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EDITORIAL NOTE

Welcome to the latest issue of our Tax Newsletter! In this issue, we highlight several legal and legislative developments in the PRC and Hong Kong that could have legal and tax implications for your business.

In the PRC, the State Administration of Taxation **(SAT)** issued a circular on 18 March specifying certain circumstances where before-tax deductions will be denied for a payment made by a Chinese payer to its overseas affiliate. This should warrant much attention from multi-national enterprises as it could have significant implications on current profit repatriation arrangements.

With respect to Enterprise Income Tax **(EIT)**, there have been two major legislative changes in March 2015. Firstly, SAT and three other central government authorities jointly released a circular allowing three additional types of integrated circuit enterprises to access certain EIT incentives if specific requirements are satisfied. Secondly, SAT also released a notice expanding the scope of small low-profit enterprises which are entitled to EIT benefits, including reduction in both the EIT rate and taxable income.

Apart from the above, on 30 March 2015, the Ministry of Finance and SAT jointly released a notice adjusting Business Tax treatment of the transfer of personal houses. On the same day, they also issued a circular and an announcement clarifying the tax treatment of investment made by individuals with non-monetary assets as well as the relevant tax administration measures for such transactions. Furthermore, it is worthwhile to note that the *Catalogue for the Guidance of Foreign Investment* **(2015 Catalogue)** has come into effect on 10 April 2015, which lifts restriction on foreign investment in various industries. Last but not the least, the State Council has released framework plans for three more Pilot Free Trade Zones in Guangdong, Tianjin and Fujian respectively.

In Hong Kong, two bills were introduced into the Legislative Council seeking to amend certain important aspects of the *Inland Revenue Ordinance (Cap. 112)*. The first bill proposes to extend the profits tax exemption such that offshore private equity funds may also enjoy this tax benefit to a certain extent. Another bill seeks to implement the tax concessionary measures proposed by the Government in the 2015/16 Budget, the most promising change being the increase in child allowance.

Furthermore, as an interim administrative measure, the Inland Revenue Department has announced that taxpayers can continue to adopt a mark-to-market fair value basis as an alternative to realization basis for computing 2013/14 and 2014/15 profits tax return. Taxpayers should stay tuned for further clarification on this issue.

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

THE PEOPLE'S REPUBLIC OF CHINA

CHINA TIGHTENS TAX CONTROL OVER CROSS-BORDER INTERCOMPANY PAYMENTS

The State Administration of Taxation **(SAT)** issued the *Public Announcement on Relevant Enterprise Income Tax Issues Concerning Payments Made by Enterprises to Foreign Related Parties* (Public Announcement [2015] No. 16) **(Circular 16)** and its interpretations **(Interpretations)** on 18 March 2015 and 19 March 2015 respectively.

Circular 16 specifies the following circumstances where before-tax deduction will be denied for a payment made by a Chinese payer to its overseas affiliate.

a) Where the payment is made to a foreign related party which undertakes no substantial functions or risks or has no operation/business substance;

b) Where the payment is a service fee, but the performance of the relevant service does not directly or indirectly create any economic benefit to the Chinese payer, including:

   - services that are irrelevant to the functions, risks or operations of the Chinese payer;
   - services that are concerned with the control, administration and monitoring services conducted by the foreign related party of the Chinese payer so as to protect the investment interests of the direct or indirect investors;
   - activities already performed by the Chinese payer itself or purchased from third parties;
   - no specific services were provided by the foreign related party, even though the Chinese payer may have obtained additional benefits due to its affiliations with the multinational group;
   - services that have already been compensated in other related party transactions;
   - other Services that cannot produce direct or indirect economic benefits to the Chinese payer.

c) Where the payment is a royalty paid to a foreign related party:

   - which merely owns the legal rights of the underlying intangible assets (e.g., technology, brand), and has made no contribution to the value creation of such underlying intangible assets; or
   - for benefits arising from the relevant financing and/or listing arrangement.

Circular 16 is considered as a further step of the SAT towards incorporating the recommendations made under Base Erosion and Profit Shifting **(BEPS)** into China transfer pricing practice. It is also noted that the above rules might bring about a significant impact on multi-national enterprises' current profit repatriation arrangements through different forms of inter-company royalty and service fee payments.

CHINA PROVIDES FURTHER EIT INCENTIVES FOR INTEGRATED CIRCUIT INDUSTRY

On 2 March 2015, the State Administration of Taxation **(SAT)** and three other central government authorities jointly released the Notice on Enterprise Income Tax Policies for Further Encouraging the Development of Integrated Circuit Industry (Cai Shui [2015] No. 6) **(Circular 6)**, which has taken retrospective effect from 1 January 2014. This long-awaited circular represents another remarkable step for China's gradual move to facilitate the supply chain operation of integrated circuit **(IC)** industry from tax standpoint.

1. Circular 6 allows three further types of IC enterprises to be eligible for the enterprise income tax **(EIT)** incentive if certain requirements are satisfied. These enterprises include (i) IC packaging and testing enterprises, (ii) enterprises for manufacturing key and specialized IC materials, and (iii) enterprises for manufacturing specialized IC equipment. Specifically, a qualified IC enterprise will be entitled to a tax holiday of EIT exemption for two years, followed by a reduction of the statutory EIT rate by 50% **(2+3 Tax Holiday)**. The statutory EIT rate is 25%.
2. Under the previous rules, a qualified IC design or manufacturing enterprise is entitled to the 2+3 Tax Holiday commencing from the first profit-making year by the year end of 2017. In other words, the qualified IC enterprise would lose the 2+3 Tax Holiday benefits if it fails to generate profits by or before 2017. Under Circular 6, this requirement has been relaxed whereby the qualified IC enterprise would still be entitled to the 2+3 Tax Holiday even if it fails to generate profits by or before 2017; and in such case, the tax holiday will commence from year 2017.
3. The competent authorities will consider all the following factors to determine whether the IC enterprises will be qualified for the tax incentive under Circular 6:
   - date of establishment;
   - whether the product falls into the scope of *EIT Incentives Catalogue;*
   - number of employees with degrees of junior college or higher, and size of R&D staff;
   - key technology owned by the enterprise;
   - percentage of R&D expenses (particularly R&D expenses incurred locally) in total operating income;
   - percentage of sales revenue generated by specialized IC service/products in total operating income;
   - relevant qualifications to demonstrate the enterprise's production capacity; and
   - general conditions about the enterprise's hardware and software facilities.

2. Our Comments

We suggest that taxpayers who are interested in the benefits under Circular 6 consider the followings to secure the tax benefits:

(1) Fully assess whether the company is qualified for the tax benefits under Circular 6;

(2) If so, carefully prepare and submit the application package to competent authority for obtaining the official certificate;

(3) Make timely tax filings to meet the compliance requirements for the preferential EIT treatment;

(4) Closely monitor the operation of company to make sure that all requirements under Circular 6 are fulfilled to avoid potential claw back of the taxes exempted, and maintain detailed supporting documentations to sustain the status of a qualified PTC, MCM or MCE.

REQUIREMENTS FOR BEING A QUALIFIED PTC, MCM OR MCE			
NO.	Item	PTC	MCM or MCE
1	Date of establishment	after 1 January 2014	same as PTC
2	Product type	N/A	which falls into the scope of *EIT Incentives Catalogue*
3	Employment	signs employment contracts	same as PTC
3.1	Academic degree	not less than 40% of its employees have academic degrees of junior college or higher	same as PTC
3.2	R&D staff	not less than 20% of its employees are R&D staff	same as PTC
4	Owning key technology	Yes	Yes
5	R&D expenses	not less than 3.5% of its total operating income	not less than 5% of its total operating income
5.1	Domestic R&D expenses	not less than 60% of the total R&D expenses	same as PTC
6	Revenue for packaging and testing	not less than 60% of its total operating income	N/A
7	Sales revenue for (i) key and specialized IC material or (ii) specialized IC equipment	N/A	not less than 30% of its total operating income
8	Qualifications	which can demonstrate the capacity of production (for example, 150 quality system certificate, or certificate of human resources capabilities)	same as PTC
9	Hardware and software facilities	which can fulfill the basic conditions for business operation	same as PTC

EXPANSION OF SCOPE OF SMALL LOW-PROFIT ENTERPRISES FOR PREFERENTIAL INCOME TAX TREATMENT

The State Administration of Taxation released the Public Notice [2015] No. 17 **(Notice 17)** on 18 March 2015 to further expand the scope of small low-profit enterprises for the entitlement of the Enterprise Income Tax **(EIT)** benefits. Specifically, qualified small low-profit enterprises are subject to EIT benefits including a reduction of EIT rate from the standard rate of 25% to 20%, and a half reduction of the taxable income.

Under Notice 17, qualified small low-profit enterprises, including those are taxed based on the accounting books or deemed-profit methods, may enjoy the aforesaid EIT benefits at their own discretions without obtaining any prior approvals from tax authorities.

Nevertheless, where a small low-profit enterprise has enjoyed the EIT benefits at the time of the quarterly EIT reporting, but it fails the criteria (i.e. its annual taxable income for the previous taxable year is in excess of RMB 200,000) at the time of annual tax reporting by the end of the year, the enterprise would still not be entitled to the EIT benefits for this year. Accordingly, the enterprise is required to settle the underpaid EIT for that year during the annual final EIT reporting.

ADJUSTMENT OF BUSINESS TAX ON TRANSFER OF PERSONAL HOUSES

The Ministry of Finance and State Administration of Taxation jointly released the *Notice Regarding Adjustment of Business Tax on Transfer of Personal Houses* (Caishui [2015] No. 39) **(Notice 39)** on 30 March 2015. Notice 39 took effect on 31 March 2015.

According to Notice 39:

where individuals sell houses that have been bought for less than two years, Business Tax **(BT)** shall be paid in full amount without any deduction;

- where individuals sell non-ordinary houses that have been bought for two years or more, BT shall be levied on gains calculated based on the difference between the sales proceeds and the purchase price;
- where individuals sell ordinary houses that have been bought for two years or more, BT would be exempted.

INDIVIDUAL INCOME TAX TREATMENT OF INVESTMENT WITH NON-MONETARY ASSETS

On 30 March 2015, the Ministry of Finance and State Administration of Taxation **(SAT)** jointly released the *Circular of the Ministry of Finance and State Administration of Taxation on Individual Income Tax (**IIT**) Policies for Individuals' Investment with Non-monetary Assets* **(Caishui [2015] No. 41)**, which was followed by a detailed implementation rule issued by the SAT on 1 April 2015, namely the *Announcement of the SAT Regarding IIT Collection and Administration on Income from Investment with Non-monetary Assets by Individuals* **(SAT Announcement [2015] No. 20)**. The above rules clarified the tax treatment of investment by individuals with non-monetary assets and provided detailed tax administration measures for such transactions.

Tax Treatment

According to the above rules, investment by individuals with non-monetary assets to the investee company (including establishing new enterprises, acquiring existing or new shares of enterprises, or participating in enterprises' share restructuring) shall be viewed as two transactions from the PRC tax perspective: (a) disposing the non-monetary assets and (b) investment with income derived from assets disposal.

The gains arising from transfer of non-monetary assets shall be taxable for IIT under the category of "gains from property transfer". The gains shall be determined based on the fair value of the non-monetary assets, the original cost basis of the assets and reasonable expenses and taxes incurred in the transaction.

Deferred Tax Payment

For taxpayers who have difficulties in settling the IIT in one lump sum, the rules allow the IIT to be settled by instalments within a period of up to five years following the investment date. Taxpayers electing to pay IIT by instalments shall decide on the instalment payment plan and record it with the tax authorities.

If such taxpayer receives cash compensation in the transaction, the cash should be used to pay IIT first and the instalment payments only apply to the non-cash part.

If the equity of the company being invested is disposed by the taxpayer during the period of instalment tax payments, the remaining IIT must be settled within 15 days in the month following the equity disposal.

NEW FOREIGN INVESTMENT GUIDANCE CATALOGUE RELEASED

On 10 March 2015, the Ministry of Commerce and National Development and Reform Committee of China jointly promulgated the *Catalogue for the Guidance of Foreign Investment* **(2015 Catalogue)** which came into effect from 10 April 2015. The 2015 Catalogue further lifts the restriction on foreign investment in various industries.

The 2015 Catalogue lists out 349 encouraged industries, 38 restricted industries and 36 prohibited industries for foreign investment purposes. As compared with the previous version promulgated in 2011, the number of restricted and prohibited industries have been significantly reduced from 79 to 38 and from 38 to 36 respectively. Restrictions on foreign shareholding ratio have also been relaxed. Specifically, the number of industries subject to cooperative or equity joint venture requirements have been reduced from 43 to 15, whereas the number of industries subject to the Chinese holding or control requirements have been reduced from 44 to 35.

Nonetheless, despite the more and more liberalized investment environment in China, it is worth to mention that certain prohibited industries have been newly added to the 2015 Catalogue which include wholesale and retail of tobacco, online publishing services, auction of cultural relics, etc.

CHINA OPENS UP THREE MORE FREE TRADE ZONES AND INCLUDE LUJIAZUI AS PART OF SHANGHAI PILOT FREE TRADE ZONE

On 20 April 2015, the State Council released framework plans for the Guangdong, Tianjin and Fujian Pilot Free Trade Zones **(FTZs)**. Each FTZ comprises three sub-zones that make full use of the respective geographic locations. The Guangdong Pilot FTZ is strategically positioned for enhancing cross-border collaboration and market integration with both Hong Kong and Macau. The Tianjin Pilot FTZ is close to major oil and gas deposits, making petrochemicals one of Tianjin's economic foundations, alongside aircraft leasing, ship building and pharmaceuticals. A Tianjin government official said its FTZ would initially focus on leasing ships and aircraft to avoid direct competition with Shanghai. The Fujian Pilot FTZ, situated in one of the wealthiest regions in China, can tap onto the existing economic ties with Taiwan to develop further collaboration between Fujian and Taiwan.

Meanwhile, the State Council also approved a plan to expand the geographic extent of the China (Shanghai) Pilot Free Trade Zone **(SHFTZ)** to cover Lujiazui Finance and Trade Zone, Zhangjiang High-Tech Park and Jinqiao Export Processing Zone, increasing its area more than four-fold to 120.27 square kilometers. Apart from being home to Shanghai's tallest skyscrapers, Lujiazui has a concentration of financial institutions and established capital distribution functions which can unleash Pudong's advantage in innovation and higher degree of opening-up.

The SHFTZ has received mixed review amongst foreign investors and multinational companies since its inception in September 2013. The government's move to open up three more areas and the expansion of SHFTZ is definitely a positive sign of deepening market reform as well as further liberalisation in China. Foreign investors can expect to enjoy reduced operating, filing and compliance costs in more areas of China and tailor make business strategies based on the geographical location.

We will closely monitor any new developments related to the FTZs and SHFTZ that are expected in the next few months and provide further updates.


HONG KONG

FOURTH PROTOCOL TO DTA

On 1 April 2015, Hong Kong and China have signed a new protocol **(Protocol)** supplementing the Hong Kong-China comprehensive double tax agreement **(China-HK DTA)**. This is the 4th protocol signed by Hong Kong since the China-HK DTA has entered into force on 8 December 2006.

Under the Protocol, the PRC capital gain tax exemption has been extended to cover gain derived by Hong Kong tax residents from disposal of shares listed in China, provided that such shares are purchased and sold on the same stock exchange. This exemption also applies to investment funds which satisfy the Hong Kong residency requirement stipulated under the China-HK DTA.

Furthermore, the Protocol reduces the withholding tax rate for rentals derived from aircraft and ship leasing business from 7% to 5%, allowing Hong Kong to benefit from having the lowest rate amongst the tax treaties that China has entered into.

Apart from the above, it also introduces an anti-avoidance provision for passive income. Tax benefits for dividends, interest, royalties and capital gains provided under the China-HK DTA will not be available if the main purpose of creating or entering into the relevant arrangement is to take advantage of the benefits under the China-HK DTA. Last but not the least, in order to align with the global standards for tax transparency, the Protocol expands the scope of information exchange to also cover value added tax **(VAT)**, land VAT, business tax, consumption tax and property tax in addition to individual income tax and enterprise income tax.

The Protocol is not yet effective. It will come into force after the ratification procedures and notification are completed by both China and Hong Kong.

SOME GOOD NEWS FOR OFFSHORE PRIVATE EQUITY FUNDS

Under the current regime, non-resident persons are exempted from profits tax for profits derived from "specified transactions" (e.g. transaction in listed securities) arranged or carried out by SFC licensed persons. However, trading securities of private companies is not one of the "specified transactions" and therefore profits derived from such transactions by the offshore private equity funds **(Offshore PE Funds)** are still subject to profits tax.

With the view to strengthen Hong Kong's position as a premier international asset management center and foster development of the private equity sector, the Government proposed in the 2013/14 Budget to extend the profits tax exemption to Offshore PE Funds. In response to that, the *Inland Revenue (Amendment) Bill 2015* **(Bill)** was published in the Gazette on 20 March 2015, seeking to amend the *Inland Revenue Ordinance (Cap. 112)* to such effect that Offshore PE Funds may also enjoy profits tax exemption.

A brief overview of the three major proposals in the Bill is set forth below:-

(1) Expanding scope of exemption for Offshore PE Funds:

It is proposed that profits tax exemption will apply to trading securities in an "excepted private company" (i.e. portfolio company). To qualify for the exemption, such portfolio company must be a private company incorporated overseas, and that at all times within three years before the transaction, it must not:

(a) have carried on any business through or from a permanent establishment in Hong Kong;

(b) directly or indirectly hold interests in one or more private companies carrying on business through or from a permanent establishment in Hong Kong and the aggregated value of such interests is more than 10% of the value of its own assets; and

(c) directly or indirectly hold immovable properties in Hong Kong and the aggregated value of such holding is more than 10% of the value of its own assets.

Note however that, the proposed exemption does not cover trading securities in Hong Kong private companies or other offshore private companies.

(2) Allowing qualifying funds to enjoy profits tax exemption:

With the view to allow Offshore PE Funds which are not managed by SFC licensed persons to also enjoy profits tax exemption, the Bill provides that a fund (i.e. qualifying funds) will not be subject to profits tax arising from all "specified transactions" if the following conditions are met:

(a) at all times after the final closing of sale of interests –

i. the number of investors exceeds four; and

ii. the capital commitments made by investors exceed 90% of the aggregate capital commitments; and

(b) the portion of the net proceeds arising out of the transactions of the fund to be received by the originator and the originator's associates, after deducting the portion attributable to their capital contributions (which is proportionate to that attributable to the investors' capital contributions), is agreed under an agreement governing the operation of the fund to be an amount not exceeding 30% of the net proceeds.

(3) Allowing exemption for Special Purpose Vehicles (**SPVs**):

To acknowledge the fact that Offshore PE Funds would generally set up one or multiple-tier SPVs to hold their portfolio companies, it is proposed under the Bill that:

(a) transaction in securities in SPVs will not be excluded from the definition of "specified transactions"; and

(b) SPVs are exempted from profits tax for profits derived from trading in interposing SPVs or excepted private company.

The Bill was introduced into the Legislative Council and had received its First Reading on 25 March 2015.

PAY LESS TAX!

The Inland Revenue (Amendment) (No. 2) Bill 2015 **(Bill No. 2)** was gazetted on 17 April 2015 and introduced into the Legislative Council on 29 April 2015. Bill No. 2 seeks to amend the *Inland Revenue Ordinance (Cap. 112)* so to implement the tax concessionary measures proposed by the Government in the 2015/16 Budget.

Bill No. 2 first proposes to increase both the child allowance and the additional one-off child allowance in the year of birth from $70,000 to $100,000 under salaries tax and tax under personal assessment, taking effect from the year of assessment 2015/16 onwards. It is expected that around 370,000 taxpayers would benefit from it.

Secondly, it suggests to reduce salaries tax, tax under personal assessment and profits tax by 75% for the year of assessment 2014/15, with a cap of $20,000 for each case. This proposal is expected to benefit around 1.82 million taxpayers and around 130,000 tax-paying corporations and unincorporated businesses.

If Bill No. 2 has passed, the total revenue forgone relating to the above proposals is estimated to be about $19.7 billion a year.

PROFITS ARE ONLY TAXABLE ONCE REALIZED

Following the landmark Court of Final Appeal judgment of *Nice Cheer Investment Limited v CIR* in 2013, which ruled that unrealized profits are not taxable; the Inland Revenue Department **(IRD)** has received enquiries from taxpayers who have computed their profits tax using mark-to-market fair value basis and are concerned that profits would be required to be recomputed on a realization basis based on the judgment.

As an interim administrative measure, the IRD, for two years in a row, has announced that taxpayers can continue to adopt a mark-to-market fair value basis for computing 2013/14 and 2014/15 profits tax return. While the announcement provides flexibility for taxpayers to choose between the fair value basis and the realization basis for profits tax filing, it also signifies that the IRD has yet to conclude its considerations and review of the *Nice Cheer* case.

The IRD also announced that it will agree to any recomputation of assessable profits for 2014/15 that have been computed on a fair value basis if taxpayers subsequently adopt the realization basis as long as requests for recomputation are submitted to the IRD within time limits stipulated in sections 60 or 70A of the Inland Revenue Ordinance.

The IRD's announcement seems to create more confusion – taxpayers can opt for either fair-value basis or realization basis when computing profits while not knowing whether they will be subsequently penalized for doing so.

A LITTLE TOO LATE

A recently published Board of Review **(Board)** case has confirmed that the Hong Kong Inland Revenue Department **(IRD)** is not prepared to give special allowance when it comes to enforcing time limits for making an appeal. Section 66(1A) of the *Inland Revenue Ordinance* (Cap.112) **(IRO)** states that the Board would only extend the time limit for lodging an appeal if an appellant was prevented from doing so because of illness, or absence from Hong Kong or other reasonable cause. The word "prevented" means "unable to", which has a higher threshold than a mere excuse such as, negligence, delay, ignorance, being busy at work, or not knowing the law.

Let's look at the facts of this case. Upon the rejection of the dependent brother allowance by the IRD via a formal determination on 8 February 2012, the Appellant was informed that he could lodge an appeal with the Board in accordance with section 66 of the IRO. While he acknowledged receipt of such formal determination within two days, he did not lodge any appeal with the Board within the prescribed time limit of one month even though he was in Hong Kong during that period. Subsequently, the IRD sent a letter to the Appellant on 6 November 2012 to revoke the dependent brother allowance that was previously granted to him. It was only then that the Appellant expressly stated his objection on 5 December 2012, to which the IRD responded by saying that since the Appellant received a formal determination, he should have lodged an appeal in accordance with the IRO at that point (i.e. a month from 8 February 2012). On 31 May 2013, the Assessor, for a second time, informed the Appellant that he needed to lodge an appeal with the Board if he was not satisfied with the formal determination and it was not until almost four months later on 27 September 2013 that the Appellant's letter was faxed to the Board.

To the Board, the Appellant should clearly know that he must lodge his appeal within one month from 31 May 2013 at the latest. The Appellant's appeal was out of time, and he was unable to put forward any specified or other justifiable reasons to explain why he was prevented from lodging the appeal. Hence, the Board did not need to deal with the substantive appeal.

YOU GOT SAY

In line with the Hong Kong Government's priority to conclude comprehensive avoidance of double taxation agreements, it has launched a public consultation exercise on the proposed model for implementing automatic exchange of financial account information in tax matters **(AEOI)** in Hong Kong on 24 April 2015.

The OECD standard for exchange of information consists of two modes: (i) upon request or (ii) on automatic or spontaneous basis. So far, Hong Kong has only opted for the former mode but the Government's commitment to the latter mode is evidenced by the present consultation exercise. Hong Kong cannot implement the AEOI without the necessary domestic legislation in place. Hence, the goal for Hong Kong would be to introduce an amendment bill into the Legislative Council in early 2016, gazette the legislation by 2017 and commence the first automatic information by end of 2018 which is the latest time allowed by the Global Forum on Transparency and Exchange of Information for Tax Purposes.

The consultation will end on 30 June 2015.

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