows remittance of fees before reporting and paying taxes. However, a considerable number of tax bureaux still demand the enterprises to report tax first or reserve a sum equivalent to the tax amount before remittance. Would the SAT consider issuing regulations on this issue?

The SAT pointed out that the procedure requirements have been clearly stated in Public Notice No.40, and also the tax payment receipt was not required to be submitted in the remittance application. Thus, the above mentioned practice was not consistent with the requirements of the Public Notice No.40. As the Public Notice No.40 has clearly stated the requirements, the SAT considered it inappropriate to issue any regulation again. The SAT believed that the situation mentioned above might just be a single incident. If the above-mentioned treatment occurred only in some regions, the SAT might further communicate with those local tax authorities.

(c) Tax exemption treatment under China-HK DTA

When a Hong Kong enterprise applies for the tax exemption treatment for the capital gain under China-HK DTA, should the application be submitted to the in-charge tax authority of the transferee or the in-charge tax authority of the target enterprise in the mainland China? Whether the application could be submitted to any one of the tax authorities if the transaction involves two or more domestic transferees? In addition, as it takes time to apply for the tax exemption, if the application for the tax exemption as instructed by Circular No.124 has already been submitted, should the tax still be required to be withheld and paid within 7 days?

The SAT pointed out that, pursuant to provisions of Guo Shui Fa [2009] No.124 ("Circular No.124"), an enterprise should apply for DTA treatment with the tax authority to which it paid tax according to the tax law. If there were two transferees, the enterprises should submit the application to their respective tax authorities based on the respective transfer proportion. Regarding the application time, the SAT recommended that the applicants applied in advance while pending other procedures once an intention of transfer is reached. The enterprise could communicate with the tax authority in advance and submit the required documents. If application was not submitted in advance, the tax authority would still require the enterprise to withhold and pay relevant taxes within 7 days according to the tax law. That is to say, the withholding agent should withhold and pay the relevant taxes within 7 days if the approval for DTA treatment has not been granted by the tax authority. If, after assessment, the taxpayer could enjoy the DTA treatment, the tax overpaid could then be refunded.

B2. CIT issue on raising funds through hybrid instruments

The SAT Public Notice [2013] No.41 (Public Notice No.41) clarifies that the CIT treatment on qualified hybrid instrument business should be subject to the tax

treatment of a debt investment. Hybrid instrument business which fulfils all of the five conditions prescribed in Public Notice No.41 is deemed to be qualified hybrid instrument business. However, there is still uncertainty between Circular No.41 and the prevailing practice, such as:

(a) How to define the five conditions in Public Notice No.41

How would the five conditions prescribed in Public Notice No.41 be defined? If one of the 5 conditions is not fulfilled, should the return on the hybrid instrument be treated as a dividend? In practice, if the investor would like to avoid being treated as having interest arrangements, and thus, intentionally getting rid of one of the 5 conditions, e.g., not specifying investment terms, or reselling equities to investors, what would the tax treatment be?

The SAT considered that whether an investment was a debt investment or an equity investment should depend on the actual situation, and failure to meet one of the 5 conditions would not affect the overall judgment of the investment nature. For the definition of debt investment, reference could also be made to the specific explanation in Article 119 of Regulation on the Implementation of the CIT Law.

(b) Cross-border investment

Whether Public Notice No.41 is applicable to cross-border investment? What if DTA treatment could be applied to the transaction?

The SAT pointed out that enterprises mentioned in the Public Notice No. 41 referred to those enterprises covered under the CIT law, which, in principle, applied to cross-border investments. When DTA treatment was applied, the nature of the income derived by the non-resident enterprises would continue to be defined pursuant to Public Notice No.41. There was no conflict with the definition of "interest" in the DTA.

B3. CIT issue on share incentive mechanisms

The SAT Public Notice [2012] No.18 ("Public Notice No.18") clarifies the CIT treatment on share incentive plans. Circular No.18 is applicable to share incentive plans established by domestic listed resident enterprises for their employees. We would ask the SAT to further consider and clarify the following treatments:

(a) Tax deduction issue concerning the payment of equity expenses to domestic listed companies

Regarding the share incentive plan of a PRC listed company for the employees of its Chinese subsidiaries, if relevant charges are collected from subsidiaries, could the subsidiaries claim the tax deduction according to Public Notice No.18 if certain criteria are fulfilled? If possible, can the SAT list out those criteria? (Note: under the Hong Kong tax law, if listed companies collect relevant charges from its subsidiaries, the subsidiaries can claim tax deduction if certain criteria are fulfilled,

e.g., the parent company is required to issue or to purchase its own shares in public market for the employees of the subsidiaries, and the charges collected from the subsidiaries should not deviate from the market price.)

The SAT pointed out that the equities mentioned in Public Notice No.18 were the listed companies' shares and the incentive target should be employees of these listed companies. The SAT understood that there were situations in which the listed companies were overseas and the employees were with the domestic subsidiaries. However, these did not comply with the conditions of Public Notice No.18 therefore Public Notice No.18 was not applicable in these cases.

(b) Tax deduction issue concerning the payment of equity expenses to overseas listed companies

Similarly, for the share incentive plan of an overseas listed company for the employees of Chinese subsidiaries, if the relevant charges are collected from Chinese subsidiaries, would the Chinese subsidiaries be allowed to claim the tax deduction, provided certain conditions were fulfilled (such as conditions referred in Part (a))?

The SAT pointed out that, based on the above reasons, Public Notice No.18 was not applicable in cases where the overseas companies collected relevant expenses from domestic subsidiaries concerning the share incentive plan for the employees of Chinese subsidiaries. The SAT would further study these cases.

The SAT would also like to understand the tax position of the Hong Kong Inland Revenue Department ("IRD") on share incentive plans. HKICPA agreed to further provide the relevant Hong Kong tax policies for the SAT's reference.

B4. Deduction of employees' IIT borne by enterprises

Employees' IIT borne by enterprises is in effect part of the employee's salary, which should be included in an individual's salary and subject to IIT. It should also be deductible from the enterprise's CIT taxable income.

In accordance with Article 3 of Guo Shui Han [2005] No. 715, employees' IIT borne by CIT payers, individual proprietorships and partnership enterprises, individual industrial and commercial households, should not be deducted. Some local tax authorities do not allow claims of CIT deduction for these expenses according to this regulation. Which CIT treatment should be applied? We agree with the above deduction principle, which most enterprises and tax authorities have been following.

The SAT pointed out that, according to provisions in Article 8 of the Individual Income Tax Law, individuals who received the salary income should be the IIT taxpayer and the employer who paid the salary should be the withholding agent. The IIT which should have been withheld, but which was not and so was borne by enterprises, should therefore not be deducted from CIT. However, if the IIT borne by enterprises (which has been grossed up to the salary) was part of the enterprise's salary cost, it could be deducted as the salary cost when computing CIT. For example, the enterprise paid a salary of RMB1,000 and withheld the IIT of RMB 200.

The salary amount received by the employee should be RMB800. As the salary of RMB1,000 paid by the enterprise was borne by the enterprise, it should be deductible. The IIT amount of RMB200 should not be deducted again, meaning that the CIT deduction base should not be RMB1,200.

B5. Income tax treatment of partnership enterprises

Regarding the partnership enterprises whose partners are legal entities, are there any new regulations clarifying the relevant CIT polices?

(a) Tax exemption policy on dividends

Where Chinese corporate partners of a partnership receive dividends from investments made by the partnership, would the tax exemption treatment be applicable? (If the tax treatment principle is consistent with that of IIT, we consider it should be exempted).

(b) Taxation on overseas corporate partners

Regarding the tax issues for overseas corporate partners (e.g., whether the overseas corporate partners would be considered as having a permanent establishment in China, the applicable tax rate, etc.), would the SAT issue circulars to further clarify the position?

In accordance with Cai Shui [2008] No.159, if the partners of the partnership entity are corporate partners, they should report CIT on their respective taxable income. If the partners are natural persons, they should report IIT. The principle of taxation for partnership entities was, firstly, to allocate the partnership income, and then for the partners to report the respective income and pay tax accordingly. However, the specific taxation measures were still under study by the SAT.

B6. Interest paid for borrowing money from non-financial enterprises and individuals

(a) How to interpret the financial institutions' lending rates for the same type of loans offered during the same period?

In accordance with the CIT Law, interest expenses for loans borrowed by a non-financial enterprise from another non-financial enterprise should not exceed the amount as calculated based on the interest rates charged by financial institutions for the same type of loans during the same period. In accordance with Guo Shui Han [2009] No.777, interest expenses on loans borrowed by an enterprise from natural persons, which do not exceed the amount calculated based on the above principle, are allowed to be deducted. However, since the floating interest rates in a variety of financial institutions are inconsistent, how should the deductibility of the interest expenses be calculated?

The SAT pointed out that, in accordance with the requirements of the People's Bank of China on the market-oriented interest rate, the ceiling of deposit interest

rates and the floor of loan interest rates have been set. In accordance with the SAT Public Notice [2011] No.34, the interest rates for the same type of loans during the same period could be the average interest rates announced by the financial institutions or their average interest rates on loans provided to a group of similar enterprises. As long as the enterprise could provide supporting documents, the tax authority would usually allow the CIT deduction of the interest expenses.

(b) Thin capitalization

When an enterprise pays interest to Chinese banks under the guarantee of an overseas related company, the bank loans are treated as loans from the related company. Would the interest expenses exceeding the prescribed ratio (related party debt over equity) be allowed to be deducted?

The SAT considered that the deductibility of interest expenses should comply with Article 46 of the CIT Law and Article 119 of the Implementation of the CIT Law.

In addition, according to the CIT Law, for intra-group loan arrangements, unless it can be proved that the loan is in line with the arm's length principle, the interest exceeding the prescribed ceiling is not allowed to be deducted under the thin capitalization rule. However, the interest rate under arm's length principle could sometimes be higher than the financial institutions' interest rate for the same type of loans offered during the same period. What would the tax treatment be under such case?

In general, reasonable expenses related to taxable income were allowed to be deducted, while the interest paid to financial institutions could be deemed as qualified reasonable expenses, in principle, as the interest arose from loans to non-related parties. For loans from related companies, if the enterprises could prove that equivalent independent arrangements could be achieved, the interest would be allowed to be deducted.

(c) Valid supporting documents for the CIT deduction of interest expenses

Regarding the interest expenses for the loans borrowed by an enterprise from a non-financial enterprise or an individual, are tax invoices issued by local tax bureaux required to secure the deductibility of the interest expenses? For interest expenses paid on loans borrowed from an individual, is the receipt for withholding IIT required to claim the tax deduction?

The SAT pointed out that, according to Article 19 of Invoice Management Measure, companies and individuals engaged in the sale of goods, provision of services and other business activities, should issue invoices to the payers when collecting payments. Under certain circumstances, payers could issue invoices to payees. However, the situation mentioned in the above question was not included in those special circumstances. When financial enterprises lent funds to other entities, they could apply and issue invoices in accordance with Article 15

and Article 16 of the Invoice Management Measure. When enterprises borrowed funds from other parties, invoices received could be the supporting documents to secure the tax deduction. For the interest received by an individual, since IIT would generally be imposed by the local tax bureaux when the individual applied for invoices, the enterprise paying interest to the individual was not required to withhold IIT for this individual.

C. Cross-border taxation

C1. Tax treatment for the corporate M&As

Opinions of the State Council on Further Optimizing the Market Environment for the M&A of Enterprises (Guo Fa [2014] No. 14) requires improving policies for CIT and Land Value-Added Tax, and implementing policies for Value Added Tax and Business Tax. Please advise the current progress of the development of these policies, especially the development in respect of the special tax treatment under CIT. We wonder whether pure intra-group restructuring would be included in the scope of special tax treatment where the commercial purpose is reasonable and sufficient.

The SAT pointed out that Guo Fa [2014] No.14 was released for the purpose of promoting corporate M&As, and optimizing market resource allocation, which were encouraged by the State. Currently, the SAT was studying Cai Shui [2009] No.59 (Circular No. 59) and the SAT Public Notice [2010] No.4 (Public Notice No. 4) for further improvement. Since the process involved both SAT and the Ministry of Finance ("MOF"), the publication timeline was still to be decided.

C2. Determination of the beneficial owner

The SAT Public Notice [2012] No.30 (Public Notice No.30) further clarifies the standards when determining the beneficial owner mentioned in tax treaties between China and other countries/ regions, and introduces the safe harbour rules for listed companies.

According to the Public Notice No. 30, for the share holding structure where a Hong Kong listed company indirectly controls a Chinese subsidiary through a British Virgin Islands ("BVI") company, could the BVI company apply for the safe harbour rules if it could obtain the Hong Kong tax resident certificate? In practice, some Hong Kong listed companies have a lot of difficulties when they apply for the certificate for their BVI subsidiaries. In such case, would the SAT have any recommendation?

The SAT considered the safe harbour rules were not applicable to the above-mentioned situation. The rules applied only to the situation where the holding companies of the Chinese subsidiaries were in the same countries or regions (e.g., they were both Hong Kong companies). The Shuizonghan [2013] No.165 specified the SAT's basic principle in determining the above issue. Although it was only a reply to a number of provinces, it served as a good reference.

In the application, the BVI company should apply for DTA treatment as a Hong Kong resident, based on its place of actual management in Hong Kong. The application process and requirements were consistent with those general

applications for DTA treatment.

Hong Kong companies were required to obtain a referral letter issued by the Chinese tax authority to apply for the Hong Kong tax resident certificate from IRD. This was a rule formulated through negotiation between the two tax authorities, which had fully taken into account the IRD's workload. Regarding the above question, which mentioned Hong Kong companies usually had difficulties in applying for the referral letter, the SAT pointed out that the Chinese tax authority would consider issuing the referral letter only when the Hong Kong company applied to enjoy DTA treatment. In addition, if the Chinese tax authority considered that a company was not qualified to enjoy DTA treatment, it could refuse to issue a referral letter.

(HKICPA note: Shuizonghan [2013] No.165 also mentions that where an overseas registered company (e.g., a BVI company) is interposed between the applicant and the ultimate listed company and has been accredited as Hong Kong resident, this would not have a negative impact on the listed company's ability to enjoy the safe harbour rules.

In addition, the taxpayer has no chance to apply for the relevant DTA treatment if the Chinese tax authority considers that the taxpayer is not qualified to enjoy DTA treatment and refuses to issue a referral letter. The HKICPA considers that the Chinese tax authority should still issue referral letters to taxpayers to apply for a Hong Kong tax resident certificate from IRD, in case the taxpayer would like to apply for DTA treatment in the future; whether or not the taxpayer could enjoy the relevant treatment is a separate matter.)

C3. Whether the transfer of property and land use rights fall into the taxable scope of LAT and BT

Would the transfer of property and land use rights because of the splitting off of an enterprise be included in the taxable scope of LAT and BT? Would there be any regulation to clarify such issues?

The SAT pointed out that, according to the SAT Public Notice [2011] No. 51, when taxpayers transfer all or part of physical assets and the relevant rights, debts and labour force to other enterprises or individuals by ways of merger, split-off, disposal and exchange, etc. during restructuring, BT was not applicable and the transfer of property and land use rights would not be subject to BT.

LAT provisions had no specific regulation on the transfer of property and land use rights during a split-off exercise. However, the SAT tended to levy LAT under such situations, based on the following reasons:

- When the original company transferred property and land to the newly split-off company, this transfer was treated as the property transfer between different legal entities.

- The income earned in transferring land-use rights, not only included the income from transferring land and real property, but also included intangible assets and other forms of economic benefit.

- Pursuant to the Company Law, Enterprise Law and financial requirements, financial assessment was required to be performed when a company was split up, which might have added value to the part being split off during this transaction, i.e., value might have been added by the splitting up.

Based on the above three points, the above transfers were considered to fall into the taxable scope of LAT under the circumstances where ownership had been transferred, revenue realised (for intangible assets) and incremental value had been identified. Since the relevant formal regulations had not been issued yet, this issue was still under study by the SAT.

C4. Circular Guo Shui Han [2009] No.698

(a) Supplementary regulations

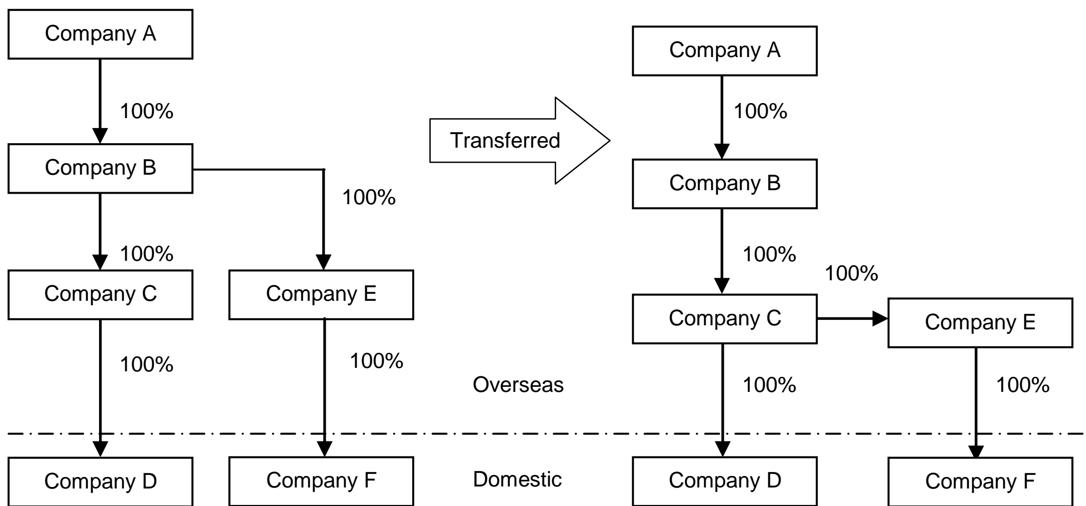
Whether and, if so, when, the supplementary regulations of Guo Shui Han [2009] No.698 ("Circular No.698") would be issued? Would the special tax treatment be applied to the overseas intra-group restructuring which involved the indirect transfer of China resident enterprises?

The SAT had completed the draft of the supplementary regulations of Circular No. 698. Currently, the draft was under review among relevant departments of the SAT. The promulgation timeframe had not yet been decided, but the supplementary regulations would likely be issued by the end of 2014.

As for the restructuring issues, the SAT [2013] No.72 (Circular No.72) raised some procedural requirements in relation to Article 7 of Circular No.59. Under Article 1 of Circular No.72, if an overseas restructuring changed the holding structure of the Chinese resident enterprise, whether special tax treatment could be applied would depend on whether it could fulfil the relevant requirements under Circular No.59. However, in the supplementary regulations of Circular No.698, the SAT might also try to list out the safe harbour rules for intra-group restructurings.

(b) Whether indirect transfer applies to special tax treatment

Illustration as below: Company B transfers Company E's equity to Company C, which involves the indirect transfer of Chinese resident Company F's equity. Since Company E is a shell company, the tax authority considers that Company B is transferring Company F's equity in substance. Would Company B fulfil the criteria of the special tax treatment, i.e., a non-resident enterprise transfers the shares of a resident enterprise to its 100% directly owned non-resident enterprise?



The SAT pointed out that special tax treatment was not applicable in the above case.

D. Stock

D1. QFII and RQFII

(a) CIT issue

Would the capital gains derived by QFII and RQFII from trading the A-shares and listed bonds in China be subject to CIT? Would the CIT treatments of QFII and RQFII vary depending on their different legal forms, such as company, trust or partnership?

The SAT pointed out that, under Clause 3 of Article 7 of Implementation Regulations of the CIT, in theory, if the A-share trading income was sourced from China, it should be subject to CIT, based on the principle that the source of income should be determined by the location of the investee enterprise. Considering that the QFII situation was unique, currently there was no specific regulation on whether it should be subject to tax or not, but it should not be tax exempted. Relevant tax policies were being drafted.

(b) Tax treaty

If capital gains from A-share trading of QFII and RQFII are subject to CIT, would the tax treaty between their countries/ regions of incorporation and China be applicable?

Currently, the legal forms of QFII or RQFII had not been given specific consideration by the SAT. QFII or RQFII could apply for DTA treatment as long as they could obtain the relevant tax resident certificates.

(c) Retroactive principle

If capital gains from A-share trading of QFII and RQFII are subject to CIT, would corresponding tax liabilities be retroactive to 2008, when the new CIT law came into effect, or would it be subject to the statutory limitation of 5 years according to the China Tax Administration Law?

The SAT pointed out that Article 52 of Law of the People's Republic of China on the Administration of Tax Collection should be referred to regarding the retroactive period of tax collection.

(d) Offsetting loss against gain

Could the loss be offset against the gain when calculating the CIT for A-share trading of QFII and RQFII?

The SAT had conducted several meetings with MOF and China Securities Regulatory Commission ("CSRC") regarding treatment on QFII and RQFII, and was also aware what concerned enterprises most was the tax treatment of QFII and RQFII. The SAT and MOF had performed studies before, but had not come to any conclusions on how to calculate the taxable income. Now the SAT was proactively following up and hoped to issue a clear instruction as soon as possible.

D2. Shanghai-Hong Kong Stock Connect

(a) Latest development

CSRC officially approved the pilot programme of the Shanghai-Hong Kong Stock Connect on 10 April 2014 and it will take 6-months' time for preparation before the programme is formally launched. Regarding this development, would there be any new policies, in terms of tax regulations, administration and management of the tax collection system and measures? Could the tax policy of QFII and RQFII be referred to?

(b) CIT issue

How would CIT be imposed on income obtained from the transfer of A-share by Hong Kong and other foreign institutional investors through the programme?

(c) Tax treatment of A-share investment by individuals

Could Hong Kong and other foreign individual investors, which derive capital gains from trading A-share through the programme, enjoy preferential treatments, like the IIT exemption for Chinese investors on transferring A-shares, as stipulated in Cai Shui Zi [1998] No.61, and the BT exemption for individuals engaging in the financial commodity trading business, as stipulated in Cai Shui [2009] No.111? What is the tax treatment of the A-share dividend income? For securities acquired through the programme from foreign investors in the name of Hong Kong Securities Clearing Co. Ltd. ("HKSCC"), could the CIT treatment for stock

bonuses received by QFII refer to the treatment stipulated in Guo Shui Han [2009] No.47?

The SAT indicated that issues relating to the programme were under discussion with CSRC and MOF. Also, the programme's tax administration was comparatively complicated. HKSCC, as the nominal holder, did not distinguish individuals from enterprises for registration and settlement purposes. The SAT had initially communicated with CSRC and would communicate with MOF at a later stage. The SAT was also considering whether to stay in line with the relevant policies of QFII from a fairness perspective. The policy and administrative procedures of the programme would be reported to and finally approved by the State Council.

E. Tax treaty

E1. The effective date of tax treaty

China, France, Germany, Netherlands, etc. have recently updated their DTAs respectively. These DTAs should take effect upon the completion of the corresponding legislative and diplomatic procedures. Therefore, would the dividend clauses of the new DTA or the prevailing DTA be referred to for dividend income that has been declared but has not been actually paid to foreign investors (assuming the dividend is expected to be remitted after the new DTA has taken effect)?

The SAT pointed out that, under Implementation Regulations of the CIT Law, dividends should be taxable in the period of their distribution date. Therefore, which DTA (i.e., the new or the old) should be applicable depended on when the dividend distribution was declared. However, the prevailing DTA was still applicable for dividends that had been declared for distribution but had not been actually remitted to foreign investors. Moreover, the tax treaty between China and Netherlands would take effect from 31 August 2014 and would be implemented from 1 January 2015. The SAT would issue a relevant circular in the near future.

For example, the new DTA between China and UK took effect on 13 December 2013. For profit generated by Chinese enterprises before 2014 but distributed to British investors after 1 January 2014, would the 5% favourable withholding tax rate be applicable?

The SAT pointed out that although some wording in the new DTA between China and UK had changed, the principle had not changed, and the time when the income was realised would still be decided by the time when the dividend distribution was declared. If the dividend distribution was declared after the implementation of the new DTA, the new DTA should be applied.

F. IIT

F1. The policy of introducing special tax treatment to IIT

Group restructuring is usually required before an enterprise goes public, which often requires the original individual shareholder to inject his/ her domestic equity into a to-be-listed enterprise. This restructuring arrangement may result in paying IIT because of the property transfer. Currently, there is no IIT policy similar to the special tax treatment for corporate restructuring income, as stipulated in Circular No. 59. We understand the State encourages the development of both state-owned and private enterprises to improve their international market competitiveness. Lack of policies on IIT deferral on business restructuring would weaken the private enterprises' financing capability. Please advise whether the special tax treatment would be introduced in the IIT policy.

The SAT pointed out that the above suggestion would be considered in improving the relevant policies of corporate restructuring, but standardized regulations for IIT were currently not being considered.

G. Others

G1. The deductibility of royalty expenses

According to the relevant tax law, if reasonable royalty expenses are paid to overseas enterprises and the corresponding tax liability has been reported in China, the royalty fees are allowed to be deducted. Regarding royalty expenses agreed in the contract but which have not been actually paid, even though they are booked as expenses, if the relevant tax has not been withheld, they should be added back when computing CIT. However, if the enterprise has paid the royalty fees and withheld the relevant tax in subsequent years, would the expenses be allowed to be deducted? If yes, whether the deduction of the expenses should be dated back to the year as agreed in the contract or the year in which the royalty fee is actually paid and the tax is withheld?

The SAT pointed out that, according to Article 6 of the SAT Public Notice [2012] No.15, for expenses incurred in prior years that should have been deducted according to the relevant tax regulations, but which had not been deducted or not deducted in the full amount, they could be deducted in the year when the expenses were incurred, provided that the enterprise made a special report to the in-charge tax authority. In practice, entities should comply with the principle of the accrual basis. Also, the requirements of the Tax Collection and Administration Law should be taken into account, e.g., the retroactive period was 5 years.

G2. Application of certain tax regulations throughout the nation

Are the supplementary replies to specific provinces regarding some tax treatments issued by the SAT applicable to other provinces? In practice, we still apply them when dealing with some tax issues.

The SAT pointed out that if the supplementary notice was a reply to a specific province, taxpayers firstly needed to understand the explanation of the SAT and the

nature of the policy. If the policy was a special one (such as western region development policy), it was absolutely not applicable in other regions. If it was a policy with general applicability, though it was only a reply to specific provinces, it should be applicable to other regions under the same conditions.

G3. SD issues

All enterprises and individuals who execute or receive documents in the categories specified in the Interim Regulations on Stamp Duty ("SD") in China should be the SD taxpayer. Regarding the purchase and sales contracts signed by domestic enterprises and overseas companies,

(a) Whether the overseas companies would be required to pay SD in China?

(b) How overseas companies could report and pay the SD?

Since the overseas companies have not established institutions in China nor performed tax registration in China, how should they report and pay the SD in China?

The SAT pointed out that, Decision of the Standing Committee of the National People's Congress Concerning the Application of Interim Regulations on Such Taxes as Value-added Tax, Consumption Tax and BT to Enterprises with Foreign Investment and Foreign Enterprises (“Decision”) was adopted at the Fifth Meeting of the Standing Committee of the National People's Congress in 1993. According to the Decision, foreign enterprises referred to foreign companies, enterprises and other economic organizations which have set up institutions in China for business operations, or although they had not established any institution, they had income sourced from China. Guo Fa [1994] No.10 also clarified that the Interim Regulations on Stamp Duty (“Regulations”) was applicable to foreign enterprises. The Regulations made it clear that enterprises and individuals who executed or received documents in the categories specified in the Regulations in China, should be SD taxpayers. According to the implementation rules of the Regulations, enterprises and individuals referred to domestic enterprises and government agencies and organizations, including Chinese-foreign joint ventures, Chinese-foreign contractual joint ventures, foreign-capital enterprises and foreign enterprises. Foreign enterprises in China referred to foreign companies and enterprises that had set up institutions in mainland China for business operations. If a foreign enterprise had not established any institutions in China, it was not a Chinese SD taxpayer and was not required to pay SD in China. Institutions and places mentioned in the SD regulations referred to entities that were registered according to the China regulation of Administration of Industry and Commerce, which were different from the institutions and places defined in the CIT Law, or the permanent establishments defined in the DTAs.

Hong Kong Institute of Certified Public Accountants

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