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In this issue of the China Tax Monthly, we will discuss the following tax developments in China:

1. The SAT Issues Rules to Clarify Certain VAT Issues
2. China Issues Formal CRS Legislation
3. Defa Case: Supreme Court Rules in Favor of Deemed Taxation in An Auction Sale
4. Xuzhou Case: Tax Bureau Denied Tax Exemption on Dividends Derived by A PRC National Hong Kong Identity Card Holder from A PRC Foreign-invested Enterprise
5. Small- or Medium-sized Technology Enterprises Entitled to Increased R&D Expenditure Deduction
6. IIT Exemption for Certain Employer-paid Commercial Health Insurance Premiums Expands Nationwide
7. China Reduces the VAT Rate on Agricultural Products and Certain Life Necessities to 11%

## 1. The SAT Issues Rules to Clarify Certain VAT Issues

On 20 April 2017, the State Administration of Taxation (SAT) issued Bulletin 11[1] to clarify certain value-added tax (VAT) issues. Among these issues, the provisions on construction services and invoice verification are worth noting.

### Construction services

Bulletin 11 clarifies that a taxpayer who sells self-produced goods such as equipment and steel structures and provides construction and installation services at the same time should separately account for revenue from sales of goods and revenue from provisions of services and pay VAT accordingly. Previously, some local tax bureaus used to treat such a situation as a mixed sale of goods and services, which is subject to VAT either as sale of goods (for a taxpayer whose main business is the manufacturing, wholesale or retail of goods) or provision of services (for all other taxpayers).

Where a contractor subcontracts construction services to an entity within the same group, the subcontractor rather than the contractor should issue special VAT invoices and pay VAT on constructions services, provided that the service recipient directly settles the service fee with the subcontractor.

The above provisions apply from 1 May 2017.

### VAT invoice verification

In order to claim input VAT credits, a general VAT taxpayer has to verify a special VAT invoice within a certain period from when the invoice is issued. Bulletin 11 extends the VAT verification period from the current 180 days to 360 days starting 1 July 2017.

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1 *Bulletin of the State Administration of Taxation to Further Clarify Certain Issues Involved in the VAT Pilot Program*, SAT Bulletin [2017] No. 11, dated 20 April 2017, effective date depends on the specific issues involved.

In practice, taxpayers normally do not have difficulty in meeting the 180-day deadline. Thus, we do not expect the extension to 360 days will have significant impact on taxpayers. However, taxpayers do need to note that the invoice verification procedure does not automatically grant input VAT credits to taxpayers. Instead, the taxpayer has to declare the input VAT credits within the VAT declaration period of the month following the verification. Otherwise, the taxpayer will permanently lose the input VAT credits except in situations such as natural disasters, internet or computer system failure at the tax bureau, or death, injury or other sudden unavailability of the taxpayer's finance staff.

## 2. China Issues Formal CRS Legislation

On 19 May 2017, the SAT, the Ministry of Finance (MOF), the People's Bank of China, the China Banking Regulatory Commission, the China Securities Regulatory Commission and the China Insurance Regulatory Commission finally issued the formal common reporting standards (CRS) legislation, i.e., Bulletin 14[2]. Bulletin 14 provides key provisions on financial institution reporting, reportable financial accounts, due diligence procedures, and information requirements. The reporting standards and due diligence procedures under Bulletin 14 are basically consistent with the OECD CRS proposal. Bulletin 14 will take effect on 1 July 2017. For a more detailed discussion of Bulletin 14, please refer to our October 2016 issue of China Tax Monthly, in which we discussed a draft containing basically the same provisions as those of Bulletin 14.

Prior to Bulletin 14, China signed the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information ("**CRS MCAA**") on 16 December 2015. As of 22 June 2017, the CRS MCAA has 92 participating jurisdictions. [3] Although China has not activated the exchange relationship under the CRS MCAA, we expect the automatic exchange of CRS information will soon become a reality in China.[4] As non-PRC residents have very limited channels of investing in China or bringing capital to China due to China's foreign currency control, China's automatic exchange network for CRS information is unlikely to have a material impact on non-PRC residents. However, this automatic exchange network could immediately impact PRC residents who hold offshore assets.

China has long been a world-wide taxation jurisdiction. However, due to lack of information on Chinese residents' offshore income, the Chinese tax authorities lacked the ability to enforce the world-wide taxation against Chinese tax residents during the past years. The upcoming automatic exchange of CRS information will enable the PRC tax authorities to obtain more information for them to enforce tax collection on the PRC residents' offshore income.

2 *Administrative Measures on Due Diligence of Tax related Information of Non-resident Financial Accounts*, SAT, MOF, CBRC, CSRC and CIRC Bulletin [2017] No. 14, dated 9 May 2017, effective as of 1 July 2017.
3 See http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/.
4 China has committed to conduct first exchange of CRS information in 2018.

## 3. Defa Case: Supreme Court Rules in Favor of Deemed Taxation in An Auction Sale

In April 2017, the Supreme People's Court (SPC) ruled that the tax bureau is authorized to levy business tax[5] based on a deemed transactional price in an auction sale where the real property was transferred at an obviously low price. This is the SPC's first tax retrial case.

### Facts

On 30 November 2004, a Chinese company named Guangzhou Defa Real Property Construction Ltd. ("**Defa**") entered into an agreement with a Chinese auction company to entrust the auction company to sell some real estates. Under the agreement, Defa estimated that the total value of these real estates would be HKD 530.77 million and instructed the auction company to set a guarantee payment of HKD 68 million. Any person who wanted to participate in the auction shall make the guarantee payment first.

On 19 December 2004, a Hong Kong company as the only participant purchased approximately 95% (measured at building area) of these real estates at the reserve price, i.e., HKD 130 million (approximately RMB 138.26 million). Based on this price, Defa then paid RMB 6.91 million in business tax and RMB 0.12 million in dike maintenance fee to the tax bureau.

In 2006, the tax bureau's audit department initiated an audit on this transaction. The tax bureau compared the transfer price in question with the market price of similar real estates and found that the price was lower than half of the market price. The tax bureau concluded that the transfer price was obviously low without a proper reason. In 2009, the tax audit department made a decision to tax the real estate transaction at a deemed price of RMB 311.68 million, for which the additional business tax and dike maintenance fee was RMB 8.67 million and RMB 0.16 respectively. In addition, the tax audit department decided to charge late payment surcharges totalling RMB 2.85 million.

Faced with these decisions, Defa initiated an administrative review but failed. Defa then brought the case to the court. After losing the first trial, second trial as well as the retrial at the Guangdong Provincial People's Court, Defa eventually applied to the SPC for retrial.

### Issues and holdings

The SPC identified three key issues in this case:

- *Whether the transfer price in question is obviously low without a proper reason* — The SPC held that the tax bureau should in principle respect a transfer price in a valid auction. However, a valid auction sale does not preclude the tax bureau from adjusting the price for tax purposes, especially when the state's tax revenue may suffer. In the present case, although the law does not deny the validity of an auction which has only one participant, the auction was conducted without adequate competition. Thus, considering the state's tax revenue interests, the tax bureau may adjust the tax basis in accordance with the law. Further, the SPC held that the assessment of a tax basis as "obviously low without proper reason" involves a large degree of discretion and the

5 Business tax on transfer of real estate has been replaced by VAT from 1 May 2016.

court normally would respect the tax bureau's decision, unless such decision is obviously unreasonable or constitutes misuse of authority.

- *Whether the decision to levy tax is within the statute of limitation (SOL)* — Although the tax law does not specify the SOL for cases where the tax bureau decides to re-adjust the tax basis after the taxpayer's tax settlement, the SPC held that the tax bureau should refer to the three-year SOL (which is for unpaid or underpaid taxes due to the tax bureau's mistake) in a situation where the taxpayer commits no fault. Given that Defa did not engage in any illegal acts, the three-year SOL should apply. Although the tax decision was issued in 2009, the tax bureau initiated the audit in 2006, which is within the three-year SOL. As such, the decision to levy tax is within the SOL.
- *Whether the tax bureau may charge late payment surcharges* — The SPC pointed out that the *Tax Administration and Collection Law* (TCAL) only provides three situations where late payment surcharges would apply: (i) the taxpayer fails to pay tax within the prescribed period; (ii) the unpaid/underpaid tax is due to taxpayer's calculation mistake; and (iii) the taxpayer has committed tax evasion or export tax refund fraud, or refuses to pay tax by using violence or threating behaviour. Given that the tax bureau could not prove the underpaid tax in question was due to Defa's calculation mistakes or illegal acts, the SPC held that the law should be interpreted in favor of Defa by referring to Article 52 of the TCAL that no late payment surcharges shall be charged when the tax bureau is responsible for the underpaid tax. On this basis, the SPC held that the tax liability should be viewed as arising on the deemed taxation date and thus no late payment shall apply.

## Observations

The SPC ruled partly in favor of the tax bureau (in terms of deemed taxation) and partly in favor of Defa (in terms of the late payment surcharges).

According to Article 35 of the TCAL, the tax bureau may tax on a deemed basis provided that the tax basis declared by a taxpayer is obviously low without a proper reason. A key reason why Defa lost the fight against deemed taxation is that Defa was unable to justify that the transfer price had a proper reason while the tax bureau presented strong arguments[6]. A lesson from the Defa Case is that each taxpayer must conduct a "proper reason" analysis when entering into a low-price transaction and keep necessary supporting documents to mitigate the deemed taxation risk.

In terms of late payment surcharges, taxpayers would welcome that the SPC held that the law should be interpreted in favor of taxpayers in the case of uncertainty. In practice, we have seen plenty of tax disputes arising from uncertainties in the tax law. In the light of the Defa Case, taxpayers should be confident to defend their own tax interests in similar cases.

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6 The tax bureau argued that the price did not have a proper reason because (i) the auction only had one participant due to the high guarantee payment requirement, and (ii) the low reserve price, which only accounted for 20% of the estimate value, did not confirm with the normal practice in auction business.

## 4. Xuzhou Case: Tax Bureau Denied Tax Exemption on Dividends Derived by A PRC National Hong Kong Identity Card Holder from A PRC Foreign-invested Enterprise

On 7 April 2017, China Taxation News reported that the Xuzhou Local Tax Bureau collected RMB 4.29 million in individual income tax (IIT) from a Hong Kong identity card holder on dividends distributed by a Chinese company.[7]

### Facts

In March 2016, the tax bureau learned that a Xuzhou company planned to make a dividend distribution of RMB 30 million, among which RMB 21.43 million will be distributed to its individual shareholder. The individual shareholder held a Hong Kong identity card. He or she acquired his or her shareholding in the company from the company's prior Australian corporate shareholder at the end of 2014.

The company claimed that the individual shareholder, as a Hong Kong identity card holder, should be entitled to the IIT exemption for foreigners[8] on dividend income from foreign-invested enterprise (FIE) pursuant to Cai Shui Zi [1994] No. 20 ("**Notice 20**").

The tax bureau believed that the issue turned on whether the individual shareholder was a Hong Kong tax domiciliary. Upon searching for public online information, the tax bureau ascertained that the individual shareholder originated from Guangdong and continued to have strong economic and political ties to that area. The tax bureau also sought assistance from the public security bureau and ascertained that the individual shareholder still held a PRC identity card and a permanent household registration (户口) in Guangdong province. Lastly, the tax bureau understood from online information that the type of Hong Kong identity card held by the individual shareholder only entitles him or her to a right of residence in Hong Kong, but not a right of abode / permanent residence in Hong Kong. Where a PRC national holds this type of identity card, it means that he or she is not eligible for a Hong Kong passport (which would have required the individual to forfeit PRC nationality) and continues to have a PRC nationality and uses a PRC passport.

Based on this, the tax bureau decided that the individual shareholder was still a Chinese tax domiciliary and was not eligible for the IIT exemption for foreigners.

### Observations

It is not surprising for the tax bureau to conclude in this case that the shareholder remained a Chinese tax domiciliary based on his or her permanent household registration.

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[7] See http://www.ctaxnews.net.cn/html/2017-04/07/nw.D340100zgswb_20170407_1-10.htm?div=-1.

[8] In practice, some tax bureaus may broadly interpret the term "foreigner" to include a Chinese national who holds permanent residency in a foreign jurisdiction.

Under the IIT rules, an individual is a Chinese tax domiciliary if he or she is habitually resident in China due to permanent household registration, family and economic connections to China.

Practically, the tax authorities tend to focus on the nationality of a PRC individual in determining whether he or she remains or ceases to be a Chinese tax domiciliary. That said, a PRC individual who has obtained foreign nationality can continue to be a Chinese tax domiciliary because of permanent household registration, family and economic ties to China.

As the individual shareholder in this case had no foreign nationality or permanent residency, the tax authorities could easily conclude that he or she is still a Chinese tax domiciliary not entitled to IIT exemption for foreigners.

In respect of the IIT exemption policy of dividends derived by foreigners from FIEs, while the State Council proposed to repeal this exemption in Guo Fa [2013] No. 6, the SAT has not issue any rules to repeal or revise Notice 20. This case indicates that the tax authorities may recognize and continue to allow the IIT exemption under Notice 20 in practice.

## 5. Small- or Medium-sized Technology Enterprises Entitled to Increased R&D Expenditure Deduction

On 2 May 2017, the MOF and the SAT jointly issued Notice 34[9] to increase small- or medium-sized technology enterprises' tax deduction for R&D expenditures.

According to Notice 34, a qualified small- or medium-sized technology enterprise can either (i) take a one-time enterprise income tax (EIT) deduction in the current year equal to 175% of the actual R&D expenses if no intangible asset results from the R&D, or (ii) amortize the resulting intangible asset at 175% of the actual R&D expenses that are calculated into the cost of the relevant intangible asset.[10] This tax policy will remain in effect from 1 January 2017 to 31 December 2019.

Then on 3 May 2017, the Ministry of Science and Technology, the MOF and the SAT jointly issued Notice 115[11] on the qualification of small- or medium-sized technology enterprises. According to Notice 115, a qualified small- or medium-sized technology enterprise should be a PRC-incorporated resident enterprise with a total staff of no more than 500, annual sales revenue of no more than RMB 200 million and total assets of no more than RMB 200 million. In addition, Notice 115 introduces a scoring system based on the following three factors: (i) scientific and technical staff; (ii) R&D investment; and (iii) intellectual properties. Each factor is allocated different values that add up to a total value of 100. A score of 60 or more is required to qualify. As

[9] *Notice of the Ministry of Finance, the State Administration of Taxation, the Ministry of Science and Technology on Increasing the R&D Expenditure Super Tax Deduction Ratio for Small- or Medium-sized Technology Enterprises*, Cai Shui [2017] No. 34, dated 2 May 2017, retroactively effective from 1 January 2017.

[10] As background, an enterprise is generally entitled to a 150% EIT deduction or amortisation for R&D expenditures incurred.

[11] *Notice of the Ministry of Science and Technology, the Ministry of Finance and the State Administration of Taxation on Printing and Issuing the Evaluation Measures for Small- or Medium-sized Technology Enterprises*, Guo Ke Fa Zheng [2017] No. 115, dated 3 May 2017, effective as of the same date.

a major exception, a high and new technology enterprise that satisfies all the other qualification requirements can skip the scoring process.

Note an enterprise that satisfies all the qualification requirements is not automatically granted the small- or medium-sized technology enterprise status. Instead, the enterprise shall first register its qualification information at a specific platform. The competent science and technology authority will then review and grant a registration code to the qualified enterprise. Any enterprise that intends to seek the benefit of the increased R&D tax deduction should self-assess its eligibility and register in due course before its annual EIT filing.

## 6. IIT Exemption for Certain Employer-paid Commercial Health Insurance Premiums Expands Nationwide

In the January 2016 issue of China Tax Monthly, we reported that China initiated a pilot program in certain areas to allow certain IIT taxpayers to deduct premiums paid for qualified commercial health insurance (limited to RMB 200 per month) from their taxable income.

On 28 April 2017, the MOF and the SAT jointly issued Notice 39 to expand the above IIT policy nationwide. The expansion will take effect on 1 July 2017. Except the geographic expansion, Notice 39's provisions on qualified insurance products and taxpayers are basically the same as the previous pilot rules.

## 7. China Reduces the VAT Rate on Agricultural Products and Certain Life Necessities to 11%

On 28 April 2017, the MOF and the SAT jointly issued Notice 37[12] to implement a VAT policy proposed by the State Council earlier this year, i.e., to simplify the current four-bracket VAT rates into three. As background, general VAT payers are currently subject to VAT at rates of 17%, 13%, 11% and 6% based on the types of goods and services supplies.

According to Notice 37, the currently 13%-rated goods will be subject to VAT at 11% from 1 July 2017. These goods include:

- agricultural products;
- certain life necessities, including edible vegetable oil, food-grade salt, tap water, heating, air conditioning, hot water, coal gas, liquefied petroleum gas, natural gas, methane gas and coal/charcoal products for household use;
- books, newspapers, audio and video products, magazines and electronic publications; and
- feed, chemical fertilisers, agricultural chemicals, agricultural machinery and plastic-film for agricultural purposes.

[12] *Notice of the Ministry of Finance and the State Administration of Taxation on Policies Concerning the Simplification of Value-added Tax Rates*, Cai Shui [207] No. 37, dated 28 April 2017, effective as of 1 July 2017.

## Observations

The four-bracket VAT rates have caused many practical and compliance difficulties for taxpayers as they need to properly classify their supplies to ensure that they adopt the correct VAT rate. The replacement of the 13% VAT rate with 11% can to some extent help to save taxpayers from these difficulties.

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