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

2016

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 in Beijing on 29 July 2016. Yu Shuchun, Deputy Counsel of the SAT and leaders of relevant Divisions and Offices welcomed the HKICPA delegates. Mabel Chan, the vice president of the HKICPA, expressed gratitude to the SAT for taking time to attend the meeting and expressed her view that the meeting would help strengthen the development of communication between the HKICPA and the SAT.

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

HKICPA would also like to express thanks to PwC for providing a representative to take the notes at the meeting.

Meeting notes

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Attendees

SAT

Yu Shuchun	Deputy Counsel, International Taxation Department
Zeng Yuqin	Deputy Director, Policies and Laws Department
Zhang Ying	Deputy Director, Value-added Tax Division of Goods and Services Tax Department
Li Xiaotong	Principal Staff Member, the Second Division, Income Tax Department
Ren Yu	Deputy Director, Individual Income Tax Division, Income Tax Department
Wang Tao	Deputy Director, Tax Collection Technology Administration Department
Zhang Jin	Principal Staff Member, Tax Treaty Division, International Taxation Department
Li Jingyu	Principal Staff Member, Anti-Tax Avoidance Division, International Taxation Department
Zeng Wencong	Principal Staff Member, Non-Resident Division, International Taxation Department
Xu Yuncheng	Deputy Director, Overseas Tax Division, International Taxation Department
Chen Feng	Principal Staff Member, Hong Kong, Macau and Taiwan Affair Office

HKICPA

Mabel Chan	Vice President
Anthony Tam	Chairman, Taxation Faculty Executive Committee and Convenor, Mainland Taxation Subcommittee
So Kwok Kay	Deputy Chairman, Taxation Faculty Executive Committee and Member, Mainland Taxation Subcommittee
William Chan	Member, Taxation Faculty Executive Committee and Mainland Taxation Subcommittee
Li Wen Huan	Member, Mainland Taxation Subcommittee
Mak Ho Sing	Member, Mainland Taxation Subcommittee
Shanice Siu	Member, Mainland Taxation Subcommittee
To Tat Wang	Member, Mainland Taxation Subcommittee
Travis Lee	Tax Senior Manager, KPMG
Yan Hai	Tax Senior Manager, PricewaterhouseCoopers Consultants (Shenzhen) Limited, Beijing Branch
Eric Chiang	Deputy Director, Advocacy and Practice Development
Wallace Wong	Manager, Advocacy and Practice Development

Summary of Discussion

A. Corporate income tax ("CIT")

A1. SAT Public Notice [2015] No. 7 ("PN7")

(a) Dividing the taxable properties

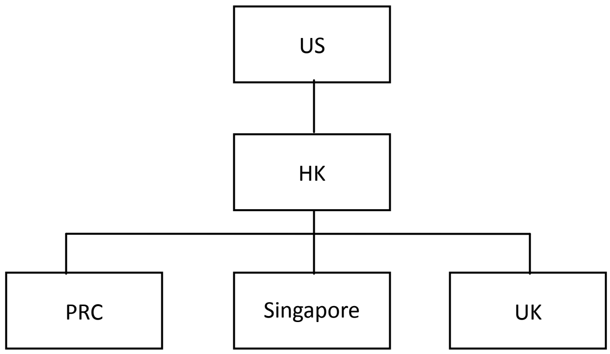
Tax treatment of income from indirect transfer of taxable properties in China is governed by Article 2 of PN7.

There are cases where the foreign holding companies are holding China properties and non-China properties and debts. Under these circumstances, both China and non-China properties and debts would be taken into account when calculating the consideration for the equity transfer transaction. How should the taxpayers calculate the amount attributable to the China properties from the consideration? We understand that taxpayers are facing practical difficulties in agreeing the amount with the tax authorities. We would like to seek your guidance on the same.

SAT: PN7 was issued in 2015 and based on Article 47 of "Corporate income tax law" ("CITL") and Article 120 of "Corporate income tax law implementation rules". One should also refer to Article 47 of CITL and Article 120 of the rules when inferring the provisions in PN7. If there is a lack of commercial justification, the sole and dominant purposes is to minimize the tax liability or defer tax payment in an indirect transfer of China taxable property, tax adjustments on the transaction should be made on a reasonable basis. In practice, bundled asset disposals could be cross-border arrangements; or the assets could spread over different cities in China. Each indirect transfer may have its unique features. Hence, the tax authorities would handle the indirect transfers on a case-by-case basis.

Enterprises should avoid disposing of properties on a bundled basis. It is preferable for enterprises to transfer assets item by item.

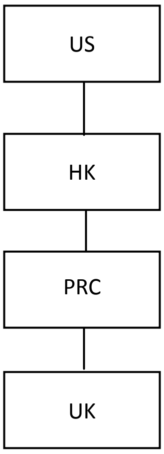
Example 1:



Q: Revenue distribution of the group is: China: 70%, Singapore: 20%, UK: 10%. However, asset distribution of the group is: China: 50%, Singapore: 20%, UK: 30%. What should be the basis for calculating the amount attributable to the China assets?

SAT: In general, the tax authorities would determine the transfer price of the assets based on all factors instead of one single factor. For example, the tax authorities may make reference to the assets and income of the enterprises. They may use certain ratio or weighted average in calculating the transfer price. Enterprises may engage professional valuation companies to evaluate what is the appropriate value for the transfer. Such valuation reports would serve as a useful reference for the tax authorities.

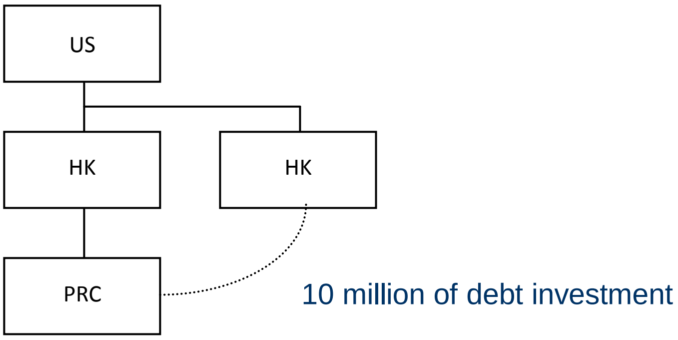
Example 2:



Q: Will the UK company be considered as a China taxable property?

SAT: If the above case falls within the scope of PN7, the transfer would be deemed to be direct transfer of assets of the Chinese company by the U.S. company. Accordingly, the foreign investments of this China company (i.e., the U.K. subsidiary in this case) would also be treated as a China taxable property.

Example 3:



Q: Can the taxpayer deduct the debt investment in the Chinese entity from the value of the China revenue?

SAT: This is a complicated issue. We cannot come to a conclusion on whether the debt investment can be deducted from the China revenue without going through a detailed case analysis. For example, if the seller sold the equity interest in the Chinese company together with the debt investment, the debt investment should be deducted from the China revenue. However, if the seller only sold the shareholding in the China company but not the debt investment, the debt investment should not be deducted from the China revenue.

(b) What are "reasonable commercial purposes" for the indirect transfer between non-resident enterprises under Article 3 of PN7?

We should use a holistic approach by taking into account all relevant facts and circumstances in determining whether there are reasonable commercial purposes for the indirect transfer. Relevant factors could briefly be summarized as follows:

(1) Is the value of the overseas company mainly attributable directly or indirectly to the taxable properties in China?
(2) Is the asset base of the overseas company mainly composed of investments in China, either directly or indirectly? Does the revenue of the overseas company mainly come from the territory of China, either directly or indirectly?
(3) Does the overseas company or the intermediate holding company which holds taxable properties in China assume any real functions or risks? Is there any evidence to support the contention that there is real economic substance in the holding structure?
(4) What is the duration of the shareholdings, business model of the overseas company and related organizational structure?
(5) Does the group need to pay any income tax on the indirect transfer of China taxable properties outside China? If yes, how much?
(6) Can the indirect transfer of China taxable property be substituted by direct transfer from the perspective of China taxable property vendor?
(7) What is the applicability of tax treaty provisions on the indirect transfer of taxable properties in China?
(8) Other relevant factors

i. Application of items 1 & 2 of Article 3

How should we infer "value of the shares of the overseas company is mainly derived directly or indirectly from taxable properties in China" as stipulated in item 1 of Article 3? Should the taxpayers provide the tax authorities with share valuation reports issued by relevant authorities for their reference? Do the tax authorities use other standards in interpreting this provision in PN7?

SAT: There is no specific guideline for determining whether the "value of the shares of the overseas company is mainly derived directly or indirectly from taxable properties in China ". We need to have a thorough analysis on all circumstantial factors before coming to a conclusion. Enterprises can engage valuation companies to evaluate the value of the share being transferred. However, it is not a mandatory requirement under PN7 for taxpayers to submit such report to the tax authorities. It is worth nothing that the tax authorities would not just rely on the valuation report to determine the value of the shareholding being transferred. In fact, the tax authorities would also review the overall situation of the enterprises, capital and equity investment structures and cash positions of the enterprises before they draw any conclusions.

How should we infer "whether the assets of the overseas company are mainly composed of investments in China directly or indirectly or whether its income is mainly derived from China directly or indirectly" as stipulated in item 2 of Article 3?

Could you please define "mainly" as mentioned in items 1 & 2 of Article 3? Should we adopt 50% as the threshold? Can we use shareholders' value indicated in the audited financial statements as the "value of the share of the overseas company" stipulated in item 1 of Article 3?

SAT: In general, we extract figures from the consolidated financial statements of the overseas holding companies in calculating the revenue and asset ratios. However, in practice, we need evidence to determine whether there

are any related party transactions. Therefore, we may also need to analyze the related party transactions in calculating the ratios.

We would like to make use of the following example to illustrate the implications of the using different basis in calculating the parameters for items 1&2 of Article 3. In this example, an overseas holding company holds the equity interests in subsidiary companies in different jurisdictions as shown below:

	China subsidiary	Singapore subsidiary	US subsidiary	Consolidated adjustment	Consolidated accounting value
Assessment factors, e.g., income	1,000	900	300	(100)	2,200

China subsidiary accounts for 45% of the consolidated income, i.e., 1,000 / 2,200 (related party transactions and accounting adjustments are not taken into account in this example)

a. Do you agree with the above calculation?
b. Can we conclude that income of the overseas parent company in the above example is not mainly derived from China?

SAT: There is no clear guideline for assessing the constitutional criterion whether "the income of the overseas parent company is mainly derived from subsidiaries in China". Therefore, the figure of 50% is not a definitive benchmark for "mainly derived from subsidiaries in China" but it is not unreasonable to use 50% as a reference point in most cases. In general, we need to conclude if income of the overseas parent company is "mainly derived from subsidiaries in China" on a case-by-case basis. Besides, there is no single basis for calculating (income from subsidiaries in China) / (overall income of the overseas parent company) ratio. We need to review details of the operations of the group in coming up with the best calculation formula for the said ratio.

ii. Item 4 of Article 3

How do we measure the "duration" in "duration of shareholdings, business model of overseas company and related organizational structure" as stipulated in item 4 of Article 3?

SAT: There is not any standard method in quantifying "duration" in "duration of shareholdings, business model of overseas company and related organizational structure". That the current organizational structure has existed for a long time does not necessarily mean that it is advantageous for the enterprises. However, if the existing organizational structure has only been used for a very short period of time, the enterprises would be in a relatively disadvantageous position.

iii. Item 6 of Article 3

We are of the view that substitutability in item 6 of Article 3 should not be interpreted superficially. We should take the following factors into consideration for the substitutability:

- Is there any inter-relationship between the manufacturing entities within the group?
- What is the cost of acquisition?
- Is the acquisition considered as timely and efficient?

Do you agree with our point of view? For example, Group A is about to acquire Group B. Group B has subsidiaries in different countries, which assume different manufacturing and operational functions. In theory, Group A can acquire subsidiaries of Group B in different countries one by one. However, Group A will not execute this acquisition scheme from a business efficiency and practicality point of view. Therefore, we are of the view that "substitutability" is not applicable to this case. Do you agree?

SAT: Before setting up companies in tax haven countries, one would generally consider local tax rules and actual execution status, business friendliness for foreign investors, integrity of the regulatory framework and actual execution status. Therefore, it would be easier for you to have a good understanding of the "substitutability" if you have a thorough understanding of Article 47 of the CITL. Tax authorities would tend to view the indirect transfer cases from a tax angle. Unless there are reasonable commercial purposes for the indirect transfer, e.g., enterprises can fulfil the safe harbour conditions stipulated in PN7or internal group re-organization, the tax authorities would examine whether tax avoidance is the main driving force for the indirect transfer. However, enterprises would look at the commercial elements of the transactions when talking about "substitutability". Therefore, there is a clear difference in the focus between the tax authorities and the enterprises in the "substitutability" context.

iv. Item 2 of Article 4

Referring to the test that "90% or more of total assets (excluding cash) of the overseas company is directly or indirectly composed of investments in China at any point of time within one year before the indirect transfer of taxable properties in China; or 90% or more of the revenue of the overseas company in the year before the indirect transfer of taxable properties in China is derived from China directly or indirectly", as stipulated in item 2 of Article 4, is it the case that if either the asset test or the revenue test satisfied, the said provision in PN7 would be applicable?

SAT: The said provision in PN7 would be applicable if the answer to either one of the tests is affirmative.

v. Recent case

The recent indirect transfer of a shareholding by a non-resident in Zhejiang province has been under the spotlight. In that case, the overseas target company in the indirect transfer was an issuer of corporate bonds. However, transfer of certain industry specific qualifications of the underlying Chinese company and problematic communications with minority shareholders made direct transfer of the underlying Chinese company impossible. It was held in this case that there was no commercial justification for the indirect transfer. Hence, the transaction was deemed to be direct transfer of resident company and tax was imposed accordingly. This is a rather controversial judgment.

In practice, the tax authorities always look at the overall tax effect of the transactions to determine whether there are commercial justifications for the indirect transfers. Yet, the tax authorities seldom conduct thorough analysis whether tax saving is the sole and dominant purpose for effecting the indirect transfer. Can SAT provide us with a summary on recent relevant cases for our reference so that we will have a better sense on what would qualify as "reasonable commercial purposes" in indirect transfers?

SAT: "Reasonable Commercial purpose" is not an easy topic and it is not a straight forward exercise to conclude if there are commercial purposes for the indirect transfer. SAT is in the course of consolidating the experiences in recent cases and plan to publish some classic cases in 2017 for the reference of the general public.

A2. Preferential tax treatments to software enterprises

Initially, "software product registration certificate" issued by the in-charge authority or "software copyright registration certificate" issued by the copyright administrative and management authority are considered as the pre-requisite before taxpayers could qualify for the preferential VAT treatment, i.e., levy and refund immediately. Taxpayers are also required to produce their "software product registration certificate" to the tax authorities before they can enjoy preferential tax treatments on CIT.

Since the State Council abolished the requirement for registration and record filing requirements for qualification recognition of software and integrated circuit design enterprises in early 2015, many enterprises have been unable to obtain the above-mentioned preferential VAT and CIT treatments. What should these enterprises do in order to secure the preferential VAT and CIT treatments?

SAT: The State Council has cancelled the registration and filing requirements for status validation for software and PCB design enterprises. The government authority in charge of the management of software enterprises has stopped issuing "software product registration certificate". Certificates that were issued previously and in their validity period can still be used. From a VAT point of view, enterprises which have either "software product registration certificate" or "software copyright registration certificate" would be entitled to the preferential VAT treatment of "levy and refund immediately". It was the practice in the past that enterprises were required to obtain the "software copyright registration certificate" before they could apply for the "software product registration certificate". Therefore, stopping the issue of "software product registration certificates" would not affect enterprises in enjoying the preferential VAT policy of "levy and refund immediately".

As for CIT, according to the tax circular, "Certain issues on the preferential tax treatment on CIT in relation to software and PBC enterprises" (Caishui [2016] No. 49) jointly issued by Ministry of Finance ("MoF"), SAT, National Development and Reform Commission and Ministry of Industry and Information Technology, enterprises can enjoy CIT preferential tax treatments as usual.

A3. Tax treatments on the hedging provisions in merger and acquisition ("M&A") transactions

In order to reduce the buy side risk of the M&A transactions, it is common to have hedging provisions in the M&A agreements. Under the hedging provisions, the buyers would in general compare the actual profits against the projections a few years after completion of the transactions. If there are adverse variances, the sellers would compensate the buyers. The two common compensation arrangements are as follows:

- Direct cash compensation
- If the buyers issued new shares to settle the purchase considerations, the buyers would be able to repurchase certain amount of shares from the sellers at discounted prices as compensation.

Under the above circumstances, can the buyers and sellers adjust their considerations for purchase and disposals based on the compensation amount, and hence, adjust the tax computations for the year when the transaction was effected and apply for tax refund?

SAT: We have received some cases related to the hedging provisions on the M&A transactions. We need to check if the above proposed treatments are in line with the existing tax rules and regulations. If we cannot find any clear reference in the tax rules and regulations on these cases, we will still need to handle the tax treatments of these transactions on a case by case basis.

Note: Hainan local tax bureau is the only tax authority as at today that issued tax circular to clarify that they would allow buyers to adjust the considerations, hence, the initial investment amount recognized in the finance statements, if they received compensation from the sellers under the hedging arrangements. It appears that the circular focuses on cash compensation arrangements. However, there is no clarification on the acceptable treatment on the seller side. [Qiong Dishuihan [2014] No.198 – Reply on enquiry on corporate income tax issue on compensation payments under hedging arrangement in M&A transactions]

A4. Special corporate income tax treatment in relation to the "Belt and Road" initiative

According to Article 3 of Caishui [2014] No.109, special tax treatment is an option for shareholding or asset transfer based on net book value among wholly-owned subsidiaries of China domestic companies or single/multiple common shareholders of the subsidiaries, as long as the transferor and transferee have not recognized profit or loss for the transfer and both transferor and transferee satisfy some other conditions.

Chinese enterprises are encouraged to have outbound investments under the "Belt and Road" initiative. Certain outbound investments may involve cross-border asset reorganizations and mergers (i.e., activities covering both China and overseas) between two large enterprises. Could you please clarify if "shareholding or asset", as stipulated in Circular 109, refer to shareholdings or assets outside of China? Based on the direction of Circular 109, there will not be any loss of tax revenue for China if the transferee and transferor are both China domestic enterprises and the shareholding/asset being transferred is located outside of China. We hope that SAT can consider the genuine business needs of the enterprises when executing rules in Circular 109 on a consistent basis.

SAT: Whether shareholding or assets are located outside of China was not further elaborated in Circular 109 issued in 2014. When we review cases where asset transfer is conducted in a number of countries outside of China, we will review the accounting standards and legal requirements of the country where the underlying assets are transferred. We will also take the foreign credit set off status into account in the review process. We are not aware that there is any existing tax rule and regulation that would allow the above proposed tax treatments. Internal discussions between SAT and MoF were conducted on these issues but we have not had any conclusion on the same yet. We may issue a supplementary circular at a later stage to clarify what are the appropriate tax treatments on these arrangements.

A5. Special tax treatment

According to Article 7 of Circular 59, "special tax treatment" is applicable to three types of cross border group restructuring:

(I) Transfer of the shareholding of a China domestic company between the overseas parent company and its wholly-owned subsidiary incorporated outside of China; and the withholding tax obligation on any future change of shareholding of the China domestic company will not be affected; and the transferor provides a written guarantee to the tax authority that it will not dispose its equity interest in the transferee within three years.

(II) Transfer of shareholding of a China domestic company between the overseas holding company and its wholly-owned subsidiary in China.

(III) Capital injection by asset transfer or transfer of shareholding by a China domestic company to its wholly-owned subsidiary outside of China.

(a) Scope

i. Transfer of shareholding of a China domestic company from the overseas holding company to its parent company also located outside of China

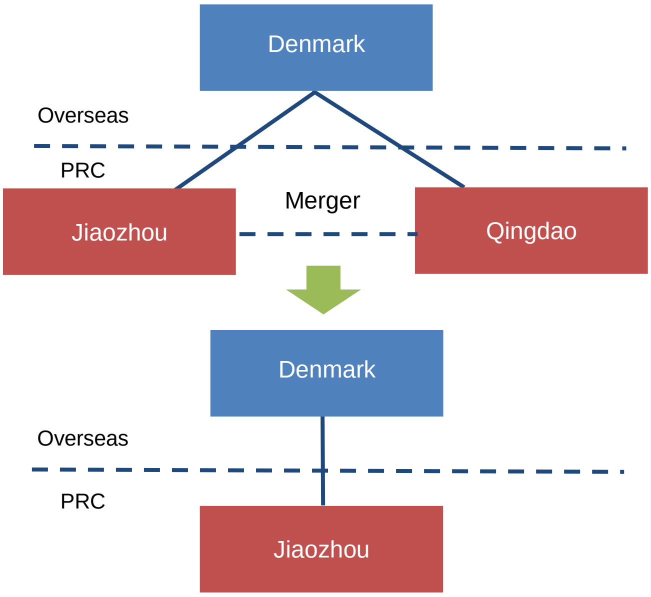
Currently, "special tax treatment" is only applicable to the three types of cross-border group re-organization as stipulated in Circular 59. However, actual cross-border group reorganization arrangements can be in other forms (please refer to the examples listed below for reference). Therefore, application of the "special tax treatment" appears to be too narrowly defined and many taxpayers could not understand why they cannot enjoy the "special tax treatment" if their re-organization arrangement is in a form other than the three types stipulated in Circular 59. We would like to ask if the SAT would extend the scope by applying item 4 of Article 7 "other arrangements as approved by MoF or SAT" and implement an upward reporting and approval mechanism between local tax bureaus and SAT on "special tax treatment" during the formulation of policies.

SAT: The "special tax treatment" is applicable to three types of cross-border re-organization, as provided in Article 7 of Circular 59 issued in 2009. Application of "special tax treatment" is relatively relaxed with a wider scope for companies residing in China, but relatively stringent, with narrower scope, for non-resident enterprises. According to the spirit of the directive from the State Council, China is doing its best in clearing the approval process for pending cases. Therefore, it is unlikely that SAT will handle cases submitted by various overseas tax authorities on "special tax treatment" on a case-by-case basis for the time being. If there is any change in the application scope of "special tax treatment", SAT will issue public notice to clarify the changes.

ii. Cross-border re-organization

For instance, would a merger between two foreign invested enterprises ("FIEs") owned by an overseas holding company be considered as a cross-border re-organization, such that the form of the merger would have to be one of three forms stipulated in Circular 59 before the "special tax treatment" could be applied on the transaction?

For example, Qingdao tax authority once allowed the "special tax treatment" on a merger of two FIEs owned by a Danish holding company.



iii. Merger of the overseas holding companies

We understand that different local tax authorities may take different approaches in handling merger of overseas parent companies. For example, the Wuxi tax authority had once granted the "special tax treatment" to a taxpayer on the merger of overseas holding companies. The merger steps of this case are shown in Diagram 1. On the other hand, Yantai tax authority rejected a case involving a similar scenario (as shown in Diagram 2). What is the SAT's stance?

Diagram 1

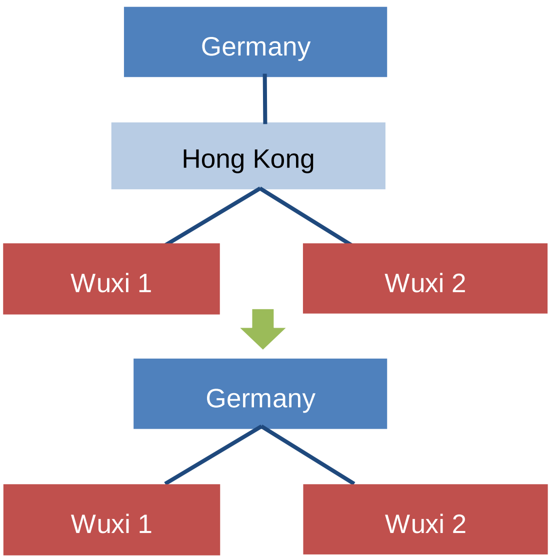
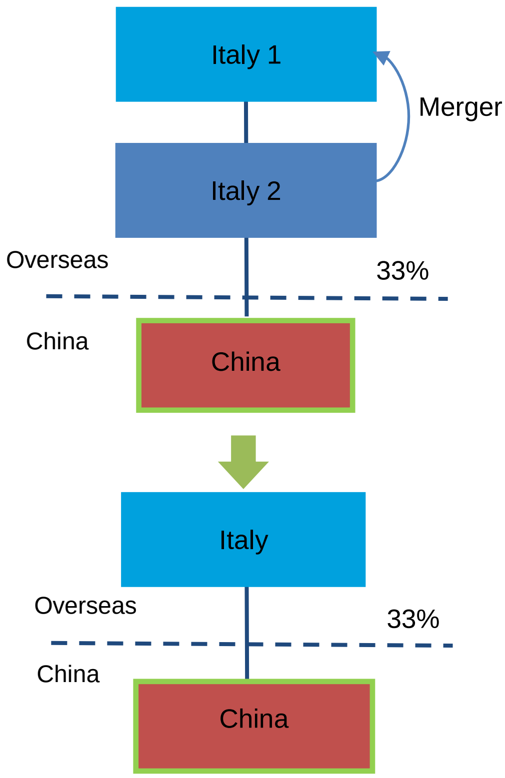


Diagram 2



SAT: Corporate merger is by itself a complicated issue. For instance, in the Qingdao case mentioned above, it could be the case that the Qingdao company sold all its assets to the Jiaozhou company. Thereafter, the Qingdao company went through the liquidation process. It could also be the case that the Danish company sold all its shareholding in the Qingdao company to the Jiaozhou company in order to effect an absorption merger. Therefore, the in-charge tax authority would need to review details of the merger arrangements and analyze the case before concluding whether cases like the above cases should be classified as a cross-border group re-organization and the "special tax treatment" can be applied to the transaction.

In the case handled by the Yantai tax authority, the overseas holding company of the China domestic company was absorbed by its holding company. And they lodged an application for "special tax treatment" on this transaction. There were some differences in the case handled by the Qingdao tax authority and there could be some differences in the two cases which were not reported. According to the requirements of the tax administrative law, local tax authorities will handle "special tax treatment" applications while the SAT is responsible for the interpretation of the rules and regulations on "special tax treatment" and provides guidelines to the local tax authorities on how to handle cases when situations warrant this. As mentioned above, corporate merger is by itself a complicated issue. Tax authorities are required to analyze the details of each individual case and follow closely the requirements on the application of "special tax treatment" on cross-border group re-organizations, as stipulated in Circular 59. The Yantai case may not 100% fulfil the requirements for "special tax treatment" and this case is relatively controversial. The case is under administrative litigation procedures for the time being.

iv. Striking off of overseas company

If the overseas holding company is struck off, the shareholding of the China domestic company will be changed as well. There is a lack of clarity in Circular 59 about "special tax treatment" if deferred tax payment is applicable to this kind of case. Would SAT consider including this kind of case in the scope of "special tax treatment"?

SAT: There are similarities in the above case with the case handled by the Yantai tax authority. If the overseas holding company is struck off, it should follow the liquidation procedures in its country of incorporation. As mentioned above, only the types of cases specified in Article 7 of Circular 59 would qualify for "special tax treatment". As long as there is no amendment to Circular 59, we should follow the existing requirements under Circular 59 in granting "special tax treatment" to taxpayers.

v. Change of legal form of the overseas holding company

If the legal form of the overseas holding company changed (e.g., from a corporation to a partnership), will the subsequent change in the registration formalities be deemed to be shareholding transfer of the Chinese domestic company? (E.g. because of the change in the legal form of the parent company, the withholding tax position due to future shareholding transfer of the Chinese domestic company may also be affected). Is the "special tax treatment" applicable to this kind of case?

SAT: Internal discussions were conducted within the tax authorities on this issue. We do not have a convergent view on this matter. Some considered that partnership is not a legal entity. When the legal form of the holding company of the Chinese domestic company changes from a company to a partnership, there is change of shareholders of the Chinese domestic company and hence there is a deemed transfer of shareholding of the China domestic company. However, some were of the view that the change in the legal form of the holding company should not result in a deemed transfer of shareholding. On a separate note, the arrangement is not one of the arrangements specified in Article 7 of Circular 59. Hence, "special tax treatment" is not applicable to this case.

(b) Advance ruling

If a group undergoes a major group re-organization exercise, "special tax treatment" and the general anti-avoidance rule may be applicable to the transaction. According to the existing practice, the tax authority will not issue any written comments on the tax implications of the re-organization transactions. Hence, the group has uncertainties on its tax position in relation to the re-organization exercise. If the group would like to ascertain its tax position on the re-organization transaction, can the group obtain a transaction specific advance ruling from the tax authority?

SAT: There is no measure or procedure for advance ruling applications on group re-organizations at the SAT level. However, certain provinces or cities, e.g., Jiangsu province and Guangdong province, have provided avenues to the large enterprises for advance ruling applications by signing memorandums of understanding with them. SAT will introduce implementation rules after the new tax administrative rules are implemented in which the advance ruling application details will be laid down. We will make reference to the rules and regulations on advance ruling in Hong Kong when we draft the part of the implementation rules relating to advance ruling.

B. Value-added tax reform ("B2V")

B1. Clarification on tax exemption policies on cross-border services provided by Chinese domestic enterprises

Appendix 4 of Caishui [2016] No. 36 provides that:

(II) Sales of the following intangible assets or provision of following services by Chinese domestic enterprises or individuals are VAT exempted. However, the exemption is not applicable when zero tax rate is applicable as specified by MoF and SAT.

(iii) Provision of the following services and intangible assets to be used by overseas entities outside of China by Chinese domestic enterprises……

(VII) "To be used entirely outside of China" stipulated in this circular refers to:

(i) Actual service recipient is physically located outside of China and there is no association with goods and immovable properties located in China.
(ii) Usage of the intangible assets is entirely outside of China and there is no association with goods and immovable properties in China.

(a) What is the definition of "actual service recipient"?

In order to qualify for tax exemption for offshore service or intangible assets, the actual recipient has to be located outside of China and there is no association with any goods and immovable properties within China. How should we interpret these requirements? Are we talking about service recipient or service beneficiary?

SAT: Cross-border service VAT levy is indeed an issue related to the authority of China in imposing tax on such transactions. Many countries which have VAT systems in place are studying the impacts of this issue. When we talk about trading of goods, it is easy for us to draw a conclusion as the goods are in physical form or there is a carrying medium for them. However, services do not exist in a physical form and therefore it is difficult and challenging to conclude if the services have been imported. We understand that many countries have adopted locality of service usage as the determining factor for service importation. We usually use "locality of service used or service provider/recipient" to determine whether a service has been imported. In other words, if a service is used in China, China has the authority to impose VAT on the service income. Alternatively, if the service provider/recipient is located in China, the service should be regarded as provision of service in China.

Example: A consulting company in China accepted a due diligent engagement appointment from an overseas client on an acquisition transaction where the target company is a Chinese domestic company. The service is provided to a non-China resident company by the consulting company. However, the target company in China or its original shareholders can be regarded as service beneficiaries. As the original shareholders of the target company are located in China, can we conclude that the tax exemption policy on cross-border transaction is not applicable to this case?

SAT: When the consulting company in China performed due diligence services to its overseas client, we can easily conclude that the consulting company was providing service in China to an overseas service recipient. However, we need to make reference to the requirements in Appendix 4 of Caishui [2016] No. 36 in determining whether the service should be treated as "entirely used outside of China". If the target company of the due diligent exercise is located in China and the consulting company is required to assess the values of the stocks and immovable properties of the target company, the services so provided by the consulting company are to certain extent associated with the goods and immovable properties in China. Hence, the services so provided do not meet the condition that the services are used "entirely used outside of China".

(b) How should we interpret "no association with goods and immovable properties in China"?

Should the coverage of "no association with goods and immovable properties in China" be extended to include any asset within China, and including intangible assets and shareholdings, etc. (like the above example)?

SAT: When the provision of being "entirely used outside of China" was drafted, association with goods or immovable properties was used as a key reference point because these could easily be identified and hence it would

be easy for all stakeholders to conclude whether the services were "entirely used outside China". In general, the concept of "assets located in China" would not be extended to any assets, e.g., shareholdings. Transfer of intangible assets would be subject to specific taxes and their corresponding scope. Transfer of shareholdings is not within the scope of transfer of intangible assets.

For example, a Chinese domestic company delivered services to an overseas company by providing them with software and assisting them in printed circuit board ("PCB") testing. The overseas company provided the sample PCB to the Chinese company by mail for testing. If the PCB passed the quality assurance test, the overseas company would sell the PCB to buyers in China. Would this Chinese domestic company qualify for provision of technical/consulting services for overseas usage and, therefore, a tax exemption or zero VAT rate could be applied to the arrangement?

SAT: The testing service in the above example was conducted in China and the PCB would be sold to buyers in China. In other words, the Chinese domestic company performed testing services on goods to be imported to China. Even if the testing services were performed outside of China, the services would not satisfy the condition of being "entirely used outside of China" as the PCB would be imported to China and the testing services would be regarded as associated with goods in China. Hence, a tax exemption or zero tax rate for cross-border taxable activities would not be applicable to the above case.

B2. What are the qualifying conditions for VAT exemption in relation to offshore entities providing services to a Chinese domestic company where the services are entirely performed outside of China?

(a) Is there any further elaboration what constitutes satisfying the condition that a service is "entirely performed outside of China" in Article 13 of Appendix 1 "offshore entities providing services to Chinese domestic company where the services are entirely performed outside of China"?

SAT: It could be unreasonable if we simply use locality of the service provider and where the service is rendered as the determining factors for being "entirely performed outside of China", as locality of the service provider may not necessarily correspond to the locality of service rendered. Therefore, we introduced the concept of being "entirely used outside of China". One needs to refer to the association with goods and immovable properties in China to determine if the service is "entirely used outside of China". If there is an association with goods and immovable properties in China, it can be concluded that the services are not being "entirely performed outside China".

(b) Example: A Chinese domestic company engages in entrepot trade. Procurement is done outside of China and sales are made to overseas customers. All trading transactions were effected outside of China. An overseas company has been appointed by this domestic company to conduct business development activities, identifying new clients. The Chinese domestic company will pay commission to this overseas agent for the services performed. Would this commission payment be exempt from VAT, as the services of the overseas agent can arguably qualify for the test that they are "entirely performed outside of China"? If that is the case, do you agree that the Chinese domestic company does not have any withholding obligation on this commission payment?

SAT: If the entire entrepot trade is conducted outside of China, the activities do not fall within the scope of VAT, and hence, no VAT is payable on these activities. Despite the fact that the overseas company provided business development services and sourced new clients for a Chinese domestic company, the services were entirely provided and used outside of China and there was no association with goods in China or immovable property in China. Hence, the services provided by the overseas company are not within the scope of VAT and the Chinese domestic company does not have any VAT withholding obligation.

B3. Immovable property

If a landlord acquired an immovable property before 30 April 2016 (say there are many units in the building). The units in the immovable property have been rented to different parties. Can the landlord apply the simplified tax method in calculating VAT liabilities in some units and the general VAT calculation formula in some other units? If the mixed calculation method is acceptable to the tax authority, should the landlord calculate the respective VAT liabilities based on the contract value of each lease agreement?

SAT: The simplified tax method and the general tax method can be applied to different units in the same property. For example, the landlord entered into three lease agreements of three different units in the same property (which was acquired before 30 April 2016) with three different tenants. The landlord and the tenants can choose simplified tax method and the general tax method according to their wishes. Different tax calculation bases can be applied to different leases.

Can the above-mentioned calculation basis be applied on subletting arrangement, i.e., the sub-lessees do not have legal title of the immovable property and hence they would not capitalize the immovable property in their financial statements?

SAT: Original acquisition date of the immovable property should not be the determining factor for new/old project for subletting arrangements. What matters is the date that the lessor acquires the immovable property for subletting arrangements. If the lessor acquired the immovable property for subletting later than 30 April 2016, the leasing arrangement would be considered as a new project and taxation basis applicable to new projects would apply.

B4. Land use rights

It is provided in Circular 36 that when property developers, who are also general VAT payers, sell properties from their projects (excluding those who have opted to be taxed under the simplified method on old projects), the turnover for the VAT calculation of the property developers should be the gross receipts (consideration and other fees) minus the land cost paid to the government when they acquired the land.

It is common for local governments to provide incentives so as to attract investors to invest in their region. The local governments may promise the investors to provide land to them free of charge or use land as capital injections into the projects. The local government may also grant land use rights to the investors or use such land use rights as capital injections. In these cases, should the taxpayers ignore the land cost in calculating output VAT in future?

SAT: Property developers have to fulfil a specific requirement before they can deduct the land cost in calculating the VAT. The specific requirement is that the property developers need to obtain receipts from provincial government or above for the consideration paid to land management department or the organizations appointed by the government for receiving the considerations for land. The property developers have not paid anything for acquiring the land in the above case. Hence, the property developers should not be able to obtain the corresponding receipt from the provincial government or above; and land cost is not a deductable item for calculating output VAT.

B5. Insurance business

(a) Deductible items

Insurance companies are required to pay VAT after implementation of the last stage of B2V. Please advise us what are the qualifying items for input VAT credits for the insurance companies?

SAT: There is no special requirement for input VAT set off for insurance companies. Insurance companies can make reference to the input VAT set off mechanism applicable to other industries.

(b) Transfer out of input VAT

If compensation received by the claimants is not a taxable item for VAT, should the claimants transfer out the input VAT associated with the damaged goods when filing their VAT returns?

SAT: The insurance companies would not be provided with any services by the claimants when they make the compensation payments in relation to the loss of property of the claimants. Hence, compensation payments for loss of properties made by insurance companies do not fall into the charging scope of VAT. Under the existing rules and regulations, there are provisions governing input VAT transfers out due to tax exempted activities, simplified tax method, abnormal losses, etc. However, there is no requirement for input VAT transfer out for activities that are not within the charging scope of VAT. Hence, there is no requirement for transfer out of VAT when taxpayers receive compensation for loss of property from insurance companies.

B6. Hotel industry

In order for the hotel guests to claim input VAT on room charges, do they need to have separate VAT invoices for room, food and beverages from the hotels?

SAT: It is not a mandatory requirement under the existing rules and regulations that input VAT claimants have to get separate VAT invoices in respect of room charges, and food and beverage bills. It is worth noting that VAT associated with certain expenses incurred by the taxpayers are not allowed to be treated as input VAT credits, e.g., staff welfare, personal consumption; VAT invoices should not be issued in respect of these items. If there is no other restriction, vendors can issue specific VAT invoices. Whether claimants are getting one invoice or separate invoices for their room charges, food and beverages from the hotels, it would make no difference to their input VAT entitlements. VAT associated with food and beverages is not allowed to be treated as input VAT and hence only VAT associated with room charges can be treated as input VAT by claimants. Having said that, VAT payers should make sure that room charges are not related to those activities that are not qualifying for claiming input VAT credits, e.g., staff welfare, personal consumption items, etc. VAT associated with these non-qualifying activities cannot be treated as input VAT.

B7. Personal consumption items

VAT paid in relation to certain personal consumption items cannot be treated as input VAT credit. For example, taxpayers are unable to claim input VAT credit on those personal travel expenses incurred by their staff. However, such travel expenses could be incurred for business purposes and should be booked under business operating expenses. Hence, it appears to be unreasonable that taxpayers are not allowed to claim input VAT credit on these expenses. Could the taxpayers ask the service providers to issue VAT invoices to them with their names as payers and the taxpayers claim input VAT credit afterwards? What is the view of the SAT on this proposed arrangement?

SAT: It is a fundamental concept in the VAT system that end user bears VAT liability in the entire VAT value chain. Therefore, that VAT associated with the personal consumption items cannot be treated as input VAT is in line with this fundamental concept and that makes sense. Since VAT associated with personal consumption items cannot be treated as input VAT, there is no point to ask the service providers to issue VAT invoices to the users.

Could the SAT issue a circular to illustrate the tax credit setoff mechanism for taxpayers who opt to be taxed under the simplified tax basis?

SAT: Tax credit set off mechanism is not applicable for the simplified tax basis. This policy has been touched on in various tax circulars. SAT does not have any plan for the time being to issue a tax circular to illustrate the practical application of this policy or share the consolidated past experiences on the applications of this policy. However, the SAT will consider suggestions from the taxpayers on this particular issue.

Will the tax authority implement any compensation measures during the transition period for enterprises with increased tax burdens as a result of implementation of B2V?

SAT: According to the directive given by the Premier Li Keqiang and the spirit of the State Council documents, each industry rather than each individual taxpayer would have less tax burden than before as a result of implementation of B2V. We have conducted tax liability analysis on 23 industries. Tax burdens of these 23 industries are less than before as a result of implementation of B2V. However, we cannot guarantee that the tax burden of every taxpayer would be reduced as a result of implementation of B2V, hence, some taxpayers may suffer from increase in their tax burdens.

SAT has tried its best to take the unique features of each industry into account in the tax liability analysis, and ensure that the overall tax burden in each industry would be less than before as a result of implementation of B2V. However, we are not using one single tax rate in VAT and there are industry-specific policies. It is difficult for us to ensure that tax liabilities of each taxpayer would be reduced after implementation of B2V.

C. <u>Transfer pricing</u>

C1. Advance pricing agreements ("APAs")

It has been challenging for the taxpayers with the Customs Office in relation to the year-end transfer pricing adjustments they put through based on the APA agreed with the tax authorities. For example, import prices have to be adjusted downwards based on the year-end adjustments, but the paid duty has been based on higher prices. Is it possible to get refund on the overpaid duty? As for manufacturing entities, VAT refunds on export would also be affected as a result of putting through the transfer pricing adjustments based on the APA. Will the Customs Office agree to changes in the quantum of the VAT refund as a result of transfer pricing adjustments?

SAT: We noted that some enterprises may have practical difficulty in implementing the APA that they have agreed with the tax authorities. Therefore, trading companies may need to put through year-end adjustments on amounts related to purchases and sales with the overseas related companies. The situation is rather undesirable and the enterprises should have better implemented their APA and monitored the variance between the amounts on trading transactions with the overseas related parties and those documented in the APA. In fact, the tax authorities are in the course of building up an information exchange mechanism with Customs. We hope that Customs will honour the APA endorsed by the tax authorities. Unfortunately, there is no mechanism under the existing rules and regulations that enterprises can apply for duty refunds.

D. Individual income tax ("IIT")

D1. Foreign individuals

A foreign individual is employed by a Hong Kong company. Due to the business needs, he assumes multiple senior roles in Hong Kong and China concurrently; and including the following scenarios:

Scenario I: Acting as the legal representative and director of a Chinese domestic entity;
Scenario II: Acting as the General Manager of a Chinese domestic entity; or
Scenario III: Acting as the General Manager and director of a Chinese domestic entity.

As a senior executive of the Chinese domestic company, the foreign individual is required to travel to China only to attend meetings a few times during a year and he stays in China just for a short duration on each visit. Moreover, as the daily routine of the Chinese domestic company is handled by the locally-appointed managerial staff, the foreign individual's stay in China does not exceed 183 days in any 12 months/year.

If all the salary of the foreign individual is paid/borne by the Hong Kong employing entity under the above three scenarios and the Chinese domestic entity does not pay any salary, director fee, or social security contributions for this foreign individual, will the foreign individual be exempt from IIT by virtue of Article 2 of Guoshuifa [1994] No. 148 and item 1 of Article 3 of Guoshuifa [2004] No. 97?

SAT: Based on the information provided in the case, the individual is employed by a Hong Kong company but he also assumes senior positions and performs duties in the China companies. The fact that all his salary is paid by the Hong Kong company is not in line with normal business operations. Therefore, we are of the view that we should first investigate to see if this is a tax avoidance case. After confirming that this is not a tax avoidance case, we will then determine the IIT burden of this individual based on the prevailing IIT rules and regulations.

D2. IIT reform

What is the progress of the IIT reform? Will some changes be implemented in the second half year of 2016?

SAT: We are still working with MoF and other relevant government departments on the IIT reform. IIT reform is unlikely to be implemented in the second half of 2016. We anticipate that the detailed IIT reform measures will likely be introduced in 2017 or 2018.

D3. IIT implementation rules

According to Article 28 of the IIT implementation rules, a levy minus expense calculation basis is applicable to "an individual who is domiciled in China but employed by an overseas employer and given employment income from such overseas employer". For those individuals who are domiciled in China, employed by overseas companies and who work in China on an assignment basis, should they be regarded as "an individual who is domiciled in China but employed by overseas employer and given employment income from such overseas employer", and, therefore, be subject to the levy minus expense calculation basis?

SAT: For those individuals who are domiciled in China, employed by overseas companies and given employment income, they would enjoy monthly personal deduction of RMB4,800 for IIT purposes. However, if these individuals are assigned to work in China from their overseas employers, they will only be entitled to a monthly personal deduction of RMB3,500 on their income derived in China.

D4. Social security contributions

Are the social security contributions made by the foreign employers for the expatriates working in China regarded as taxable income of the expatriates for IIT purposes?

SAT: In general, social security contributions made by the overseas employers of the expatriate employees would be treated as taxable income for China IIT purposes.

E. Others

E1. Overseas Non Government Organisations

(a) The Law of the PRC on the administration of activities of overseas non-governmental organizations (NGOs) within the territory of China was passed in April 2016. Under the law, overseas NGOs are required to set up representative offices, according to the prevailing rules and regulations, before they can carry out any activities within China. For those NGOs which do not maintain any representative office in China and need to conduct activities in China on a temporary basis, they are required to inform the relevant authority before they can conduct any activities in China. Does this mean that those NGOs which have ongoing activities in China are required to register representative offices in China and be required to pay CIT and VAT on a deemed basis by reference to their actual expenses.

SAT: For CIT, the NGOs can either choose to be taxed on a deemed basis where the deemed income is calculated by reference to its actual expenses or file CIT returns based on their actual profit and loss. As for VAT, we should check if the NGOs' activities fall within the taxation scope of VAT. If no, no VAT will be levied. Therefore, VAT is not levied on the representative offices of the NGOs on a deemed basis where the deemed income is calculated by reference to its actual expenses.

(b) Besides, many overseas NGOs have been carrying out activities in China via partnership arrangements with various parties in China. The overseas NGOs may have received different fees (e.g., membership fees, examination fees, etc). How should these fees be taxed in China? Has the taxation basis been applied consistently over different regions in China?

SAT: We should first clarify the nature of the membership fee and examination fee of the overseas NGOs. For example, whether the fee income is paid for services rendered or is a royalty in nature. If the fee is paid for services rendered, we will need to first determine if the overseas NGOs maintain permanent establishments in China. There is no consistent taxation basis for this kind of fee income of the overseas NGOs. We will need to handle this on a case-by case-basis.