Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Meeting notes

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

2017

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Foreword

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 16 May 2017. Yu Shuchun, Deputy Counsel of SAT and leaders of relevant Divisions and Offices welcomed HKICPA delegates. Mabel Chan, the president of HKICPA, expressed gratitude to SAT for taking time to attend the meeting and expressed her view that the meeting would help strengthen the development of communication between HKICPA and 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 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 EY for providing a representative to take the notes at the meeting.

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Attendees

SAT

Yu Shuchun	Deputy Counsel, International Taxation Department
Zhang Ying	Deputy Director, Value-added Tax Division of Goods and Services Tax Department
Wei Zhiguo	Associate Consultant, Tax Audit Division of Goods and Services Tax Department
Zhou Tao	Associate Consultant, Export Tax Refund Division of Goods and Services Tax Department
Zhou Meifeng	Principal Staff Member, The First Division of Corporate Income Tax, Income Tax Department
Zhao Liang	Deputy Division Director, The Second Division of Individual Income Tax, Income Tax Department
Xiong Yan	Deputy Division Director, Tax Treaty Division, International Taxation Department
Li Qiaolang	Deputy Division Director, The First Division of Anti-Tax Avoidance, International Taxation Department
Ma Guang	Principal Staff Member, The Second Division of Anti-Tax Avoidance, International Taxation Department
Zheng Xiaoyong	Non-Resident Division, International Taxation Department

HKICPA

Anthony Tam	Chairman, Taxation Faculty Executive Committee and Member, China Tax Subcommittee
So Kwok Kay	Deputy Chairman, Taxation Faculty Executive Committee and Member, China Tax Subcommittee
William Chan	Convenor, China Tax Subcommittee and Member, Taxation Faculty Executive Committee
Lorraine Cheung	Member, China Tax Subcommittee
Daniel Hui	Member, China Tax Subcommittee
Li Wen Huan	Member, China Tax Subcommittee
Shanice Siu	Member, China Tax Subcommittee
To Tat Wang	Member, China Tax Subcommittee
Rebecca Wong	Member, China Tax Subcommittee
Joy Li	Senior Accountant, China Tax & Business Advisory Services, Ernst & Young (China) Advisory Limited
Eric Chiang	Deputy Director, Advocacy and Practice Development
Serena Fong	Associate Officer, Advocacy and Practice Development

Summary of Discussion

A. Non-resident Enterprise Income Tax

1. Financial product trading transactions

There has been a considerable amount of financial products transactions between Chinese resident and non-resident companies in recent years. It is useful to discuss the China tax reporting obligations of the non-resident companies on the income derived from these transactions.

Case 1: A Chinese resident company entered into a currency futures contract with a non-resident company. On the contract maturity date, the Chinese resident company made a payment to the non-resident company as a result of the unfavourable exchange rate movement (e.g. the Chinese resident company is obliged to buy the foreign currency at RMB100 each unit under the futures contract although the spot exchange rate of the currency unit has dropped to RMB80 for each foreign exchange unit on the contract maturity date. Therefore, the Chinese resident company is required to pay the non-resident company RMB20 per foreign exchange unit under the futures contract). What is the nature of the income derived from the above-mentioned transaction from an enterprise income tax ("EIT") perspective? Should it be classified as "income derived from transfer of moveable property", "other income", or "no income" from an EIT perspective? If the said income is classified as "income derived from transfer of moveable property", the income should not be treated as sourced from China as the enterprise is not residing in China, hence the non-resident company would not have any tax payment obligation (and it would not be necessary to study which provisions under the tax treaty would be relevant at this point). If the income is classified as "other income", it is difficult to determine the source of the income according to EIT laws and regulations, as there is no clear source rule in the tax law for other income. Moreover, certain provisions in Mainland China ("China")'s tax treaties are on the rights to impose tax. Most China's tax treaties (i.e. China-Singapore tax treaty) states that "If there is no specific rule in the treaty governing the taxability of an income item and the income is related to activities occurred in a contracting state, this contracting state can impose tax on this particular income item". Hence, it appears that China cannot impose tax on the non-resident company in respect of this income item.

Case 2: A non-resident company realized gains via trading of Chinese financial products outside of China (e.g. bonds issued by Chinese resident companies, options and futures contracts or other financial derivatives issued in China). Will these gains be regarded as "income derived from transfer of moveable properties" or "other income"?

Will the non-resident company have value-added tax ("VAT") liabilities due to the above-mentioned transactions?

SAT: The core issue in the above two cases is whether China has the authority to impose tax. It is an international norm that turnover tax would be imposed based on the locality of service provided. When China underwent the business to VAT reform, some business tax taxing principles were inherited, i.e. the transaction would become taxable when either the service was provided in China or the service recipient is located in China. Despite this, there are certain exclusion provisions in the VAT law, e.g. if a foreign unit provides services to a Chinese

taxing unit where the services were entirely provided outside of China, such transaction would not be taxable for VAT purposes.

As a separate note, transfer of financial instruments by the non-resident mentioned in the example fall into the taxation scope of VAT. Hence, if the non-resident transfers China financial instruments and the counterparty is a Chinese resident, the transaction should be subject to VAT.

(Note: The classification of income and how to determine the source of income are extracted from EIT law and its implementation rules as follows:

- "Income from the transfer of property" refers to transfer of fixed assets, biological assets, intangible assets, shareholdings, bonds and etc. Source of income for transfer of immovable property is determined by reference to the location of the immovable property. Source of income for transfer of moveable property is determined by reference to the location of the enterprise/organization or the place of business. Source of income on transfer of rights/ownership of investee companies is determined by reference to location of the investee companies.

- "Interest income" refers to the income generated by enterprises which allow others to use their capital but this usage does not constitute investment with right/ownership element in the third parties. Or, income generated as a result of other parties using the capital of the enterprises includes deposit interest, loan interest, bond interest, interest on receivable overdue. Source of income is determined by reference to the location of the corporate interest payer/party which bears the interest expenses. If the interest payer is an individual, the location of the dwelling of the interest payer is used in determining the source of interest income.

- "Other income" refers to income items besides the ones specified in items 1-8, Article 6 of the EIT law. This includes income from asset write back (which had previously been written off); deposit forfeiture (as the deadline for returning the packaging materials has passed; write off of accounts payable; write back of bad debts (which had been previously written off); income from debt restructuring; subsidies, penalty payment on breaching the contracts, foreign exchange gains, etc. Source of other income is based on locality as announced by the State Council and the competent tax authorities.

SAT: There are distinct differences on the fundamental taxing principles between EIT and VAT.

There is no clear definition in the tax law whether FOREX futures, oil futures and other financial derivatives should be classified as movable properties or equity investment. Whether transfer of these financial products should be subject to income tax in China in the hands of the non-resident would depend on whether the income derived from the transaction is sourced in China.

2. <u>Insurance premium</u>

When ascertaining the nature of the insurance premiums received by non-resident companies from Chinese resident companies or individuals for EIT and tax treaty point of view, should the income items be regarded as income from labour services

or items that are royalties in nature? If the insurance premiums are treated as income from labour services, the non-resident companies will not have any EIT liabilities provided that they do not have any permanent establishments in China.

SAT: From a China EIT perspective, an insurance premium is not royalty and can be classified as other income. The Ministry of Finance ("MoF") and the relevant tax authorities would need to undergo detailed analysis on the nature of the income and provide guidance on the taxation basis of insurance premiums. As no clear guideline has been issued on other income, no tax has been imposed on insurance premium mentioned in the case for the time being.

It is worth noting that there are differences in the classification of "other income" in the tax treaties and China EIT law. Insurance premiums stated in the case are classified as service income under tax treaties. As long as a non-resident has not established any permanent establishment in China, it will not have China EIT liability in respect of the insurance premiums received.

3. <u>How to apply the tax treaty provisions on royalty payments</u>

Under the China-Hong Kong double tax agreement royalty payment provisions, the withholding tax rate on royalty payments on aircraft and ship leasing rental has been reduced to 5%. If Chinese resident airlines make aircraft leasing rental payments to an aircraft leasing company based in Hong Kong, withholding tax will be levied at 5% on the gross rental payment.

a. If the above-mentioned lease is a finance lease, should the payment made by the resident airlines be subject to withholding tax at 5% on the gross payment or 7% on the interest elements of the payments on the finance lease. (We have noticed that a lot of companies are not following the guidelines laid down in Article 4 of SAT Public Notice [2011] No. 24 ("PN24") (see below for the citation of the provisions) in exercising the withholding obligations and remitting the corresponding taxes to the tax authorities. There seems to be some inconsistency among different regions in enforcing the provisions.)

   SAT: The interest element of the rental income received in relation to finance leases should be subject to 7% withholding tax.

b. The Hong Kong SAR Government has been actively promoting the aircraft leasing business in recent years. Does SAT have any plan to have technical discussions with the Hong Kong Inland Revenue Department ("IRD") on the cross-border tax issues on aircraft leasing; and explore the possibility of refining the tax treatment under the China-Hong Kong tax agreement in relation to the aircraft leasing businesses.

   SAT: SAT does not currently have any plans to sign any revised agreement on the tax treatment of aircraft leasing transactions with the IRD. The IRD has not raised any request on the same as at the date of meeting.

   There are fundamental differences on the nature and the risks borne by the parties involved on operating and finance leases. Hence, the tax treatments applicable to operating and finance leases are not the same. According to the tax treaty between China and Hong Kong, tax is levied at a preferential rate of 5% on rental income on operating leases; whereas, tax is levied at 7%

on the interest element of the rental income on finance leases. There are practical difficulties in lowering the tax rate from 7% to 5% on the interest element of the rental income on finance leases.

[As per Article 4 of PN24 - "Public Notice on certain EIT management issues for non-residents": EIT tax treatment on finance leases and rental income on leasing of movable properties:

(1) If a Chinese resident company enters into a finance lease with a non-resident company, the rental property that is used in China and the title of the property will be transferred to the Chinese resident company after the lease is expired (including transfers with consideration when the leases expire). Where the non-resident company does not have any establishment or place of business in China, the resident company is required to withhold and remit EIT in relation to the transaction to the tax authorities. EIT should be calculated as if the non-resident company was receiving interest income and interest income is the difference between the total rental payments received (including consideration payable for transferring the title of the property after the lease is expired) and the market value of the underlying property.

(2) When non-resident companies letting out immovable properties, e.g. flats, buildings, etc, within China, where the non-resident companies have not established organizations or places of business in China to manage the daily business activities, EIT payable by the non-resident company will be calculated based on the gross rental income received. The tenants of the immovable properties are required to withhold and remit EIT to the tax authorities on every payment they make or everytime when the rents become payable.

4. **Foreign tax credits**

a. Direct setoff – Overseas tax incurred by China partnership

If a Chinese partnership obtained overseas investments and incurred overseas taxes, should the partnership or the individual partners (which could be natural person or corporate partners) claim tax credits in respect of the overseas tax incurred? If the tax payment receipt from the overseas jurisdiction was issued to the individual partner, is the individual partner eligible to claim the tax credit? As the partnership, but not the individual partners, incurred the overseas tax, some tax authorities do not allow tax credit set off applications by the individual partners. (We understand that as the partnership is not an EIT paying unit, the individual partners should claim the foreign tax credits when computing their EIT liabilities.)

SAT: The tax system for partnership has not been fully established in China at the moment; hence, there are still certain ambiguities in the taxing principles for partnerships. We are making our best efforts in building up a tax system for partnerships and we will only be able to further clarify the overseas tax credit set-off mechanism for partnerships after the partnership tax system is properly established.

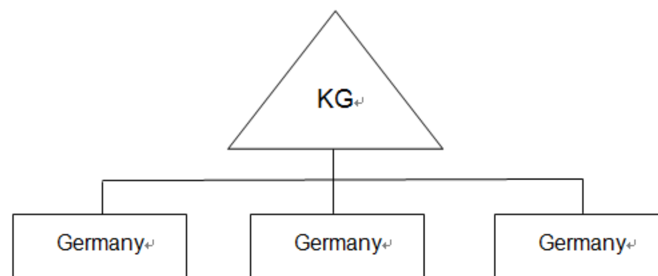
b. Indirect tax credit set-off – overseas partnership/transparent entity for tax purpose/group tax credit set-off

When counting the 3 layers for tax credit set-off, will a partnership/ transparent entity or permanent establishment be counted as "one layer" or "multiple layers"? There is no clear illustration on this issue in the existing China tax literature, including laws and regulations.

Case 1: Tax consolidation is allowed in certain overseas jurisdictions. For example, under a structure of China – HK 1 – HK 2 – U.S. C-corp – U.S. LLC, as the U.S. LLC is a tax transparent unit, all the income and expenditure of the U.S. LLC will be consolidated into U.S. C-corp for EIT filing purposes. As a result, only one tax payment receipt will be issued. However, the U.S. LLC and U.S. C-corp. may be treated as "two layers" under the EIT laws. Under this situation will the U.S. LLC be regarded as layer 4 or U.S. C-corp and U.S. LLC together be regarded as layer 3 for tax credit purposes?

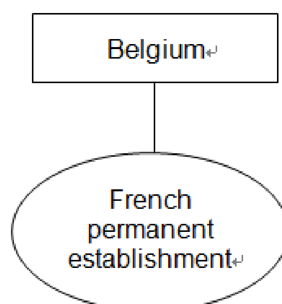
SAT: The U.S. LLC in the case will be regarded as layer 4 entity from the China tax law perspective. U.S. C-corp is the layer 3 entity for tax credit calculation purpose. Tax paid by the U.S. LLC will not be taken into account when calculating the credit attributable to the U.S. C-corp.

Case 2: KG structure is used by a German group for consolidated tax filing



SAT: If the three German entities in case 2 can satisfy the requirements for indirect credit set-off on an individual and consolidated basis, the indirect tax credit set-off can be done on a consolidated basis. However, as KG is a special holding structure, we need to further discuss and analyze the case before concluding how the tax credit set off is calculated.

Case 3: A Belgium company has a permanent establishment in France. Under the circumstances, will the French permanent establishment be regarded as one layer? It is worth noting that the permanent establishment is not a separate legal entity and it cannot distribute any dividend to its parent entity.



SAT: From a China tax perspective, a permanent establishment will not be regarded as a principal and therefore will not be able to enjoy indirect tax credit set-off. And also, the permanent establishment will not distribute dividends to its parent company. Therefore, indirect tax credit set-off should be irrelevant to this case.

c. Others

The tax authorities have been handling more actual cases recently; will the tax credit set-off rules be changed, taking the practical experience into account? Will the 3-layer restriction on tax credit set-off be relaxed in the new regulations? What is SAT's view of applying tax credit set-off rules on individuals? Will SAT issue guidelines on tax credit set-off for individuals, similar to what has been done with EIT?

SAT: The tax credit set-off system is currently being revamped. After the discussions with the MoF, SAT is considering relaxing the foreign tax credit arrangements from 3 layers to 5 layers. Tax paid in one country may be able to be grouped together as foreign tax credit, regardless of the underlying income items of the tax paid. A tax exemption law may also be considered in the longer term.

5. Hong Kong tax resident certificate

According to item 3, Article 7 of "Management of tax treaty benefits of Non-resident taxpayers" (SAT Public Notice [2015] No. 60 "PN60"), taxpayers are required to provide "a tax resident certificate issued by the other contracting state one year prior to the tax credit claim". It is mentioned in another SAT Public Notice [2016] No. 35 ("PN35") – "Public Notice on the usage of the Hong Kong resident certificate" that "The tax resident certificate issued by the IRD can be used as a proof of tax residency for the year of issue and two subsequent years". However, some tax authorities follow the old rules in PN60 instead of rules in PN35 and insist that the tax resident certificate issued by the IRD is only good for one year.

For example, a taxpayer can use the preferential tax treatment under the "China-Hong Kong tax arrangement" in 2016 where the taxpayer has a 2014 tax resident certificate issued by the IRD. Some local tax bureaus would still insist that the taxpayer has to provide them with a 2015 tax resident certificate issued by the IRD according to the rules in PN60. However, if the taxpayer tries to ask the IRD to issue a 2015 tax resident certificate, the IRD would make reference to the rules in PN35 and decline to issue a 2015 tax certificate to the taxpayer. What is SAT's view on the inconsistency in the application of the said rules? Is it possible that guidelines could be issued on this particular matter in order to simplify the process such that the taxpayer can avoid having to ask the IRD to issue a new resident certificate while the old certificate is supposedly still valid for the intended purpose, e.g. by requiring the Hong Kong company to submit a written declaration that there has been no change of residency status during the past 3 years?

SAT: The statement "tax resident certificate issued in 2014" stated in the case is not entirely clear. If the tax resident certificate issued is to certify the resident status for 2014, the certificate should be good for 2014 and the following two consecutive years, i.e. from 2014 -2016. If the certificate issued in 2014 is for certifying the resident status for 2013, the certificate would be good for 2013 and

the following two consecutive years, i.e., 2013-2015.

SAT has been providing guidance on the principle of the Circular to the various tax bureaus in China.

B. Corporate restructuring

1. Indirect transfer/Direct transfer – ascertaining the cost base for the transfer (PN7, Circular 59, Circular 698)

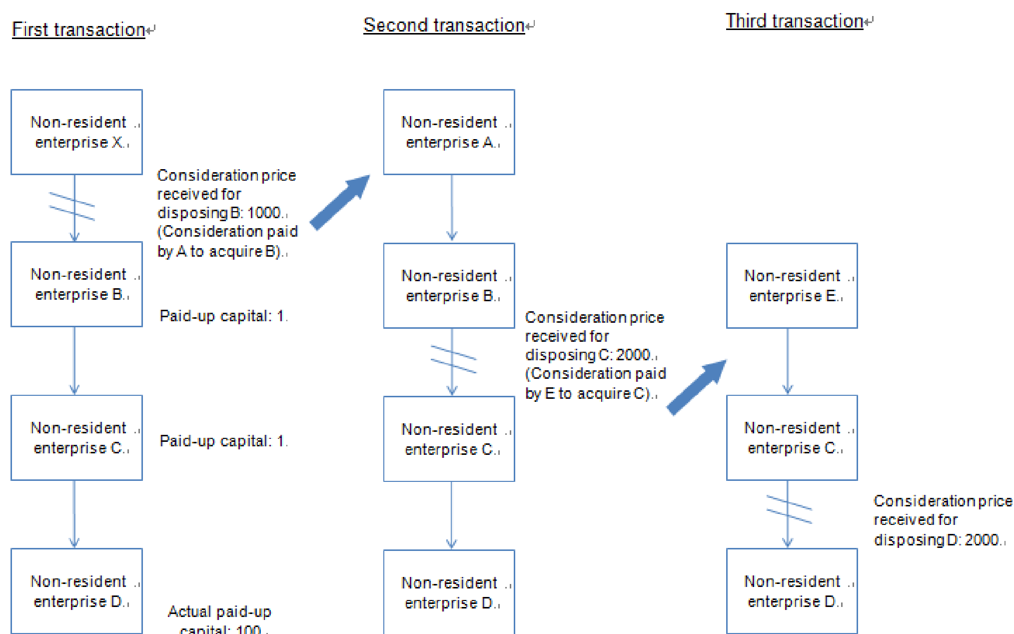
According to Guoshuihan [2009] Circular 698, the cost base in an equity interest disposal of Chinese domestic company by a non-resident company should be the paid up share capital of the Chinese domestic company contributed by the vendor; or the consideration paid by the non-resident company in acquiring equity interest of the Chinese domestic company.

Case 1: A Chinese domestic company was involved in two indirect transfers where different levels of foreign holding companies were involved. Will the tax authority accept the cost of acquiring the foreign holding company by the overseas buyer (i.e. also the vendor in the 2nd indirect transfer) as the cost base for the 1st indirect transfer, i.e. not limited to the paid up share capital of the Chinese domestic company?

As shown in the diagram: Consideration for purchasing non-resident company B by non-resident company A was 1,000. Non-resident X had paid China tax in relation to this indirect transfer. Non-resident company A disposed its interests in the resident company D via its subsidiary - non-resident company B. As non-resident company B had been looked through in the 1st indirect transfer transaction, will the tax authority accept 1,000 as the cost for the 2nd indirect transfer? The 3rd disposal is a direct transfer where non-resident company C disposed its equity interest in resident company D directly. As C had been looked through in the 2nd indirect transfer transaction, will the tax authority accept 2,000 as the cost base for this direct transfer transaction?

If no tax had been paid for the 1st indirect transfer transaction, can the amount paid by non-resident company A in the 1st indirect transfer be used as the cost base for the 2nd indirect transfer?

As there is inconsistency in the interpretation of the rules by the local tax authorities, will SAT issue guidelines to clarify how the said rules should be applied?



SAT: The cost concept has only been briefly defined in Circular 698 and there is no further elaboration or clarification on the cost concept in PN 7. Therefore, there could be inconsistency in applying the cost concept in practice.

SAT did not address the case directly. Instead, SAT had given a generic briefing on the consequence on acquiring the entity indirectly but selling out the target directly; or selling the target via the intermediate holding company level. In general, gains from transfer in the cases that had just been mentioned should be calculated by reference to the cost of acquisition. As for tax that had not been paid at the time of acquisition, the case can be analyzed in two different scenarios. If the first transfer did not fall into the China tax net, the tax authority will not endorse the cost of acquisition in the 2nd transfer. Instead, the tax authority will only agree to the investment made to the underlying Chinese entity as the cost base for calculating the gains in the 2nd transfer. If the first transfer fell into the China tax net but the seller failed to pay tax, the tax authority would endorse the cost of acquisition for calculating the gains in the 2nd transfer. However, the tax authority will also recover the unpaid tax in the 1st transfer when the 2nd transfer is reported to the tax authority. It is worth noting that the vendor in the 2nd transfer, i.e. buyer in the 1st transfer has withholding obligation in the 1st transfer.

SAT is consolidating the experience gained from the precedent cases and the practical experience from executing rules in PN7. SAT may issue guidelines to the tax bureaus aimed at applying a consistent tax treatment in similar cases in future.

2. Reasonable commercial purposes and transactions involved restructuring by phases (PN7, Circular 59)

The 1st group internal restructuring exercise, which involves an indirect transfer that also satisfies the requirement of "having a reasonable commercial purpose", from the safe habour rules in Article 6 of PN7 [2015].

The 2nd group internal restructuring exercise which involves a direct transfer also satisfies the special tax treatment in Caishui [2009] Circular 59 (assuming that there was commercial purpose for the transfer, e.g. preparing for listing)

Some tax authorities consider that the two transactions should be reviewed together to assess if there were commercial reasons for the transactions. If there were no strong commercial reasons for the transactions on a collective basis, the tax authorities would deny the application of the safe harbour rules in the 1st transaction. However, it is our understanding that, as long as the transaction satisfies the 3 conditions laid down in Article 6 of PN7 (i.e. shareholding ratio, shareholding payment ratio, no reduction on the tax burden before and after the transaction), there are reasonable commercial reasons for the indirect transfer, and we do not need to consider other factors; hence, the decision should not be affected by subsequent transactions.

Do you agree with our above interpretation on the safe harbour rules? What is the relationship on the tax laws and regulations between direct and indirect transfer? Is there any value for cross-referencing on the two types of transfer?

SAT: As for direct transfers, according to Circular 59, they can be deemed to be one single transfer if all the transfers happened within 12 months. As for indirect transfer, when the 3 conditions in Article 6 of PN7 are satisfied, the transaction will be regarded as an indirect transfer transaction with commercial justifications. It is worth noting that Article 6 of PN7 does not contain any other provisions except for the three conditions. As long as these three conditions under Article 6 of Announcement 7 are satisfied, there are no other conditions that will affect the claim for commercial justifications. Certain tax bureaus may have different interpretations on these provisions. Therefore, taxpayers should have in-depth discussions with the in-charge tax authorities based on the facts of the case. As a separate note, the fundamentals for direct and indirect transfers are not the same and the tax treatments of the two kinds of transfer should not be cross-referenced with each other.

3. Indirect transfer transaction that would lead to income tax consequence

Article 2 of the EIT law stipulates that "Non-Chinese resident companies are those incorporated according to the law of foreign jurisdictions (regions) and their actual management is residing outside China; and they have not maintained any organization, place of business, nor permanent establishment in China. However, they have income sourced in China." Item 2 of Article 3 of the EIT Implementation Rule stipulates that "companies incorporated according to the law of foreign jurisdictions (regions) mentioned in Article 2 of the EIT law includes those income earning companies and organizations which were established according to the law of foreign jurisdictions (regions)."

a. Units that are not legal entities or perceived EIT paying units

Is PN7 applicable to non-Chinese resident units that are not legal entities or perceived EIT-paying units (e.g. partnerships established outside China), which have transferred overseas holding companies, leading to indirect transfers of Chinese domestic companies? If yes, should the partnerships be treated as "income earning organizations established according to the law of foreign jurisdictions (regions)" and so the taxpayers of the indirect transfer transactions, or the individual partners of the partnership, will end up being the

taxpayers in such cases? If the individual partners will end up as the taxpayers, what is the legal basis for this treatment?

According to Item 2, Article 5 of PN7, when non-resident companies directly hold Chinese taxable properties and subsequently transfer the properties out, gains arising from the transfers would be exempt from paying EIT if there are tax exemption clauses in relation to that kind of transfer in the relevant tax treaties. If a corporate partner of a non-Chinese resident partnership is a tax resident of a jurisdiction where the jurisdiction has a tax treaty with China and there is a provision in the tax treaty that gains arising from shares transfers are tax exempted in China, can we conclude that the corporate partner would have no EIT liability in relation to the indirect transfer transaction by applying Item 2, Article 5 of PN7?

SAT: Article 2 of EIT law spells out that the law is not applicable to individuals. It also indicates that income earning foreign entities or organizations that are properly set up under the foreign law would be regarded as "income earning organizations established according to the law of foreign jurisdictions (regions)", and such foreign entities or organizations can be the taxpaying units. Also there is no further elaboration in the provision whether the foreign entities or organizations are partnerships or transparent entities. Moreover, partners of partnerships will not be treated as taxpaying units.

In addition, the SAT International Tax Division supplemented that tax treaty provisions can only override the local tax law when it is spelt out clearly in the tax treaty. Hence, looking through the partnerships and deeming the individual partners as the taxpaying units may not be appropriate. If partnership are included in future tax treaties, some limitations on the application of the related provision are likely to be added; e.g. the non-resident partnership must have paid tax in the other contracting state before the partnership can enjoy the tax treaty benefits.

b. <u>Ultimate natural person shareholder</u>

We noticed that some tax bureaus will examine the nationality of the ultimate natural person shareholder of the overseas transferor in an indirect transfer transaction, even though the transferor in the transaction is a legal entity, so as to ascertain the EIT consequence of the transaction. If the ultimate natural person shareholder of the overseas transferor is a Chinese national, the tax bureau may look through the transaction and may deem the gain on the transfer as arising from a property transfer between Chinese resident individuals. Accordingly, the ultimate natural person shareholder will be liable to pay individual income tax ("IIT"). What is the legal basis for such tax treatment?

SAT: The "look through" concept does not apply to IIT for the time being. Despite the fact that in a case in 2014 where an individual shareholder engaged in an indirect transfer, the shareholder was deemed to be engaged in a direct transfer transaction. However, this case was special and one should not take this case as a precedent for future reference. After all, non-resident corporations, but not non-resident individuals, are the subject of Circular 698 and PN7. There is lack of legal support to apply the "look

through" concept in Circular 698 and PN7 to individual taxpayers.

4. **Special tax treatment on share transfer transaction**

According to Caishui [2014] Circular 109, special tax treatment on share transfer transactions is applicable on transfers between 100% wholly-owned vertical subsidiaries within China. In a situation where Company A holds Company B and Company B holds Company C (all three companies are Chinese resident companies and they are 100% wholly-owned vertical subsidiaries), special tax treatment would be applicable if the shares of Company B and Company C are transferred to Company A.

a. If there are more layers in the 100% vertical subsidiary structure, say, Company A -> Company B -> Company C -> Company D -> Company E, and Company D transfers its shareholding in Company E directly to Company A, can we still apply the special tax treatment on the transaction? Or the special tax treatment is only valid if the share transfer is done on a step-by-step basis, i.e. transfer to Company C, then Company B and then Company A? If we need to do it step by step, do we need to wait for 12 months before proceeding to step 2 after step 1 is completed?

SAT: Special tax treatment on share transfers is applicable when the 12-month rule can be satisfied under the existing rules and regulations. SAT is studying whether the 12-month rule can be relaxed for group restructuring transactions.

b. If the shares of overseas company are transferred between 100% owned Chinese resident vertical subsidiaries, will the transfer transaction enjoy the special tax treatment?

SAT: There is no specification in Circular 109 whether the share or assets being transferred are located in China or overseas. SAT inclines to the view that it does not matter whether the share or assets being transferred are located in China or overseas for the purpose of enjoying the special tax treatments under Circular 109.

5. **Reasonable commercial purposes (PN 7)**

We noticed that there are many administrative orders from the government demanding that enterprises go through group reorganization. From that "indirect transfer" may be involved in these group reorganization arrangements. Can these administrative orders be regarded as "reasonable commercial purposes" for the indirect transfer transactions?

SASAC had demanded all enterprises to simplify their holding structures, such as reducing the number of layers and number of legal entities in the holding structure. As a result of this simplification exercise, a lot of overseas intermediate holding companies without much business operations have been struck off.

Striking off companies would lead to "indirect transfers" of Chinese resident companies. The simplification exercise mentioned above indeed does not lead to any real change in the ultimate ownership of the Chinese taxable properties. As

there is no monetary settlement on the consideration of the transfer, the PN7 safe harbour rule cannot be applied directly. Therefore, the groups undergoing the simplification processes are facing a high risk of being looked through. Will the tax bureaus consider the "indirect transfers" in the above-mentioned simplification processes as having reasonable commercial purposes?

SAT: Article 3 of PN7 states 7 conditions with detailed elaboration for determining "reasonable commercial reasons". As for the two scenarios discussed in PN7 where the safe harbour rule is applicable, no discussion on "reasonable commercial purposes" is required and we can conclude that Article 1 of PN7 is not applicable to these cases. It is rather inappropriate to conclude administrative orders as reasonable commercial purposes for indirect transfers. The 7 conditions in Article 3 of PN7 are still the key factors which we should make reference to in concluding whether there are reasonable commercial purposes for the indirect transfers.

Referring back to the case, the arrangement may not qualify as internal group restructuring. However, this does not mean that "look through" would automatically apply to this case. We should still refer to the 7 conditions in Article 3 of PN7 and other factors in determining if there are "reasonable commercial purposes" for the transaction.

C. Enterprise Income Tax

1. Preferential tax treatments

A software company set up in 2013 was accredited as a high-technology enterprise such that it can enjoy 2-year tax exemption from the first profit generating year and 50% tax reduction for the subsequent 3 years. The software company made a profit in 2014 and also commenced the 2-year tax holiday in 2014. It follows that the 50% tax reduction treatment commenced in 2016. The software company was also accredited as a key software company in 2016 such that it can enjoy reduced EIT rate of 10%. Should the software company pay EIT at 12.5% or 10% at 2016? If the software company is required to pay tax at 10% in 2016, would the tax exemption status in 2014 and 2015 be affected?

SAT: Inconsistent tax treatments on these cases were noted. Some tax bureaus consider the "2-year tax exemption and 3-year subsequent 50% tax reduction" incentive have to be used in consecutive years once the arrangement has started. Whereas, some tax bureaus would review annually if the taxpayers can still enjoy the tax incentive over the 5 years. The taxpayer can enjoy the 10% tax rate from the year it obtained the key software company accreditation; and the tax status for prior years will be unaffected. SAT will have further discussions with MoF on this issue hoping that consistent tax treatment can be applied on these cases in future.

2. Tax filing requirements for partnerships

According to Caishui [2000] Circular 91 – "Regulation requiring sole proprietor and partnership paying IIT" issued by MoF and SAT, partnerships would no longer be required to pay EIT starting from 1 Jan 2001 and they would be liable to pay IIT according to the IIT laws and regulations instead. This ruling also applies to the

CPA practices set up in the form of special partnership (including conversion from cooperative joint-venture to special partnership Big 4 firms).

http://www.mof.gov.cn/zhengwuxinxi/caizhengwengao/caizhengbuwengao2000/caizhengbuwengao20007/200805/t20080519_21469.html

Most well established CPA firms (or law firms) would have branch offices in major cities in China and the headquarters would send partners to the branch offices to take charge of the business operations. Should these partners under assignment report IIT in the headquarters location or in situ of the branch offices; or where the partners are domiciled?

Certain provisions in Circular 91 could be relevant:

Article 20

Investors should report and pay tax where the actual operation and management takes place. The partnerships should handle the tax filing formalities for the investors who receive profit distribution from partnerships on their operating profit. Partnerships should report and pay IIT where the actual operation and management take place; and copies of the tax returns should be forwarded to the investors for record keeping.

Should we infer "The location of the actual operation and management" as where the headquarters of the company is located? If yes, all the partners should be reporting IIT to the tax bureau where the headquarters is located. However, most tax bureaus in charge of the tax affairs where the branch offices are located disagree with this inference and have a view that the partners working in the branch offices should pay IIT locally. However, if, for instance, there are a few hundred partners working in 10 branch offices and they file tax returns on a consolidated basis at the tax bureau where the headquarters is located, administrative work in relation to tax reporting would be reduced substantially. What is the SAT's view on this matter?

SAT: If the branch itself is also a partnership in nature, it should report IIT of the partners in situ of the branch. If the branch is not a partnership in nature and it is merely a temporary place for business, IIT of the partners should be reported in situ of the headquarters of the partnership.

Besides, the partnership should be subject to corporate income tax and it is inappropriate to attribute the profit to individual partners for tax filing purposes.

D. Value-Added Tax

1. Tax exemption, set off and refund

Assuming there is a company set up and registered in Guangdong, which company maintains a branch office in Beijing; both the headquarters and the branch office are providing research and development ("R&D") services to their overseas clients. According to Caishui [2016] Circular 36, entities providing R&D services to overseas clients can apply for VAT "tax exemption, set off and refund" where the output VAT on their service income would be calculated at zero tax rate. However, the entities have to produce the "foreign trade permit" to the in-charge tax authority before making the VAT "tax exemption, set off and refund" on the above-mentioned

basis. It is worth noting that branch offices would not be able to get the "foreign trade permit" on its own and hence the Beijing branch office would not be able to apply for VAT "tax exemption, set off and refund" on the above basis.
Possible means in resolving the problem for the Beijing branch office:

- Beijing branch office issues R&D VAT invoices to the headquarters and the headquarters would collect all service fees from the overseas clients. The headquarters would also make VAT "tax exemption, set off and refund" application on a consolidated basis. (The drawback for this option is it will take longer to complete the tax refund formalities; and there will be imbalance of tax revenue in the two locations).

- Beijing branch office uses the "foreign trade permit" of the headquarters to lodge the VAT "tax exemption, set off and refund" application with the Beijing tax bureau. (To make it a viable option, SAT has to agree on this proposal and issue guidelines to tax bureaus in different region such that there will not be any geographical differences in the tax treatments).

What is SAT's view on this issue?

SAT: The assumption in the above case is invalid. Companies are no longer required to obtain "foreign trade permit" according to the foreign trade rules and regulations issued in 2014. According to the relevant rules and regulations, companies engaged in foreign trade are only required to file records with the relevant Commercial Bureaus. The tax authorities will handle the tax refund request based on the filing records with the Commercial Bureaus and the documentary proof from the Customs.

As to the solutions proposed above, issuing fake VAT invoices is arguably involved in the arrangements in the 1st proposed solution, hence, it will not work. For the 2nd proposal, the branch office will only be required to file a record with the relevant Commercial Bureau before it applies for the tax refund.

2. Trading of codes by criminals

Recently, many enterprises have raised concerns that their import VAT tax credits have been taken by other companies. As the system only acknowledges the underlying codes rather than the taxpayer names, the codes could easily be sold for illegal purposes. Under the circumstances, should the affected taxpayers inform the in-charge tax authorities on the details of the cases, letting the in-charge authorities to investigate the cases with the tax authorities, and thereby the in-charge tax authorities deal with the party that has tax reductions? The numbers of relevant cases are increasing significantly; hence, it is advisable that tax authorities give more attention to this issue in order to assist taxpayers to file their tax returns correctly.

SAT: The above issue had been resolved due to the continuous betterment of the cooperation between SAT and the Customs.

This is indeed a historical problem. In the past, the Customs had not provided the tax bureaus with the names of the parties involved in goods importations. Therefore, the tax bureaus could not cross check the names of the entities that applied for tax credits and the entities that paid tax at the Customs office. As a

result, if information of the importing entities was leaked out, other entities could claim the corresponding tax credits illegally. As the illegal activities were carried out very swiftly, it was difficult to catch parties involved in these illegal activies. Besides, SAT introduced the new VAT invoice-issuing system in 2013 where information for issuing VAT invoices will be uploaded to the system and information will be cross checked on a real time basis. As such, the chance for issuing fake VAT invoices under the new system is very slim. The focus of the illegal activities then shifted to claiming the input VAT credits.

In the past, if there was mismatched information on the claimants of the input VAT credits, SAT would confirm with the Customs who were actually paying the import VAT. However, the problem became very serious and resolving the problem was a high priority for SAT. SAT closely liaised with the Customs and developed a highly efficient collaboration mechanism to resolve the problem. Under the collaboration mechanism, the Customs would feed the detailed information on the payers of the import VAT to SAT. Based on the information fed from the Customs office, SAT implemented procedures in cross checking the names of the import VAT payers and VAT credit claimants in late 2016. A public notice was issued on the said arrangement and this also signified that a historical problem had been resolved completely.

As some entities had not been claiming input VAT credits in relation to the imported goods on a timely basis and the input VAT credits could possibility be related to importation prior to the implementation of the new mechanism, the taxpayers may face the same old problem when they try to claim the VAT credits. As mentioned above, the problem has been fundamentally resolved after implementation of the new mechanism, so the number of these cases should reduce substantially over time.

In the above stated cases, the tax authorities indeed can protect the taxpayers' right via the subsequent validation mechanism. According to the Public Notices 31 & 69 issued in 2013, if the tax credits were claimed by people other than the legitimate claimants due to illegal activities, the legitimate claimants can claim VAT credits after SAT has successfully validated the relevant information with the Customs. In addition, as the systems of SAT and the Customs for checking the import VAT information will be linked up starting from 1 June 2017, the efficiency of the validation process would be further improved at that time.

3. Shares listed in National Equities Exchange and Quotations

Public Notice 53 issued in late August 2016 stipulates that publicly traded shares are within the VAT scope, and lays down rules for determining the purchase prices of three restricted share types. However, the Public Notice did not clarify whether transfer of shares listed in National Equities Exchange and Quotations ("NEEQ") should be subject to VAT and how the tax should be levied. There are two schools of thought. Some people find the profit on trading of shares in NEEQ should be subject to VAT as the underlying shares, it could be argued, are publicly traded even though the differences are noted between NEEQ and the main boards. Others think that the trading gain should be non-taxable as the entities listed in NEEQ are not listed companies under the definition of the regulation issued by China Securities Regulatory Commission on provisional measures for the administration of NEEQ. Local tax authorities are reluctant to give direct answer on this question.

SAT: There is no definite answer to the question regarding share trading on NEEQ. The question is not new and indeed there was no consistent view on how to calculate the business tax burden before implementation of the B2V reform. From the point of fairness and to make sure that the tax treatment would follow a consistent policy, SAT issued a Public Notice clarifying that when the trading restriction on shares is uplifted, the shares will be treated as listed shares. VAT is payable on transfer of listed shares. However, transfers of shareholdings of private companies will not attract VAT. Shares listed on NEEQ have a similar nature to public listed shares, e.g. with public circulation, prices of the shares are determined by market forces. The only marked difference between the NEEQ and the Stock Exchanges in Shanghai and Shenzhen is the mode of trading. However, the mode of trading should not affect the nature of the transaction. Despite this, it is a hard fact that shares listed on NEEQ do not have the listed company status, and people are holding divergent views whether transfers of shares listed on NEEQ should be subject to VAT. SAT will further study on this topic and may issue policy or guidance on this topic at a later stage.

E. Transfer pricing/advance pricing arrangements

1. Master files and domestic files

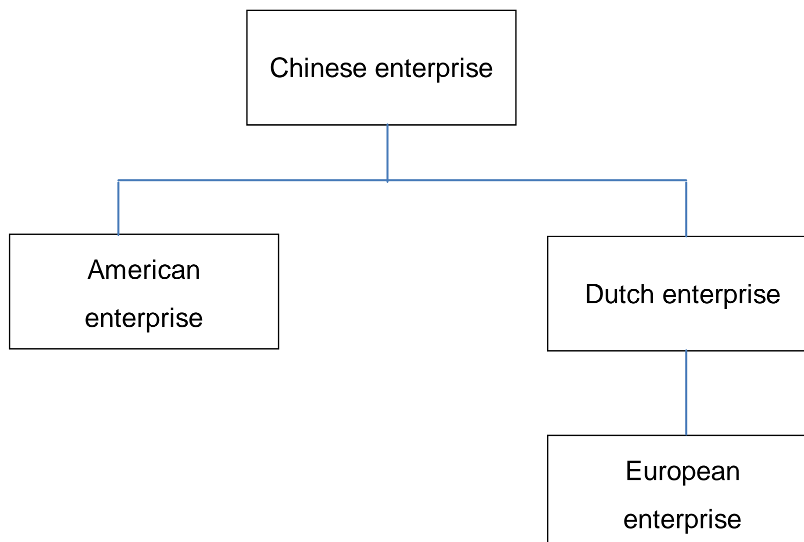
a. Master files

It is provided in SAT Public Notice [2016] No. 42 ("PN42") that enterprises fulfiling the following conditions should prepare master files:

1. A group of companies has cross-border related party transactions during the year and the head office which consolidates all financial results in its financial statements is required to prepare a master file.

2. Quantum of related party transactions during a year exceeds RMB1b

There are certain ambiguities in the first point, please see below:



i. Despite the fact that the quantum of the related party transactions in the Dutch entity is low, the Dutch entity is still required to prepare a master file according to the requirements of the Netherlands. In this case, the

Dutch entity is only required to document the related party transactions between the Dutch entity and other group entities in Europe.

As the Dutch entity in the group has already prepared a master file, some tax authorities consider that it is not necessary for the Chinese holding company to prepare a master file according to the first point. We are of the view that the master file prepared by the Dutch entity is a limited scope report i.e., only covers related party transactions between the Dutch entity and the group companies in Europe. Therefore, the master file prepared by the Dutch entity is not an equivalent to the master file for the entire group. What is SAT's view on this point?

> SAT: If the ultimate holding company in China does have the obligations to prepare and file master file, it has to prepare and file the master file covering all entities in different parts of the world. Master files that only cover the Netherlands and Europe will be considered as incomplete. If, however, the holding company does not have any obligation to prepare and file master file, the Dutch subsidiary will only need to follow the local requirements for master file preparation.

ii. Chinese groups adopting the "going aboard" strategy may not have a lot of related party transactions with overseas group companies (approximately a few million RMB during the year). However, these Chinese groups may have a lot of related party transactions with other group companies in China (approximately over RMB1b). As per the second point, these groups would be required to prepare master files as the quantum of related party transactions exceed RMB1b. Will SAT consider refining the "quantum of the related party transactions exceeds RMB1b" condition by dividing the related party transactions into related party transactions with domestic and foreign group entities?

> SAT: It is difficult to assess the weighting between domestic and international related party transactions in the initial stage of setting up the standards. Therefore, SAT choose to set a lump sum figure of RMB1b to encapsulate both domestic and international related party transactions. The example quoted above is an extreme case. The taxpayer would have minimal reporting obligations on the international related party transactions. Hence, the master file is nearly the same as its local file such that preparation of the master file would not be very burdensome to the taxpayer.

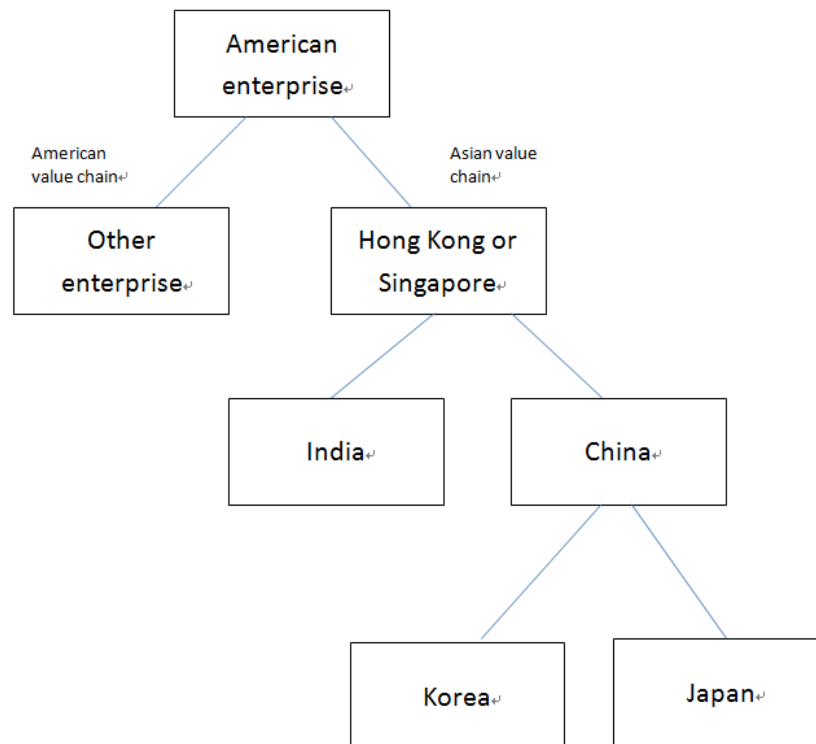
b. <u>Domestic files</u>

Enterprises are required to include a value chain analysis in the local file starting from 2016 per PN42, including:

- An analysis on the business transaction flow, logistic arrangements and fund flow – including analyses of the design and development, manufacturing, marketing and promotion, sales, goods delivery, settlement, consumption pattern, after sales services, recycling and other participants in the transactions.

- The most recent financial statements of parties involved in the above-mentioned activities.
- Location advantages enjoyed by the enterprises; basis for quantifying the location advantages and source of these advantages.
- Income allocation basis among the global value chain and allocation outcome.

Fulfilment of the above requirements could be impose a heavy burden on large multinational corporations, as multiple entities could be involved in a part of the value chain, e.g.



As indicated in the above diagram, multiple entities in Asia are involved in part of the value chain and these entities are in different countries. It is a lot of work and burdensome if detailed information of the entities involved in part of the value chain is required to be disclosed in the report. All these information may not be entirely relevant to the value chain analysis to be conducted by the tax authorities. Will SAT consider allowing taxpayers to include value chain section information on a consolidation basis, i.e. consolidating information of the multiple entities involved in the particular section of the value chain?

As a separate note, the Chinese entity is only involved in the Asia value chain. In other words, the America value chain is irrelevant to the business activities of the Chinese entities. We would like to clarify whether we can exclude the America value chain in the value chain analysis in the local report.

Will SAT issue further guidelines or model value chain analysis that needs to be included in the local report?

SAT: The tax authorities do not have a strong grasp of the information. Therefore, SAT would like to look at the full picture of the mode of operations of the taxpayers via studying the value chain analysis. For example, if an entity located at location A only carries out a single function, the tax authorities would only have the chance to review activities related to this single function. If, however, the tax authorities were able to understand the mode of operations of the group via studying the value chain analysis, the tax authorities would have relatively complete picture of the group. Reviewing the China-related Asia value chain should be the focus of the above example.

Besides, tax authorities will also study the actual functions performed by the group entities, profit generating activities and the allocation basis between the entities. For example, some Hong Kong groups have allocated a big portion of profit to Hong Kong but most of the staff of the group are located in Dongguan. The workforce in Dongguan indeed takes charge of most of the actual operations of the group. However, the Dongguan entity would only be allocated profit on the basis of cost plus a thin margin. The Hong Kong entity seems to be the procurement centre on the surface but the actual situation could be different.

The value chain analysis requirement, on one hand, follows the BEPS requirement. On the other hand, it is also an action taken after consolidating the experience of transfer pricing cases over the years.

Though the value chain analysis requirement does lead to additional work to the taxpayers, taxpayers' risks for being tax audited by the tax authorities due to information asymmetry would be greatly reduced.

2. **SAT Public notice [2017] No. 6**

a. It has been reiterated in SAT Public Notice [2017] No. 6 ("PN6") that the tax authorities will not conduct tax investigations or make tax adjustments in relation to related party transactions within group entities in China, as long as the related party transactions have not resulted in a reduction in the tax collection of the nation. We would like to clarify whether the special tax adjustment procedures in PN6 would be applicable to related party transactions where the tax rates applicable to the parties involved were different.

SAT: Ideas contained in Article 38 of PN6 are in line with Circular 2 issued in 2009, i.e., as long as the overall tax revenue of the nation will not be affected by transactions between two domestic entities, which are subject to the same tax rate, no special tax adjustment will be imposed. In relation to the actual operations, we can use the reverse logic to think about the case: (i) Is there any difference in the tax rate and (ii) will the difference in the tax rate directly or indirectly affect the tax revenue of the nation. Point (ii) is the focus of the tax authorities in reviewing similar cases.

b. As per the requirements in PN6, enterprises should file the new "special tax adjustment self declaration form" as a supporting document for making additional tax payments, as a result of the self-initiated adjustments made. Can the duly completed forms be used to initiate the mutual discussion process so as to eliminate the risk of double taxation?

SAT: Taxpayers cannot use this form to apply for mutual negotiation for double tax elimination. SAT encourage taxpayers to file self declaration adjustment forms from a risk management point of view. However, the management system for self declaration adjustment forms is far from satisfactory. SAT will not rule out the proposed operation in future, but it is definitely not possible at the present stage.

c. According to PN6, when tax authorities analyse the transfer pricing on cross-border import processing agreements, the tax authorities may make adjustments by reversing the transactions on free-of-charge importation of raw materials and equipment if there is lack of market comparables to the transactions. Can we make reference to this method in analysing the transfer pricing for those groups which engage their domestic group companies in the manufacturing processing?

SAT: A lot of contract processing arrangements in Guangdong have been converted into import processing arrangements in recent years. Processing fees charged by the domestic factories were calculated on a cost plus basis, but cost of raw materials had not been included in the base in the "cost plus" calculation. The tax bureaus considered the cost of raw materials should be included in the base for the cost plus calculation and therefore tax adjustments will be made. As most of the domestic factories would provide certain raw materials in the processing arrangements and it is rare for domestic factories merely providing processing services to the overseas parties, the comparable items would be missing if the cost of raw materials is not included in the base for the cost plus calculation. Tax authorities would be very cautious in making this kind of adjustment and the adjustment would in general not exceed 10% of the processing fees. SAT stressed that the tax adjustments are to bring the comparable items back into the formula, not merely aimed at increasing the tax revenue of the tax bureaus.

d. We noticed that there is no clarification/guideline on how to quantify location advantages and basis of adjustments among the group entities, if applicable, in PN6. Will SAT issue further guidelines in relation to this subject?

SAT: There have been a lot of discussions on the topic, including cost saving and market premium, at both the international and domestic levels. Cost saving is easier to manage in practice. However, we noticed that there are major differences across industries (e.g. motor vehicles, drug manufacturing, luxury products) in the market premium study as there are fundamental differences on the risk levels associated with different industries. Hence, it would be difficult to issue a clear unified guidance on this part. SAT would follow the OECD approach but it would be difficult to produce a valuation template for this purpose.

It is actually appropriate for SAT to include location premium in the valuation model. SAT, at one time, considered including location premium as intangible asset in the valuation model. However, SAT will follow the BEPS profit attribution to economy benefit rule in the actual valuation exercises.

F. Individual Income Tax

1. Income from partnerships

Partnerships have been commonly used as shareholding platforms for listed companies in China. Certain partners in the partnership are indeed employees of the group and these partners receive their share-based incentive via the partnership. Under the said arrangement, employees are required to sign partnership agreements in which they will bear the responsibility and risk of the partnership. Despite the partnership arrangement, the employees would still be required to render services to the company and receive salary. It is not uncommon for the partnership agreements to include clauses that require the employees to meet certain requirements (e.g. good service performance or number of years of services in the company the employees are working in). The profit sharing ratio may not be the same among the employees and the employees may cease their partner status in the partnerships when they leave the companies that they are working with.

Should the nature of income (e.g. profit sharing, gains arising from share transfers) of the employee partners be the same as other partners of the partnership? It may be worthwhile to revisit the reasonableness of deeming the income from the partnership as employment income or share-incentive plan of the employees.

SAT: No special tax treatment would be applied to individual partners from a tax angle. Therefore, it does not matter whether the partner is an employee of the company. To certain extent, the look through concept applies to the profit sharing by individual partners for IIT purposes. As for the income from transfers of shareholdings, it should be treated as income from business operations. Tax will be levied after distributions are made to the individual partners.

Shares or equity stake holding incentive plans (no matter whether the shares or equity stake belong to the company that distributes the incentives) are indeed a means for the employers to distribute shares (or pay remuneration in a tangible form) to the employees at a discounted price. When employers distribute an equity stake to employees, the tax treatments should follow those applicable to share incentive plans. While the employees are partners and there is profit sharing from the partnership after the underlying enterprise gets listed, or the employee transfers out shares of the listed company as a partner of the partnership, tax will be levied after the real distribution has been made to the employee as that income will be regarded as income derived from the business activities of the partnership.