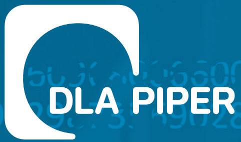

TAX NEWSLETTER

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EDITORIAL NOTE

Welcome to the latest July/August 2014 issue of our Tax Newsletter.

We saw a number of legislative developments taken place in the PRC and Hong Kong in the past two months that might bring about legal and tax implications on your businesses.

In the PRC, concerning the China Controlled Companies (**CFC**) rules, the State Administration of Taxation (**SAT**) requires certain PRC resident entities being considered as CFCs to report their overseas investment activities and income. In addition, the SAT promulgated a set of interim measures as the key legislations to govern the income tax compliance of non-resident international transportation businesses operating in China. As part of the national VAT reform program, the telecommunication industry has now been brought under the scheme such that the applicable income derived from this industry will be subject to VAT, instead of business tax.

In the area of foreign exchange, the State Administration of Foreign Exchange (**SAFE**) issued the new set of rules to encourage China outbound investment in replacing the prior rules that governed the same subject for the past decade. In addition, the SAFE has launched a pilot reform to ease the process of converting foreign exchange capital into the local currency (i.e. Renminbi) for foreign invested enterprise. Furthermore, the Customs authorities put forward rules to regulate import/export activities conducted via e-commerce trade. Last but not the least, we have also seen the Shanghai local government laid down legislative ground work to further promote the business activities carried out in Shanghai Pilot Free Trade Zone.

In Hong Kong, the 30th comprehensive agreement for avoidance of double taxation for Hong Kong was concluded on 8 July 2014. In addition, Stamp Duty (Amendment) (No. 2) Ordinance 2014 was published in the gazette and is effective retrospectively as of 23 February 2013. To help keep tax representatives and other interested parties informed of the current developments, the Inland Revenue Department (**IRD**) has also issued Departmental Interpretation and Practice Notes No. 50 on taxation of specified Islamic bonds, Stamp Office Interpretation and Practice Notes No. 5 and No. 7 on Special Stamp Duty and Buyer’s Stamp Duty respectively.

In our International Tax Corner, special thanks would be given to our Australian tax group contributing an update concerning Australian government’s review of its treaty negotiation program.

welcome your feedback and any questions you may have about this issue of the Tax Newsletter.

FOR FURTHER INFORMATION, PLEASE CONTACT:

Anderson Lam
Partner
T +852 2103 0722
anderson.lam@dlapiper.com

Doris Ho
Partner
T +852 2103 0759
doris.ho@dlapiper.com

THE PEOPLE REPUBLIC OF CHINA

SAT STRENGTHENS REPORTING REQUEST UNDER THE CHINA CFC RULES

On 30 June 2014, the SAT issued the *Announcement on Issues concerning Reporting of Information on Outbound Investment and Overseas Income of Resident Enterprises* (SAT Announcement [2014] No. 38, **Circular 38**), which has been effective on 1 September 2014. Promulgation of this Circular 38 has significantly strengthened China tax authorities in monitoring China Controlled Foreign Companies (**CFC**).

Under Circular 38, resident enterprises meeting the following conditions are obliged to report information on their outbound investments and overseas income in the quarterly and annual enterprise income tax filings, starting from 1 September 2014:

- directly or indirectly hold 10% or more shares or voting shares in a foreign company;
- increase of shares or voting shares, held directly or indirectly, in a foreign company from less than 10% to 10% or more after the promulgation of Circular 38; or
- reduction of shares or voting shares, held directly or indirectly, in a foreign company from 10% or more to less than 10% after the promulgation of Circular 38.

The information to be reported encompasses outbound investments of such resident enterprises, information on CFCs and their annual financial statements based on China GAAP.

Circular 38 further provides that a resident enterprise may apply for an extension for reporting, if the requested information cannot be made available in time supported by reasonable justifications. However, any foreign laws, commercial contracts/agreements that prohibit disclosure of such information does not constitute a reasonable justification.

Circular 38 also emphasizes that non-compliance may trigger penalties, and may allow the in-charge tax authorities to impose tax adjustment on a deemed basis.

INTERIM ENTERPRISE INCOME TAX MEASURES FOR NON-RESIDENT INTERNATIONAL TRANSPORTATION COMPANIES

On 30 June 2014, the SAT issued a set of interim measures for administration of filing enterprise income tax (**EIT**) of non-resident international transportation companies (**NITC**), namely the *Announcement of the State Administration of Taxation on Promulgating the Interim Measures for the Tax Administration of Non-resident Enterprises Operating International Transportation Business* (SAT Announcement [2014] No. 37, **Interim Measures**). The Interim Measures has come into effect on 1 August 2014 and stands now as the key tax rule governing EIT compliance in connection with NITCs operating in China.

The Interim Measures defines "Taxable International Transportation Services" to mean operating activities with respect to transportation of passengers, goods, mails or others across China border and into or out of China ports via self-owned or leased vessels, flights or shipping spaces, including related business activities such as loading and unloading, and warehousing services. Specifically, income derived from leasing of vessels and flights under the arrangement of voyage charter, time charter and wet lease fall within the scope of Taxable International Transportation Services and are also governed by the Interim Measures.

Under the Interim Measures, a NITC engaged in the Taxable International Transportation Services is required to file tax registration with the tax authority at one of the China ports that it has business operation, and within 30 days after securing the relevant business license, permit or business agreement. The registration information should later be shared with tax authorities at other China ports where the NITC has business operation.

Except for circumstances where the China withholding income tax rules should apply, NITCs engaged in Taxable International Transportation Services are generally required to maintain complete books and records in connection with their China operations, conduct regular EIT filings, and should be subject to EIT at the standard rate of 25% on their operation profits. Failure in compliance could lead to imposition of EIT on a deemed basis.

The Interim Measures also confirms that if a NITC is a tax treaty country resident, the NITC may apply with the in-charge tax authority for relevant tax treaty benefits.

VAT EXEMPTION POLICY EXTENDED TO INTERNATIONAL FREIGHT TRANSPORTATION AGENCY SERVICES INDIRECTLY PROVIDED BY PILOT TAXPAYERS

On 4 July 2014, the SAT issued Announcement [2014] No. 42 which confirms that VAT exemption has been extended to international freight transportation agency services indirectly provided by pilot taxpayers (i.e. services provided through the agents) as long as the service fee charged by the relevant pilot taxpayer to its customers and the agency commission paid to the agents are settled through financial institutions. Such VAT exemption policy took effect from 1 September 2014.

Pilot taxpayers refer to those taxpayers providing indirect freight transportation agency services in relation to goods transported between China and Hong Kong, Macau and Taiwan.

Under current regulations on VAT pilot program, VAT taxable income in relation to international freight transportation agency services provided by pilot taxpayers would be the difference between the service fee collected by pilot taxpayers from customers for provision of international transportation agency services and the payment made to international transportation carriers. Such VAT taxable income would be exempted from VAT during the pilot stage (i.e. the business tax-to-VAT transition stage) provided that certain conditions are satisfied.

VAT CONSOLIDATION FOR TELECOMMUNICATION ENTERPRISES

Effective from 1 June 2014, the telecommunication service industry would be covered by the VAT pilot program and telecommunication enterprises would be subject to VAT instead of business tax. To strengthen the management of tax collection, the SAT issued a notice regarding the "*Provisional Measures for the VAT Collection and Administration of Telecommunication Enterprises*" (SAT Announcement [2014] No. 26, **Announcement 26**), which took immediate effect from the date on which the Announcement 26 was issued.

- ***Qualified enterprise*** – Telecommunication enterprises refer to group companies of China Telecom, China Mobile and China Unicom that provide telecommunication services in China. Telecommunication enterprises that were approved by the finance bureaus and offices of the SAT of all provinces, autonomous regions, municipalities directly under the Central Government and cities separately designated in the State plan may declare and pay VAT on a consolidated basis. Specifically, the qualified telecommunication enterprises shall calculate VAT payable for its head office and branches on a consolidated basis and the net VAT shall be reported and settled by the head office with its tax authority in charge.
- ***Applicable income*** – VAT consolidation only applies to income relating to provision of the telecommunication services and other VAT taxable services that are covered under the VAT pilot program (**Taxable Services**). Income such as that derived from the sale of goods or provision of processing, repair and replacement services shall not be covered by the Announcement 26.
- ***Consolidated VAT filing*** – Procedure wise, each branch shall fill out an *Information Form of Consolidated Tax Payment by Branches of Telecommunication Enterprises* (**Form**) summarizing sales income, prepayments received, amounts of input tax and VAT paid in relation to the Taxable Services on a monthly basis, and then send the same to its head office before the 10th day of the following month after the Form is confirmed by the competent tax authority. The head office shall calculate and file the VAT payable on a quarterly basis based on the Form provided by the branches.

NEW SAFE RULES ENCOURAGE CHINA OUTBOUND INVESTMENT

On 14 July 2014, the SAFE released the *Circular on the Relevant Issues concerning Foreign Exchange Administration of Outbound Investment and Financing and Round-trip Investment by Domestic Residents through Special Purpose Vehicles* (Hui Fa [2014] No. 37, **Circular 37**), which took immediate effect and superseded the *Circular on the Relevant Issues concerning Foreign Exchange Administration of Financing and Round-Trip Investment by Domestic Residents through Offshore Special Purpose Vehicles* (Hui Fa [2005] No. 75, **Circular 75**) that had regulated the same subject matter for nearly a decade.

Aiming to implement the national strategy of "going abroad", Circular 37 simplifies and facilitates the cross-border capital transactions involved in the PRC residents' outbound investment and financing activities via special purpose vehicles. Highlighted below are the key changes in Circular 37.

- ***Expanded Definition of Special Purpose Vehicle (SPV)*** – According to Circular 37, an SPV refers to an overseas enterprise directly established or indirectly controlled by a domestic resident (including a domestic institution or a domestic individual) for the purpose of engaging in investment and financing by using the domestic or overseas assets or interests lawfully owned by such PRC resident. Compared to Circular 75, the definition of SPV in Circular 37 has two major differences: (1) the purpose of SPV is no longer limited to offshore equity financing; and (2) a PRC resident can use overseas assets or interests to set up an SPV.
- ***Round-trip Investment*** – Circular 37 uses a general description to define "round-trip investment" without mentioning "control by agreement". "Round-trip investment" is now defined as onshore direct investments made directly or indirectly by domestic residents through SPVs, namely by forming FIE(s) or projects in China through greenfield investment, acquisition or other means and gaining the ownership, control, operation and management power, or other interests in such FIEs.
- ***Domestic Individual Residents*** – Circular 37 re-defines "domestic individual residents" to include Chinese citizens and foreigners who have no legal identity in China but habitually reside in China for reasons of economic interests.
- ***Broadened Financing Channels of SPV*** – Channels of offshore financing have been broadened, and Circular 37 allows domestic enterprises directly or indirectly controlled by a PRC Resident to advance loans to the duly registered SPV of the PRC resident based on real and reasonable demands. Furthermore, PRC residents are allowed to purchase foreign exchange and remit the same overseas for the purpose of establishment, share redemption or delisting of the SPVs.
- ***Funds to be Retained Offshore*** – Capital gains and dividends from the SPV can now be retained offshore according to Circular 37.
- ***Equity Incentive of Unlisted* SPV** – Before the issuance of Circular 37, SAFE had only released relevant regulations about the administration over domestic employees' participation in the equity incentive plan of overseas listed companies. But in Circular 37, the feasibility of SAFE registration of equity and option incentives of an unlisted SPV has been officially confirmed.

Overall, Circular 37 is a positive and welcome development, which expands the SAFE registration scope, simplifies registration procedures and provides more flexibilities in respect of some foreign exchange matters related to outbound investments. Whether and how the practice will be actually affected by Circular 37 remains to be seen.

SAFE CIRCULAR 36: PILOT REFORM OF CONVERSION OF FOREIGN EXCHANGE CAPITAL

On 4 August 2014, the SAFE launched the pilot reform of the conversion of foreign exchange capital of foreign-invested enterprises (**FIEs**) in 16 pilot areas (collectively **Pilot Areas**) through the *Circular of the State Administration of Foreign Exchange on Issues Concerning the Pilot Reform of the Administrative Method Regarding the Conversion of the Foreign Exchange Capital of Foreign-invested Enterprises in Certain Areas* (Hui Fa [2014] No. 36, **Circular 36**).

Circular 36 brings the following significant changes to the current regime on the conversion of foreign exchange capital by the FIEs:

- ***Discretionary Conversion of Foreign Exchange Capital.*** As opposed to the current general rule that the FIEs can only convert the foreign exchange capital in their capital accounts into RMB and use the converted funds on an as-needed basis, Circular 36 allows the FIEs in the Pilot Areas to convert foreign exchange capital into RMB at any time on a discretionary basis according to their actual needs of business operations. A corresponding capital account pending foreign exchange settlement payment is required to be opened for keeping such converted RMB and proceeding with payments with such converted RMB.
- ***Use of the Converted RMB for Equity Investment.*** Prior to the promulgation of Circular 36, FIEs were not allowed to use the RMB funds converted from foreign exchange capital to make equity investment. Circular 36 lifts this restriction. Pursuant to Circular 36, the investment-type FIEs (such as holding companies and venture capital companies) in the Pilot Areas are allowed to directly convert the foreign exchange capital into RMB and transfer the converted fund to the account of the invested company. Where a non-investment-type ordinary FIE makes domestic equity payment with the RMB fund converted from foreign exchange capital, the RMB fund shall be transferred to the corresponding account pending foreign exchange settlement payment opened by the invested company.

Circular 36 will liberalize the process for conversion of the foreign exchange capital, allow FIEs in the Pilot Areas to hedge risk of foreign exchange rate fluctuation, and facilitate the FIEs in the Pilot Areas to make domestic equity investment.

GENERAL ADMINISTRATION OF CUSTOMS ANNOUNCES THE RULES FOR REGULATING THE IMPORT/EXPORT ACTIVITIES FOR E-COMMERCE

On 23 July 2014, the General Administration of Customs announced a "*Notice Regarding Supervision of Imported and Exported Goods and Articles via Cross-border e-Commerce*" (**Announcement**), which took effect since 1 August 2014.

The Announcement has streamlined the measures applied to goods and articles imported and exported via e-commerce trade. Unlike the traditional requirements under the general Customs regime, in respect of goods and articles imported and exported via e-commerce trade, a more simplified procedure would be applied to facilitate customs clearance.

The Announcement applies to e-commerce enterprises[1] and individuals engaged in cross-border e-commerce trade via an e-commerce business platform recognized by and connected with the Customs system.

For e-commerce enterprises, a "consolidated declaration" procedure shall be followed which means goods can be released based on a declaration list filed with Customs followed by a formal customs declaration for the goods that will be carried out later on a monthly basis. For individuals, no customs declaration is required and articles are released based on the declaration list filed by the individual or his/her agent. The Announcement does not require customs bond to be paid by e-commerce enterprises or individuals for releasing goods based on the declaration list.

The Announcement also requires e-commerce enterprises, warehouse operators, e-payment service providers and logistics service providers to transmit data to Customs related to their e-commerce trade through China E-port system established by Customs.

All the above procedures can generally be handled via the Customs E-port system with no paper filing so as to expedite the customs clearance process and minimize any adverse impact on e-commerce trade from logistics perspectives.

[1] According to the *Announcement of the General Administration of Customs [2014] No. 56*, E-commerce enterprises refer to domestic enterprises that are engaged in cross-border e-commerce via their own or third party e-commerce platforms, and enterprises that provide third-party platforms for the transaction service of cross-border e-commerce.

THE NEWLY ISSUED REGULATION FOR CHINA (SHANGHAI) PILOT FREE TRADE ZONE

Shanghai's lawmakers passed the *Regulation for China (Shanghai) Pilot Free Trade Zone* (**Regulation**) on 25 July 2014, aiming to legalize the reforms that are being tested in China (Shanghai) Pilot Free Trade Zone (**SH Pilot FTZ**) and to summarize all existing regulations and implementation rules in this area which provides a legal framework for future innovations.

As the first local regulation for the SH Pilot FTZ, the Regulation can be regarded as the basic law of SH Pilot FTZ.

The salient points in the Regulation include:

- ***Encouraging innovative activities in the areas which are not prohibited by laws*** – The lawmakers believe that the establishment of SH Pilot FTZ is a significant attempt to upgrade China's economic reform and to conform to new trends under global circumstances. In this regard, it is necessary to respect people's creative ideas and encourage them to contribute to the development of the SH Pilot FTZ.
- ***Adjusting the negative list timely*** – One important feature of the SH Pilot FTZ is its "negative list" approach – foreign investment is permitted in all sectors unless explicitly prohibited by the negative list. The government would like to update the negative list timely so that they can explore a better way to manage the negative list. Till now, the Shanghai Municipal Government has already released a negative list in 2013, while 2014 version of the list is still under draft and discussion.
- ***Facilitating business registration and pursuing one-stop service model*** – The SH Pilot FTZ aims to facilitate various governmental formalities for business registration and operation in this area, e.g., it allows business registration by way of capital subscription and establishes a united window mechanism for administrative affairs, under which the application formalities for approval and recordal could be processed under a "one-stop" mode.
- ***Deepening reform of the supervision of customs and improving trade facilitation*** – To increase the competition in international trade, the SH Pilot FTZ allows foreign goods with importation manifest to firstly enter into the SH Pilot FTZ before the completion of the customs declaration formalities. Further, it does not impose any time limitation for goods stored in the bonded warehouse.
- ***Continuing financial innovations*** – The innovations mainly include encouragement of cross-border use of RMB, promotion of the building of market interest rate liberalization, etc.
- ***Preferential tax policies*** – The lawmakers are contemplating to lay down preferential tax policies in the SH Pilot FTZ to facilitate the overseas equity investment and offshore business development.

PRC INDIVIDUAL INCOME TAX (IIT) INCENTIVE FOR TAIWANESE WORKING IN FUJIAN PINGTAN COMPREHENSIVE PILOT ZONE

In March 2014, the Ministry of Finance and the SAT jointly issued a tax circular *Notice Concerning IIT Preferential Policies for Fujian Pingtan Comprehensive Pilot Zone* (**Notice**).

- According to the Notice, the allowance (**Allowance**) received by Taiwan residents working in Pingtan Comprehensive Pilot Zone granted by the Fujian Provincial People's Government can be exempt from PRC IIT;
- Pursuant to the *Approval of the State Council on the Overall Development Plan of Pingtan Comprehensive Pilot Zone*, the Allowance is capped at the amount of the difference between PRC IIT and the relevant personal income tax in Taiwan on the same remuneration income (normally, PRC IIT is higher than Taiwan individual tax based on the same amount of income);
- The period of the preferential IIT policy is from 1 January 2013 to 31 December 2020.

HONG KONG

COMPREHENSIVE DOUBLE TAX AGREEMENT WITH KOREA

On 8 July 2014, Hong Kong's double taxation arrangement network has reached 30 in number, as Hong Kong and Korea signed a comprehensive double tax agreement (**DTA**).

In the absence of the DTA between Korea and Hong Kong in the past, income earned by Korean residents in Hong Kong is subject to both Korean and Hong Kong income tax. In addition, Hong Kong companies with profits attributable to a permanent establishment in Korea may be liable for tax in both places if the profits are considered to be sourced in Hong Kong.

With the signing of the DTA, such double taxation will be avoided. Tax paid by Korean residents in Hong Kong will be allowed as a credit against the tax payable in Korea. Also, any Korean tax paid by Hong Kong companies will be allowed as a credit against the tax payable in Hong Kong.

With regards to passive income, there is a reduction in withholding tax rates on dividends, interest and royalties derived from Korea by a Hong Kong resident as beneficial owner.

	Korea Non-treaty Withholding Tax Rate	HK/Korea Treaty Withholding Tax Rate
Dividends	20%	10%[2]/15%
Interest	14%[3]/20%	10%
Royalties	20%	10%

KOO MING KOWN AND TADO MURAKAMI V CIR (2014) CACV 182/2013

Two former directors of a company applied for judicial review on the section 82A of the Inland Revenue Ordinance regarding additional tax assessments issued to them by CIR for the profit tax returns they have signed for the company. They appealed to the Board of Review (**Board**) on grounds that they were not liable as directors (the director's liability point) and they had reasonable excuse. While the appeal to the Board was still ongoing, the directors applied for judicial review. The application for judicial review was also on the director's liability point where the applicants argued that it is a distinct point of law that the court can readily resolve independently from other points raised in the appeal to the Board and that this point might not be open to them in the Board.

Leave was not granted by the Court of Appeal. It was confirmed that where the complaint can be dealt with by way of statutory appeal, the court should generally decline to entertain collateral challenges by way of judicial review and there were no exceptional circumstances in this case to justify deviation. Even though the director's liability point was a legal point, the determination of a legal issue was not per se a ground for judicial review. There was no good reason to segregate the director's liability point and substantial delay and costs would be incurred if the point was determined as a preliminary point before going back to the other issues raised in the appeal before the Board.

STAMP DUTY UPDATES

1) The Stamp Duty (Amendment) (No. 2) Ordinance 2014

The Stamp Duty (Amendment) (No. 2) Ordinance 2014 has finally been gazetted on 25 July 2014 to implement the higher stamp duty rates and to advance the timing for charging of stamp duty on non-residential property transactions from the conveyance on sale to the agreement for sale. It has retrospective effect from 23 February 2013.

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[2] If the beneficial owner is a company which holds directly at least 25% of the share capital of the payor; the 15% applies in all other cases.

[3] If the interest is derived from bonds issued by a Korean company or government bodies.

2) Stamp Office Interpretation and Practice Notes No. 5 and 7 (SOIPN 5 and SOIPN 7)

The Inland Revenue Department has issued SOIPN 5 and SOIPN 7 in light of the changes brought by the Stamp Duty (Amendment) Ordinance 2014. SOIPN 5 concerns the application of the Special Stamp Duty imposed on certain transactions of residential property that occur within 36 months of acquisition. SOIPN 7 provides guidance on the application of the Buyer's Stamp Duty on certain agreements for sale and conveyances on sale of residential property.

NEW DEPARTMENTAL INTERPRETATION AND PRACTICE NOTICE: DIPN 50 "TAXATION OF SPECIFIED ALTERNATIVE BOND SCHEMES"

The IRD has issued DIPN 50 to set out its view and practice on the application of the new provisions under Section 40AB "Schedule 17A: specified bond scheme and its tax treatment" and Schedule 17A "Specified Alternative Bond Scheme and its Tax Treatment" of the ***Inland Revenue and Stamp Duty Legislation (Alternative Bond Schemes) (Amendment) Ordinance 2013.***

The purpose of the Amendment Ordinance was to allow stamp duty relief to some common types of Islamic bond arrangements that are economically equivalent to debt arrangements.

INTERNATIONAL TAX CORNER

AUSTRALIA

The Australian government is currently reviewing its double tax treaty negotiation program and has sought recommendations from business on firstly, preferred countries with whom to update existing or enter into new double tax treaties and secondly, key outcomes (for example, low withholding tax rates) sought in negotiating double tax treaties.

Australia currently has an outdated double tax treaty with China (signed in 1988) and there is strong business support for updating the treaty to reduce withholding tax on dividends, interest and royalties.

Further Australia does not currently have a double tax treaty with Hong Kong and this is viewed amongst other things as a serious impediment to the growth of funds management activities in the region. Thus, there is strong Australian support for the entering into of a new double tax treaty between Australia and Hong Kong over the next 1-2 years.

We will keep you updated on developments and any progress with these and other double tax treaties.

If you have finished with this document, please pass it on to other interested parties or recycle it, thank you.

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Switchboard +86 10 8520 0600 (Beijing) +86 21 3852 2111 (Shanghai) + 852 2103 0808 (Hong Kong).

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