BAKER & McKENZIE

2016 Asia Pacific Tax Update

China

Contents

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1. Introduction

This paper summarizes the major tax developments in China during the past year.

Over the past year, multinational companies (MNCs) have experienced increasingly aggressive tax enforcement and collection from the Chinese tax authorities. According to the State Administration of Taxation (SAT), the Chinese tax authorities collected RMB58 billion in taxes from anti-avoidance investigations in 2015, representing an 11 percent increase over 2014. As illustrated in Sections 2 and 3 of this paper, the tax audits during the past year mainly focused on transfer pricing issues, outbound service fee or royalty payments, indirect share transfers, entitlement to treaty benefits and permanent establishments (PEs).

The PRC tax authorities have been shining a spotlight on transfer pricing over the past years. This scrutiny has intensified in response to the Base Erosion and Profit Shifting (BEPS) Project. In June 2016, China revised its transfer pricing documentation rules to introduce new concepts and requirements such as country-by-country reporting, value chain analysis, and location specific advantages (LSAs). As a result, MNCs today face significantly greater transfer pricing audit risks in China.

At the same time, taxpayers are becoming more confident about standing firm in their legal positions and advancing strong arguments in negotiations with tax bureaus during tax audits and disputes. This year, like the year before it, has seen more formal controversies, even with some litigation cases against the tax authorities by MNCs. Practice indicates that tax authorities are more motivated to make a compromise if taxpayers are willing to go the distance by pursuing formal dispute resolutions forums up to and including litigating the matter in a court of law.

Other major Chinese tax developments over the past year include the expansion of the value-added tax (VAT) pilot program to cover all industries, the revisions to the R&D super deduction rules and high and new technology enterprises (HNTE) rules, the improvement of information exchange network, new individual income tax (IIT) rules on equity incentives and amendments to tax treaties.

2. Transfer Pricing

2.1 New Transfer Pricing Documentation Rules Introduced to Implement BEPS Country-by-Country Reporting

On 29 June 2016, the SAT finally issued the long-awaited Bulletin 42[1] to revise the transfer pricing documentation requirements under Circular 2[2]. By introducing the key recommendations under Action Plan 13 of the BEPS Project, Bulletin 42 will have a far-reaching impact on taxpayers.

In this section, we will first look at who is affected by Bulletin 42. We will then discuss key provisions introduced under this bulletin and their implications on MNCs. Finally, we will provide some recommendations to MNCs on how to ensure compliance with the new transfer pricing documentation requirements and how to develop appropriate strategies to safeguard their tax interests in China.

2.1.1 Who is affected?

Any MNC engaged in a cross-border, related-party transaction can expect to be significantly affected by the transfer pricing documentation requirements in Bulletin 42. MNCs engaged in purely domestic related-party transactions are expressly excluded from these requirements.

Bulletin 42 requires MNCs to prepare transfer pricing documentation for related-party transactions occurring in or after 2016. Non-compliance may lead to a punitive interest penalty equal to the RMB loan benchmark rate published by the People's Bank of China plus 5 percentage points if and when the PRC tax authorities make a final transfer pricing adjustment.

2.1.2 What does the bulletin require?

Consistent with the OECD proposals under the BEPS Action Plan 13, Bulletin 42 requires the taxpayer, subject to certain conditions as illustrated below, to provide a three-tier transfer pricing documentation[3]: (i) a master file containing general information about the MNC group's global business operations; (ii) a local file containing detailed information about the related-party transactions of the Chinese enterprise in the group; and (iii) a country-by-country report containing information about the global allocation of the MNC group's income and taxes ("**CbC Report**"). In addition, Bulletin 42 requires the taxpayer to prepare a special file for cost sharing agreements and thin-capitalisation.

(i) Master file

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[1] *State Administration of Taxation's Bulletin on Issues Relating to the Enhancement of the Declaration of Related Party Transactions and Administration of Contemporaneous Documentation*, SAT Bulletin [2016] No. 42, dated 29 June 2016, retroactively effective from 1 January 2016.

[2] *Circular of the State Administration of Taxation on Printing and Distributing the Implementing Measures for Special Tax Adjustments (for Trial Implementation)*, Guo Shui Fa [2009] No. 2, dated 8 January 2009, retrospectively effective from 1 January 2008.

[3] Transfer pricing documentation used in this section include (i) the Annual Statement of Related Party Business Transactions, which consists of 22 standard forms (including six forms on CbC reporting), and (ii) contemporaneous documentation, including a master file, a local file and special documentation.

An enterprise must prepare a master file within 12 months from when the fiscal year ends for the MNC group's ultimate holding company if (i) the enterprise's total related-party transactions exceed RMB1 billion, or (ii) the enterprise has cross-border related party transactions and the MNC group has already prepared a master file.

The master file provides a "blueprint" of the MNC group and contains:

- the MNC group's organizational chart;
- a description of the MNC's business, including profit drivers, supply chain and main geographic markets of major products/services, intercompany service agreements, brief functional and value creation analysis for group entities, and recent restructurings;
- information on the MNC's intangibles, e.g., a list of intangibles important for transfer pricing with legal owners and a general description of the MNC group's transfer pricing policies for R&D and intangibles;
- a description of the MNC's financial arrangements, including related and unrelated financing; and
- documents containing the MNC's financial and tax positions, e.g., the latest consolidated financial statements of the MNC group, a list and a brief introduction of advance pricing agreements (APAs) and tax rulings on income allocation, and the reporting entity for the CbC Report.

Normally, a Chinese affiliate does not have direct access to most (or any) of this information. Therefore, it would be burdensome if not impossible for the Chinese affiliate to prepare the master file by itself.

Fortunately, most Chinese affiliates will not have to prepare the master file from scratch. Since the information required for the master file under Bulletin 42 is basically the same as the information required under the BEPS proposals[4], the Chinese affiliate can modify the master file that has been prepared by the MNC group to satisfy the BEPS requirements and submit that modified file to satisfy the Bulletin 42 requirements. As such, we recommend Chinese affiliates ask the MNC group's parent company to share the most recent BEPS master file whenever the Chinese affiliate prepares the Bulletin 42 master file.

(ii) Local file

An enterprise must prepare a local file for its annual related-party transactions (excluding transactions covered by APAs) by 30 June of the following year if:

- its annual amount of related-party transfers of tangible assets exceeds RMB200 million;

[4] Except, Bulletin 42 requires the reporting entity for the CbC Report to be specified in the master file.

- its annual amount of related-party transfers of financial assets exceeds RMB100 million;

- its annual amount of related-party transfers of intangible assets exceeds RMB100 million; or

- its annual amount of other related-party transactions exceeds RMB40 million.

Although most of the information required for the local file has already been required under Circular 2, Bulletin 42 does require some new information, such as information on value chain analysis, LSAs, the enterprise's contribution to the MNC group's overall or residual profits, related-party equity transfers[5], intragroup services, APAs and tax rulings related to the transactions conducted by the enterprise.

Even though Bulletin 42 marks the first time that any regulation will expressly require value chain analysis to be included in transfer pricing documentation, the SAT has consistently instructed local tax authorities to conduct a value chain analysis when making transfer pricing adjustments because the SAT enthusiastically insists that "value chain analysis" is consistent with the BEPS Project's principal objective, i.e., to ensure that "profits [are] taxed in the jurisdiction where economic activities occur and value is created." Notably, the financials of all the related parties along the value chain will have to be provided to the Chinese tax authorities under the value chain analysis. We expect the value chain analysis as part of the local file to encourage the PRC tax authorities to use the profit split method more frequently when determining a Chinese affiliate's proper returns.

(iii) CbC Report

A Chinese resident enterprise must submit a CbC Report when filing its annual tax return if:

- it is the ultimate holding company in an MNC group with a consolidated revenue for the last fiscal year in excess of RMB5.5 billion; or

- it is designated by the MNC group as a reporting entity for the CbC Report.

Consistent with the BEPS recommendations, the CbC Report under Bulletin 42 requires aggregate country-by-country data about entities (and permanent establishments) in every country, including information about revenue, profits (and losses) before income tax, income tax paid (on cash basis), income tax incurred, stated capital and accumulated earnings, number of employees, and tangible assets other than cash and cash equivalents.

In addition, the PRC tax authorities may request an enterprise under audit to submit a CbC Report if: (i) the MNC group to which the audited enterprise belongs is required to prepare a CbC Report under any jurisdiction's law; and

[5] For the first time, Bulletin 42 codifies the tax authority's practical approach in requiring a valuation report to evidence a related-party equity transfer is conducted at arm's length.

(ii) the PRC tax authorities cannot obtain that CbC Report through an information exchange program [6].

On 30 June 2016, the US Treasury and the Internal Revenue Service released the final regulations implementing CbC reporting[7] ("**US CbC Regulations**"). The US CbC Regulations require every US-parented MNC with an annual group income of US$850 million or more to prepare a CbC Report for reporting periods that begin on or after 30 June 2016. Notably, the US has said it will not participate in the CbC MCAA. Instead, it would enter into bilateral agreements for exchange of CbC Reports to conform with US government's practice on international agreements. Thus, before China enters into a bilateral arrangement with the US on the exchange of CbC Reports, a US MNC's CbC Report will not be exchanged to the PRC tax authorities. That being said, with US domestic law requiring a US MNC to prepare a CbC Report, the PRC tax authorities can now request an MNC's Chinese subsidiary(ies) to provide the MNC's CbC Report during a transfer pricing audit.

In addition to increasing the compliance burden on MNCs, CbC reporting could pose a risk for MNCs because the PRC tax authorities may attempt to claim a larger share of the MNC's global profits.

(iv) Special file

Although the term "special file" is being used for the first time, the information required for the special file was already required under Circular 2. The new terminology will not have any substantial impact on MNCs.

2.1.3 What are the impacts on MNCs?

The PRC Enterprise Income Tax Law (EITL) and its implementing regulations only require taxpayers to provide information relevant to the related-party transactions. Whereas, Bulletin 42 requires information beyond the scope of the taxpayer's related-party transactions, for example, the CbC Report. Technically speaking, the EITL and its implementing regulations should prevail over Bulletin 42 in case of conflict. In practice, however, it would be difficult for taxpayers to challenge Bulletin 42 based on the said conflict.

With more transfer pricing documentation information being required under Bulletin 42 and being disclosed to the PRC tax authorities, we expect more transfer pricing audits and more tax disputes to follow in China. In particular, the SAT may introduce new transfer pricing legislation in the future as weapons to bring more profits to China.

However, as concerning as it may sound, Bulletin 42 and potential transfer pricing regulations to follow, are by no means the end of tax planning in China. After all, China's transfer pricing rules still follow the arm's length principle. Therefore, amid the heightened scrutiny, taxpayers should remain confident in being able to defend their related party transactions before the tax

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[6] On 12 May 2016, China signed the Multilateral Competent Authority Agreement on the Automatic Exchange of Information of Country-by-Country Reports ("**CbC MCAA**").

[7] The full text of the legislation is available at https://www.federalregister.gov/documents/2016/06/30/2016-15482/country-by-country-reporting.

authorities as long as their positions are based on a sound application of the arm's length principle and are supported by high-quality comparable data. In addition, taxpayers can still expect assistance and relief from other involved jurisdictions. Action Plan 14 under the BEPS Project requires jurisdictions to settle disputes within 24 months. In response to this requirement, the SAT has invested vastly in its mutual agreement procedure program. Even if a taxpayer on its own is not able to settle with the SAT, the competent authority of the taxpayer's jurisdiction could always intervene to negotiate with the SAT on the taxpayer's behalf or provide a corresponding adjustment to alleviate double taxation.

Last but not the least, the tax administration environment is improving in China. Previously, administrative review and administrative litigation were not used by foreign companies and foreign-invested companies. The past two years have seen more formal controversies, even with some litigation cases against the tax authorities by MNCs. Practice indicates that tax authorities are more motivated to make a compromise if taxpayers are willing to go the distance by pursuing formal dispute resolutions forums up to and including litigating the matter in a court of law. In short, MNCs with a solid legal basis for their structure must be ready, willing and able to vigorously defend their positions.

2.1.4 What should MNCs do?

With Bulletin 42 taking effect from 1 January 2016, MNCs will be required to comply with the new transfer pricing documentation requirements. Coupled with the PRC tax authorities' increasing scrutiny on cross-border related-party transactions in a post-BEPS environment, every MNC should consider the following actions to safeguard its tax interests in China:

- invest in human resources and accounting systems to comply with new transfer pricing documentation requirements;
- review and assess existing legal structures and the economic substance of income receiving entities to determine whether these arrangements are defensible;
- manage the tax risks from BEPS by obtaining certainty through APAs where appropriate;
- prepare to challenge tax authority decisions through administrative review processes, litigation, mutual agreement procedures or other procedures when a sound legal basis exists and it is commercially necessary and feasible to do so.

2.2 New Rules on APA Administration: Signs of Hope or Greater Challenges Ahead?

Many MNCs have expressed frustration with China's APA program. For a country with the economy size and importance of China, the program has historically been understaffed and has never received the attention and resources that most believe it deserves.

On 18 October 2016, the SAT released Bulletin 64[8], which introduces new rules on the administration of APAs. Bulletin 64 will supersede the current APA administrative rules, which are found in Chapter 6 of Circular 2, starting 1 December 2016. The SAT issued Bulletin 64 in response to the key recommendations under Actions 5 and 14 of the BEPS Project. Those recommendations were to include unilateral APAs (UAPAs) in the information exchange network and to provide guidance on the APA program. More generally, Bulletin 64 aims to provide comprehensive and practical guidance to enterprises and tax bureaus seeking to reach an APA. Bulletin 64 is the second bulletin released this year as part of the SAT's ongoing plan to revise parts of Circular 2. The first was Bulletin 42, which was released in July (see Section 2.1 above).

The key question now is whether Bulletin 64 will help to address the logjam in this process and how changes in China's administration of APAs will be a net win or loss for MNCs seeking the certainty an APA should provide in what is now one of, if not the most, important market(s) for their business globally. There is little doubt that Bulletin 64 constricts the availability of APAs as a technical matter, but given that the key barriers to access to APAs in China have historically been more practical in nature, there is hope here.

2.2.1 Who is affected?

The tax authorities in China have been shining an increasingly bright spotlight on transfer pricing over the past several years. The BEPS Project has certainly added to that focus, and MNCs today are faced with significantly greater transfer pricing audit risk. An APA is one way of effectively managing this risk. Therefore, any MNC that seeks to manage the uncertainties associated with transfer pricing issues via an APA will be significantly affected by the new APA administration rules under Bulletin 64.

The APA program in China has suffered from a lack of resources. Many APA applications have stalled at either the APA letter of intent stage or the examination and evaluation stage. According to China's 2014 Annual APA Report dated 18 Decmber 2015, 90 applications were stuck at the letter of intent stage and 39 applications at the examination and evaluation stage by the end of 2014. Overall, China has concluded a relatively modest number of bilateral APAs (BAPAs) (with only eight BAPAs signed in 2013, and six in 2014). Given the backlog of APAs in China, MNCs have long been hoping for greater resources and attention being paid to China's APA program. Bulletin 64 impacts the administration of APAs by tightening the scope of availability for potential APAs, but a key question is whether these changes may be paired with greater access for those who qualify.

2.2.2 What does Bulletin 64 say?

(i) In-charge tax authority for APAs

Bulletin 64 specifies different in-charge tax authorities depending on the type of APA involved: a UAPA, a BAPA or a multilateral APA (MAPA). A UAPA will normally be handled by an enterprise's in-charge tax authority, whereas, a BAPA or an MAPA will normally be jointly handled by the SAT and the enterprise's in-charge tax authority. Bulletin 64 further defines "the in-

[8] *Bulletin of the State Administration of Taxation on Issues Concerning Improving the Administration of Advance Pricing Arrangements*, SAT Bulletin [2016] No. 64, dated 11 October 2016, effective from 1 December 2016.

charge tax authority" as the tax authority that is responsible for an enterprise's special tax adjustment.

From a technical reading, "the in-charge tax authority" appears to include a tax bureau at the district level. This would be a change from Circular 2, under which only a tax authority at or above the level of a municipality divided into districts or an autonomous prefecture can handle APA procedures. However, this part of Bulletin 64 has to be understood in conjunction with what has actually happened in practice across China. Given that most provinces have centralized the special tax adjustment function, the in-charge tax authority for an APA has been de facto elevated to the provincial level tax bureaus.

The situation is more complicated where an APA involves:

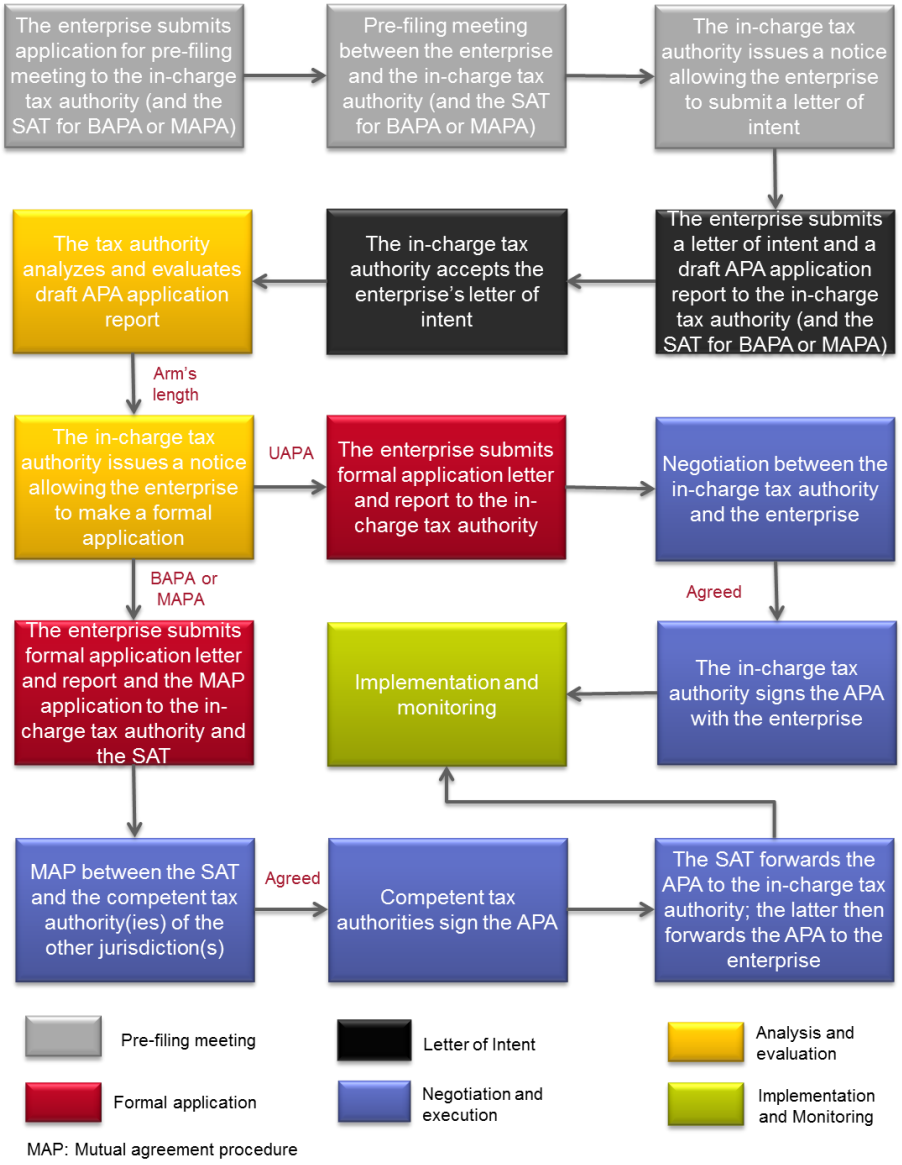
- tax authorities from two or more provincial-level administrative regions; or
- a state tax bureau and a local tax bureau.

Bulletin 64 does not change the existing rule that the APA procedure should be coordinated by the SAT in both of these situations, but Bulletin 64 moves a step further by clarifying that the enterprise should submit the APA application to the SAT and its designated tax authority when seeking a UAPA. Thereafter, the SAT or its designated tax authority may sign a consolidated UAPA with the enterprise; or each in-charge tax authority involved may sign a separate UAPA with the enterprise.

(ii) APA procedure

Bulletin 64 divides the APA procedure into six stages: (i) pre-filing meeting; (ii) letter of intent to seek an APA; (iii) analysis and evaluation; (iv) formal application; (v) negotiation and execution; and (vi) implementation and monitoring. The detailed APA procedure is set out in Diagram One:

Diagram One:



The most significant procedural change is that Bulletin 64 officially moves the analysis and evaluation stage (called the examination and evaluation stage under Circular 2) ahead of the formal application process. This change formalizes a longstanding practice of conducting examination and evaluation before formally accepting an enterprise's APA application. From the SAT's perspective, this practice helps to prevent a backlog of formal APA applications and also gives the SAT greater discretion to remove an APA from the pipeline much later in the process, even after the analysis and evaluation has been completed.

Bulletin 64's other notable changes include:

- *Increased focus on value/supply chain analysis and LSAs.* At the pre-filing meeting stage, the enterprise is required to provide a concise explanation of whether there exist any LSAs. Next, at the letter of intent stage, the enterprise should include analysis of LSAs and of the group's value/supply chain. Then, at the analysis and evaluation stage, the tax authority will assess whether the analysis on value/supply chain is complete and accurate and whether full consideration has

been given to LSAs. This increased focus on assessing value/supply chain analysis and LSAs is consistent with new transfer pricing documentation requirements under Bulletin 42, which requires analysis of value chain and LSAs in the local file. But Bulletin 64, like Bulletin 42, fails to provide any clear guidance on how to conduct the value chain and LSA analysis.

- *Frees the tax authority from application response deadlines*. Bulletin 64 sets no deadlines for the tax authority to respond to the enteprise's application at each stage. This represents a departure from Circular 2, which contained time limits for the tax authority to respond at each stage. For example, under Circular 2, the tax authority had to issue a written notice to the enterprise within 15 days from the date on which an agreement was reached at the pre-filing meeting stage. By removing these time limits, the tax authority will have full discretion and control over the timing of the APA procedure. Thus, enterprises will face increased uncertainty in the expected timeline of the APA process.

- *Increases monitoring of the enterprise's profitability*. The tax authortity may adjust the enterprise's profit rate in the current year up to the median of the agreed profitability range if the enterprise's acutal profit rate falls outside of the agreed profitability range during the APA application period. Upon the expiration the APA, an enterprise with a weighted-average annual profit rate in the APA application period lower than the the median of the agreed profitability range will not be eligible to renew the APA unless it adjusts its profit rate to the median for the expired APA period. This represents a significant departure from Circular 2, which only provided for a profit rate adjustment to reach the agreed profitability range. That said, some tax authorities have imposed this profit adjustment mechanism now expressed in Bulletin 64 for years despite the lack of solid legal authority.

(iii) Prioritized list and blacklist

Bulletin 64 permits the tax authority to prioritize an enterprise's APA application if:

- The enterprise has duly declared its related party transactions and prepared contemporaneous documentation;
- The enterprise has an A-level tax payment credit rating;
- The tax authority has already imposed a special tax adjustment on the enterprise and the case has been closed;
- The enterprise has not undergone any substantial change when an application is filed to renew an APA;
- The enterprise has submitted complete documents, which contain complete and accurate analysis on value/supply chain and LSAs and use reasonable transfer pricing principles and calculation methods;
- The enterprise proactively cooperates with the tax authority;
- The BAPA/MAPA partner country is willing to conclude the APA; or
- Other factors exist that may faciliate the conclusion of the APA.

The tax authority may reject an enterprise's APA letter of intent if:

- The enterprise is under a tax audit (including a transfer pricing audit);
- The enterprise has not duly declared its related-party transactions;

- The enterprise has not duly prepared, kept and provided contemporaneous documentation; or
- The tax authority and the enterprise do not reach an agreement during the pre-filing meeting stage.

In addition, Bulletin 64 provides that the tax authority may reject an enterprise's formal APA application if:

- The enterprise refuses to change inappropriate pricing principles and calculation methods used in the draft APA application report;
- The enterprise refuses to provide required documents or to correct insufficient documentation on a timely basis;
- The enterprise refuses to cooperate with the tax authority during the onsite interviews; or
- Other factors exist that obstruct the conclusion of the APA.

(iv) Roll-back of APA

According to Bulletin 64, an enterprise may apply and the tax authority may agree to retrospectively apply the pricing principles and calculation methods under an APA to identical or similar related-party transactions during the previous 10 years.

Furthermore, Bulletin 64 provides that the tax authority will collect the additional tax or grant a tax refund accordingly where an APA is applied to previous transactions. This provision is the first time that an established rule has provided legal authority for tax refunds in transfer pricing situations. However, it remains to be seen how the tax refund mechanism will work in practice.

(v) Information exchange

In response to the recommendations under Action 5 of the BEPS Project, Bulletin 64 introduces a new rule that the SAT may conduct information exchange with the competent tax authorities in other jurisdictionsabout UAPAs signed after 1 April 2016, unless national security information is involved.

2.2.3 What should MNCs do?

As mentioned before, the APA program in China has suffered from a lack of resources. As such, MNCs have found it difficult to have their applications formally accepted by the SAT. The hope is that while Bulletin 64 narrows the availability of APAs and seems to erect additional roadblocks for MNCs seeking an APA, given how difficult access has been due to insufficient resources, the hope is that these changes will focus the SAT on what they consider as higher value APAs and provide greater clarity for taxpayers on whether the pursuit of an APA has sufficient merit. Of course, for this to be true, the SAT will need to make additional resource commitments to the program.

Faced with the APA procedural changes in Bulletin 64, every MNC trying to manage potential transfer pricing risks through any of the three types of APAs should consider the following:

- Evaluate the prioritized list and the blacklist under Bulletin 64 to identify and satisfy as many prioritized conditions as possible and to minimize the risk of being blacklisted;

- Develop a complete and appropriate analysis on the value/supply chain and the LSAs;

- Within the bounds of reasonableness, demonstrate an attitude of proactive cooperation with the tax authorities; and

- Understand the incentives that the local tax bureau, as well as the local government more generally, has to reach an APA and align your APA strategy with these incentives.

2.3 2014 APA Annual Report

On 18 December 2015, the SAT released the *2014 China Advance Pricing Arrangement Annual Report* ("**Annual Report**")[9]. The sixth edition of this annual report focuses on China's APA mechanisms, procedures and practices, and provides statistics and analysis for 2005 through 2014.

Although it generally does not include annual statistics, a side-by-side comparison of the Annual Report with the 2013 and 2012 annual reports reveals taxpayer and SAT activity during 2014.

2.3.1 APA requests filed in 2014

Taxpayers filed fifteen bilateral and nine UAPA requests in 2014, up from six bilateral and seven unilateral requests in 2013. Both amounts are still significantly lower than in 2012 when 42 bilateral and 3 unilateral requests were filed.

This drop highlights the impact of the OECD BEPS Project on the APA program. On one hand, taxpayers want to reduce the uncertainties created by the BEPS Project via APAs. On the other hand, taxpayers are deterred from filing APA requests because the BEPS project has diverted a lot of SAT resources away from the APA program[10].

2.3.2 APAs signed

Nine APAs (three unilateral and six bilateral) were signed in 2014 — a 53 percent decrease from the 19 APAs (11 unilateral and eight bilateral) signed in 2013. This drop probably resulted from the SAT diverting resources from the APA program to the BEPS Project. This lack of resources even caused the SAT to suspend BAPA negotiation starting from September 2014. Fortunately, in early 2015, the SAT allowed BAPA negotiation to resume. Various competent authority meetings have been held, including with the US, Korea, Japan and various European countries.

2.3.3 Open requests

On 31 December 2014, 136 APA requests (119 bilateral and 17 unilateral) were open. At the end of 2013, 121 APA requests (110 bilateral and 11 unilateral) were open. We expect this year-end trend to continue where open bilateral requests significantly outnumber open unilateral requests.

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[9] The English version of the 2014 APA Report can be downloaded at http://www.chinatax.gov.cn/n810219/n810724/c1951566/part/1951585.pdf.

[10] At present, the APA program has only six staff members at the SAT headquarters.

2.3.4 Industries covered

The Annual Report lists seven industry categories, in which APAs were signed from 2005 to 2014:

- manufacturing (92);
- commercial services (5);
- wholesale trade and retail (9);
- transportation, warehousing, and postal services (2);
- scientific and technical services (2);
- electricity, heating, gas and water generation and supply (1); and
- information transmission, software and information technology services (2).

Of the nine APAs signed in 2014, six involve the manufacturing industry and the remaining three involve wholesale trade and retail.

2.3.5 Transfer pricing methods

The following table lists the transfer pricing methods used in signed APAs from 2005 to 2014 and in 2014 alone:

Table one

Transfer pricing method	2005 to 2014	2014
Comparable uncontrolled price method	5	0
Resale price method	1	0
Cost plus method	17	0
Transactional net margin method	95	9[11]
Profit split method	3	0
Other methods	4	0

As shown in the table, the transactional net margin method (TNMM) is the most frequently used transfer pricing method, while the comparable uncontrolled price (CUP) method, the resale price method and the profit split method are rarely used.

In the Annual Report, the SAT explains that the infrequent use of the CUP method is a result of its high comparability standard. This explanation indicates that the SAT generally thinks it is difficult for the enterprises to meet the high comparability standard required by the CUP method. Thus the SAT may continue to be reluctant to accept the CUP method in future APA negotiations.

[11] Of the nine APAs signed in 2014, four applied the Return on Sales Ratio and five applied the Full-cost Mark-up Ratio.

Meanwhile, the SAT explains that the resale price method and the profit split method were applied less frequently due to enterprises providing insufficient information about transactions and pricing. Thus, the SAT is encouraging enterprises to provide sufficient information so that the resale price method and the profit split method can be used more frequently.

2.3.6 Term length

From 2005 to 2014, most unilateral and BAPAs were completed[12] within two years. Of the completed BAPAs, 56 percent were completed within one year.

Among the nine APAs completed in 2014, all three UAPAs and three BAPAs were completed within two years. Two BAPAs took more than three years . Although the SAT aims to complete the review and negotiation process for BAPAs within two years, the actual time required varies.

Nonetheless, based on the numbers from previous years, taxpayers should remain optimistic that the APA process will normally not take more than two years once the APA application has been formally accepted by the SAT.

2.3.7 BAPAs

Among the six BAPAs completed in 2014, three were signed with Asian countries, two were signed with European countries and one was signed with a North American country. These numbers are consistent with previous years in which Asian countries have signed the most APAs with China.

2.3.8 What to expect for the future

In the annual reports, the SAT traditionally includes a preface that describes its general transfer pricing strategy for the following year.

The preface in the Annual Report quotes President Xi's statement at the 9th G20 summit in 2014: "the world should enhance global cooperation in tax matters, crack down on international tax evasion and help developing countries and low-income countries build up tax administration capacity". According to the Annual Report, this statement has guided China's tax authorities in their work on international taxation. Therefore, we should expect that the SAT's strategy will continue to be influenced by the BEPS Project.

As mentioned in Section 2.2 above, the APA program in China has suffered from a lack of resources. More importantly, Bulletin 64 seems to erect additional roadblocks for MNCs seeking an APA by narrowing the availability of APAs. But given that the key barriers to access to APAs in China have historically been more practical in nature, the situation could change in the future.

2.4 Jiangsu State Tax Bureau Proposes A New Transfer Pricing Method

As reported in Section 2.1, Bulletin 42 requires taxpayers to include value chain analysis into the transfer pricing documentation. As a result, Bulletin 42 raises questions about how the value chain analysis will affect the PRC tax authorities' attitudes toward transfer pricing methods. We initially expected

[12] The time starts to run only if the APA request is formally accepted by the SAT.

that the tax authorities might be more inclined to accept two-sided methods, e.g., the profit split method.

On 9 August 2016, the Jiangsu State Tax Bureau issued its 2016-2018 Administration Plan for International Tax Compliance, i.e., Su Guo Shui Fa [2016] No. 125 ("**Circular 125**"). By recommending MNCs use a new transfer pricing method based on value chain analysis, Circular 125 introduces another possibility of how the PRC tax authority will view the value chain analysis. According to Circular 125, this new method involves a three-step approach:

1) collect sufficient information to understand the value chain, including the group's master file, country-by-country report, data from commercial databases and internal financial data, etc., and fully understand the substance of such information;
2) analyse the group's value chain to identify each function performed by a participant in the value chain and to identify all the key value contributors (e.g., intangibles, fixed assets, number of employees, and markets);
3) allocate profits to participants based on a set of core indicators (such as assets, sales, expenses and costs, etc.) to ensure that the profit allocation matches each participant's functions and risks.

Notably, Circular 125 states that the application of this new method should be based on the arm's length principle. The tax authority should avoid simply applying the global formula allocation method.

Observations

Under the new transfer pricing method, there is a concern that the tax authorities may allocate MNCs' profits simply based on some "core indicators". Where intangible asset is given no or limited consideration when selecting the allocation indictor(s), this method would be a concern for any MNC that derives value from intangible assets such as IP and branding rather than tangible assets.

That being said, Circular 125 only provides guidance rather than the mandatory effect of legislation; therefore, taxpayers and tax bureaus (even the Jiangsu tax bureaus) will not be bound by its recommendations. As pointed out by the OECD, the value chain analysis is simply a tool to assist in accurately delineating the transaction, and it does not, of itself, indicate that the transactional profit split is the most appropriate method.[13] That is to say the value chain analysis itself is not sufficient to justify the profit split method, let alone the new transfer pricing method proposed by Circular 125. More importantly, China's transfer pricing rules still follow the arm's length principle. Therefore, taxpayers should remain confident in being able to defend their related party transactions before the tax authorities as long as their positions are based on a sound application of the arm's length principle and are supported by high-quality comparable data.

[13] OECD: *BEPS Actions 8-10 Revised Guidance on Profit Splits* (public discussion draft, 4 July 2016), Para. 27.

2.5 Qingdao Case: Transfer Pricing Adjustments to Outbound Royalty Payments

On 28 June 2016, China Taxation News reported that the Qingdao State Tax Bureau made a transfer pricing adjustment to outbound royalty payments and collected RMB14.95 million in EIT and interest from an equity joint venture (EJV)[14].

Facts

According to the news report, the EJV was investigated because it had stable sales revenue but fluctuating profits in the past ten years. In particular, from 2004 to 2007 when the EJV was entitled to tax incentives, it had positive profits. Whereas, it incurred loss in those years when the tax incentives were not available.

During the investigation, the tax bureau identified two abnormal royalty payments from the EJV. The first payment related to a technology, which was announced to be outdated by the Ministry of Commerce in 2003. However, the EJV kept paying royalties for this technology until 2009. The other payment related to a long-term license of a patented technology. The royalty payment was calculated at a fixed rate, which remained the same for 20 years. However, the tax bureau expected such royalty payment to reduce by year because the technology would normally become less advanced as time goes by.

The tax bureau determined that these two royalty payments were not at arm's length, and decided to make a transfer pricing adjustment using the net margin method. As a result, the EJV recognized an additional taxable income of RMB95 million, and paid RMB14.95 million in EIT and interest.

Observations

The PRC tax authorities have started to focus more on cross-border intercompany payments such as royalties and service fees. Unreasonable royalties paid by Chinese subsidiaries to offshore affiliates are subject to increasing scrutiny. MNCs should conduct a thorough review of its existing and future transfer pricing policy on IP related transactions.

2.6 Anshan Case: Transfer Pricing Adjustment on Service Fees

On 22 December 2015, China Taxation News reported that the Anshan State Tax Bureau of Liaoning province made a transfer pricing adjustment to outbound service payments and collected RMB11.34 million in EIT and interest from a foreign invested enterprise (FIE).[15]

Case Facts

According to the news report, the FIE was investigated because it paid unusually large service fees to its overseas parent company. The tax authority's investigation found that the FIE's service payments had increased significantly: in 2006, the FIE paid RMB180,000 for five service items; and in

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[14] See http://www.ctaxnews.net.cn/html/2016-06/28/nw.D340100zgswb_20160628_3-07.htm?div=-1(China Taxation News is a newspaper indirectly owned by the SAT).

[15] See http://www.ctaxnews.net.cn/html/2015-12/22/nw.D340100zgswb_20151222_1-05.htm?div=-1.

2013, it paid RMB19.85 million for 24 service items. The FIE's previous annual profit rates of 20 to 35 percent dropped to 13.71 percent in 2013. By the end of 2013, the FIE had cumulatively deducted RMB49.9 million in service fees when calculating EIT.

On this basis, the tax authority reached a preliminary conclusion that the FIE was likely to be involved in tax avoidance. Their preliminary conclusion led them to conduct a functional analysis on the FIE. According to their functional analysis, the FIE was not a full-function enterprise because it did not have sales functions (the FIE did perform all production and had some procurement, management and contract R&D functions).

The tax authority required the FIE to provide a breakdown of the service items. It applied Bulletin 16's six tests[16] to analyze the authenticity and reasonableness of the service items. The tax authority then provided opinions on the service items:

- *Financial and human resource (H&R) service.* The FIE could have operated normally without the parent company's services; therefore, the financial and H&R services were not provided due to the FIE's operational needs.

- *Information dissemination service.* The FIE neither owned its own brand nor sold products to third parties; therefore, it could not have benefitted from the information dissemination service.

- *Planning service for product development.* The FIE did not own the patent produced from product development; therefore, it could not have benefitted from the planning service for product development.

- *Enterprise resource planning service.* The parent company had been compensated by previous royalties; therefore, the parent company should not charge a separate fee here.

- *Market research service.* The FIE did not sell products to third parties; therefore, it could not have benefitted from the market research service.

- *Production process support and technical service.* The service content was identical to other services – consulting service and production efficiency planning service; therefore, the parent company should not charge a separate fee here.

- *Product application supporting service.* This service should be provided by a sales company to third-party customers; therefore, it should not be borne by the FIE as a non-sales company.

[16] Six service categories are not deductible for EIT purposes, including: (i) services irrelevant to the enterprise' functions, risks or operations; (ii) shareholder activities; (iii) duplicative services; (iv) incidental benefits; (v) services that have been compensated in other related-party transactions; and (vi) other services that cannot bring economic benefits to the enterprise. *State Administration of Taxation's Bulletin on Enterprise Income Tax Issues Related to Outbound Payments by Enterprises to Overseas Related Parties*, SAT Bulletin [2015] No. 16, dated 18 March 2015, effective as of the same date.

- *Technical support service for product development.* The parent company controlled and implemented the whole process of product development while the FIE did not have any product development function; therefore, the service was never provided to the FIE.

After nearly 10 rounds of negotiations, the FIE finally agreed to pay the additional tax and interest.

Observations

This case shows that the PRC tax authorities have become highly sophisticated in conducting transfer pricing analysis on intercompany services. Coupling this development with the tax authorities' aggressive auditing of intercompany service payments in response to the BEPS Project, MNCs may face greater challenges in their intercompany service payments. To meet these challenges, MNCs should conduct a thorough review of whether their intercompany services fall within the six categories of non-deductible services.

2.7 Transfer Pricing Adjustments to Share Transfers

2.7.1 Yinchuan Case: Share Transfer Price Adjusted Based on Internal Comparable Transactions

On 6 May 2016, China Taxation News reported that the Yinchuan State Tax Bureau adjusted the transfer price of a share transfer based on an internal comparable share transfer and collected RMB3.5 million in EIT from the share transfer.[17]

Facts

In June 2012, a foreign shareholder ("**Transferor**") transferred its 25 percent shareholding in an FIE to a Hong Kong company ("**Transferee**"), which was an affiliate of the Transferor. Six months before the 2012 share transfer, the FIE repurchased 3.84 percent of its own shares from a domestic shareholder at the price of RMB13.8 million. Although the 2012 share transfer was conducted only six months after the share repurchase transaction, the profit rates of the two transactions were found to differ significantly. The domestic shareholder realized a 453 percent profit while the Transferor only realized a 21 percent profit.

Due to the huge difference in the profit rates, the tax bureau suspected the 2012 share transfer was conducted at an "obviously low price" to avoid tax. The tax bureau then questioned the FIE's financial officer about the two transactions. In response, the FIE's financial officer argued that the two transactions were not comparable. Although not entirely clear from the news report, it appears the FIE's financial officer argued that the FIE's main business purpose in the share repurchase was to buy back enough shares so that the FIE could be listed in Hong Kong. In order to repurchase the needed shares, the FIE had to pay an inflated share repurchase price to the domestic shareholder who had refused to sell the shares for less.

In order to assess the 2012 share transfer price, the tax bureau required the FIE to provide: (i) the FIE's board resolution and pricing documentation for the share repurchase transaction; and (ii) the FIE's audit report and appraisal

[17] See http://www.ctaxnews.net.cn/html/2016-05/06/nw.D340100zgswb_20160506_3-10.htm?div=-1.

report from the time of the 2012 share transfer. At first the FIE was reluctant to provide the information.

Without access to this information, the tax bureau said they would adjust the transfer price using the share repurchase price as the comparable uncontrolled price unless the FIE could submit information to evidence the arm's length price of the 2012 share transfer. Faced with this "threat", the FIE submitted its audit report and development plan. However, the tax bureau concluded that the information submitted was not sufficient to prove the arm's length price of the 2012 share transfer.

The tax bureau finally decided to calculate the FIE's overall value based on the share repurchase price and adjusted the 2012 share transfer price accordingly. As a result, the Transferor paid an additional tax of RMB3.5 million on the share transfer.

Observations

In practice, the tax authorities would normally rely on the appraisal report of the target company to assess the share transfer price when there is no comparable uncontrolled transaction.

In this case, the FIE argued that the share repurchase was conducted at an inflated price and therefore should not be used to determine the arm's length price of the 2012 share transfer. However, as the FIE was unable to provide sufficient information (for example, an appraisal report) to evidence the arm's length price of 2012 share transfer, the tax bureau adjusted the 2012 transfer price based on the share repurchase price even though the resulting adjusted price probably exceeded the arm's length price.

The news report does not contain enough factual information about the 2012 share transfer and the share repurchase for us to determine whether they were actually comparable. Nevertheless, this case shows how poor supporting documentation can lead to an unfavourable tax result. Therefore, taxpayers should sufficiently document the arm's length price for all share transfers to avoid unnecessary tax costs.

2.7.2 Taizhou Case: PRC Target Company Enterprise Required to Withhold Tax on Capital Gains

On 26 April 2016, China Taxation News reported that Taizhou State Tax Bureau collected RMB1,590,000 in EIT on a share transfer by having the PRC target company withhold the tax due.[18]

Facts

On 28 August 2014, a Hong Kong company ("**Transferor**") transferred a 60 percent share in a PRC company ("**Target**") to another Chinese company ("**Transferee**"). The share purchase agreement provided that the share transfer should be conducted as a no-gain share transfer, i.e., the Transferor would not realize any gain from the share transfer.

As the Target had a good profitability and owned real property, the tax bureau considered it unreasonable for the Transferor to transfer the shares on a no-gain basis. The tax bureau informed the Target that the tax bureau was entitled

[18] See http://www.ctaxnews.net.cn/html/2016-04/26/nw.D340100zgswb_20160426_4-06.htm?div=-1.

to adjust the transfer price. After negotiations, the Target agreed to adjust the share transfer price based on its net asset value.

The tax bureau decided that the Target was obliged to withhold the tax due based on the actual value of the transferred shares. The Target then asked for an extension to withhold the tax because the consideration would be paid in three instalments.

The tax bureau denied the Target's request and required it to withhold the full tax after the completion of the share transfer registration with the industry and commercial authority. As the legal basis for this order, the tax bureau cited Article 3 of Circular 79, which states that income from a share transfer should be realized at the time when the share transfer agreement has entered into force and the share transfer registration has been completed.[19]

The Target then withheld a total amount of RMB1,590,000 in EIT.

Observations

In recent years, the so-called no-gain share transfer has been subject to increasing scrutiny from the tax authorities. It was therefore not surprising that the tax bureau adjusted the share transfer price based on the Target's net asset value.

However, it was legally questionable whether the tax bureau should have required the Target to withhold the tax because Article 3 of Guo Shui Fa [2009] No. 3[20] clearly states the withholding agent in a share transfer is the payer — not the target. In this case, it should have been the Transferee rather than the Target that had the withholding obligation.

Nevertheless, it is not uncommon that some local PRC tax authorities prefer to collect tax from the PRC target company for their own convenience in a share transfer between two non-resident enterprises because the burdensome foreign exchange procedure for receiving tax payments from a foreign taxpayer. They do so irrespective of the fact that the target company is not a party to the transfer and has no legal obligation to pay or withhold such tax.

2.8 Changzhou Case: Transfer Pricing Adjustments on Related-party Transaction Between Domestic Affiliates

On 31 May 2016, China Taxation News reported that the Changzhou Local Tax Bureau made a transfer pricing adjustment on a financing transaction between two domestic affiliates and collected RMB10.44 million in enterprise income tax (EIT) and interest.[21]

Facts

[19] *Announcement of the State Administration of Taxation on Several Taxation Issues Related to the Implementation of Enterprise Income Tax Law*, Guo Shui Han [2010] No. 79, dated 22 February 2010, effective as of the same date.

[20] *Announcement of the State Administration of Taxation on Printing and Distributing of the Interim Administrative Measures for Source Withholding and Remittance of Non-Resident Enterprise Income Tax*, Guo Shui Fa [2009] No. 3, dated 9 January 2009, retroactively effective from 1 January 2009.

[21] See http://www.ctaxnews.net.cn/html/2016-05/31/nw.D340100zgswb_20160531_2-06.htm?div=-1.

A tax official learned from bank information that a real property development enterprise established in Changzhou ("**Subsidiary**"), which was a wholly-owned subsidiary of another Changzhou enterprise ("**Parent**"), borrowed RMB720 million as long-term debt in 2013, resulting in a total outstanding debt of RMB1.82 billion. The tax official doubted the commercial rationale behind the Subsidiary taking on such a large debt load because the Subsidiary had not invested in any new projects since 2013.

The tax official then examined the Subsidiary's financial statements and annual tax returns and found that the Subsidiary deducted RMB121 million in financing expenses before tax in 2013. Meanwhile, the Subsidiary had RMB605 million in account receivables from the Parent in 2013.

The tax official questioned the Subsidiary's financial officer about why the Subsidiary would bear the financing expenses on funds that were actually used by the Parent. The financial officer explained that such arrangement was common for real property development enterprises and argued that the arrangement did not reduce the EIT payable because both the Subsidiary and Parent were subject to EIT at 25%.

Not convinced by this explanation, the tax official extended the investigation to the Parent. The tax official found that the Parent's main source of income was dividends distributed by its subsidiaries. Because these dividends were exempt from EIT, the Parent had negative taxable income in 2012, 2013 and 2014 after deduction of expenses.

Based on these findings, the tax official concluded that the purpose of the financing arrangement was to avoid EIT. As an enterprise with negative taxable income, the Parent would not benefit from interest expense deductions unless it transferred its subsidiaries and therefore realized sufficient taxable income to offset the interest expenses within five years. Whereas, as an enterprise with positive taxable income, the Subsidiary would receive immediate EIT benefits from the interest expense deductions.

After further negotiation, the Subsidiary agreed to book interest income from the Parent based on the average interest rate and pay RMB10.44 million in EIT and interest on the income.

Observations

As a general principle, the PRC tax authorities would not make a transfer pricing adjustment on a domestic related-party transaction where the transactional parties are subject to the same effective tax rate and the transaction does not lead to a decrease of the country's overall tax revenue.[22] This case shows the tax authority's willingness to scrutinize a domestic related-party transaction where the overall tax revenue is reduced. Thus, multinationals should conduct a thorough review of related-party transactions between their Chinese operations to determine whether those transactions could trigger a tax audit.

[22] Article 30 of Guo Shui Fa [2009] No. 2, dated 8 January 2009, retroactively effective from 1 January 2008.

3. Anti-avoidance and Non-residents

3.1 Indirect transfer cases

3.1.1 Haidian Case: 15 Non-resident Enterprises Taxed on Indirect Transfers

On 15 July 2016, China Taxation News reported that the State Tax Bureau of Haidian District in Beijing collected RMB1.2 billion (approximately US$183 million) in EIT from 15 non-resident enterprises on indirect share transfers.[23]

Facts

The indirect share transfers were realized through two transfers of shares in a Cayman Island company ("**Target**") that indirectly owned shares in three PRC companies (two in Beijing and the other in Tianjin). The transferors involved were 15 non-resident enterprises. The total consideration for the two share transfers was US$2.75 billion, which was paid in cash and equity. In 2015, the transferors submitted share transfer documents to the tax bureau for recordal purposes. After reviewing these documents, the tax bureau decided to further analyse whether China had the right to tax the share transfers.

The tax bureau first analysed the applicability of the Bulletin 7[24] safe harbor provisions:

- the public trading safe harbor was not applicable because the two share transfers were not public trading activities;
- the treaty safe harbor was not applicable because 12 of the transferors were from non-treaty partner jurisdictions (the remaining 3 transferors came from treaty partner jurisdictions in Luxemburg, Singapore and Mauritius);
- the internal restructuring safe harbor was not applicable because the transferors and transferees were not related parties and a part of the consideration was paid in cash.

The tax bureau then analysed the reasonable commercial purpose of the share transfers. The tax bureau decided that the share transfers should, in accordance with Article 4 of Bulletin 7, directly be deemed as lacking reasonable commercial purpose because:

- the Target and the intermediate holding enterprises had no substantial business activities;
- the main value of the Target's equity was derived from the three PRC companies;
- nearly all of the Target's revenue was sourced from China; and

[23] See http://www.ctaxnews.net.cn/html/2016-07/15/nw.D340100zgswb_20160715_1-05.htm?div=-1.

[24] *State Administration of Taxation Bulletin on Several Issues of Enterprise Income Tax on Income Arising from Indirect Transfers of Property by Non-resident Enterprises*, SAT Bulletin [2015] No. 7, dated 3 February 2015, effective as of the same date.

- none of the resident jurisdictions for the 15 transferors taxed the share transfers.

On this basis, the tax bureau concluded that the share transfers should be subject to tax in China.

To determine the amount of taxable capital gains, the tax bureau and the transferors agreed to:

- set the transfer price for the shares in the PRC enterprises as the transfer price stated in the share transfer agreement minus the intermediate holding enterprises' cash assets in proportion to the transferred shares; and

- set the cost basis for the shares in the PRC enterprises as the PRC enterprises' paid-in capital in proportion to the transferred shares.

According to the agreed transfer price and cost basis, the tax bureau recognized taxable capital gains of approximately US$2 billion. Further, to calculate the capital gains subject to tax in Haidian District, the tax bureau referred to the allocation method in Shui Zong Han [2013] No. 82 ("**Notice 82**"), i.e., the capital gains should be allocated to the three Chinese enterprises based on three factors of equal weight: the paid-in capital, the net asset value and the total operating income of each enterprise.

Observations

Treaty Safe Harbor

China's tax treaties with Luxemburg, Singapore and Mauritius allocate the exclusive right to tax capital gains arising from a share transfer to the resident state if: (i) the target company is not a land-rich company; and (ii) the transferor's shareholding in the target company is less than 25 percent. The news report did not contain enough information to explain why the Luxemburg, Singapore or Mauritius transferors were not entitled to the treaty safe harbor. Perhaps they each indirectly held 25 percent or more shares in each of the three PRC enterprises.

Another possibility is that the PRC tax authorities denied treaty benefits based on the beneficial ownership test for the capital gains. Although China's tax treaties do not subject treaty benefits for capital gains to the beneficial ownership requirement, there are several published cases where Chinese tax authorities mistakenly applied the "beneficial ownership" analysis to deny treaty benefits for capital gains. Despite not knowing whether the beneficial ownership test was applied in this case, MNCs should be aware that the tax authorities may apply the beneficial ownership test to deny treaty benefits for capital gains.

Yet another possibility is that the PRC tax authorities denied treaty benefits because they treated the 15 transferors' share transfers as a single transaction. The share transfers seemed to have been realized through the same share purchase agreement; therefore, the PRC tax authorities might have denied treaty benefits to all transferors because a majority of the transferors were not entitled to a treaty exemption for capital gains. In consideration of this possibility, MNCs should group transactions under a single share purchase agreement only if all the transactions have similar tax consequences. Otherwise, MNCs should use separate share purchase agreements to avoid

losing the opportunity to claim the most favourable tax treatment for each transaction.

Capital Gains Allocation Method

Another issue worth noting is the application of the capital gains allocation method under Notice 82. Although Notice 82 only applies to the Trust-Mart acquisition and has no binding authority in other cases, this case shows Notice 82 has persuasive authority when the tax authorities are examining similar transactions.

3.1.2 Xianyang Case: Tax Authorities Highly Sensitive to Indirect Transfers

On 17 November 2015, China Taxation News reported that the Xianyang Local Tax Bureau collected RMB15.76 million on an indirect transfer by a BVI company ("**Transferor**").[25] This case is the first indirect transfer case reported within Shanxi Province's local tax bureau system.

Case Facts

The indirect transfer in question was realized through a transfer of 100 percent of the shares in a BVI company ("**Target**"), which indirectly owned 100 percent equity in a PRC company.

The tax authorities noticed the transaction when the PRC company's previous individual shareholder, a Chinese tax resident, made tax declarations in July 2011. The documents submitted in the declaration indicated that the shareholder transferred 100 percent of the shares in the PRC company to a HK company, which was wholly owned by the Target, for RMB60 million in December 2010. The PRC company later changed its name in January 2012.

The tax authorities suspected a second transaction might have occurred after the transfer by the individual shareholder ("**the First Transfer**") because: (i) the price of the First Transfer was low; and (ii) the new name of the company was similar to the name of a HK listed company. Further, they found online news reports stating that the HK listed company acquired the Target, which was wholly owned by the Transferor, in June 2011 with the main purpose of acquiring the underlying PRC company.

At this point, the Xianyang tax bureau launched an indirect transfer investigation. And the tax officials confirmed the existence of the second transaction according to a report of the HK listed company. The report also stated that both the Target and the HK company did not have any operational business other than share acquisition.

On this basis, the tax authority concluded that the substance of the second transfer was to transfer the PRC company, and it began direct negotiations with the offshore Transferor to recover the taxes. During this time, the tax authority sought leverage by restricting the enterprise's actual owner from travelling abroad (it was not clear in the China Taxation News report whether the "owner" referred to the owner of the offshore Transferor or the underlying PRC company). After more than a year of negotiation, the Transferor finally agreed to pay the tax.

Observations

[25] See http://www.ctaxnews.net.cn/html/2015-11/17/nw.D340100zgswb_20151117_1-05.htm.

It is not clear from the China Taxation News report whether the Xianyang tax bureau conducted a reasonable commercial purpose analysis. The report indicates only that the focus of the investigation was the identification of the indirect transfer.

Regardless of whether the Xianyang tax bureau conducted a reasonable commercial purpose analysis, this case shows that the tax authorities have become sensitive to indirect transfers and can utilize various resources and techniques to identify them, including news reports and listed company reports.

3.2 Land VAT Imposed on Share Transfers

At the end of October 2015, an informal letter[26] (Bian Han [2015] No. 3) issued by the Hunan Provincial Local Tax Bureau became available to the public. This informal letter states that land value-added tax ("**Land VAT**") should be levied on share transfers conducted by a controlling shareholder that actually transfers real estate via a share transfer and derives economic interest from the transfer.

The legal position in the letter is controversial because Land VAT normally only taxes gains realised from the transfer of land, buildings and associated structures. It does not normally apply to share transfers. The position in the letter is based on three SAT notices, i.e., Notice 687[27], Notice 387[28] and Notice 415[29].

The three SAT notices

Notice 687 responded to a Guangxi case in which two shareholders jointly transferred 100 percent of the shares held in a company. The company's main assets were land use rights and buildings. The SAT decided the share transfer was subject to Land VAT.

Notice 387 responded to a Guangxi case in which a company contributed real estate to another company and then transferred the received shares less than two months later. The SAT decided the substance of the transfer was a real estate transfer and was therefore subject to Land VAT.

Notice 415 responded to a Tianjin case. The notice provided no details about the case. Instead, it simply stated that a shareholder transferred land use rights via a share transfer and that transfer was therefore a real estate transaction subject to Land VAT.

Observations

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[26] *Notice of the Asset and Behavior Taxation Office of Hunan Provincial Local Tax Bureau to Clarify the Land VAT Imposition on Transfer of Real Estate in the Form of Share Transfer*, Xiang Di Shui Cai Xing Bian Han [2015] No. 3, dated 27 January 2015.

[27] *Reply of the SAT to Questions relating to the Land VAT Imposition on Transfer of Real Estate in the Form of Share Transfer*, Guo Shui Han [2000] No. 687, dated 5 September 2000.

[28] *Reply of the SAT to Questions concerning Relevant Land VAT Policies*, Guo Shui Han [2009] No. 387, dated 17 July 2009.

[29] *Reply of the SAT to Questions concerning the Land VAT Imposition on the Transfer of Land Use Rights by Tianjin Taidahengsheng*, Guo Shui Han [2011] No. 415, dated 29 July 2011.

The three SAT notices demonstrate that Chinese tax authorities have been increasingly aggressive to counter tax avoidance. In such circumstances, the share transfer in a special purpose vehicle (SPV) is subject to an increasing risk of being subject to Land VAT if the SPV has little to no substance and merely holds real estate. For example, if a shareholder makes a tax-free contribution of land into an SPV and then immediately transfers the received shares, the share transfer faces significant risk of Land VAT exposure.

That said, it is questionable whether the tax authorities have any legal basis to impose Land VAT on share transfers given that the *Interim Regulations on Land VAT* does not include a share transfer as a taxable event. Further, for Land VAT, there is no anti-avoidance rule at legislation level that authorizes tax authorities to re-characterize the share transfer as a real estate transaction. However, we should bear in mind that China may include a general anti-avoidance rule (GAAR) that can be applied to various taxes in the future. If introduced, the GAAR will provide the tax authorities with the legal basis to justify the land VAT imposition on share transfers.

3.3 Treaty Benefit Cases

3.3.1 Wuzhong Case: Hong Kong Company Denied Treaty Benefits for Dividends

On 23 September 2016, China Taxation News reported that the Wuzhong State Tax Bureau in Ningxia reported that it denied a Hong Kong company's treaty benefit claim for dividends and that it collected RMB7.84 million in EIT from the Hong Kong company.[30]

In June 2016, an FIE declared a dividend distribution of RMB174 million. As a result, the Hong Kong company, which held 49 percent shares in the FIE, derived RMB78.39 million in dividends. The FIE made a Bulletin 60[31] recordal with the tax bureau for the Hong Kong company, claiming the reduced 5 percent withholding tax rate on the dividends China-Hong Kong Double Taxation Arrangement ("**China-HK Arrangement**"). However, after reviewing the submitted documents, the tax bureau decided the Hong Kong company was a conduit company and could not qualify as the beneficial owner of the dividends because:

- the Hong Kong company could not provide a Hong Kong residency certificate;
- the Hong Kong company's main income was dividends;
- the Hong Kong company conducted almost no business activities and therefore incurred almost no operational expenses; and
- the Hong Kong company's assets, staff and operations did not match its income.

As a result, the tax bureau imposed a 10 percent withholding tax on the dividends.

Observations

[30] See http://www.ctaxnews.net.cn/html/2016-09/23/nw.D340100zgswb_20160923_1-10.htm.

[31] *State Administration of Taxation's Bulletin on the Administrative Measures for the Non-resident Taxpayer to Claim Tax Treaty Benefits*, SAT Bulletin [2015] No. 60, dated 11 August 2015, effective from 1 November 2015.

Although Bulletin 60 has replaced the approval procedure with a recordal procedure for a non-resident taxpayer to claim tax treaty benefits, the Wuzhong Case shows the PRC tax authorities' readiness to scrutinize the taxpayer's eligibility for the treaty benefits. According to the *PRC Tax Administration and Collection Law*, the tax authority may levy late payment surcharges (i.e., 0.05% per day) and potential penalties (in the range of 50% to 500%), in addition to any underpaid tax if the taxpayer has enjoyed but is found to be disqualified for the treaty benefit. To avoid unnecessary tax costs, every MNC should make a careful assessment before it decides to claim the treaty benefit.

3.3.2 Huzhou Case: Tax Bureau Applies Beneficial Ownership Test to Treaty Benefits for Capital Gains

On 2 September 2016, China Taxation News reported that the Huzhou State Tax Bureau of Zhejiang Province denied a Hong Kong company's treaty benefit claim for capital gains from share transfer and that it collected RMB77.79 million in EIT from the Hong Kong company.[32]

Facts

In April 2016, a PRC listed company announced that one of its shareholders, a Hong Kong company, planned to reduce its shareholding in the PRC company. After obtaining this information, the tax bureau approached the PRC company and the Hong Kong company, requiring the Hong Kong company to pay tax once the planned share transfer was completed.

Faced with this requirement, the Hong Kong company argued that it should be exempt from EIT in China according to the China-HK Arrangement because it only held 24.77 percent of the PRC company.[33]

The tax bureau rejected this treaty benefit argument because the Hong Kong company was not the beneficial owner. According to the tax bureau, a non-resident should be the beneficial owner in order to enjoy the treaty exemption on capital gains. Whereas, the Hong Kong company could not provide evidence that it had substantial business activities. Thus, the tax bureau decided that the Hong Kong company was not the beneficial owner and was not entitled to the treaty exemption. The Hong Kong company finally accepted the tax bureau's decision and agreed to pay the tax.

Observations

As none of the capital gains provisions under the China-HK Arrangement or China's other tax treaties have a "beneficial ownership" requirement for capital gains tax exemption, it is technically incorrect to apply the beneficial ownership analysis to treaty benefits on capital gains. However, even before this case, several published cases had mentioned the Chinese tax authorities mistakenly applying "beneficial ownership" analysis to deny treaty benefits on capital gains. These cases mainly involved taxpayers from traditional tax havens, such as Barbados. However, the Huzhou Case indicates the tax authority's scrutiny of capital gains treaty benefits may expand to other

[32] See http://www.ctaxnews.net.cn/html/2016-09/02/nw.D340100zgswb_20160902_1-10.htm?div=-1.

[33] Under the China-HK Arrangement, income from a share transfer in a company other than a land rich company is taxable only in the resident jurisdiction if the transferor holds less than 25 percent of the capita of the target company.

jurisdictions even though the tax authorities are using a technically questionable method.

3.3.3 Shunyi Case: Withholding Tax Levied on Disguised Guarantee Fees

On 1 January 2016, China Taxation News reported that the Shunyi State Tax Bureau in Beijing identified a disguised guarantee fee payment and collected RMB7.89 million in EIT.[34]

Case Facts

A PRC airline company entered into a tripartite agreement ("**Agreement**") with a French bank and a US bank. According to the Agreement, the two banks would provide financing services to the PRC company for its financial leasing of two airplanes. The agreement expressly stated that another US bank was the guarantor and that the PRC company should pay export credit agency fees (出口信贷机构费) of US$10.8 million to the guarantor via the two banks.

The PRC company submitted the Agreement for recordal with the tax authority and applied to the tax authority for tax exemption on the fees. In the application, the PRC company characterized the fees as service fees. However, when reviewing the Agreement, the tax authority thought the fees might actually be guarantee fees because: (i) the fees were calculated at 4 percent of the initial guarantee amount; and (ii) the PRC company had not paid any specifically named guarantee fees to the guarantor. After further analysis of the Agreement and negotiations with the PRC company, the tax authority recharacterized the fees as guarantee fees for domestic tax purposes. Specifically, the fees were recharacterized as PRC-sourced guarantee fees derived by a non-resident, which meant they should be taxed at a rate of 10 percent EIT on the gross amount of the fees[35].

In order to avoid paying tax on the gross amount of the fees, the PRC company then argued that the fees, as part of the interest for financial leasing, should be treated as royalties paid for the use or right to use industrial, commercial or scientific equipment under the PRC–US tax treaty. According to the PRC–US tax treaty, a US resident only needs to pay PRC income tax on 70 percent of these fees. The tax authority rejected this tax treaty argument because Notice 75 provides that interest paid in relation to a financing lease arrangement should be excluded from royalties paid for the use or right to use industrial, commercial or scientific equipment[36].

The PRC company then advanced a final, desperate argument that the fees should be completely exempt from PRC income tax. The PRC company argued that the fees should be characterized as interest for PRC–US treaty purposes and that the guarantor as a government-owned financial institution should be exempt from PRC income tax on the fees. The tax authority rejected

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[34] See http://www.ctaxnews.net.cn/html/2016-01/01/nw.D340100zgswb_20160101_4-10.htm.

[35] *Announcement of the State Administration of Taxation on Several Issues concerning the Administration of Income Tax on Non-Resident Enterprises*, SAT Bulletin [2011] No. 24, dated 28 March 2011, effective from 1 April 2011.

[36] *Announcement on Issuing Interpretations on the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income and the Protocols thereof*, Guo Shui Fa [2010] No. 75, dated 26 July 2010, effective as of the same date.

this tax treaty argument because Notice 75 provides that guarantee fees charged by a person other than the creditor should not be characterized as interest for treaty purposes. The fees in question were charged by the guarantor rather than the creditor and therefore could not be characterized as interest.

The PRC company finally agreed to withdraw the tax exemption application and withhold the tax accordingly.

Observations

The report does not reveal the final characterization of the fees for treaty purposes. Technically speaking, the fees should be characterized as "other income" because the fees do not belong to any of the specific income items under the treaty. In this case, as the PRC–US tax treaty does not restrict China's tax rights on "other income" sourced in China, China's right to tax the fees could not be restricted.

The result might be different under other China tax treaties, which provide "other income" shall be taxable only in the resident state unless the taxpayer has a permanent establishment in China. Typical examples are China's tax treaties with the UK, the Netherlands, France, etc. Under such a treaty, guarantee fees charged by a non-resident other than the creditor could possibly be exempt from PRC income tax.

3.4 PRC Tax Authorities Increase Scrutiny on Service PEs

Recently, an increasing number of cases are being published in which the PRC tax authorities are reported to have decided a non-resident enterprise to have a PE due to its services performed in China.

Nanjing Case

According to a news report published on the Hainan Local Tax Bureau's website, the Nanjing State and Local Tax Bureaus in Jiangsu cooperated in an investigation to collect RMB5.89 million in EIT and RMB31 million in IIT.[37]

The local tax bureau started the investigation when it learned that a Chinese company had paid large service fee amounts to an offshore company. As the services were rendered over a long period, the local tax bureau decided to look into whether the offshore company had created a PE in China. The local tax bureau contacted the state tax bureau and asked to review the service contract submitted by the PRC company to the state tax bureau for recordal purposes.

After reviewing the service obligations in the service contract, the two tax bureaus suspected that the offshore company would need employees in China to perform the obligations. After questioning the PRC company's employees and conducting an on-site investigation, the tax bureaus found that the offshore company did have technical staff in China. After further investigation, the tax bureaus confirmed that these technical staff had stayed in China long enough to establish a PE. Therefore, the offshore company was liable to pay EIT and withhold IIT for its technical staff working in China.

[37] See http://www.tax.haina n.gov.cn/hnportal/yasf/869245.jhtml.

In order to determine the EIT payable, the state tax bureau allocated RMB157.12 million from the total service fees (i.e., RMB368.31 million) to the PE and taxed the PE using the deemed profit method.

Ningbo Case

On 12 August 2016, China Taxation News reported that the Ningbo State Tax Bureau in Zhejiang collected RMB10.88 million in EIT from a UK university on service fees received from a Chinese university ("**Payer**").[38]

The Payer was a Sino-foreign cooperative university jointly owned by the UK university and a Chinese university. The UK university and the Payer entered into a service agreement, according to which the former provided education services to the latter. These education services included seconding experienced teaching and management staff to China.

The tax bureau decided to investigate because the UK university had been receiving increasing service fees in recent years but had never paid EIT in China. A key issue under investigation was whether the seconded staff created a PE for the UK university. The UK university argued that no PE was created because the seconded staff signed labor contracts with the Payer and therefore were the Payer's employees. The tax bureau rejected this argument because the investigation showed that the seconded staff were hired and paid by the UK university. On this basis, the tax bureau decided the UK university had a PE in China and was liable for tax on income attributable to the PE.

In order to determine the EIT payable, the tax bureau allocated 47 percent of the total service fees to the PE and taxed the PE using the deemed profit method.

Observations

Due to the tax recordal mechanism for outbound remittances,[39] the PRC tax authorities can examine outbound payments to determine whether a PE is created. The Nanjing and Ningbo Cases indicate the PRC tax authorities are being especially rigorous in searching for service PEs. We expect this trend to continue.

If a service PE is created, the offshore service provider's EIT burden depends largely on how much income is attributable to the PE. As such, every offshore service provider should maintain sufficient documentation on the income allocation between services performed inside and outside of China to prevent the PRC tax authorities from arbitrarily allocating income to the PRC PE.

3.5 Guiyang Case: Management Fee Deemed to Be Distributed Dividends

On 26 April 2016, China Taxation News reported that the Baiyun District State Tax Bureau collected a total of RMB20,610,000 in EIT from a non-

[38] See http://www.ctaxnews.net.cn/html/2016-08/12/nw.D340100zgswb_20160812_1-10.htm?div=-1.

[39] Under PRC law, a PRC taxpayer must make a tax recordal for each non-trade outbound remittance in excess of US$50,000.

resident enterprise, of which RMB16,800,000 was withholding tax imposed on deemed dividends.[40]

Facts

A foreign company ("**Transferor**") sold a 9.8 percent share in a PRC company ("**Target**") to another PRC company ("**Transferee**") for RMB10,000,000 ("**Share Transfer**").

The Target was acquired by the Transferor at a purchase price of US$2,000,000 (approximately RMB13,090,000) in 2006. In 2012, two Chinese companies (including the Transferee) became the Target's shareholders through capital contribution, and the Transferor's shareholding in the Target was diluted to 9.8 percent. In 2013, the Transferee acquired all shares in the Target from the other two shareholders (including the Transferor).

The tax bureau suspected the Share Transfer might not comply with the arm's length principle because the transfer price was obviously lower than the acquisition cost even though the Target had been profitable during the intervening years. During further investigation, the tax bureau discovered that the Target had a huge amount of retained earnings that were attributable to the Transferor but were paid to another Chinese company ("**Management Co.**") as a management fee before the Share Transfer.

The investigation also revealed that immediately before the capital contribution in 2012, the Target and the Management Co. entered into a management agreement under which the Target would only keep an annual profit of RMB1,000,000 and would pay the remaining profits to the Management Co. as management fees.

The tax bureau questioned the business rationale behind the management agreement because the Target was operationally sound and had increasing profits. During an onsite visit to the Management Co., the tax bureau found that the Management Co. had suspended operation due to poor management. Based on these discoveries, the tax bureau concluded that the Management Co. lacked the capability to provide management services to the Target and that the purpose of the management fee was to avoid the withholding tax on dividends.

The tax bureau decided to adjust the Share Transfer price from RMB10,000,000 to RMB49,500,000. It deemed the Target's retained earnings of RMB168,000,000, which was paid to the Management Co. as a management fee before the Share Transfer, as a dividend distributed to the Transferor. Accordingly, RMB20,610,000 in EIT was imposed on the Transferor.

Observations

Although the news report does not mention the complete reasoning behind the tax bureau's decision to deem the management fee as distributed dividends and there could be other potential methods to recharacterize the nature of the payments in this case, this case reveals that the PRC tax authorities are increasingly willing to challenge transactions that lack a reasonable

[40] See http://www.ctaxnews.net.cn/html/2016-04/26/nw.D340100zgswb_20160426_2-05.htm?div=-1.

commercial purpose. Thus, every multinational should test each new and every existing transaction for reasonable commercial purpose.

4. Enterprise Income Tax

4.1 New Rules on Super Deduction of R&D Expenses

On 2 November 2015, the Ministry of Finance (MOF), the SAT and the Ministry of Science and Technology (MOST) jointly issued Notice 119[41], addressing the new rules on super deduction of R&D expenses..

Super deduction refers to the tax incentive available to enterprises engaged in R&D. An enterprise can either (i) take a one-time enterprise income tax (EIT) deduction in the current year equal to 150 percent of the actual R&D expenses if no intangible asset results from the R&D, or (ii) amortize the resulting intangible asset at 150 percent of the actual R&D expenses that are calculated into the cost of the relevant intangible asset.

Super Deduction expanded to new industries

Previously, the super deduction was only available to enterprises engaged in listed high-tech industries. Notice 119 expands the super deduction to cover all industries except for those on a "negative list". The negative list includes the following industries:

- tobacco manufacturing;
- hotel and catering;
- wholesale and retail;
- real estate;
- leasing and business services;
- entertainment; and
- other industries specified by the MOF and the SAT.

Qualified activities expanded

Same as the previous rules, Notice 119 defines R&D activities as systematic activities conducted by an enterprise to obtain and creatively apply new scientific and technological knowledge or to materially improve technologies, products (services) and techniques.[42] Notably, Notice 119 extends the super deduction to creative design activities.

Qualified expenses expanded

Notice 119 categorizes qualified R&D expenses into the following seven broad categories:

- labor costs;
- direct investment expenses;
- depreciation expenses;
- amortization of intangible assets;
- design fees for new products, formulating fees for new technique procedures, clinical test expenses for new drug development and field trial expenses for the exploration and development of technology;

[41] *Notice on Improving the Super Deduction Policy of R&D Expenses*, Cai Shui [2015] No. 119, dated 2 November 2015, effective from 1 January 2016.

[42] Notice 119 specifically names seven activities to be excluded from the super deduction because the activities do not meet the definition of R&D activities.

- other related expenses; and
- other expenses specified by the MOF and SAT.

"Other related expenses" should not exceed 10 percent of the total qualified R&D expenses. The new qualified expenses under Notice 119 are labor costs for external R&D personnel, inspection fees for trial products, expert consulting fees, insurance premiums for high-tech R&D, and travel and conference expenses directly related to the R&D. The last three items are classified as other related expenses and thus subject to the 10 percent limitation.

Contract R&D

For contract R&D, Notice 119 leaves unchanged the rule that permits the principal rather than the entrusted party to take the super deduction. But Notice 119 limits the qualified R&D expenses to 80 percent of the actual expenses. Further, under Notice 119, expenses incurred by a foreign entrusted party are not eligible for the super deduction.

Notice 119 makes a welcome change in only requiring the breakdown of contract R&D expenses between related parties instead of between unrelated parties as the previous rules required.

Simplified procedures

In addition to its expanded scope, Notice 119 has simplified procedures. First, Notice 119 changes the accounting requirement from the previous special account to subsidiary account. Compared to the complicated standards for special accounts, the simpler standards for subsidiary accounts will lower compliance burdens.

Second, Notice 119 reduces the burden on an enterprise during a dispute with the tax authority over eligibility for the super deduction. Previously, a tax authority might require an enterprise to submit an appraisal opinion issued by a government science and technology department if the tax authority disputed the enterprise's eligibility for the super deduction. Notice 119 instead requires the tax authority to directly solicit that appraisal opinion from the competent science and technology department. Therefore, the enterprise will no longer bear the cost of obtaining the appraisal opinion.

Retroactive super deduction

According to Notice 119, starting from 1 January 2016, an enterprise, which is eligible for but fails to enjoy the super deduction, can retroactively enjoy the super deduction after completing a recordal procedure within three years. Notice 119 does not clarify how this retroactive super deduction will be implemented: e.g., cash refund or decrease in the tax due in the year the enterprise claims to enjoy the super deduction.

Article 51 of the *PRC Tax Collection and Administration Law* (TCAL) should provide the tax authorities with guidance in handling the retroactive super deduction. This general provision states that a taxpayer can claim a refund of overpaid tax within three years from the date of the tax payment. Therefore, after applying the retroactive super deduction, the tax authorities should refund any overpaid tax in cash. However, it remains to be seen how the tax authorities will implement the retroactive super deduction in practice.

Observations

With its expanded scope and simplified procedure, Notice 119 will benefit resident enterprises directly conducting R&D activities or outsourcing R&D activities to other resident enterprises.

As the entrusted party under a contract R&D arrangement is not entitled to the super deduction, a Chinese subsidiary conducting R&D activities on behalf of a foreign principal will not be able to enjoy the super deduction. To enjoy the super deduction, the Chinese subsidiary needs to conduct the R&D activities on its own behalf. The foreign principal could transfer the intellectual property (IP) ownership to the Chinese subsidiary so that it could enjoy the super deduction. But, in practice, as IP protection concerns in China remain paramount for most foreign companies, the super deduction incentive will likely not induce many foreign companies to move R&D activities and IP ownership to China.

Notice 119 makes one more significant change. It expressly excludes expenses for R&D outsourced to foreign companies from the super deduction incentive. This exclusion will likely discourage enterprises from purchasing foreign R&D services.

4.2 New rules Regarding the HNTE Recognition

4.2.1 New HNTE Recognition Rules

On 29 January 2016, the Ministry of Science and Technology (MOST), the MOF and the SAT jointly issued the revised *Administrative Measures for the Recognition of High and New Technology Enterprise*s ("**Notice 32**").[43] Notice 32 retroactively takes effect from 1 January 2016 and replaces the previous HNTE Recognition rules in Notice 172.[44] An HNTE is subject to EIT at the preferential rate of 15 percent rather than the standard 25 percent.

Changes to HNTE qualifications

Notice 32 makes some notable changes to the previous HNTE recognition qualifications:

- *Ownership of IP is required.* Previously, to qualify as an HNTE, an enterprise needed to obtain core IP rights of the main products / services within the last three years by way of self-development, transfer, donation, merger & acquisition, or a global exclusive license for a period of more than five years. Notice 32 removes the three-year requirement and provides that the enterprise must own the relevant IP for the enterprise to qualify as an HNTE.

- *Personnel requirements are lowered.* Previously, science and technology ("**S&T**") related employees with an associate degree (three-year program or above) had to account for at least 30 percent of the total work force, and at least 10 percent of the total work force had to be engaged in R&D activities ("**R&D Personnel**"). Notice 32 repeals both the educational requirement for S&T related employees

[43] *The Revised Administrative Measures on the Recognition of High and New Technology Enterprises*, Guo Ke Fa Huo [2016] No. 32, dated 29 January 2016, retroactively effective from 1 January 2016.

[44] *The Administrative Measures on the Recognition of High and New Technology Enterprises*, Guo Ke Fa Huo [2008] No. 172, dated 14 April 2008, retroactively effective from 1 January 2008, repealed on 1 January 2016 .

and the R&D Personnel minimum percentage requirement. Under Notice 32, S&T related employees engaged in R&D or technology-innovation activities should account for at least 10 percent of the total workforce.

- *R&D expense requirement is lowered.* Notice 32 leaves unchanged the rules that R&D expenses in the past three accounting years should not be lower than 4 percent of sales revenue for an enterprise with sales revenue ranging from RMB50 million (excluded) to RMB200 million (included) in the last year, and 3 percent for an enterprise with sales revenue over RMB200 million in the last year. However, Notice 32 lowers the floor for R&D expenses from 6 percent to 5 percent for an enterprise with sales revenue of no more than RMB50 million in the last year.

In addition, Notice 32 now requires the enterprise to have no serious safety or quality accidents and no serious illegal environmental acts within one year prior to its application.

Observations

The IP ownership requirement under Notice 32 is likely to affect many Chinese subsidiaries of MNCs. Due to IP protection concerns in China, many MNCs are reluctant to allocate IP ownership to Chinese subsidiaries. Therefore, in practice, many Chinese subsidiaries obtain IP via a license from a foreign affiliate. Under Notice 32, these Chinese subsidiaries will no longer qualify as HNTEs.

4.2.2 New Guidelines for HNTE Recognition

On 22 June 2016, the MOST, the MOF and the SAT jointly issued the revised Working Guidelines for the Recognition and Administration of High and New Technology Enterprises ("**Notice 195**")[45] to implement the new HNTE recognition rules issued under Notice 32 earlier this year.

IP requirement

Notice 195 restates the intellectual property (IP) ownership requirement under Notice 32. It requires an enterprise to own the core IP in its main products or services for the enterprise to qualify as an HNTE. When an IP is jointly owned by two or more enterprises, only one of them can use the IP to apply for HNTE status.

Notice 195 further classifies IP into two categories:

- **Type I** covers invention patents, exclusive rights over integrated circuit layout-design, new plant varieties, etc.; and
- **Type II** covers utility model and design patents and software copyright (excluding trademark).

A particular piece of Type II IP can only be used for one HNTE application, i.e., the applicant cannot reuse the same piece of Type II IP to renew its HNTE status after its original HNTE qualification expires. Whereas, there is no such limitation on a Type I IP.

[45] *Working Guidelines for the Recognition and Administration of High and New Technology Enterpris*es, Guo Ke Fa Huo [2016] No. 195, dated 22 June 2016, retroactively effective from 1 January 2016.

Main products or services

According to Notice 32, an enterprise must own the IP in its main products or services to qualify as an HNTE. However, Notice 32 does not clearly define what constitutes a "main product or service". Notice 195 closes this gap by providing a revenue threshold in its definition. According to Notice 195, a "main product or service" are high-tech products or services which generates an aggregate revenue in excess of 50 percent of the enterprise's total revenue from high-tech products or services in the current period.

Total revenue

Notice 32 requires the revenue from the high-tech products or services to account for more than 60 percent of the enterprise's total revenue without defining the term "total revenue". Notice 195 provides that total revenue equals the overall revenue less the non-taxable revenue. Both the overall revenue and non-taxable revenue should be calculated in accordance with the *PRC Enterprise Income Tax Law* and its implementing regulations.

Previously, some local authorities (e.g., in Hunan) did not consider non-operating revenue when calculating the total revenue. Now under Notice 195, the total revenue calculation will also include non-operating revenue since non-operating revenue is subject to enterprise income tax. Under this expanded scope of total revenue, enterprises with large non-operating revenue may find it more difficult to reach the revenue threshold for HNTE qualification.

Observations

Taking effect retroactively on 1 January 2016, Notice 195 may significantly affect an enterprise's HNTE qualification. Every enterprise that intends to apply for or renew HNTE qualification should assess its qualification against the requirements under Notice 32 and Notice 195, and make necessary adjustments, if possible, to increase the likelihood of successfully applying for an HNTE.

4.3 Yantai Case: Offshore Upstream Merger Disqualified from Notice 59 Exemption

In late December 2015, a Chinese district court ruled that an offshore upstream merger carried out by two Italian companies was disqualified from receiving the tax-free treatment under Notice 59[46].

Facts

On 17 July 2012, an Italian company named Illva Saronno Holding S.p.A ("**Italian Parent**") passed a resolution to merge with its wholly owned Italian subsidiary, i.e., Illva Saronno Investments S.r.l. ("**Italian Subsidiary**"). As a result of the merger, the Italian Parent, as the surviving company, acquired all of the Italian Subsidiary's assets and debts, including a 33 percent share in a Chinese resident company, i.e., Changyu Group Co. Ltd. ("**Target**"). The Italian Subsidiary was deregistered on 21 November 2012 following the merger.

[46] *Announcement of the Ministry of Finance and the State Administration of Taxation on Issues Concerning the Enterprise Income Tax Treatment of Enterprise Restructurings*, Cai Shui [2009] No. 59, dated 30 April 2009, retroactively effective from 1 January 2008.

On 9 September 2013, Zhifu State Tax Bureau issued a notice ("**Notice**") to the Italian Parent, stating that the merger had resulted in a taxable share transfer. The tax bureau decided to adjust the share transfer price to RMB994,845,943.21, which equals to 33 percent of the book value of the Target's net assets. Thus, the Italian Subsidiary was deemed to realize from the share transfer a gain of RMB463,421,683.21, i.e., the share transfer price of RMB994,845,943.21 less the share acquisition cost of RMB481,424,260. Accordingly, the Italian Parent was required to pay RMB46,342,168.32 in EIT.

However, the Italian Parent thought the merger had satisfied the conditions for the tax-free treatment in Article 5 of Notice 59 and therefore should not trigger EIT liability in China. After paying the required tax, the Italian Parent initiated an administrative review to the Yantai State Tax Bureau requesting a revocation of the Notice. The Yantai State Tax Bureau rejected the Italian Parent's request because the share transfer did not meet the additional conditions in Article 7[47] of Notice 59.

The Italian Parent then brought the case to the Zhifu District Court.

Holding and ruling

The court identified three issues in the case:

- *Whether the offshore merger should be characterized as a share transfer for Notice 59 purposes* — The court held that it was proper for the tax bureau to characterize the restructuring as a share transfer because (i) the merger directly resulted in a change of ownership over the 33 percent share in the Target; and (ii) Bulletin 72[48] clearly states that a share transfer as a result of an offshore merger belongs to a share transfer by a non-resident enterprise.

- *Whether the offshore merger satisfied the conditions for tax-free treatment under Notice 59* — For a cross-border share transfer to qualify for the tax-free treatment, Article 7 requires the offshore transferor to hold 100 percent shares in the offshore transferee. Whereas, in this case, it was the transferee holding 100 percent shares in the transferor. Therefore, the court held that the offshore merger was disqualified from receiving the tax-free treatment.

- *Whether the offshore merger could enjoy tax-free treatment based on the non-discrimination provision under the China–Italy tax treaty* — The court held that taxing the offshore merger did not constitute discrimination toward the non-resident enterprise because international practice allows for a jurisdiction to establish specific tax rules for non-resident enterprises.

Based on these holdings, the court ruled that the tax bureau's decision was correct and dismissed the Italian Parent's claim.

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[47] In order to enjoy the tax-free treatment, a cross-border share transfer must meet not only the general conditions in Article 5 but also the additional conditions in Article 7 of Notice 59.

[48] *Announcement of the State Administration of Taxation on Issues Concerning the Special Tax Treatment Applicable to Equity Transfer by Non-resident Enterprises*, SAT Bulletin [2013] No. 72, dated 12 December 2013, effective as of the same date.

Observations

The Italian Parent's major argument in this case was that the offshore merger should be characterized as a "merger " rather than "a share transfer" for Notice 59 purposes. Although Notice 59 does not expressly limit the word "merger" to a merger carried out by resident enterprises, the PRC tax authorities have generally interpreted the Notice 59 rules on mergers as applying only to domestic mergers between resident enterprises. Bulletin 72 reinforced this interpretation by stating that a transfer of equity interest in a resident enterprise resulting from an offshore merger should be treated as a share transfer for purposes of Notice 59.

The court's decision is consistent with the tax authorities' general view of cross-border reorganizations. Technically speaking, the court in this Yantai Case is only a district court and its judgment is not binding on other courts. However, this court decision may still have some influence on how the tax bureaus and other courts decide on the tax treatment of cross-border reorganizations.

5. Turnover Tax

5.1 Bye-bye BT! Comprehensive VAT System to Cover All Industries

On 1 May 2016, China completed its VAT pilot program and ended the bifurcated VAT and business tax (BT) system that had been in place since 1994. A comprehensive and uniform VAT system now applies to all industries, and BT has been swept into the dustbin of history.

The MOF and the SAT jointly issued Notice 36[49] on 23 March 2016 to extend the VAT pilot program to the four industries still under the BT regime at that time: financial services, real estate services, construction services and consumer services. Notice 36 also introduces significant changes to the current VAT pilot program rules. On 31 March 2016, the SAT released seven bulletins, numbered consecutively from SAT Bulletin [2016] No. 13 to SAT Bulletin [2016] No. 19, to address the detailed implementation of Notice 36 starting on 1 May 2016.

In this section, we first comment on the general changes introduced by Notice 36 and the seven bulletins (collectively "**New VAT Rules**") and then discuss certain industry-specific changes. We also provide some general recommendations for taxpayers.

5.1.1 General analysis

(i) Expansion of VAT pilot program

The New VAT Rules has transitioned all remaining BT taxpayers into VAT taxpayers. The applicable VAT rates for the four new industries covered by the VAT regime are as follows:

- 6 percent for financial services;
- 11 percent for real estate services, as well as the leasing or sale of immovable property and the transfer of land use rights;

[49] *Notice of the Ministry of Finance and the State Administration of Taxation on Fully Expanding the Value-added Tax Pilot Program*, Cai Shui [2016] No. 36, dated 23 March 2016, effective from 1 May 2016.

- 11 percent for construction services;
- 6 percent for consumer services.

The applicable VAT rate for small-scale VAT taxpayers in these industries is 3 percent, in common with small-scale VAT taxpayers generally, with an exception that small-scale VAT taxpayers is taxed at 5 percent on revenues from leasing or sale of immovable property.

In general, the New VAT Rules permits the use of input VAT credits in these four industries, with certain exceptions that we will discuss later in Section 5.1.2*(ii)*.

(ii) Broad definition of intangible assets

The previous BT and VAT rules provided that the transfer of certain types of intangible assets was subject to BT or VAT. The New VAT Rules similarly provide that the sale or licensing of the following intangible assets is subject to VAT:

- patented and unpatented technology;
- trademarks;
- copyrights;
- goodwill;
- land use rights; and
- other use rights to natural resources, such as mining exploration rights, mining rights and water rights.

But Notice 36 goes a step further by providing a new catch-all category of "other intangible assets" (其他权益性无形资产). This category covers all types of intangible assets capable of generating economic benefits. The examples provided in Notice 36 include, among other things, operation rights to infrastructure, franchise rights, distribution rights, memberships, quotas, name rights and agency.

This expanded definition of intangible assets resolves the difficulty under current rules of allocating business transfer value for turnover tax purposes. Previously, when a business was sold at a premium above the net asset value of the business, the technical turnover tax treatment of this premium value was unclear, and it was often treated under the general category of "goodwill". Under the New VAT Rules, the broader concept of "other intangibles" will be able to cover all or part of this premium value.

(iii) Exemption and zero-rating for exported services

The New VAT Rules continue the previous exemption or zero-rating for domestic suppliers of exported services and domestic sellers or licensors of

intangibles to overseas parties, and include the new services and intangibles that are now subject to VAT within the scope of exemption or zero-rating.[50]

Notice 36, however, adds an additional criterion for enjoying VAT exemption or zero-rating, i.e., that the relevant service or intangible must be "completely consumed outside China". "Completely consumed outside China" is defined to mean: (i) the actual service recipient is outside China or the intangible is completely used outside China; *and* (ii) the service or intangible is not connected with goods or immovable property located in China.

This new criterion may disqualify certain exported services or transactions that would enjoy VAT exemption or zero-rating under the previous VAT pilot program rules. For example, sales and marketing services provided by a Chinese enterprise to a foreign affiliate used to be exempt from VAT based on local interpretation. It is possible based on Notice 36 that the tax authorities will assert these sales and marketing services are connected with goods located in China and therefore not qualified for the VAT exemption.

As a transitional rule, Notice 36 grandfathers service contracts signed before 30 April 2016 and allows the VAT exemption or zero-rating to continue in accordance with the current rules until the contracts expire.

(iv) Adjustment to sale price that lacks reasonable commercial purpose

Notice 36 follows the previous VAT rules in authorizing the tax authorities to adjust a taxpayer's taxable revenue if the taxpayer provides services or transfers real estate or intangibles at an obviously high or low price without a reasonable commercial purpose.

For the first time in the turnover tax context, Notice 36 defines "lack of reasonable commercial purpose" to mean using artificial arrangements to reduce, avoid or defer VAT payments or to increase VAT refunds, with the main purpose of obtaining these tax benefits.

As the present VAT rules do not define "lack of reasonable commercial purpose", tax authorities have tended to interpret this term broadly to cover many situations where services are provided substantially below the market price for commercial reasons. This new definition may give taxpayers more room to undertake legitimate transactions at an obviously high or low price with good commercial reasons.

(v) Mixed sale of services and goods

Where one transaction involves both the sale of goods and the provision of services, Notice 36 provides that the entire transaction should be subject to VAT as either a sale of goods or a provision of services depending on the taxpayer's main business. If the taxpayer's main business is the manufacture, wholesale or retail of goods, all of its revenue from mixed sale transactions is subject to VAT at 17% as a sale of goods. The revenue of other taxpayers from mixed sale transactions is subject to VAT as the provision of services at the applicable rate under the New VAT Rules.

[50] Under both the VAT exemption regime and the VAT zero-rating regime, no output VAT is levied on service fees. However, a credit or refund of input VAT incurred in the provision of the relevant services is only available under the VAT zero-rating regime.

This new rule takes away the ability of taxpayers under the current rules to separate revenue from mixed sale transactions into sale of goods and provision of services and pay VAT at the different rates applicable to each revenue category.

(vi) Transfer of going concern

Notice 36 keeps the previous transfer of going concern (TOGC) rules under the BT and VAT regimes. This rule provides that a business transfer falls outside the scope of VAT where the transfer includes all of the assets and associated creditor rights, debts and workforce of an enterprise or of a line of business within an enterprise.

The failure of the previous TOGC rules to address the transfer of intangible assets has created technical and practical uncertainty about whether TOGC treatment covers the transfer of intangibles or only the transfer of other assets, such as inventory, fixed assets and real property. Unfortunately, the TOGC rule in the New VAT Rules fails to clarify this uncertainty.

(vii) Adjustment to credited input VAT

Where a taxpayer has credited input VAT arising from the acquisition of fixed assets, real estate or intangible assets, but subsequently uses the asset for one of the purposes listed below, Notice 36 requires that part of the input VAT credited in the previous period must be deducted from the total creditable input VAT for the current period:

- in connection with generating revenue that is taxed using the simplified calculation method;
- in connection with generating revenue that is VAT-exempt;
- for collective welfare or personal consumption; or
- the asset incurs an abnormal loss.

The amount of the adjustment to current period creditable input VAT is equal to the net value (after depreciation or amortization) of the fixed asset, real estate or intangible multiplied by its applicable tax rate.

5.1.2 Industry analysis

(i) Existing industries

(a) Modern services

Notice 36 adjusts the current sub-categories with the broad category of modern services. Among other things, Notice 36:

- introduces a "business support services" category and a catch-all modern services category;
- expands leasing services to cover financial leasing;
- excludes transfer of technology, trademarks, copyrights and goodwill from modern services and re-categorizes them as transfers of intangibles; and

- expressly categorizes market research services as consulting services.

"Business support services" includes (i) enterprise management services, (ii) human resource services, (iii) agency services, and (iv) security protection services.

In general, the VAT treatment of modern services provided by domestic suppliers remains unchanged. With respect to the export of modern services, the VAT treatment may change in practice depending on the tax authority's interpretation of the requirement that the service be completely consumed outside China (see Section 1.3 above).

(b) Transportation, express and freight forwarding services

Transportation services

Overall, the tax treatment of transportation services remains unchanged except that non-vessel operating common carrier (NVOCC) service is expressly categorized as a transportation service subject to VAT at 11 percent. According to Notice 36, NVOCC services provided by a domestic entity or individual to a foreign person are exempt from VAT. With respect to international transportation services provided via an NVOCC, Notice 36 applies a look-through principle, i.e., the actual domestic transportation company is eligible for VAT zero-rating while the domestic NVOCC is VAT exempt.

Although NVOCC service is now recognized under domestic law as a transportation service for VAT purposes, it is unclear whether NVOCC service will enjoy treaty benefits as an international transportation service under applicable tax treaties.

Express delivery services

Like the current VAT rules, Notice 36 divides express services into transportation services subject to VAT at 11 percent and pick-up and delivery services subject to VAT at 6 percent.

International transportation services provided by a domestic transportation enterprise are zero-rated for VAT purposes. But pick-up and delivery services are VAT exempt only where provided for exported goods.

Freight forwarding services

Although re-categorized from logistics support services to business support services, domestic freight forwarding services receive the same VAT treatment under Notice 36 as under the previous rules, i.e., they are subject to VAT at a 6 percent rate. International freight forwarding services (direct or indirect) remained exempted from VAT on a transitional basis.

Notably, Notice 36 provides that the taxable revenue for freight forwarding services (international or domestic) is the total revenue and any additional charges received less government fees collected from and paid on behalf of the principal. This means the netting method for international freight forwarding services under the current rules is no longer available under Notice 36.

(ii) New industries

(a) Real estate services

Applicable tax rates and taxable revenue

Normally, a general VAT taxpayer is liable to VAT on gross sales revenue[51] from the transfer or lease of real property at 11 percent with input VAT credits available.[52] As an exception, a general VAT taxpayer can elect the simplified taxation method, i.e., elect to be taxed at 5 percent of taxable revenue without input VAT credits, for the transfer or lease of real property that the taxpayer acquired before 30 April 2016. A small-scale taxpayer is automatically taxed using the simplified taxation method.

Provisional filing and prepayment

Regardless of the taxation method, all taxpayers (excluding individuals) must provisionally file and prepay VAT where the real property is located if the property is not located in the same county (city) as the taxpayer. The applicable VAT prepayment rates are:

- 5 percent on the gross sales revenue from transfer of self-built real properties;
- 5 percent on the net sales revenue from transfer of real properties other than self-built real properties;
- 5 percent on the gross rent from lease of real properties acquired before 30 April 2016; and
- 3 percent on the gross rent from lease of real properties acquired after 1 May 2016.

After the VAT prepayment, a general VAT taxpayer must file with its own in-charge tax authority.

This prepayment procedure will increase the administrative burden on real property sellers and landlords and increase the likelihood of overpayment. Although a taxpayer can claim a VAT refund if the prepaid tax exceeds the VAT payable,[53] claiming a tax refund is always a painful exercise for taxpayers. Moreover, the tax authorities may disagree over which of them is responsible for issuing the refund.

Input VAT credits from real property

Under the New VAT Rules, a general VAT taxpayer can credit the input VAT from real property acquired after 1 May 2016 or where construction of the real property started after that date. The credits should be taken in two instalments: 60 percent creditable in the current period when the taxpayer obtains the VAT

[51] "Gross sales revenue" as used in Section 5.1 means total sales revenue plus any additional charges.

[52] As an exception, for a real property development enterprise that is taxed using the general taxation method, its taxable revenue equals the gross sales revenue less the purchase price of the land use rights paid to the government.

[53] The language of Notice 36 suggests that the tax authority is more likely to allow the taxpayer to stop future VAT prepayments or payments for a period than it is to grant a tax refund in the current period.

special invoice; and the remaining 40 percent creditable in the thirteenth month following the taxpayer obtains the VAT special invoice.

However, a general VAT taxpayer can credit the input VAT from the following real property without being subject to the above instalment limitation:

- real property self-developed by a real property development enterprise;
- real property obtained via financial leasing; and
- temporary construction or buildings built on a construction site.

Transfer of a residential property by an individual

Under Notice 36, the VAT treatment on a transfer of a residential property by an individual differs depending on how long the residential property was held: for less than two years, 5 percent VAT on the gross sales price; for two years or more, VAT exempt. However, in Beijing, Shanghai, Guangzhou and Shenzhen, an individual is liable for VAT on the net sales revenue from the transfer of a non-ordinary residential property held for two years or more.

(b) Construction services

Applicable tax rates and taxable revenue

Construction services provided by a general VAT taxpayer are normally subject to VAT at 11 percent on the gross sales revenue, while those provided by a small-scale VAT taxpayer are subject to VAT at 3 percent on the gross sales revenue less any amounts paid to a sub-contractor.

Notably, a contractor with general VAT taxpayer status can choose to apply the simplified taxation method, i.e., to be taxed at 3 percent on the gross sales revenue less any amounts paid to a sub-contractor, if:

- the contractor provides the construction services for a project but does not provide the construction materials or only purchases (and provides) auxiliary materials;
- the contractor provides the construction services for a project and the owner independently purchases all or part of the equipment, materials and power; or
- the contractor provides services for "old construction projects".[54]

Provisional filing and prepayment

A taxpayer that provides construction services in a county or a city other than where the taxpayer is registered must provisionally file and prepay VAT where the construction services are provided. The applicable VAT prepayment rates are:

[54] "Old construction projects" refers to construction projects with a commencement date on or before 30 April 2016 as indicated in the Construction Permit for Construction Engineering or the construction project contract (the latter if there is no Construction Permit for Construction Engineering).

- 2 percent on the gross sales revenue if the taxpayer applies the general taxation method; or

- 3 percent on the gross sales revenue less any amounts paid to a sub-contractor if the taxpayer applies the simplified taxation method.

(c) Financial services

Tax rates and taxable services

VAT applies at a 6 percent rate to financial services provided by a general VAT taxpayer and at a 3 percent rate to financial services provided by a small-scale VAT taxpayer. Financial services are further divided into the following four sub-categories:

- **Lending services** – include interest income from the provision of capital, such as loan interest, interest on bonds held to maturity, sale-and-lease-back financing arrangements and fixed or guaranteed minimum returns on monetary investment;

- **Chargeable financial services** –include service fees from the provision of services related to the flow of funds and other financial operations, such as currency exchange services, credit card services, financial guarantee services and clearing, and settlement and payment services;

- **Insurance services** –include commercial insurance services, including personal insurance and property insurance; and

- **Transfer of financial products** – includes foreign currency, securities, non-goods futures and other financial products (such as all forms of financial derivatives and all forms of asset management products, such as funds, trusts and financial instruments).

Notably, financial leasing is excluded from financial services. Instead, it is grouped under leasing services, which are subject to VAT at 17 percent for tangible assets and 11 percent for real property.

Items not subject to VAT and VAT-exempt items

Insurance compensation and bank deposit interest are not within the scope of VAT. In addition, the following items are exempt from VAT as a continuation of the present BT exemption:

- Specific types of interest income, such as interest on:

  - national and local government bonds;
  - loans from the People's Bank of China to financial institutions;
  - foreign exchange loans provided by the State Administration of Foreign Exchange via financial institutions in the course of foreign exchange operations; and
  - intra-bank and interbank borrowing and lending;

- Insurance premium income from personal insurance with a period of more than one year; and

- Income from:
    - trading of securities by a qualified foreign institutional investor;
    - trading of A shares by Hong Kong investors via the Hong Kong Shanghai Stock Connect program;
    - trading of China funds by Hong Kong investors via the mutual recognition of funds program;
    - trading of shares and bonds by fund managers of securities investment funds; and
    - transfer of financial products by individuals.

Input VAT on lending services

Input VAT on lending services and on financing advisory fees, handling fees and consultancy fees directly related to a loan paid by the borrower to the lender cannot be credited against the taxpayer's output VAT.

The non-creditable input VAT will increase the borrower's financing costs. Therefore, taxpayers will be incentivized to choose financing methods other than loans (e.g., finance leasing) or to use independent financial advisors to arrange loans.

Netting method for transfer of financial products

Similar to the current BT position, the VAT taxable revenue on the transfer of financial products is the gain, i.e., the sale price less the purchase price. Losses can be carried forward to taxable periods in the same year but cannot be carried forward to the next calendar year. The taxpayer can choose either the weighted average method or the moving weighted average method to calculate the purchase price. Once selected, the method cannot be changed for 36 months.

Further, Notice 36 provides that special VAT invoices cannot be issued for the transfer of financial products. This taxation approach based on gains rather than revenue is more realistic and practical for trading in financial products, although the prohibition of carrying forward losses from one year to the next will continue to result in loss of tax relief.

Cross-border financial services

VAT exemption is extended to insurance services for exported goods (including export goods insurance and export credit insurance) and chargeable financial services provided to foreign entities if the chargeable financial services do not involve flow of funds to or from Chinese entities and are not related to goods, intangible assets or immoveable property in China. However, Notice 36 does not generally allow VAT exemption or zero-rating for cross-border lending services or financial product transfers.

(d) Consumer services

Tax rates and taxable services

From 1 May 2016, consumer services provided by a general VAT taxpayer are subject to VAT at a 6 percent rate, and consumer services provided by a small-scale VAT taxpayer are subject to VAT at a 3 percent rate.

Consumer services are divided into the following six sub-categories:

- cultural and sports services;
- educational and medical services;
- tourism and entertainment services;
- catering and accommodation services;
- daily services for residents; and
- other consumer services.

Taxable revenue

Generally, taxable revenue from the provision of consumer services is the gross sales revenue received. As an exception for the tourism services, a taxpayer can choose to calculate its taxable revenue by deducting travel fees paid to third parties from the gross sales revenue received from the service recipients. Under this method, the taxpayer is not allowed to issue special VAT invoices to the service recipient for the deducted amount.

Non-creditable consumer services

Notice 36 provides that input VAT on catering services, daily residential services and entertainment services cannot be credited against the taxpayer's output VAT.

5.1.3 Actions to consider

In response to the transition of all industries under the VAT regime, we recommend that companies engaged in the new sectors subject to VAT, whether as a service provider or service recipient or as a seller or buyer, consider the following actions:

- analyse the impact of the New VAT Rules on its business activities and choose appropriate pricing strategies to reflect the tax burden on both transactional parties;
- review contracts signed while BT was the applicable tax, analyse whether the service provider or seller has the right to collect VAT from the service recipient or buyer, and consider renegotiating the contracts where necessary; and
- ensure compliance with VAT administration rules, such as general VAT taxpayer registration, invoice management and VAT declaration.

5.2 VAT Exemption or Zero-rate Regime

5.2.1 VAT Zero-rate Regime Extended to More Services

On 30 October 2015, the MOF and the SAT jointly issued Notice 118[55], which extends the zero-rate regime to cover the following exported services provided by general VAT taxpayers (which are presently VAT exempt):

[55] *Notice of the MOF and the SAT on the Application of VAT Zero-rate to Exported Services Relating to Films, etc.*, Cai Shui [2015] No. 118, dated 30 October 2015, effective from 1 December 2015, repealed on 1 May 2016.

- radio, film and television program distribution and production services;

- technology transfer services, software services, circuit design and testing services, information system services, business process management services and contract energy management services with offshore subjects; and

- information technology outsourcing (ITO), business process outsourcing (BPO) and knowledge process outsourcing (KPO) services as prescribed in the applicable catalogue in Notice 106[56].

As background, VATable exported services, i.e., VATable services provided by Chinese service providers to foreign service recipients, are zero-rated or exempt for VAT purposes. Regardless of whether zero-rated or exempt, no output VAT is levied on service fees. However, a credit or refund of input VAT incurred in the provision of the relevant services is only available under the zero-rate regime. In other words, compared to the exemption regime, the zero-rate regime grants the general VAT taxpayer more favourable tax treatment.

Following Notice 36 taking effective from 1 May 2016, Notice 118 has been repealed. However, Notice 36 continues to grant VAT zero-rate treatment to the aforementioned services provided that the services are completely consumed outside China.

Observations

Notice 118 fixes an inconsistency in VAT treatment of exported R&D services. Before Notice 118, exported software R&D services were considered "software services" that only enjoyed VAT exemption, and exported hardware R&D[57] were considered "R&D services" that enjoyed 0 percent VAT on export. Now, by extending the zero-rate regime to software services, Notice 118 will harmonize the treatment of software R&D and hardware R&D. In addition, the expansion of the zero-rate regime to ITO, BPO and KPO will benefit all technologically advanced service enterprises (TASE)[58] because export of these services is a TASE's sole or main business activity.

5.2.2 Supplementary Rules to the Administrative Measures on VAT Zero-rate Regime

On 14 December 2015, the SAT issued SAT Bulletin [2015] No. 88[59] ("**Bulletin 88**") to supplement and partially repeal SAT Bulletin [2014] No.

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[56] *Notice of the MOF and the SAT on the Inclusion of the Railway Transport Industry and Postal Service Industry in the Pilot Collection of VAT in Lieu of Business Tax,* Cai Shui [2013] No. 106, dated 12 December 2013, effective from 1 January 2014, repealed on 1 May 2016.

[57] The research and development of new technology, new products, new techniques or new materials or their systems.

[58] A Chinese TASE will be able to enjoy a reduction in its enterprise income tax rate from 25 percent to 15 percent.

[59] *Supplementary Announcement of the State Administration of Taxation on the Administrative Measures for Applying the Tax Refund (Exemption) to Taxable Services Eligible for Zero-rated Value-added Tax*, SAT Bulletin [2015] No. 88, dated 14 December 2015, retroactively effective from 1 December 2015.

11[60] ("**Bulletin 11**"), which contains the current administrative measures on the VAT zero-rate regime. Bulletin 88 was mainly issued to clarify the administration and implementation of Notice 118, which extends the VAT zero-rate regime to additional services.

Failure to claim

Under both Bulletin 11 and Bulletin 88, a service provider must claim VAT zero-rate treatment during a VAT declaration period[61] before April 30 of the year following the year in which the sales revenue was recorded for accounting purposes. Previously, according to Bulletin 11, in case of late declaration, the relevant service export would be treated as a normal sale subject to VAT. Bulletin 88 now permits the service provider to claim tax exemption[62] in case of late declaration. Only if the service provider fails to claim the tax exemption will the service export be treated as a normal sale subject to VAT.

Receipts

Generally speaking, a service provider must submit a receipt to demonstrate it derived income from a foreign service recipient. In practice, the tax authority normally requires the service fees to be directly paid to the service provider by the service recipient.

Bulletin 88 now allows an exception to this rule. A member company of an MNC may submit a receipt issued by a bank to another member company conducting the centralized operation (or receipt and payment) if: (i) the MNC group has been approved to conduct centralized operation of foreign exchange funds or centralized receipt and payment of current-account cross-border *renminbi* capital; (ii) the payer on the receipt is the service recipient or its foreign affiliates as agreed in the service contract; and (iii) the service provider is stated as the payee or actual payee on the receipt.

Certificate issued by the Ministry of Commerce (MOC)

Under Bulletin 88, in order for certain taxpayers to enjoy VAT zero-rate treatment, the taxpayer must submit a certificate to show its service contract was registered and approved. For a taxpayer who provides software services, circuit design and testing services, information system services, business process management services or offshore service outsourcing, the certificate is issued by the MOC's Information Administrative System for Service Outsourcing and Software Export. For a taxpayer who provides radio, film and television distribution and production services, the certificate is issued by the MOC's Cultural Trade Administrative System.

Observations

[60] *Announcement of the State Administration of Taxation on the Issuance of the Administrative Measures for Applying the Tax Refund (Exemption) to Taxable Services Eligible for Zero-rated Value-added Tax*, SAT Bulletin [2014] No. 11, dated 8 February 2014, retroactively effective from 1 January 2014.

[61] Generally, these VAT declaration periods occur during the first 15 days in each month.

[62] Under both the VAT zero-rate regime and the VAT exemption regime, no output VAT is levied on service fees. However, a credit or refund of input VAT incurred in the provision of the relevant services is only available under the zero-rate regime.

In order to benefit from the VAT zero-rate regime, a taxpayer should consider the following:

- **Timing the recordal of service contract sales revenue to allow sufficient time to submit the VAT zero-rate declaration for the sales revenue;**

  In practice, the tax authorities generally require all supporting documents to be submitted on time for the purpose of VAT zero-rate declaration. However, taxpayers may find it difficult to do so depending on when the sales revenue from the service contract is recorded. For example, if the sales revenue is recorded in December, the taxpayer will have no more than four months to prepare and submit the required documents as the taxpayer has to claim zero-VAT treatment in a VAT declaration period before 30 April of the next year. However, if the sales revenue is recorded in January, the taxpayer will have more than one year to prepare the required documents.

- **Paying service fees directly to branch offices; and**

  Bulletin 88 is unclear on whether each of the service provider's branch offices needs to receive separate service fee remittances from the offshore service recipient in order to qualify for the zero-VAT treatment on the fees (as each branch office is a separate VAT taxpayer from the head office). Until such time a clarification is made, we highly recommend arrangements where the branch offices directly receive the service fees.

- **Including a definite service period or a fixed service fee amount in certain service contracts.**

  As mentioned above, for certain services, an MOC certificate is necessary to enjoy VAT zero-rate treatment on certain service contracts. In order to receive the certificate, the taxpayer's contract must first be approved by the MOC. Practice indicates that the MOC is reluctant to approve service contracts that do not have either a definite service period or a fixed amount of service fees.

5.2.3 New VAT Exemption Measures

On 6 May 2016, the SAT issued Bulletin 29[63] to address the implementation of the VAT exemption rules under the new VAT regime, i.e., Notice 36.

Consistent with the full expansion of the VAT pilot program, Bulletin 29 expands the scope of the previous VAT exemption Measures[64] to cover:

- construction services for projects located outside China;

[63] *Announcement of the State Administration of Taxation on the Issuance of Administrative Measures for VAT Exemption on Cross-border Taxable Services Under the VAT Pilot Program (For Trial Implementation)*, SAT Bulletin [2016] No. 29, dated 6 May 2016, retroactively effective from 1 May 2016.

[64] *Announcement of the State Administration of Taxation on the Re-issuance of Administrative Measures for Value-Added Tax Exemption on Cross-border Taxable Services Under the VAT Pilot Program (For Trial Implementation)*, SAT Bulletin [2014] No. 49, dated 27 August 2014, effective from 1 October 2014.

- construction supervision services for projects located outside China;
- insurance services for exported goods; and
- chargeable financial services provided to foreign entities if the chargeable financial service does not involve flow of funds to or from Chinese entities and is not related to goods, intangible assets or immoveable property in China.

Notice 36 requires certain services[65] and intangibles to be completely consumed outside China if they are to be VAT exempt. Bulletin 29 restates this requirement, and provides examples of services that are not completely consumed outside of China and therefore not VAT exempt, such as services of which the "actual service recipient" is a domestic organization or individual.

Unfortunately, the term "actual service recipient" is not clearly defined under Bulletin 29. Therefore, it remains uncertain in what situations the tax authorities will refuse to accept a contract service recipient as the actual service recipient.

5.3 VAT Treatment Clarified for Prepaid Cards

On 18 August 2016, the SAT issued Bulletin 53[66] to address certain issues relating to the VAT pilot program. Among those issues, Bulletin 53 clarifies the VAT treatment on transactions involving prepaid cards.

According to Bulletin 53, prepayments received by a card seller for the sale of pre-paid cards are not subject to VAT. At this prepayment stage, the card seller can only issue a normal VAT invoice rather than a special VAT invoice to the buyer. When the buyer purchases goods or services with the pre-paid card, the supplier of the services or goods is liable to pay VAT, but the supplier cannot issue a VAT invoice (normal or special) to the buyer. If the card seller and the supplier of the services or goods are not the same party, the supplier should issue a normal VAT invoice rather than a special VAT invoice to the card seller upon receipt of payment.

Observations

Taxpayers commonly conduct transactions using pre-paid cards. Before Bulletin 53, every taxpayer was forced to decide independently how to invoice these transactions. The result was a wide range of disparate invoicing practices among taxpayers. Now, Bulletin 53 will establish a consistent invoicing practice, and taxpayers will need to change invoicing practices that are inconsistent with the new requirements under Bulletin 53.

According to Bulletin 53, neither the card seller nor the supplier of the services or goods can issue a special VAT invoice to the buyer. We do not think this is a substantial change because goods or services purchased using a pre-paid card are normally used for final consumption and it is an established rule that no special VAT invoice can be issued on goods or services used for final consumption purposes.

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[65] These services include intellectual property services, logistic support services, attestation and consulting services, and business support services, etc.

[66] *Announcement of the State Administration of Taxation on Certain Issues Concerning the VAT Pilot Program*, SAT Bulletin [2016] No. 53, dated 18 August 2016, effective as of 1 September 2016.

5.4 Tax Rules on Cross-border B2C E-commerce

On 24 March 2016, the MOF, the General Administration of Customs and the SAT jointly issued Notice 18[67] to clarify the tax treatment of cross-border business-to-customer ("**B2C**") e-commerce.

New categories of taxes applicable

Previously, imported e-commerce retail goods were subject to a "postal tax" of 10 to 50 percent of the dutiable value[68] (tax amounts less than RMB50 were waived).

Under Notice 18, imported e-commerce retail goods are instead subject to customs duties, import VAT and consumption tax. The individual who purchases the goods is the taxpayer. The dutiable price is the actual retail price, including freight and insurance. E-commerce enterprises, e-commerce transaction platform enterprises and logistics providers can be the withholding agent.

Duty exemption and tax reduction thresholds

A transaction valued at no more than RMB2,000 (approximately US$320) is exempt from customs duties and can receive a 30 percent discount for both VAT and consumption tax if the purchaser's annual cumulative transactions do not exceed RMB20,000. Otherwise, the rules on general trade of goods will apply, i.e., no exemption or reduction is available.

Scope of Notice 18

Notice 18 applies to goods that are listed as Imported E-commerce Retail Goods[69] and are :

- imported through e-commerce transaction platforms connected to the Customs network, through which cross-checking among the transactions, payments, and logistics can be made; or
- imported through e-commerce transaction platforms that do not connect to the Customs network, but where the logistics providers can provide the transactions, payments, and logistics information in electronic form, and commit to bear relevant legal responsibilities for such imports.

Observations

Unfortunately, Notice 18 does not address the uncertainties associated with the tax treatment of cross-border e-commerce digital goods because digital

[67] *Announcement of the Ministry of Finance, the General Administration of Customs and the State Administration of Taxation Concerning the Cross-Border E-Commerce Retail Import Tax Policy*, Cai Guan Shui [2016] No. 18, dated 24 March 2016, effective as of 8 April 2016.

[68] The original four-level rate of postal tax, i.e., 10 percent, 20 percent, 30 percent and 50 percent, was adjusted to a three-level rate, i.e., 15 percent, 30 percent and 60 percent from 8 April 2016.

[69] The Ministry of Finance and ten other government authorities issued two lists of Imported E-commerce Retail Goods on 6 April and 15 April respectively.

goods are not imported through Customs and are not listed as imported e-commerce retail goods.

6. Tax Treaties

6.1 Internal Guidance on Non-residents Claiming Tax Treaty Benefits

On 29 October 2015, the SAT issued Notice 128[70] providing tax authorities at all levels with further guidance on the implementation of Bulletin 60, which relates to the procedural rules on non-residents claiming tax treaty benefits. For a detailed discussion of Bulletin 60, please refer to Section 5.1 of our China paper presented at the 31st Annual Asia Pacific Tax Conference in 2015.

Focus of post-filing administration

According to Notice 128, the in-charge tax authority should conduct spot-checks on non-residents' eligibility for tax treaty benefits. The spot-check should focus on the following situations:

- The non-resident is from a tax jurisdiction with a low effective tax rate;
- The non-resident has an adverse record with respect to treaty benefits applications; and
- The treaty benefit amount is relatively large.

During the examination, the following issues should be specifically checked:

- Whether the tax residency certificate (TRC) fully complies with the relevant rules and whether the non-resident is a dual tax resident;
- Whether the taxpayer correctly classifies the income item and applies the correct treaty provision, and whether the non-resident is entitled to the relevant treaty benefit;
- Whether the tax amount calculation is correct; and
- Whether the tax treaty is abused.

Notice 128 requires the tax authorities to spot check a minimum number of cases from each quarter. They must spot check 30 percent of cases relating to tax treaty benefits for passive income (dividends, interest, royalties and capital gains) within three months of the end of the quarter and spot check 10 percent of cases relating to tax treaty benefits for other income items within six months of the end of the quarter.

Centralization under the SAT

In order to achieve more consistent practice, Notice 128 requires the local tax authorities report certain matters to the SAT in certain situations.

If a non-resident taxpayer claims tax treaty benefits under the same provision in more than one location, the in-charge tax authority that decides to recover the unpaid or underpaid tax should report to the provincial tax authority within 30 days from the tax recovery decision. The provincial tax authorities in all locations where the taxpayer claimed the tax treaty benefits should coordinate to reach a consensus on the non-resident's treaty benefit eligibility.

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[70] *The Administrative Measures on Non-residents Claiming Tax Treaty Benefits*, Shui Zong Fa [2015] No. 128, dated 29 October 2015, effective from 1 November 2015.

If a consensus cannot be reached within 90 days, the provincial tax authority located in the place of tax recovery should report to the SAT. The SAT will then decide the non-resident's treaty benefit eligibility and direct the in-charge tax authorities in implementing the decision consistently.

Any case with the tax recovery amount of RMB5 million or more should be reported to the SAT within 30 days from the date of the tax recovery decision. The SAT will summarize and collate the reported cases for distribution to tax authorities nationwide. For cases with high tax risks or inconsistent implementation, expert joint hearings will be organized aperiodically.

Observations

Since the tax authorities are required to examine 30 percent of passive income cases and 10 percent of other income cases within three months and six months respectively of the end of each quarter, non-residents face a higher risk of treaty benefit claims being examined during those periods. However, while less likely to face an examination outside those periods, the statute of limitations for tax avoidance arrangements is 10 years. Therefore, non-residents cannot completely preclude a later examination and still must labor under the basic uncertainty from Bulletin 60.

Nonetheless, the reporting mechanism introduced by Notice 128 is a welcome development. By requiring important decisions to be made by the SAT, Notice 128 should help to create a more consistent treaty benefit administration.

6.2 Referral Letter no Longer Required to Apply for a HK Tax Residency Certificate

On 30 October 2015, the Hong Kong (HK) Inland Revenue Department (IRD) published on its website the revised application forms for TRCs relating to the China-HK Double Taxation Arrangement. A referral letter issued by the PRC tax authority is no longer required in the application.

Prior to 1 November 2015, according to Bulletin 53[71], the PRC in-charge tax authority could recognize an enterprise as a HK tax resident based solely on its corporate registration certificate or business registration certificate. However, if the in-charge tax authority doubted the entity's HK tax resident status, it could issue a referral letter to the IRD, requiring the IRD to issue a TRC for the taxpayer. Only with this referral letter, can the taxpayer apply to the IRD for a TRC.

But with Bulletin 53 being repealed by Bulletin 60 as of 1 November 2015, the PRC tax authorities will no longer issue referral letters. Initially, there was a concern that this would create difficulties for HK tax residents in claiming tax treaty benefits in PRC.

Thus, the IRD's decision to no longer require the PRC tax authority referral letter as of 30 October 2015 is a welcome development. Hopefully, the

[71] *Notice of the SAT on Issues concerning the Identification of Tax Resident Status relating to the Implementation of the Arrangement between Mainland China and Hong Kong Special Administrative Region Regarding the Avoidance of Double Taxation on Income and Prevention of Tax Evasion*, SAT Bulletin [2013] No. 53, dated 13 September 2013, effective from 1 November 2013, repealed by Bulletin 60 from 1 November 2015.

taxpayer can now apply for and receive the TRC in 21 working days. However, from looking at the revised forms, it is still unclear how much substance the taxpayer need have in HK for the IRD to issue a TRC.

6.3 Hong Kong Tax Residency Certificate Valid for Three Calendar Years for Treaty Purposes

On 6 June 2016, the SAT issued Bulletin 35[72] to implement the agreement between the SAT and the Inland Revenue Department (IRD) on the use of TRCs issued by the IRD. According to Bulletin 35, a person (entity or individual) can use an IRD-issued TRC as evidence of Hong Kong residency status for the calendar year listed on the TRC and for the following two calendar years. If the person loses Hong Kong tax residency status at any point during the three years, then the IRD-issued TRC can no longer be used as evidence for the person's Hong Kong residency status.

Previously, under SAT Bulletin 60, in order to claim tax treaty benefits, a Hong Kong tax resident was required to submit an IRD-issued TRC in the preceding calendar year or in the current calendar year. In other words, under Bulletin 60, a TRC was valid proof of residency status for a maximum of two calendar years. Now, under Bulletin 35, a TRC is valid proof of residency status for a maximum of three calendar years. This extended validity will lower the Hong Kong tax resident's compliance burden when claiming tax treaty benefits with the PRC tax authorities. However, also note that nowadays the IRD is asking more questions when issuing a TRC to a Hong Kong company, such as source and nature of income, place and nature of business activities, place of management and control and information about Hong Kong employees (if any), etc. These questions may cause potential difficulties for a Hong Kong company without sufficient substance to obtain a TRC from the IRD.

6.4 New China-Germany Double Tax Treaty Applies to Income Derived on or after 1 January 2017

Following its ratification by China and Germany, the new China-Germany Double Tax Treaty entered into force on 6 April 2016 and will be applicable to income derived on or after 1 January 2017.

Key changes introduced under the China-Germany Double Tax Treaty include:

- reducing withholding taxes on dividends paid by a Chinese company to a direct German parent company or vice versa from 10 percent to 5 percent;
- reducing withholding taxes on royalties paid for the use of industrial, commercial or scientific equipment from 7 percent to 6 percent; and
- allocating the exclusive right to tax "other income" to the resident state.

For more details on the new China-Germany Double Tax Treaty, please refer to Section 6.5 of our China paper presented at the 30th Annual Asia Pacific Tax Conference in 2014.

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[72] *Announcement of the State Administration of Taxation Concerning the Use of Hong Kong Tax Residency Certificates in Mainland China*, SAT Bulletin [2016] No. 35, dated 6 June 2016, retroactively effective from 15 April 2016.

6.5 New China-Russia Tax Treaty Enters into Force

The new China-Russia Double Tax Treaty and its protocol (collectively "**New Russia Treaty**") entered into force on 9 April 2016 and will apply to income derived on or after 1 January 2017. The New Russia Treaty contains some notable changes.

Zero withholding tax on interest

Unlike the current treaty, which provides a 10 percent withholding tax rate on interest, the New Russia Treaty allocates the exclusive right to tax interest to the resident state. That is to say, interest derived by a Russian tax resident will be no longer subject to EIT in China, or vice versa. This provision is quite unusual and is rarely found in China's tax treaties.

Reduced withholding tax on dividends and royalties

The New Russia Treaty reduces the withholding tax on dividends to 5 percent if: (i) the beneficial owner is a company directly holding at least 25 percent of the capital of the company paying the dividends; and (ii) this holding equals at least EUR80,000. For all other situations, the applicable tax rate continues to be 10 percent.

In addition, the New Russia Treaty lowers the withholding tax rate on royalties from the current 10 percent to 6 percent.

Expanded exemption for gains from share transfers

The New Russia Treaty removes the 25 percent shareholding threshold. It provides that capital gains derived from transfer of shares in a company other than a land-rich company are taxable only in the resident state. This means Russia will join the few jurisdictions, such as Ireland, Korea and Estonia, with tax treaties with China that provide a broad tax exemption for gains from share transfers without a shareholding percentage requirement.

Anti-treaty abuse

Consistent with the majority of China's recent tax treaties, the New Russia Treaty contains additional provisions denying treaty benefits on dividends, royalties, interest and other income if the main purpose or one of the main purposes of creating or assigning the rights for which the payments are made is to take advantage of the treaty benefits.

More importantly, the New Russia Treaty introduces a limitation on benefits (LOB) clause to ensure a sufficient link between the entity claiming the treaty benefit and its state of residence. In order to enjoy the treaty benefit, the LOB clause requires the non-tax resident to be a "qualified person"[73] or to have located in the resident state active business activities that are substantially related to the generation of the relevant income item. We expect this LOB clause to create difficulties for companies without sufficient economic substance when trying to claim treaty benefits under the New Russia Treaty.

[73] According to the New Russia Treaty, an individual will automatically be considered a "qualified person" whereas a company must pass a complicated analysis to be considered a "qualified person".

6.6 New Protocol Amends the China-Macau Double Taxation Arrangement

On 19 July 2016, Mainland China and Macau signed the third protocol to amend the China-Macau Double Taxation Arrangement. One major change under the protocol is that the withholding rate on payments for leasing of airplanes and ships will be reduced from 7 percent to 5 percent. In addition, the protocol introduces an anti-abuse clause to deny treaty benefits for dividends, royalties, interest and capital gains where the main purpose of creating or assigning the rights for which the payments are made is to take advantage of the treaty benefits.

Although the third protocol is pending ratification, the ratification process is a formality that will eventually be concluded. Therefore, in response to the anti-abuse clause under the protocol, every MNC that conducts business in China via Macau should now start structuring new transactions to satisfy the main purpose test so that treaty benefits will not be denied.

7. Exchange of information

7.1 China Signs the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information

On 16 December 2015, China signed the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information ("**CRS MCAA**"), which is put in place as an international framework that allows the automatic exchange of Common Reporting Standard (CRS) information between jurisdictions. As of 19 August 2016, the CRS MCAA has 84 participating jurisdictions.

The CRS is an OECD proposal, under which a financial institution in one jurisdiction will be required to identify financial accounts held by tax residents of other jurisdictions and to report that financial information to the local government. The local government will then pass the information to the account holder's country of tax residence. The CRS information mainly includes:

- the name, address, jurisdiction(s) of residence and tax identification number(s) of each reportable person;
- the account number;
- the name and identifying number (if any) of the reporting financial institution;
- the account balance or value as of the end of the relevant calendar year or other appropriate reporting period; and
- the total gross amount of interest or dividends received.

As of 26 July 2016, 54 jurisdictions have committed to implementing the CRS by 2017, and 47 jurisdictions (including China) have committed to implementing it by 2018[74].

Each country that signs the CRS MCAA is required to notify the OECD Co-ordinating Body Secretariat of the jurisdictions with which it intends to cooperate with in enforcing the CRS MCAA. The CRS MCAA becomes effective between two jurisdictions when: (i) both jurisdictions have provided

[74] The data is sourced from the OECD's website: http://www.oecd.org/tax/automatic-exchange/commitment-and-monitoring-process/, visited on 12 October 2016.

such notice of intent; and (ii) the Convention on Mutual Administrative Assistance in Tax Matters ("**Convention**") has entered into force and is in effect for both jurisdictions[75].

On 14 October 2016, the SAT published the draft *Administrative Measures on Due Diligence of Tax-related Information of Non-resident's Financial Accounts* for public comments until 28 October 2016. The draft requires Chinese financial institutions to collect from non-resident account holders CRS information. Afterwards, Chinese financial institutions are required to submit such information to the SAT. The draft is expected to be finalized and take effect on 1 January 2017.

Observations

In the first few years of implementation we do not expect that each of the countries that implement the CRS will conduct automatic exchange of CRS information with every other country that implements the CRS.

To date, it remains unclear when the CRS MCAA will become effective between the PRC and a specific participating jurisdiction. However, the PRC has been pushing to implement the automatic exchange of information. According to a meeting held by the SAT on 10 October 2015 in Beijing, the PRC plans to implement the CRS and start automatically exchanging CRS information with more than 45 countries by the end of 2018.

Non-PRC residents usually do not hold accounts in PRC financial institutions due to foreign currency control policies. Thus, the PRC's automatic exchange network for CRS information is unlikely to have an immediate impact on non-PRC residents. However, once the automatic exchange network for CRS information is established, the PRC tax authorities will be able to obtain information about a PRC resident's account in an offshore financial institution. Therefore, PRC residents must prepare for the forthcoming information exchange. Among other things, each PRC resident should:

- Identify what personal and financial information is maintained by his or her financial institutions;
- Ensure the information maintained by the financial institutions is accurate (which will help prevent unwarranted tax investigations);
- Assess potential exposure and risks from the information exchange; and
- Involve tax advisors to develop proper strategies to help maintain PRC tax compliance.

7.2 China Signs the MCAA for Automatic Exchange of CbC Reports

On 12 May 2016, China signed the CbC MCAA. As of 30 June 2016, the CbC MCAA has 44 participating jurisdictions[76], which have committed to automatically exchange CbC reports among them.

[75] China signed the Convention on 27 August 2013. The Convention has become effective for China from 1 February 2016, and will become applicable to China from 1 January 2017.

CbC reporting is an OECD proposal under Base Erosion and Profit Shifting Action Plan 13, which requires each multinational enterprise with annual consolidated group revenue equal to or exceeding EUR750,000,000 (approximately US$848,475,000) to provide aggregate CbC data about its entities (and permanent establishments) in every country. These CbC reports are expected to expose instances where profits are booked in low-tax jurisdictions where little or no economic activity takes place.

The CbC MCAA will come into effect between two jurisdictions when: (i) each jurisdiction has provided a notice to the OECD Coordinating Body Secretariat that it intends to cooperate with the other jurisdiction in enforcing the CbC MCAA; and (ii) the Convention has entered into force and is in effect for both jurisdictions. There is currently no public information on the list of jurisdictions, with which China intends to enforce the CbC MCAA, and the list of jurisdictions, which intend to enforce CbC MCAA with China. Thus, it remains unclear when the CbC MCAA will become effective between the PRC and a specific jurisdiction.

8. Tax Incentives

8.1 Tax Incentives for National Independent Innovation Demonstration Zones Expand Nationwide

On 23 October 2015, the MOF and the SAT jointly issued Notice 116[77] to expand the coverage of four tax incentives from the national independent innovation demonstration zones to the whole nation. On 16 November 2015, the SAT issued three bulletins, i.e., Bulletin 80[78], Bulletin 81[79] and Bulletin 82[80], to further clarify and supplement Notice 116.

EIT treatment of corporate partners in a venture capital LLP

According to Notice 116, starting from 1 October 2015, where a limited liability partnership (LLP) established specifically for the purpose of venture capital makes an equity investment in a non-listed small- or medium-sized high-tech company for at least 24 months, its resident corporate partners may deduct 70 percent of the invested amount in the non-listed small- or medium-sized high-tech company from the profits distributed by the LLP for EIT purposes.

[76] The data is sourced from the OECD's website:http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/CbC-MCAA-Signatories.pdf, visited on 12 October 2016.

[77] *Notice on Expanding the Pilot Tax Policies for the National Independent Innovation Demonstration Zones Nationwide*, Cai Shui [2015] No. 116, dated 23 October 2015, the effective date varies depending on the tax matters concerned.

[78] *Notice of the SAT on Issues concerning the Collection and Administration of Individual Income Tax on Equity Incentives and Conversion of Undistributed Profits, Capital Reserves and Surplus Reserves into Share Capital*, SAT Bulletin [2015] No. 80, dated 16 November 2015, effective from 1 January 2016.

[79] *Notice of the SAT on Issues concerning Enterprise Income Tax on Corporate Partners of Venture Capital Limited Partnership*, SAT Bulletin [2015] No. 81, dated 16 November 2015, effective from 1 October 2015.

[80] *Notice of the SAT on Issues concerning Enterprise Income Tax on Technology Transfer Income Derived from Licensing*, SAT Bulletin [2015] No. 82, dated 16 November 2015, effective from 1 October 2015.

Bulletin 81 further clarifies that in order for a corporate partner to enjoy the 70 percent deduction, the corporate partner should also have paid the capital to the LLP for not less than 24 months.

Before Notice 116, EIT treatment differed for direct and indirect investment in a non-listed small- or medium-sized high-tech company. According to the EIT law and its implementing regulations, an enterprise could deduct 70 percent of the direct equity investment in the high-tech company from its taxable income when investment was held for two years. Whereas, for indirect investment, the 70 percent deduction only becomes available after the entry into force of Notice 116 except in some pilot zones.

By expanding the 70 percent deduction to indirect investment, Notice 116 partially changed this inconsistency. However, a difference remains in the 70 percent deduction: in indirect investment, an LLP's corporate partner can only take the deduction from profits distributed by the LLP; while in direct investment, the investing enterprise can take the deduction from its full taxable amount.

EIT treatment of technology transfer

Starting from 1 October 2015, resident enterprises are entitled to an EIT exemption of up to RMB5 million on income from a non-exclusive technology license with a minimum period of five years, and a 50 percent EIT reduction for amounts in excess of RMB5 million. Previously, only an exclusive license with a minimum period of five years or an ownership transfer of qualifying technology was eligible for these tax benefits.

Notably, Bulletin 82 limits the tax benefits to technologies owned by the licensor. Thus, income derived from sub-license does not qualify the above tax benefits.

IIT treatment of share capital increase by the enterprise

According to Notice 116 and Bulletin 80, starting 1 January 2016, where a non-listed small- or medium-sized high-tech enterprise converts undistributed profits, surplus reserves or capital reserves to share capital, any of its individual shareholders may pay the IIT due in instalments within a period not exceeding five calendar years if the individual shareholder has difficulty paying the tax on a lump sum basis. Where the relevant enterprise is a listed small- or medium-sized high-tech enterprise, no instalment payment option is available. But the individual shareholders are exempt from IIT when capital reserves resulting from share premiums are converted into capital.

These provisions in Notice 116 and Bulletin 80 triggered heated discussion nationwide. One opinion holds that individual shareholders are not liable to pay IIT on capital increase from capital reserves by the enterprise under the previous rules (i.e., Notice 198[81] and Notice 289[82]), and thus Notice 116 and

[81] *Notice of the SAT on the Individual Income Tax Exemption upon Conversion of Capital Reserves and Surplus Reserves into Share Capital and Distribution of Bonus Shares by Companies Limited by Shares*, Guo Shui Fa [1997] No. 198, dated 25 December 1997.

[82] *Reply of the SAT to Questions concerning the Individual Income Tax Treatment of the Value Increase of Shares owned by Individuals during the Reorganization of Urban Credit Cooperative into Urban Cooperative Bank*, Guo Shui Han [1998] No. 289, dated 15 May 1998.

Bulletin 80 increase the tax burden on the individual shareholders rather than providing a tax benefit.

Capital reserves can result from various items in addition to share premiums. In fact, Notice 198 and Notice 289 only exempt individual shareholders from IIT when capital reserves resulting from share premiums are converted to share capital. Therefore, technically speaking, Notice 116 and Bulletin 80 do not conflict with the previous rules.

IIT treatment of equity incentives

As provided in Notice 116, starting from 1 January 2016, where a high-tech enterprise grants stocks to its qualified technical personnel, any such technical personnel can pay IIT due in instalments within a period not exceeding five calendar years if having difficulty paying the tax on a lump sum basis. The relevant income shall be subject to tax as salaries or wages, with the taxable amounts determined by reference to the fair market value of the relevant stocks when they are received.

Stock incentives granted to the entire staff are excluded from the instalment payment option. Therefore, enterprises should be mindful of the IIT consequences on their employees when establishing equity incentive arrangements.

8.2 Tax Treatment Clarified for Mutual Recognition of Funds between the Mainland and Hong Kong

On 14 December 2015, the MOF, the SAT and the China Securities Regulatory Commission (CSRC) jointly issued Notice 125[83] to clarify the PRC tax treatment on income derived under the Mutual Recognition of Funds (MRF) Scheme.

As background, on 22 May 2015, the CSRC and Hong Kong Securities and Future Commission (SFC) jointly announced the commencement of the MRF Scheme between the Mainland and Hong Kong starting from 1 July 2015. Under the MRF Scheme, Hong Kong investors can invest in a Chinese fund that has been registered with the SFC, or vice versa if registered with the CSRC. On 18 December 2015, the CSRC announced three Hong Kong funds had been officially registered with the CSRC. Meanwhile, the SFC also announced four Mainland funds had been officially registered with the SFC.

Income tax treatment for Hong Kong investors

According to Notice 125, income derived by a Hong Kong investor (individual or enterprise) from the transfer of fund units in an MRF is exempt from PRC income tax.

The PRC-invested company is obligated to withhold 10% of the dividends or 7% of the interest paid to the recognized Mainland fund. Then, no withholding tax will apply when the fund distributes dividends or interest to the Hong Kong investor.

Income tax treatment for Mainland investors

[83] *Notice of the Ministry of Finance, the State Administration of Taxation, and the China Securities Regulatory Commission on Relevant Tax Policies on the Mutual Recognition of Funds between the Mainland and Hong Kong*, Cai Shui [2015] No. 125, issued on 14 December 2015, effective from 18 December 2015.

For income derived from a recognized Hong Kong fund, the tax treatment differs for a Mainland individual investor and a Mainland enterprise investor. Income derived by a Mainland individual investor from the transfer of fund units in a recognized Hong Kong fund is exempt from PRC income tax for the period starting from 18 December 2015 to 17 December 2018, while income derived by a Mainland enterprise investor from the transfer of fund units in a recognized Hong Kong fund is subject to PRC enterprise income tax.

Income distributed by a recognized Hong Kong fund to a Mainland individual investor is subject to PRC individual income tax at the rate of 20%, and the fund's PRC agent is the withholding agent. Income distributed by a recognized Hong Kong fund to a Mainland enterprise investor is subject to PRC enterprise income tax. The fund's agent does not have a withholding obligation.

Business tax treatment and stamp duties

Income derived by a Hong Kong investor (individual or enterprise), a Mainland individual investor or a Mainland enterprise investor (other than a financial enterprise) on the transfer of fund units in an MRF is exempt from PRC BT, while income derived by a Mainland financial-enterprise investor is subject to PRC BT. As mentioned in Section 5.1, BT has been fully replaced by VAT starting May 1, 2016. Transfer of financial products are now subject to VAT rather than BT. Under the new VAT regime, income derived by a Hong Kong investor (including both individual and enterprise investors) on transfer of fund units in an MRF is exempt from VAT.

No PRC stamp duty will be imposed on the transfer, inheritance or gift of fund units in an MRF.

8.3 Recordal Procedure Applies to All EIT Incentives

On 12 November 2015, the SAT issued Bulletin 76[84], which uniformly applies a recordal procedure to resident enterprises claiming any EIT incentive. Bulletin 76 also includes an administrative catalogue for the recordal of EIT incentives (version 2015) ("**Catalogue**") to provide further guidance on the recordal procedure.

Bulletin 76 Procedure

Under Bulletin 76, an enterprise should self-assess its eligibility to enjoy a tax incentive. If the enterprise determines that it is eligible to enjoy the tax incentive, it should file a recordal with the in-charge tax authority and preserve the relevant materials for ten years.

The documents required for the recordal depend on the type of tax incentive. For some incentives, a recordal form is sufficient. For some others, both the recordal form and supporting documents are required. Notably, for the preferential tax rate for small-scale and low-profit enterprises and for the accelerated depreciation of fixed assets, the recordal requirements can be fulfilled merely by filling the corresponding sections in the enterprise's tax return.

[84] *Notice of the SAT on Promulgating the Measures for Handling Enterprise Income Tax Incentives*, SAT Bulletin [2015] No. 76, dated 12 November 2015, retroactively effective as of the same date.

If the tax authorities find the taxpayer is not entitled to the tax incentive in the post-filing administration, they can levy late payment interest (i.e., 0.05 percent per day) and potential penalties (from 50 percent to 500 percent of the underpaid tax), in addition to recovering any underpaid tax.

Tax incentives covered

Bulletin 76 clearly limits its scope to resident enterprises, which means it is not applicable to non-resident enterprises or their Chinese establishments. The recordal procedure applies to all kinds of EIT incentives. The Catalogue specifically lists 55 tax incentives covered by Bulletin 76.

Notably, Bulletin 76 does not impact the special qualification procedures required for certain tax incentives, such as the preferential tax rate for HNTEs or TASEs. For these tax incentives, the enterprise still needs to complete the relevant recognition procedure before enjoying the tax incentive.

Timing of recordal

According to Bulletin 76, the enterprise should file the recordal no later than when it files its annual tax return, which must be filed by 31 May each year. For the majority of the tax incentives listed in the Catalogue, the enterprise can enjoy the tax incentive when making EIT prepayments and makes the relevant recordal filing later upon annual filing.

If the enterprise has enjoyed the tax incentive without filing the recordal by the deadline, the tax authority can require the enterprise to fulfil the recordal within a specified period. Meanwhile, the tax authority may impose a penalty (up to RMB10,000) on the taxpayer pursuant to the TCAL.

Observations

It is not surprising to see Bulletin 76 being issued. Starting from 2014, the SAT has been repealing the approval system for EIT tax incentives. Up to the issuance of Bulletin 58[85] on 18 August 2015, all EIT tax incentive approvals have been replaced by the recordal system.

Bulletin 76 significantly simplifies the procedures for resident enterprise to enjoy EIT incentives. Besides, the recordal system could present an opportunity for an enterprise to take a position and then defend its tax incentive eligibility on audit.

However, uncertainty could also arise under the recordal procedure. Historically, the advance approval could provide the taxpayer with certainty[86] by forcing the tax authority to take a position on the taxpayer's eligibility for a tax incentive before the taxpayer took the incentive.

Under the recordal system, the tax authority will not take a position on a taxpayer's eligibility for a tax incentive until after the taxpayer takes the incentive in most cases. At any time within the following five years, the tax

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[85] *Notice of the SAT to Announce 22 Tax-related Items for Which the Approval Procedure Has Been Abolished*, SAT Bulletin [2015] No. 58, dated 18 August 2015, effective as of the same date.

[86] In rare cases, the tax authority could overrule an approval within three years. But in these cases, the tax authority was only permitted to recover the underpaid tax without levying any late payment interest or fines.

authority can decide the enterprise was ineligible for the tax incentive and recover the underpaid tax plus late payment interest of 0.05 percent on a daily basis. If the tax authority determines the enterprise took the tax incentive as an act of tax evasion, tax refusal or tax fraud, then there is no time limit for the tax authorities to recover the tax and levy the late payment interest or fines.

8.4 Recordal Procedure Applies to Software and Integrated Circuit Enterprises Claiming EIT Incentives

On 4 May 2016, the MOF, the SAT, the National Development and Reform Commission, and the Ministry of Industry and Information jointly issued Notice 49[87] with retroactive effect to 1 January 2015 to address the problems with unrecognized integrated circuit (IC) and software enterprises being unable to claim the EIT incentives[88] available to them under Notice 27[89].

Before 2015, in order to enjoy the EIT incentives under Notice 27, an enterprise had to be recognized by the competent government authorities. In 2015, the State Council abolished the recognition procedure. Unfortunately, the SAT did not substitute a new mechanism for the enterprises to claim the EIT incentives; therefore, it had been unclear how unrecognized IC and software enterprises could enjoy the EIT incentives.

Notice 49 now requires the taxpayer to make a self-assessment on whether it is a qualified IC or software enterprise under Notice 49. If the taxpayer determines it is qualified and elects to claim the EIT incentive, it only needs to file a recordal with the in-charge tax authority at the time of its annual tax settlement.

Notice 49 also clarifies the qualifying conditions for an enterprise to be recognized as a key software or IC design enterprise that is within the national planning ("**Key Enterprise**").[90] Previously, unclear qualifying conditions gave the government authorities wide discretion in whether to recognize an enterprise as a Key Enterprise. With clear qualifying conditions, Notice 49 gives the taxpayer an opportunity to take a position and then defend its self-assessment in any subsequent audit.

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[87] *Announcement of the Ministry of Finance, the State Administration of Taxation, the National Development and Reform Commission and the Ministry of Industry and Information Technology on Issues concerning Preferential Enterprise Income Tax Policies for Software and Integrated Circuit Industry*, Cai Shui [2016] No. 49, dated 4 May 2016, retroactively effective from 1 January 2015.

[88] The incentives include five- and ten-year tax holidays and a reduced 15 percent or 10 percent EIT rate.

[89] *Announcement of the Ministry of Finance, the State Administration of Taxation on Income Tax Policies for Further Encouraging the Development of Software Industry and Integrated Circuit Industry*, Cai Shui [2012] No. 27, dated 20 April 2012, retroactively effective from 1 January 2011.

[90] A Key Enterprise may enjoy a two-year EIT exemption or a reduced 10 percent EIT rate (if not exempt from EIT in the current year).

9. Individual Income Tax

9.1 New Individual Income Tax Rules on Equity Incentives

On 20 September 2016, the SAT and the MOF jointly issued new rules on the IIT treatment of equity incentives, i.e., Notice 101[91]. On 28 September 2016, the SAT issued Bulletin 62[92] to clarify the implementation of Notice 101.

Notice 35[93] treatment extended to unlisted companies

Under Notice 101, an employee receiving shares and share rights from the employer at a price lower than the fair market price is liable to pay tax on the difference between the actual price and fair market price. The price difference should be treated as salary and the tax is payable when the employee receives the shares. The tax should be calculated in accordance with Notice 35 if tax deferral treatment (discussed below) is not available. Bulletin 62 further provides that the fair market price for the unlisted shares should be determined based on the net asset value method, analogous method or other reasonable methods applied in sequence. Under the net asset value method, the company's net asset value of the previous year-end should be used.

Previously, equity incentive income derived by an employee under an unlisted company's equity incentive plan would normally receive less preferential IIT treatment as compared to the income derived under a qualified listed company's plan. Notice 35 created this disparity by allowing income derived by an employee under a qualified listed company's equity incentive plan to be taxed as a separate month's salary using a preferential calculation method. This method averages the equity incentive income over the employee's working months in China (capped at 12 months) to determine the applicable tax rate[94]. Whereas, income derived by an employee under an unlisted company's equity incentive plan was simply added to the employee's salary in the month of receipt and subject to tax at a rate determined by the employee's overall salary in that month.[95]

Tax deferral for equity incentives from unlisted companies

Notice 101 provides that an employee may, subject to a recordal with the in-charge tax authority, defer the tax liability on stock options, restricted stocks

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[91] *Announcement of the State Administration of Taxation and Ministry of Finance on Improving Certain Income Tax Policies Concerning Equity Incentive and Equity Contribution through A Technology Transfer*, Cai Shui [2016] No. 101, dated 20 September 2016, retroactively effective from 1 September 2016.

[92] *State Administration of Taxation's Bulletin on Issues relating to the Collection and Administration of Income Tax on Equity Incentive and Equity Contribution through A Technology Transfer*, SAT Bulletin [2016] No. 62, dated 28 September 2016, retroactively effective from 1 September 2016.

[93] *Announcement of the State Administration of Taxation and Ministry of Finance Concerning the Collection of Individual Income Tax on Individuals Deriving Stock Option Income*, Cai Shui [2005] No. 35, dated 28 March 2005, effective from 1 July 2005.

[94] Salary is taxed in China at a progressive tax rate of up to 45 percent.

[95] An exception is that the Hainan Provincial Local Tax Bureau allows stock options granted by unlisted companies to be taxed using the Notice 35 preferential calculation method. Please see the Hainan Provincial Local Tax Bureau reply to the Haikou Municipal Local Tax Bureau (Qiong Di Shui Han [2015] No. 1151) for details.

and share awards (collectively as "**Equity Incentive**") granted by an unlisted employer until the transfer of the relevant shares if the following conditions are met:

- The Equity Incentive is implemented by a PRC unlisted enterprise ("**Issuer**");
- The Equity Incentive plan is approved by meetings of the Issuer's Board and shareholders;
- The Equity Incentive is paid in the Issuer's shares (for share awards, the Equity Incentive can also be paid in another PRC resident enterprise's shares if those shares were received by the Issuer as consideration for an equity contribution through a technology transfer);
- The Equity Incentive should be granted only to senior managers and core technical staff as decided by the Board or shareholders' meeting, and the total number of employees that receive grant of Equity Incentives should not exceed 30 percent of the Issuer's average workforce during the last six months;
- The employee should hold the shares for at least three years from the grant date (for stock options and restricted stocks, the employee should also hold the shares for at least one year from the vesting date);
- For stock options, the period between the grant and vesting should not exceed 10 years; and
- The business of the Issuer and the company whose shares are granted under the Equity Incentive does not fall within the restricted industry catalogue as prescribed under Notice 101.

Under this tax deferral mechanism, gains from a share transfer will be taxed as capital gains, which are subject to IIT at a flat rate of 20 percent, rather than salary, which is subject to IIT at a progressive rate of up to 45 percent.

Extended tax payment period for listed company equity incentives

Under Notice 101, the tax calculation methods for an equity incentive derived by an employee from a listed company remain unchanged. However, an extended tax payment period is now available for certain equity incentives from PRC listed companies. Previously, subject to tax authority approval, a listed company's senior manager was allowed to pay taxes on stock option income in several batches within six months from the vesting date of the stock option. Notice 101 now allows the employee, subject to a recordal with its in-charge tax authority, to defer the tax payment on stock options, restricted stocks or share awards granted by a PRC company listed on the Shanghai and Shenzhen stock exchange, for a period up to 12 months from the vesting date.

Observations

Under Notice 101, the tax deferral treatment is limited to equity incentives granted by a PRC unlisted company. Similarly, the treatment of 12-month tax payment period is only available to equity incentives granted by a PRC company listed on the Shanghai and Shenzhen stock exchange. Thus, equity incentives granted by foreign MNCs will unlikely benefit from these two preferential treatments.

What may be of relevance to foreign MNCs is the possible extension of Notice 35 treatment to cover unlisted companies' equity incentives as well as extension of such treatment to employee stock purchase plans. From a literal reading, neither Notice 101 nor Bulletin 62 limits the extension of Notice 35 treatment to PRC companies. Thus, from a purely literal reading, it is possible to interpret that Notice 101 extends Notice 35 treatment to equity incentives (including employee stock purchase plan) granted by a foreign listed or unlisted companies.

However, it seems the policy rationale of Notice 101 is to encourage domestic start-up or innovation companies. Thus, it is unclear whether PRC tax authorities would agree to grant Notice 35 treatment to equity incentives granted by foreign unlisted companies as well as an extension to employee stock purchase plans. Without further clarification, Notice 101 implementation may depend heavily on the varying local practices of the PRC tax authorities.

9.2 Certain Employer-paid Commercial Health Insurance Premiums Are Exempt from Individual Income Tax

On 27 November 2015, the MOF, SAT and China Insurance Regulatory Commission (CIRC) jointly issued Notice 126 to initiate the IIT pilot program on commercial health insurance. Further, on 25 December 2015, the SAT issued Bulletin 93[96] to implement the pilot program.

Under the pilot program, starting from 1 January 2016, certain IIT taxpayers can deduct premiums paid for qualified commercial health insurance (limited to RMB200 per month[97]) from their taxable income in pilot areas[98].

Qualified commercial health insurance

To be a qualified commercial health insurance product under Notice 126, the insurance product:

- must provide universal insurance that has security functions and includes a guaranteed minimum benefit account, and shall have both medical insurance and personal account accumulation functions;
- must provide direct management and maintenance of the insured's personal account by the insurance company;
- must be offered only to taxpayers over 16 years old who have not reached the statutory retirement age;

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[96] *Announcement of the State Administration of Taxation on Collection and Administration Issues Concerning the Implementation of Pilot Individual Income Tax Policies on Commercial Health Insurance*, SAT Bulletin [2015] No. 93, dated 25 December 2015, effective from 1 January 2016.

[97] For individual business owners, individuals operating businesses contracted or leased from enterprises or public institutions, investors of sole-proprietor enterprises and investors of partnership enterprises, the deduction is limited to RMB2,400 per year.

[98] The pilot areas include the four municipalities, i.e., Beijing, Shanghai, Tianjin and Chongqing, and one city from each of China's 25 provinces or autonomous regions.

- may not be refused to an individual based on his or her medical history and must guarantee renewal of the insurance;
- may cover medical expenses that are not fully covered by basic medical insurance[99];
- must meet the minimum insurance amount as set by the CIRC;
- must adhere to the "cost compensation and low profit" principle, i.e., if the simple loss ratio for medical insurance is lower than the prescribed ratio, the difference between the actual loss ratio and prescribed ratio shall be returned to the insured's personal deposit account; and
- must be approved by the CIRC.

Qualified IIT taxpayers

According to Notice 126, IIT taxpayers covered by the pilot program include:

- Individuals who derive employment income or consecutive labor remuneration;
- Individual business owners;
- Individuals operating businesses contracted or leased from enterprises or public institutions;
- Investors in individual sole-proprietor enterprises; and
- Investors in partnership enterprises.

Notably, insurance purchased by an employer for an employee is deemed to be purchased by the employee and can be deducted by the employee accordingly.

Tax incentive identification code

According to Bulletin 93, the taxpayer's insurance policy must have a tax incentive identification code stated on it in order for the taxpayer to claim the deduction. The tax incentive identification code is issued by the commercial health insurance information platform.

Observations

Despite the seemingly complex qualifying requirements, it is usually quite straightforward in practice for the taxpayer to determine whether a specific insurance product is a qualified commercial insurance product under Notice 126. Taxpayers and employers can simply check with the insurance company whether a tax incentive identification code is available for the insurance purchased.

[99] Basic medical insurance is a mandatory insurance under China's social security system.

9.3 Guangzhou Case: China's First Tax Litigation Case on Dual Employment Arrangements

In November 2015, a Chinese appellate court in Guangzhou ruled that a foreign individual who was dually "employed" by a PRC company and a foreign company was liable to pay IIT in China on salary derived from the foreign company.[100] This case is China's first tax litigation case on the tax treatment of "dual employment" arrangements.

Facts

The taxpayer, a US tax resident, was the legal representative and board chairman for a PRC company from 2005 to 2007. During that time, the taxpayer was also employed by a foreign company affiliated with the PRC company. In 2005, 2006 and 2007, the taxpayer was present in China for 259.5, 289 and 286 days respectively. In addition to an annual commercial insurance fee of US$7,761, the foreign company paid the taxpayer salary of US$107,124, US$176,566 and US$120,081 for foreign employment activities during those same years.

The Guangzhou Local Tax Bureau required the PRC company to withhold an additional RMB658,556.01 (approximately US$99,507) in tax on the taxpayer's salary paid by the foreign company. The taxpayer initiated an administrative review followed by an appeal in district court. Both the administrative review panel and the district court ruled in favor of the Guangzhou Local Tax Bureau.

The taxpayer then appealed the district court's judgment to the Guangzhou Intermediate People's Court ("**Appellate Court**").

Issues and holdings

The key issues and holdings in the appellate case were:

- *Was the taxpayer's salary paid by the foreign company subject to tax under PRC law?* The Appellate Court held that the taxpayer's salary was subject to PRC tax because the taxpayer was present in China for more than 183 days in each of 2005, 2006 and 2007. This presence in China meant that the salary received during that time was partially derived from employment exercised in China. Therefore, the salary was partially taxable in China, which was proportional to the time that spent in China, regardless of whether the salary was paid by the foreign company.

- *Did the PRC company have a withholding obligation if the income was subject to PRC tax?* The Appellate Court held that the PRC company was obliged to withhold IIT on the salary because the PRC Company should have paid the salary, which was instead paid by the PRC company's affiliated foreign company. The court based its reasoning on Guo Shui Fa [1999] No. 241[101], which states that an FIE must withhold IIT on

[100] The full text of the judgment is available (in Chinese) at: http://wenshu.court.gov.cn/content/content?DocID=a0a8b884-2c29-465c-9797-be259a2105ca.

[101] *Notice of the State Administration of Taxation on Issues Concerning Withholding Individual Income Tax on Salaries Paid by Foreign Entities to Employees of Foreign-Invested Enterprises and Foreign Enterprises' Establishment or Place*, Guo Shui Fa [1999] No. 241, dated 21 December 1999, effective from 1 January 2000.

employee salary that should have been paid by the FIE but was instead paid by the FIE's offshore affiliate.

- *Did the China–US tax treaty preclude China from taxing the income?* The Appellate Court held that China was not precluded by the China–US tax treaty from taxing the foreign-paid but locally-earned income because Article 14 of the China–US tax treaty entitles China to tax a US tax resident's employment income if: (i) the employment is exercised in China; and (ii) the US tax resident is present in China for more than 183 days in the relevant calendar year. The taxpayer was employed in China and was present in China for more than 183 days in each of 2005, 2006 and 2007; therefore, China was entitled to tax the US tax resident's employment income paid by the foreign company.

Observations

China's domestic law adopts the time apportionment method to tax a non-PRC-domiciled foreigner's employment income, i.e., tax is first calculated on the foreigner's worldwide employment income and then apportioned by his / her working time in China.[102] The time apportionment method has been practiced by the PRC tax authorities for years.

The Appellate Court's holding in this case once again confirmed this time apportionment method. In the light of this case, every foreigner working under a dual employment arrangement should assess his / her IIT liability in accordance with the time apportionment method, and try to avoid additional cost arising from tax non-compliance.

10. Tax Administration and Collection

10.1 Revised Measures on Publishing Tax Noncompliance Cases

On 16 April 2016, the SAT issued the revised *Measures on Publishing Tax Noncompliance Cases*, i.e., Bulletin 24.[103] The new measures make significant changes to the publishing of tax noncompliance cases. They create unified national case reporting standards, consolidate and link the publishing platforms, and grant publishing exemptions even while maintaining permanent records.

Unified national standards

Bulletin 24 unifies the previous SAT and provincial-level tax bureau tax noncompliance case publishing standards. These new standards require the following cases to be published:

- Tax evasion cases where the unpaid or underpaid tax equals RMB1,000,000 or more and accounts for at least 10 percent of the total tax payable in the corresponding year;

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[102] *Notice of the State Administration of Taxation on Issues concerning the Income Tax Liability on Salaries and Wages Derived by Individuals without Domiciles within the Territory of China*, Guo Shui Fa [1994] No. 148, dated 30 June 1994, effective from 1 July 1994.

[103] *Announcement of the State Administration of Taxation on Revising the Measures for Publishing Tax Non-compliance Cases (for Trial Implementation)*, SAT Bulletin [2016] No. 24, dated 16 April 2016, effective from 1 June 2016.

- Tax arrears cases with unpaid or underpaid tax of RMB1,000,000 or more where the taxpayer transfers or hides assets to hinder the tax bureau's tax collection;

- Cases where a person conducts export tax refund fraud;

- Cases where the taxpayer refuses to pay tax using violence or threating behaviour;

- Cases where a person falsely issues a VAT special invoice or other invoices that can be used to obtain export tax refunds or tax credits;

- Cases where a person falsely issues 100 or more general invoices or falsely issues general invoices with a total value of RMB400,000 or more;

- Cases where a person prints invoices without authorization, counterfeits or alters invoices, illegally manufactures products specifically used for anti-invoice counterfeiting, or counterfeits the seal used for supervising invoice manufacturing; and

- Cases with other serious breaches of law that have a relatively large social influence.

Consolidated and linked publishing platforms

Previously, each local tax authority published tax noncompliance cases on its own official website. Under Bulletin 24, these local cases now must be published on the provincial-level tax authority's official website. The SAT's official website will link to the provincial-level case reporting websites.

Publishing exemption and permanent recording

Bulletin 24 exempts tax evasion and tax arrears cases from being published if the taxpayer settles all unpaid or underpaid taxes, late payment surcharges and penalties. However, the cases will still be recorded in an information system for serious tax noncompliance cases. Once recorded, the records of these serious tax non-compliance cases are maintained permanently.

Observations

With the consolidated and linked publishing platforms, the public will have easier access to records identifying noncompliant taxpayers. In a world where reputation plays a crucial role in business, a taxpayer publicly identified as noncompliant could suffer immediate damage. Therefore, every multinational enterprise should assess whether it is engaged in any noncompliant behaviour that could be published under the new standards and whether such noncompliant behaviour (if any) can be cured before it results in publication.

10.2 Consolidation of Three Certificates Rolls out Nationally

According to Notice 121[104], starting from 1 October 2015, the registration reform to consolidate three certificates, i.e., the business license, the tax

[104] *Notice of the Six Departments under the State Council, Including the State Administration for Industry and Commerce, on Effectively Implementing the State Council General Office's Opinions on Accelerating Registration Reform to*

registration certificate and the organization code certificate, into a single business license, expanded to the whole nation. This single business license will contain a uniform social credit code that replaces the identification numbers from the previous three certificates. For tax purposes, the uniform social credit code will function the same way as the current tax registration code.

From 1 October 2015, all newly established enterprises will receive this consolidated business license when registering with the competent industrial and commercial bureau. Any enterprise established before this date will have its three certificates replaced with the single business license by 31 December 2020.

Observations

Enterprises no longer need to apply for a tax registration certificate from the in-charge tax authority. However, every taxpayer will still need to record with the in-charge tax authority any changes in operational address, finance employee in charge and accounting methods.

10.3 Reform Plan on Tax Collection and Administration System

On 24 December 2015, the General Office of the State Council published a *Plan on Further Reforming the State and Local Tax Collection and Administration System* ("**Plan**").[105] The Plan proposes 6 categories of tasks, which are further divided into 31 detailed tasks, to be fulfilled by the end of 2017. Among these tasks, the following have particular importance to multinationals.

International taxation

The Plan proposes that PRC tax authorities actively participate in the formulation of international tax rules, strengthen international tax cooperation, crack down on international tax avoidance and evasion, and take initiatives to promote China's outbound investment.

These tasks are restated in Shui Zong Fa [2016] No. 15[106] ("**Circular 15**"), which was issued by the SAT on 16 February 2016 to guide tax authorities nationwide on the focus for taxation in 2016. Circular 15 requires tax authorities to improve international tax information exchange mechanisms, strengthen anti-tax avoidance audits, and establish tax risk monitoring systems on multinationals.

Tax risk analysis and tax audit

The Plan requires the tax authorities to strengthen tax risk analysis and tax audits. The risk analysis will focus on large enterprises that derive high

Consolidate Three Certificates into One Certificate, Gong Shang Qi Zhu Zi [2015] No. 121, dated 7 August 2015.

[105] The Chinese version of the Plan is available at http://www.chinatax.gov.cn/n810219/n810724/c1955421/content.html.

[106] *Announcement of the State Administration of Taxation on Printing and Distributing the Focus for Taxation in 2016*, Shui Zong Fa [2016] No. 15, dated 16 February 2016.

income or have a high net value. Enterprises that are key tax sources should be examined once every five years.

Information sharing mechanism

The Plan proposes establishing a tax information sharing platform between state tax bureaus and local tax bureaus at all levels and between tax bureaus and other government departments. Furthermore, the Plan proposes including taxpayer credit records in a uniform credit information sharing platform available to the public.

Observations

As indicated by the Plan, the PRC tax authorities during the next two years will focus on strengthening the tax risk analysis and tax audit on international tax avoidance cases. In response to this tax authority focus, multinationals should refocus as well on ensuring compliance with tax laws and preparing themselves to defend their tax interests if challenged by the tax authorities.

10.4 Qingdao Case: Trustee Escaped Tax on Trust Income

In the June 2016 Issue of Taxation Research, two tax officials from the Laoshan State Tax Bureau in Qingdao, Shandong Province reported a case in which a trust company successfully defended itself from tax on trust income.[107]

Facts

In June 2012, a Chinese trust company ("**Trustee**") injected RMB600 million into a real property development company in exchange for 16.02 percent shares in the real property development company. The RMB600 million that was used for the capital injection were trust assets entrusted by another Chinese company ("**Settlor**"). In May 2014, the Trustee transferred the 16.02 percent shares for RMB702 million.

The tax bureau learned about the share transfer through the real property development company. The tax bureau decided that the Trustee had realized a capital gain of RMB102 million from the share transfer and informed the Trustee to pay an additional RMB25.5 million in taxes (i.e., RMB102 million * 25 percent).

In response, the Trustee argued that it should not be taxed on the share transfer because the transferred shares were trust assets rather than its own assets. The Trustee further argued that the Settlor who was the beneficiary should pay tax on the share transfer. To support its argument, the Trustee provided the tax bureau with documents issued by the local Banking Regulatory Bureau and the local Administration of Industry and Commerce to show that the transferred shares were trust assets.

The tax bureau conceded the argument to the Trustee and shifted its focus to the Settlor. The tax bureau found that the Settlor had not recorded any income on the share transfer. The tax bureau then informed the Settlor's in-charge tax bureau to collect the unpaid tax.

Observations

[107] See Taxation Research (June 2016 Issue), pp. 76-77.

Currently, China has few specific rules addressing the tax treatment of trusts other than regulations on taxation of commercial trusts with securitized assets. Under the PRC Trust Law, a trust is a pure contractual relationship.

In a report108 issued by the SAT in 2003, the SAT proposed taxing the trustee on trust income and then taxing the beneficiary on the distribution of the trust income with credits for taxes already paid on that trust income available. In this case, the tax bureau took a different position and passed over the Trustee probably because both the Trustee and Settlor (beneficiary) were Chinese enterprises and therefore China's tax rights were not affected by who was named as the taxpayer. But where the trustee and settlor are non-residents, the tax bureau might be more inclined to follow the 2003 SAT proposal. Thus, it remains unclear how trust income will be taxed in China.

[108] Trust Taxation Research Team of the State Administration of Taxation, *Report on Establishing the PRC Trust Taxation Mechanism*, dated 4 May 2003.