China Tax Monthly

Beijing/Hong Kong/Shanghai

Baker & McKenzie

March & April 2016

China Tax Monthly is a monthly publication of Baker & McKenzie's China Tax Group.

Beijing

Suite 3401, China World Office 2
China World Trade Centre
1 Jianguomenwai Dajie
Beijing 100004, PRC

T: +86 10 6535 3800
F: +86 10 6505 2309

Hong Kong

14/F Hutchison House
10 Harcourt Road
Central, Hong Kong

T: +852 2846 1888
F: +852 2845 0476

Shanghai

Unit 1601, Jin Mao Tower
88 Century Avenue, Pudong
Shanghai 200121, PRC

T: +86 21 6105 8558
F: +86 21 5047 0020

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

1. China Signs the MCAA for Automatic Exchange of CbC Reports

On 12 May 2016, China signed the Multilateral Competent Authority Agreement (MCAA) on the Automatic Exchange of Information of Country-by-Country (CbC) Reports ("**CbC MCAA**"). As of 12 May 2016, the MCAA has 39 participating jurisdictions, which have committed to automatically exchange CbC reports among them.

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 USD848,475,000) 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 requires a participating jurisdiction to establish domestic CbC reporting legislation within a reasonable short time after the signature of the MCAA. The State Administration of Taxation (SAT) is currently working on the domestic CbC reporting legislation, and it is yet to be seen when the formal rules will be issued.

Notably, although having released proposed CbC reporting legislation, the US is not a signatory to the CbC MCAA. Instead, the US has said it will enter into bilateral agreements to conform with US government practice on international agreements. It is yet to be seen whether China and US will enter into a bilateral agreement to automatically exchange CbC reports.

2. The SAT Issues New VAT Exemption Measures

On 6 May 2016, the SAT issued Bulletin 29[1] to address the implementation of the value-added tax (VAT) exemption rules under the new VAT regime, i.e., Notice 36[2].

Consistent with the full expansion of the VAT pilot program, Bulletin 29 expands the scope of the previous VAT exemption Measures[3] to cover:

- construction services for projects located outside China;
- 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[4] 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.

---

1 *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.

2 *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. For more details on Notice 36, please refer to our client alert in April 2016.

3 *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.

4 These services include intellectual property services, logistic support services, attestation and consulting services, and business support services, etc.

3. The SAT Revises 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.[5] 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;
- Tax arrears cases with unpaid or underpaid tax of RMB 1,000,000 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.

---

5 *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.

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.

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

On 4 May 2016, the Ministry of Finance, the SAT, the National Development and Reform Commission, and the Ministry of Industry and Information jointly issued Notice 49[6] with retroactive effect to 1 January 2015 to address the problems with unrecognized integrated circuit (IC) and software enterprises being unable to claim the enterprise income tax (EIT) incentives[7] available to them under Notice 27[8].

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

6 *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.

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

8 *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.

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**").[9] 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.

5. Shandong 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[10].

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.

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 RMB 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

---

9 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).

10 *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.

rejected the Italian Parent's request because the share transfer did not meet the additional conditions in Article 7[11] 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[12] 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.

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 generally do not accept an offshore merger to be a "merger" for Notice 59 purposes.

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

---

11 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.

12 *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.

on how the tax bureaus and other courts decide on tax treatment of cross-border reorganizations.

6. Taizhou Case: PRC Target Company 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.[13]

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 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.[14]

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

---

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

14 *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.

[2009] No. 3[15] 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.

7. 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-resident enterprise, of which RMB16,800,000 was withholding tax imposed on deemed dividends.[16]

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 USD2,000,000 (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.

---

15 *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.

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

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

8. China Issues Tax Rules on Cross-border B2C E-commerce

On 24 March 2016, the Ministry of Finance, the General Administration of Customs and the SAT jointly issued Notice 18[17] 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[18] (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.

---

17 *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.

18 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.

Duty exemption and tax reduction thresholds

A transaction valued at no more than RMB2,000 (approximately USD320) 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[19] 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 goods are not imported through Customs and are not listed as imported e-commerce retail goods.

19 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.

www.bakermckenzie.com

To find out more about how we can add value to your business, please contact:

Beijing

Jon Eichelberger (Tax)
+86 10 6535 3868
jon.eichelberger@bakermckenzie.com

Jinghua Liu (Tax and Dispute Resolution)
+86 10 6535 3816
jinghua.liu@bakermckenzie.com

Shanghai

Brendan Kelly (Tax)
+86 21 6105 5950
brendan.kelly@bakermckenzie.com

Glenn DeSouza (Transfer Pricing)
+86 21 6105 5966
glenn.desouza@bakermckenzie.com

Nancy Lai (Tax)
+86 21 6105 5949
nancy.lai@bakermckenzie.com

Hong Kong

Amy Ling (Tax)
+852 2846 2190
amy.ling@bakermckenzie.com

New York

Shanwu Yuan (Tax and Transfer Pricing)
+1 212 626 4212
shanwu.yuan@bakermckenzie.com

Beijing

Suite 3401, China World Office 2
China World Trade Centre
1 Jianguomenwai Dajie
Beijing 100004, PRC

T: +86 10 6535 3800
F: +86 10 6505 2309

Hong Kong

14/F Hutchison House
10 Harcourt Road
Central, Hong Kong

T: +852 2846 1888
F: +852 2845 0476

Shanghai

Unit 1601, Jin Mao Tower
88 Century Avenue, Pudong
Shanghai 200121, PRC

T: +86 21 6105 8558
F: +86 21 5047 0020