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

1. Hong Kong Tax Residency Certificate Valid for Three Calendar Years for Treaty Purposes
2. Jiangsu Case: Transfer Pricing Adjustments on Related-party Transaction Between Domestic Affiliates
3. Ningxia Case: Share Transfer Price Adjusted Based on Internal Comparable Transactions
4. Shandong Case: Transfer Pricing Adjustments to Outbound Royalty Payments
5. Guangdong Case: China's First Tax Litigation Case on Dual Employment Arrangements

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

On 6 June 2016, the State Administration of Taxation (SAT) issued Bulletin 35[1] to implement the agreement between the SAT and the Inland Revenue Department (IRD) on the use of tax residency certificates issued by the IRD. According to Bulletin 35, a person (entity or individual) can use an IRD-issued tax residency certificate as evidence of Hong Kong residency status for the calendar year listed on the tax residency certificate 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 tax residency certificate can no longer be used as evidence for the person's Hong Kong residency status.

Previously, under SAT Bulletin [2015] No. 60[2], in order to claim tax treaty benefits, a Hong Kong tax resident was required to submit an IRD-issued tax residency certificate in the preceding calendar year or in the current calendar year. In other words, under Bulletin 60, a tax residency certificate was valid proof of residency status for a maximum of two calendar

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1 *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.

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

years. Now, under Bulletin 35, a tax residency certificate 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 tax residency certificate 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 tax residency certificate from the IRD.

2. Jiangsu 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.[3]

Facts

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

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

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. [4] 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.

3. Ningxia 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.[5]

Facts

In June 2012, a foreign shareholder ("**Transferor**") transferred its 25 percent shareholding in a foreign-invested enterprise (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

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

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

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 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.

4. Shandong 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)[6].

Facts

According to the news report, the EJV was investigated because it had stable sales revenue but fluctuating profit 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 paid 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 TP policy on IP related transactions.

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6 See http://www.ctaxnews.net.cn/html/2016-06/28/nw.D340100zgswb_20160628_3-07.htm?div=-1.

5. Guangdong Case: China's First Tax Litigation Case on Dual Employment Arrangements

In November 2015, a Chinese appellate court in Guangdong ruled that a foreign individual who was dually "employed" by a PRC company and a foreign company was liable to pay individual income tax (IIT) in China on salary derived from the foreign company.[7] 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 USD7,761, the foreign company paid the taxpayer salary of USD107,124, USD176,566 and USD120,081 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 USD99,507) 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

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

company's affiliated foreign company. The court based its reasoning on Guo Shui Fa [1999] No. 241[8], which states that an FIE must withhold IIT on 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.[9] 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

8 *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.

9 *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.

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