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

Minutes of meeting

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

2012

2012
ANNUAL MEETING BETWEEN
THE STATE ADMINISTRATION OF TAXATION AND
THE HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Foreword

This year, Hong Kong Institute of Certified Public Accountants ("Institute") was very pleased to be able to hold its inaugural annual meeting with the State Administration of Taxation ("SAT") to discuss and exchange views on various taxation issues.

The following is a translation of the original Chinese minutes prepared by the Institute. Please note that the minutes are intended for general guidance only. Professional advice should be taken before applying the content to your particular situation. If there are differences in the interpretation between the English and Chinese versions, the Chinese version shall prevail.

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Meeting minutes

The meeting between the Hong Kong Institute of Certified Public Accountants and the State Administration of Taxation was held on 28 June 2012 at No.5 Yangfangdian Xilu, Haidian District, Beijing.

Attendance

State Administration of Taxation ("SAT")

Mr Peng Ning	Associate Counsel, International Taxation Department
Mr Zhang Weihua	Director, Business Tax Division, Goods and Services Tax Department
Ms Fu Yao	Director, International Taxation Department
Mr He Daocheng	Consultant, Enterprise Income Tax Division, Income Tax Department
Mr Gao Yungen	Deputy Director, International Taxation Department
Mr Chen Feng	Principal staff member, Division of Taiwan, Hong Kong and Macao Affairs, International Taxation Department
Mr Wang Yi	Principal staff member, Anti-Avoidance Division, International Taxation Department
Ms Wang Wei	Principal staff member, Business Tax Division, Goods and Services Tax Division

Hong Kong Institute of Certified Public Accountants ("the Institute")

Mr Clement Chan	Vice President, Hong Kong Institute of CPAs
Mr Tommy Wong	Executive Director, Hong Kong Institute of CPAs
Mr Anthony Tam	Member, Taxation Committee, and Convenor, Mainland Taxation Subcommittee, Hong Kong Institute of CPAs
Mr Christopher Xing	Member, Mainland Taxation Subcommittee, Hong Kong Institute of CPAs
Mr Michael To	Member, Mainland Taxation Subcommittee, Hong Kong Institute of CPAs
Ms Rebecca Wong	Partner, China Tax & Business Advisory Services, PricewaterhouseCoopers Consultants (Shenzhen) Limited
Ms Jia Li	Senior Consultant, Deloitte Touche Tohmatsu, Beijing
Mr Wallace Wong	Manager, Specialist Practices, Hong Kong Institute of CPAs

SAT's chief representative, Mr Peng Ning and other SAT representatives present welcomed the Institute's representatives. The Institute's vice president, Mr Clement Chan thanked the SAT for arranging the meeting. The Institute hoped that the meeting would be a platform to develop exchanges between the SAT and the Institute.

Agenda items

A. AVOIDANCE OF DOUBLE TAXATION ARRANGEMENT BETWEEN MAINLAND CHINA AND HONG KONG

A1. Shipping income

(i) "Wet lease"

According to Article 8 of the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income ("China-Hong Kong DTA") signed in 2006, the income and profit derived by a Hong Kong resident enterprise from operation of ships in international shipping which touches on Chinese waters shall be exempted from both Business Tax and Enterprise Income Taxes. Although the China-Hong Kong DTA (including the 1998 limited-scope China-Hong Kong DTA), unlike the China-Singapore Treaty, did not define what is meant by "international transportation business" (referred to in treaties as operating in "international traffic"), SAT defines "international transportation business" in GuoShuiWaiHan [1998] No.37 ("Circular 37"). Circular 37 pertains to the China-Hong Kong DTA and states that income from "wet lease" of ships, i.e., lease of ships together with equipment, crew and supplies, shall be regarded as income ancillary to international transportation business and be entitled to tax exemption in China, without specifying the maximum allowable percentage of income from these ancillary activities over the total international shipping income.

Furthermore, SAT has issued GuoShuiFa [2010] No.75 ("Circular 75") which is based on the China-Singapore Treaty. Circular 75 states that, for a foreign enterprise engaged in international transportation business by operation of ships, if there is a tax treaty between the home country of the foreign enterprise and China that includes Article 8 on international transportation business, that Article would exempt international transportation business income from taxation in China.

Such international transportation business income would include:

- Income derived from international transportation of passenger and cargo by ship.
- Income derived from activities "ancillary to international transportation business" (including "wet lease", "dry lease", and ancillary or temporary activities of container leasing associated with the "wet lease" or "dry lease" (i.e., income ancillary to international transportation business)).

When determining whether the activities generating the above second item of income are "ancillary", the first consideration is whether the enterprise's main business is international transportation business, based on the industrial and commercial registration, as well as other relevant information and documents. Then, it should consider the relative percentage of income from such ancillary activities relative to the gross income from the enterprise's international transportation business. Generally, the income from ancillary activities shall not exceed 10% of the international shipping income in an accounting year.

If a Hong Kong shipping enterprise mainly engages in "wet lease", could it continue to enjoy tax exemption, according to Circular 37, or would the tax exemption be denied due to its failure to satisfy the condition in Circular 75 that "ancillary business income shall not exceed 10% of total international shipping income"?

(There is a recent case on international transportation business in Shandong. The taxpayer, a South Korean enterprise chartered a ship with crews (i.e., wet lease) to a Shandong entity. In accordance with the China-South Korea Treaty, it applied to the Shandong Tax Bureau for an exemption of the income derived from its "wet lease". The tax bureau rejected the taxpayer's application on the basis that the company was engaged only in "wet lease" with no other income. According to Circular 75, the enterprise could not enjoy the tax exemption since its income from ancillary activities exceeded 10% of the gross income.)

SAT pointed out that the representatives of Hong Kong Inland Revenue Department ("HKIRD") also raised the same question during their meeting in June 2012. If a business operation of a Hong Kong transportation enterprise satisfied the requirements of the China-Hong Kong DTA, the income from the operation would also satisfy the requirements for tax exemption.

The provision in Circular 75 that limited the income from ancillary activities to not exceeding 10% of the gross income was mainly for the aviation industry, without detailed consideration of the shipping industry. According to the Organization for Economic Co-operation and Development, OECD guidelines, ancillary activities mainly referred to "dry lease", not "wet lease". "Wet lease" was classified as international transportation business by itself rather than as an ancillary activity. A Hong Kong shipping enterprise that was wholly engaged in "wet lease" would be classified as carrying on an international transportation business and enjoy the tax exemption.

(In the Shandong case, the company was a Korean resident enterprise. Its business scope covered service, wholesaling, transportation, immovable property, career service, etc., of which, the transportation business was in ship leasing. Although the company leased a ship and provided the shipping crews to a China company, it could not prove that it engaged mainly in international transportation business. Therefore, the question as to whether "wet lease" should be classified as international transportation business was not a consideration.)

(ii) "Dry lease"

In the case of "dry lease", what should be the treatment? (noting that Article 8 of the China-Hong Kong DTA is different from that in the China-Singapore Treaty)?

In practice, a majority of the Hong Kong shipping enterprises is engaged in "wet lease" and "dry lease", and derives rental income (i.e., charter hire). According to the provision in Circular 75 that states that income from ancillary activities shall not exceed 10% of the gross income, if the main business of the enterprise is "dry lease", the business cannot be recognized as international transportation business and cannot enjoy the exemption from Enterprise Income Tax or withholding tax that is stipulated under Article 8 of the China-Hong Kong DTA. Nevertheless, it should be noted that HKIRD, in determining the source of income, treats charter hire (irrespective of "wet lease" or "dry lease") as part of the shipping income and calculates the taxable income according to section 23B of Hong Kong Inland Revenue Ordinance, instead of treating it as ordinary rental income.

SAT pointed out that "dry lease" could only be regarded as ancillary activity to the international transportation business. Thus, if the Hong Kong shipping enterprise was engaged in international transportation business, and its income from "dry lease" did not exceed 10% of the gross income, it could enjoy the tax exemption. If the Hong Kong shipping enterprise was engaged only in "dry lease", or if the income from dry lease exceeded 10% of the gross income, the income would be regarded as rental income and taxable according to the leasing industry.

A2. <u>Circular 601</u>

(i) Revised guidelines

GuoShuiHan [2009] No. 601 ("Circular 601") defines the concept of "beneficial owner" , which is applicable in relation to double tax treaty provisions on dividends, interests and royalties. It lists some factors that would negate the "beneficial owner" status of income recipients. The circular is applicable to all China's tax treaties, including the China-Hong Kong DTA.

Would SAT be issuing more guidelines regarding Circular 601, in particular, the following aspects?

- Relaxing the conditions for the payee to have substantial commercial activities.

- How to determine whether an enterprise has substance?

- Please confirm whether "investment management" is regarded as substantial commercial activities under the category of "management" as stated in Circular 601.

SAT pointed out that Circular 601 would be clarified in stages and the next circular could not address all aspects. For example, on the matter of substantive commercial activities, it should be determined based on the enterprise's actual situation. Thus, it was difficult to give further explanation here.

(Institute note: SAT issued Announcement No.30 on 29 June 2012, which gives some guidelines on the determination of the status of a "beneficial owner". The announcement is attached at Appendix 1. Please note that only a Chinese version of the announcement is available.)

(ii) Supplementary rules on "conduit company" under the China-Hong Kong DTA

Hong Kong listed companies generally invest in China using Hong Kong or British Virgin Islands ("BVI") companies (with management in Hong Kong). These intermediate holding companies are often treated as "conduit companies" by the tax bureaus and would not be entitled to use the China-Hong Kong DTA. We understand that SAT is aware of these situations and would issue supplementary rules. Please advise on the developments of this matter.

SAT would issue the "safe harbour" rules under which companies listed in Hong Kong could enjoy the benefits of the China-Hong Kong DTA when receiving dividends, interests, etc., and the "beneficial owner" rules would not apply. Hong Kong resident companies listed in Hong Kong could fully enjoy the tax treaty benefits. If the listed companies were BVI companies, they might encounter problems when applying for treaty benefits if they did not have Hong Kong residency status.

For Hong Kong listed companies holding equity in Chinese companies via intermediate holding companies, such as Cayman Island or BVI companies, the "safe harbour" rules could not apply when the China companies distributed dividends to the direct holding companies. <u>The "safe harbour" rules could apply only when all the intermediate holding companies were Hong Kong resident companies</u> (our emphasis). It did not mean that all non-Hong Kong resident intermediate holding companies could not enjoy treaty benefits. In order to enjoy treaty benefits, these companies should first determine whether they qualified as "beneficial owners" according to Circular 601.

The Institute asked if the management of the BVI companies was located in Hong Kong, could the BVI companies be treated as Hong Kong residents and enjoy the treaty benefits? SAT pointed out that they had already communicated with the HKIRD regarding this question and hopefully HKIRD would further define the status of Hong Kong resident. Due to the widespread abuse of the tax treaties in China, SAT would, in practice, still consider the concept of beneficial owner and give more guidelines to local tax bureaus on how to determine the residency status of foreign companies.

(Institute note: According to Announcement No.30, the guidelines for the “safe harbour” rules are: "If the enterprise is a listed company of the contracting state, or if the enterprise is 100%, directly or indirectly, owned by the listed company, which is also resident of the same contracting state (excluding where equity is held via a non-Chinese resident or resident enterprise of a third party country or region), and the dividends are attributed to the equity interest held by the listed company, application can be made for "beneficial owner" status.")

B. <u>CROSS-BORDER TAXATION</u>

B1. <u>Circular 698</u>

(i) Guidance on possible tax exemption for internal group restructuring

SAT has issued <Circular of the State Administration of Taxation on Strengthening the Administration of Enterprise Income Tax on Income from Equity Transfers of Non-Resident Enterprises> (“GuoShuiHan [2009] No.698”) on 10 December 2009. According to the circular, if a foreign investor (who is the actual owner) indirectly transfers its equity in a Chinese resident enterprise by transferring the shares of the intermediate holding company ("holdco"); and if the location of the holdco, a foreign holding company, has an effective tax rate below 12.5% or levies no tax on off-shore income of its residents, the foreign investor shall provide the relevant information to the competent local tax bureau where the Chinese resident enterprise is located within thirty days upon the conclusion of the equity transfer contract.

Could SAT provide some guidance on the following aspects in relation to the circular?

Would exemption be given to "qualified internal organization restructurings"? Could SAT advise if there is a timetable for the introduction of a supplementary circular? Could any key points to be contained in the supplementary circular be explained?

SAT pointed out that the indirect transfer during internal restructuring, which fulfilled the qualifying conditions for a tax-deferred reorganization (under GuoShui Han [2009] No. 59 ("Circular 59")), would likely be tax exempted. Further supplementary comments to Circular 698 would be issued, but the comments to be included and the timetable for their release were still under consideration.

(ii) Approval time

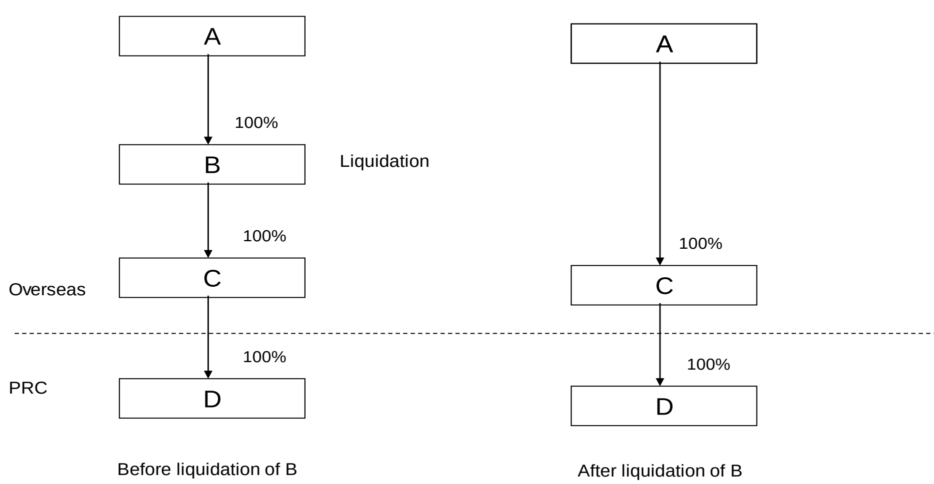
Could SAT indicate the time required to issue approvals for cases caught by Circular 698; for example, would the approval take a month or two months? Would written approvals be issued?

SAT pointed out that there would be a supplementary announcement to Circular 698, which could provide more information about the approval time.

The Institute asked about the time required for an enterprise to get a preliminary approval upon submitting the information to the local tax bureau. In practice, the local tax bureau seemed to take a long time to rule whether the enterprise would be subject to tax on the indirect transfer. SAT explained that, in practice, when the determination was not clear cut to the local tax bureau as to whether the equity transfer should be taxed or not, they would not issue the final reply. Under normal circumstances, if the tax bureau considered the equity transfer to be taxable, it would take less time for the tax bureau to conclude. If the transaction was very complex, further submission of documents to SAT would be required.

(iii) Impact on foreign companies under liquidation and definition of equity transfer

Assuming a foreign enterprise is liquidated which turns its foreign subsidiary into a directly owned subsidiary of its parent company, and the foreign subsidiary invests in a China resident enterprise (please see the following chart):



Although Circular 698 defines "equity transfer income" as the income obtained by a non-resident enterprise from the equity transfer of a Chinese resident enterprise (excluding sale and purchase of listed shares of a Chinese resident enterprise in open securities markets), there is no clear definition as to what constitutes an “equity transfer”. The general understanding of equity transfer involves sale and purchase, which means one party gives out cash, non-cash assets, or its own shares, etc. in exchange for the equity interest of another party. Under a liquidation, the investment portfolio of the liquidated enterprise (i.e., Company C in the chart), may be absorbed by the parent company in the form of distribution-in-kind by the liquidated enterprise (i.e., Company B in the chart). The parent company will book the investment portfolio in the accounts by using the fair market value.

- Would SAT treat a company under liquidation that distributes its shares in a subsidiary to its parent company and this subsidiary holds investment in a Chinese resident enterprise, as an indirect share transfer of the Chinese resident enterprise? Would SAT require the foreign enterprise under liquidation to furnish the information required under Circular 698, if the location of the foreign company under liquidation has an effective tax rate below 12.5% or levies no taxation on off-shore income?

- Since there is no clear definition of “equity transfer” in Circular 698, would the following situations be treated as “equity transfer”?

  - A foreign enterprise holding the equity in a Chinese resident enterprise issues new shares to foreign investors with a "bona-fide commercial purpose"; or
  - Several foreign companies holding shares of a Chinese resident enterprise, perform a merger/share split, etc. with a "bona-fide commercial purpose".

SAT pointed out that there was no clear definition for "equity transfer" under either tax law or company law. They would determine "equity transfer" based on the following two aspects:

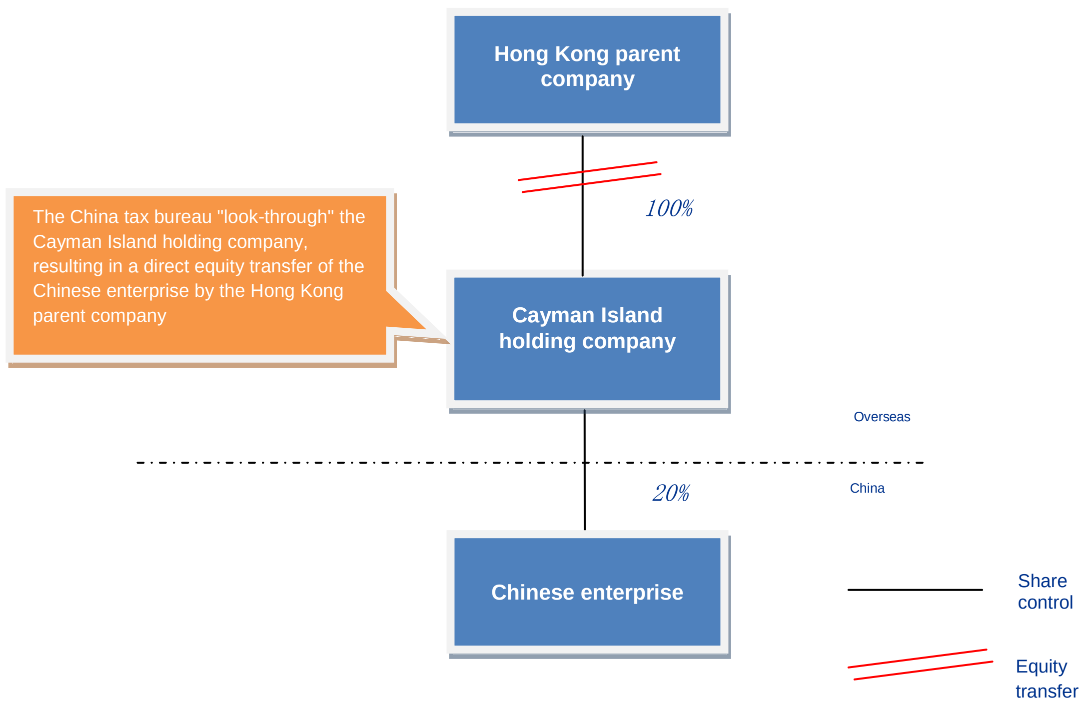
- Whether there was any change of the shareholders; or

- Whether there was any consideration paid among the shareholders. Capital injection via private placement or issuance of new shares was generally not treated as equity transfer.

In the above situation, the liquidation of the intermediate subsidiary resulted in a change of investor, thus it should be treated as equity transfer and information should be furnished to the local tax bureau, where the Chinese resident enterprise, the equity of which was being indirectly transferred, was located. With regard to whether the above situation constituted a direct equity transfer of a Chinese resident enterprise such that the foreign enterprise should be taxed according to Circular 698, judgment would be made based on the actual facts of the case.

B2. The China-Hong Kong Treaty protection against being "looked-through"

Please refer to the following chart:



In the above situation, if the Chinese tax authority looks through the transferred foreign enterprise (i.e. the Cayman Island holding company) and deems the Hong Kong parent company as disposing its interest in the Chinese enterprise, and the property of the indirectly transferred Chinese subsidiary does not directly or indirectly compose mainly of immoveable properties in China, can the transferor (i.e. the Hong Kong parent company) still enjoy treaty protection under the paragraph 6 of Article 13 of the China-Hong Kong DTA?

SAT answered that, although this was an indirect transfer, by looking through the Cayman Island enterprise, the transfer constituted a direct transfer of the Chinese enterprise. If the requirements for tax exemption under the China-Hong Kong DTA were satisfied, no tax would be imposed. Circular 698 was aimed at combating abusive tax evasion. For activities that met the DTA requirements for exemption, they should be allowed to apply the protection under the tax treaty.

B3. <u>Circular 59</u>

(i) "Share swap" arrangement during initial public offering ("IPO")

Take an example where, during restructuring, a foreign enterprise (Company A) transfers the equity of its Chinese subsidiary to another wholly-owned foreign holding company (Company B). According to GuoShuiHan [2009] No. 59, the transferor, Company A, would undertake to not transferring the equity of the transferee, Company B, within three years.

This rule often causes problem for enterprises going for IPO. During the listing process, the major shareholder needs to transfer the old shares to public investors, and then subscribe for new shares with the proceeds so obtained under a "share swap" arrangement. In the above example, Company B would undergo an IPO. During listing, Company A (the major shareholder) would transfer certain number of its shares in Company B to public investors. The proceeds would be used to subscribe equal number of new shares of the IPO enterprise (Company B). This arrangement is to facilitate pricing and control the number of shares to be issued to public investors. In essence, the major shareholder did not transfer the equity of Company B. The same percentage holding of majority and minority shareholders would result if Company B were to directly issue new shares to public investors.

Under this circumstance, would SAT consider that the major shareholder, Company A, did not violate the rule that prohibts equity transfer within three years?

SAT replied that although the "share swap" arrangement was a special circumstance in the IPO process, Circular 59 clearly stated that the foreign enterprise (transferor) should undertake not to transfer the equity of the non-resident enterprise (transferee) within three years. Thus, the arrangement violated the condition in Circular 59 when the non-resident enterprise (transferee) underwent IPO and the original transferor undertook a "share swap" during the listing process.

(ii) Whether convertible bonds could be treated as share consideration

In a corporate restructuring, as consideration for the share transfer, the transferor obtains convertible bonds from the transferee, and shortly afterwards converts the bonds into shares of the transferee. If the transferor converts the bonds into shares of the transferee before the annual tax return filing date, would SAT treat this as share consideration from the transferee?

SAT pointed out that there were two scenarios. According to Circular 59, if the restructuring was an equity acquisition, the acquirer should acquire at least 75% of the total equity of the acquiree. Thus, if the acquisition object was convertible bonds of the acquiree, the convertible bonds would not be treated as equity in calculating the 75% of total equity being transferred, whether or not they were converted shortly afterwards.

In another scenario, if the transferor obtained convertible bond of the transferee during the restructuring and the transferee used the bond as consideration to pay the transferor, there were no clear tax rules as to whether converting the bond to shares before the annual settlement date should be treated as a share consideration, which was required under Circular 59. According to the spirit of Circular 59, the transaction might be treated as qualifying tax-deferred reorganization. If the time for conversion did not exceed 12 months, it could be treated as one-off (but step-by-step restructuring) transaction. All the shares obtained during the 12 months could be included in calculating the 85% portion of share consideration relative to total consideration.

(iii) Treatment of liquidation gains

A foreign enterprise ("parent company") invests in a foreign-owned enterprise in China via another foreign holding company ("subsidiary"). Due to commercial reasons, the subsidiary is liquidated and the foreign-owned enterprise becomes directly held by the parent company. Could the accounting gains obtained by the parent company from liquidating the subsidiary be treated as deferred income for tax purposes according to the Circular 59? (Would this situation, which is similar to the B1(iii) above, only involve the treatment of Circular 698, i.e., filing relevant document to the tax authority?)

SAT pointed out that the above liquidation would be treated as equity transfer, but did not meet the qualifying conditions of the special tax treatment for restructuring under Circular 59.

B4. <u>Foreign partnership</u>

For income tax purpose, a sino-foreign partnership enterprise set up in China is taxed at the partner level with the partners as taxpayers. The tax treatment should be determined according to the nature of the income being distributed, whether the partner is a Chinese or foreign resident, and whether the partner is an individual or enterprise.

The income of a partnership enterprise often consists of operating income, including sales of goods, service income; as well as non-operating income from transfer of properties and equity, other income from equity investments such as dividends and bonuses, interest, rental, royalty, etc.

In relation to the foreign partners, the Institute has the following questions:

- Would a foreign partner be regarded as having a permanent establishment in China because of the partnership?

- When a foreign partner receives its share of operating income, would it be correct to look at whether the foreign partner is an individual or an enterprise in order to determine if the operating income should be subject to the income tax rate of 20% (for individual) or 25% (for enterprise)?

- When a foreign partner receives its share of non-operating income, should it, according to relevant tax rules, be subject to the relevant withholding tax rate of 10% or 20%?

- When a partnership makes an investment and receives dividends, would a foreign partner without a permanent establishment in China by itself be subject to the tax rate of 20% (for an individual) or 25% (for an enterprise) or withholding tax? In order to determine whether the foreign partner should be subject to Enterprise Income Tax or withholding tax, would SAT analyze whether the non-operating income i.e., dividend received, relates to other operating income of the partnership or any permanent establishment of the partnership? Would SAT consider issuing more guidelines?

- Would the treaty signed between the country where the foreign partner resides and China be applicable to reduce the withholding tax rate?

- Would a sino-foreign partnership enterprise have the obligation to withhold tax for the foreign partner?

SAT pointed out that the final conclusion on whether a foreign partner in China would constitute a permanent establishment had not been made. There were currently two views on whether the limited partner of a limited partnership in China should constitute a permanent establishment:

- General partners were business agents of the limited partnership and the limited partners. As the limited partnership had a permanent establishment in China, it would become a permanent establishment of general partners in China. Similarly, it would also become a permanent establishment of limited partners in China.

- There was no agency relationship between the general partner and the limited partner. Thus, a limited partner might not be considered as having a permanent establishment in China. This view would need to be further researched and studied.

There was no conclusion on this question yet. SAT had extensively researched this and would carefully consider the tax fairness and the taxpayers' burden to move towards a future resolution.

With regard to whether a foreign partner receiving dividends via the partnership should be subject to a tax rate of 10% or 25%, this depended on whether the foreign partner had constituted an establishment in China. If it had no establishment, the withholding tax rate of 10% would apply. If it had an establishment, the Enterprise Income Tax rate of 25% would apply.

When a foreign partner obtained non-operating income, the withholding tax rate of 10% would generally apply, unless the non-operating income related to the establishment of the partnership

The Institute asked, when a partnership made an investment, whether it would be treated as the partnership distributing the profits to investors and not the investee enterprise distributing the profits to investors via the partnership?

SAT provided two views on this question:

- Foreign partner had constituted an establishment in China and derived income from the establishment;
- The investee enterprise's profit distribution to the investors via the partnership and the foreign partner's proportion of interest in the partnership were factors to be considered.

There was no final conclusion for this question, for which a future resolution would be sought.

C. IMPLEMENTATION OF TRANSFER PRICING RULES

C1. Advanced Pricing Agreement (“APA”)

(i) Updates on Bilateral Advanced Pricing Agreement (“BAPA”) and transfer pricing

Could SAT give some updates on the cases regarding BAPA and transfer pricing, such as the numbers of cases, developments in the application process, etc.?

SAT said that there were 21 BAPA cases completed up to 2011, more than 120 cases were currently under consideration, involving 15 countries including Asia and Europe.

(ii) Expectation on Advance Pricing Agreement ("APA") between Hong Kong and China

Hong Kong already introduced the mechanism for APA. What is SAT's expectation on an APA between Hong Kong and China?

SAT said that there was no plan to engage in new negotiations with companies this year (i.e, 2012) and might consider BAPA negotiations with Hong Kong next year (i.e., 2013).

(iii) Adjustments to BAPA

During the implementation of BAPA, does SAT require the average profit of the enterprise to reach the median level during the agreement period, and not merely fall within the agreed inter-quartile range? If the enterprise experiences a financial crisis, like that in 2008, and cannot reach the median level during the agreement period, will SAT consider certain adjustment to the BAPA?

SAT did not require the enterprise to achieve profit levels within the upper half of the inter-quartile range that was agreed under the agreement, as this would also impact on the other country. It would be more reasonable for both countries if the profit level of the enterprise fell around the median level in most situations. As at 2010, SAT had concluded 16 BAPAs with enterprises, and their profit level fell in the lower half of the inter-quartile range; which was not satisfactory. Since last year, during negotiations, SAT emphasized that the enterprise's profit level should fall within the median level during the BAPA covered period. In considering future renewals, SAT would consider the enterprise's implementation status in the current BAPA. If the enterprises consistently had profit levels below median during the current BAPA, renewal might be delayed.

Comments on enterprises with annual profit level below the median due to economic crisis were:

- There were key assumptions in BAPA. If the economic crisis caused changes in the key assumptions, it could be resolved via further negotiation.
- The profit between the multinational companies could be adjusted according to the BAPA.
- SAT did not require the profit level of the enterprise to fall within the median level each year, however, SAT required the average profit level of the enterprise to approximate the median level during the BAPA's three to five year period, as the case might be.

(iv) Enterprises self-adjusting profits to expected inter-quartile range

In practice, the management of transfer pricing can be influenced by many factors such as the changes in market conditions, etc. This may result in the profit level of a year not achieving the anticipated level. At present, due to the constraints in custom, foreign exchange and value-added tax in China, it is very hard for the enterprises to adjust the profit level to meet the anticipated inter-quartile range at year end. This may lead to a large adjustment and surcharge imposed by the tax bureau. How would SAT resolve this transfer pricing problem?

SAT said that this problem involved other departments, in particular, the customs. They would proactively try to resolve this problem. No circular would be issued this year and SAT would resolve this problem on a case-by-case basis.

C2. Guidance on the implementation of transfer pricing rules

(i) Safe harbour rules

Transfer pricing has become a major concern for multinational enterprises operating in the China. Could SAT provide some measures to alleviate the concerns of enterprises about transfer pricing, such as providing more safe harbour rules (for example, the Australian tax bureau has established an approved range of the service fee paid/received by the taxpayer to/from related parties), endorsing the contemporaneous documentation for some qualified enterprises, etc.?

SAT replied that there were currently no safe harbour rules. The requirements for contemporaneous documentation had already exempted small companies and they would generally not be selected for a transfer pricing investigation. If the enterprise had good profits, the risk for a transfer pricing investigation would be lower.

(ii) Accounting treatments of transfer pricing adjustments

At present, there is no specific rule on accounting treatments when there are transfer pricing adjustments. Could SAT advise how the enterprises could handle this?

SAT said that the requirements of GuoShuiHan [2006] No. 901 were based on relevant rules relating to foreign owned enterprises and this problem had been resolved soon after the implementation of the new Enterprise Income Tax Law. (i.e., there was no deemed dividends triggered because of TP adjustments.)

(iii) Multilateral Advanced Pricing Agreement (“MAPA”)

Would SAT and tax bureaus at local levels accept the application of MAPA?

SAT said that they had not received any applications for MAPA, but they would actively consider if they receive such applications.

D. ENTERPRISE INCOME TAX

On the deduction of handling fees and commission expenses, the existing policy (CaiShui [2009] No.29 ("Circular No.29")) has limited the deduction for life insurers to 10% of the current year's annual insurance premium income net of returned premiums. It should be noted that in most cases, the handling fees and commission expenses incurred for life insurers often exceeded 50% of total expenses. Would SAT consider changing the current 10% limit and increasing the limit for tax deduction for insurers, especially for growing insurers which would have a higher tax burden?

SAT pointed out that in deciding the 10% limit in Circular 29, they had conducted research on the top five insurers in China. The percentage of commission expenses of the largest insurer of life insurance, was slightly over 8%, but was still below 10%. Thus, the circular set the 10% limit. For large insurers, renewal premiums were higher and the income base was also larger. In general, they would not exceed the limit and were able to claim full deduction of the commission expenses. For growing insurers, they might have less renewal premiums income but higher commission expenses, and might exceed the 10% limit. However, in practice, no insurance enterprise had raised concerns that the 10% limit on deduction of commission expenses was too low.

Regarding the suggestion to increase the deduction limit of commission fees or to allow expenses to be carried forward to future years for deduction, it might be considered.

Hong Kong Institute of Certified Public Accountants
October 2012

Appendix 1

国家税务总局关于认定税收协定中“受益所有人”的公告

国家税务总局公告 2012 年第 30 号

2012-06-29

根据《国家税务总局关于如何理解和认定税收协定中“受益所有人”的通知》（国税函[2009] 601 号），现对受益所有人身份的认定，公告如下：

一、在判定缔约对方居民的受益所有人身份时，应按照国税函 [2009] 601 号文件第二条规定的各项因素进行综合分析和判断，不应仅因某项不利因素的存在，或者第一条所述“逃避或减少税收、转移或累积利润等目的”的不存在，而做出否定或肯定的认定。

二、对国税函[2009]601 号文件第二条规定的各因素的理解和判断，可根据不同所得类型通过公司章程、公司财务报表、资金流向记录、董事会会议记录、董事会决议、人力和物力配备情况、相关费用支出、职能和风险承担情况、贷款合同、特许权使用合同或转让合同、专利注册证书、版权所属证明，以及代理合同或指定收款合同等资料进行分析和认定。

三、申请享受协定待遇的缔约对方居民（以下简称申请人）从中国取得的所得为股息的，如果其为在缔约对方上市的公司，或者其被同样为缔约对方居民且在缔约对方上市的公司100%直接或间接拥有（不含通过不属于中国居民或缔约对方居民的第三方国家或地区居民企业间接持有股份的情形），且该股息是来自上市公司所持有的股份的所得，可直接认定申请人的受益所有人身份。

四、申请人通过代理人或指定收款人等（以下统称代理人）代为收取所得的，无论代理人是否属于缔约对方居民，都不应据此影响对申请人受益所有人身份的认定，但代理人应向税务机关声明其本身不具有受益所有人身份。代理人的声明样式见附件。

五、税务机关按照本公告第四条的规定认定受益所有人身份，并批准相关税收协定待遇的，如果代理人所属居民国或地区与中国签有税收协定或信息交换协议，可视需要通过信息交换了解代理人的有关信息。通过信息交换可以认定代理人的受益所有人身份的，税务机关可改变此前的审批结果，向原受益所有人补征税款，并按照有关规定加收滞纳金。

六、有权审批的税务机关在处理相关审批事项时，因受益所有人身份难以认定而不能在规定期限内做出决定的，可以按照《国家税务总局关于印发〈非居民享受税收协定待遇管理办法（试行）〉的通知》（国税发[2009]124 号）第十七条的规定，做出暂不享受税收协定待遇的处理。经过审批后可以享受税收协定待遇的，税务机关应将相应税款退还申请人。

七、按照国税发[2009]124 号文件的规定，有权审批的税务机关在处理相关审批事项时，涉及到否定申请人的受益所有人身份的案件，应报经省级税务机关批准后执行，省级税务机关应将相关案件处理结果同时报税务总局（国际税务司）备案。

八、同一纳税人就类似情形需要向不同税务机关申请认定受益所有人身份并享受税收协定待遇的，可向相关税务机关说明情况，相关税务机关应在相互协商一致后做出处理决定；相关税务机关不能协调一致的，应层报其共同的上级税务机关处理，并说明协商情况。

九、本公告自公布之日起施行。

(本文取材自国家税务总局的网站：
http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/12003183.html)