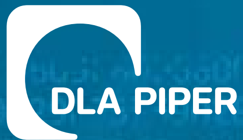

TAX NEWSLETTER

JULY/AUGUST 2015

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EDITORIAL NOTE

Welcome to the latest issue of our Tax Newsletter. As you may be aware, much has happened since our last issue. In this issue, we highlighted a number of developments in both the PRC and Hong Kong that could be of legal and tax significance to your businesses.

For the PRC, qualified importers and exporters with at least four tax filings per month can now pay taxes to Customs on a monthly basis rather than on a transaction basis under the recent announcement of the General Administration of Customs. The reform was implemented on a trial basis in certain areas but is now a nationwide program.

The State Administration of Taxation (**SAT**) has decided to strengthen its regulation by implementing two measures. Firstly, a new circular has been issued to reinforce the collection of Individual Income Tax on electronic red-envelops distributed by enterprises to individuals. Secondly, SAT released the *Notice on Implementation Measures for Enhancing Random Tax Inspection*, aiming to intensify random tax inspection in a more effective and organized manner. Inspection database will be set up and every key taxpayer would expect to be subject to at least one tax inspection in every 5 years! Beyond doubts, these moves were not welcomed by any taxpayers.

On the bright side, the Mainland China and Taiwan had finally signed a Double Taxation Agreement in late August, providing for beneficial withholding income tax rates to be enjoyed by eligible tax residents in both jurisdictions. SAT also published a notice on the tax initiatives to support the "One Belt One Road" plan to enhance economic cooperation among countries in Eurasia.

Last but not least, during the period, PRC authorities also issued (i) the draft Environmental Protection Tax Law, (ii) an announcement on trial implementation of administrative measures for taxation of Coral Resource Tax and (iii) clarifications on application of beneficial Enterprise Income Tax benefits for Shenzhen Qianhai enterprises.

For Hong Kong, we are bringing you a number of updates as well.

Firstly, the tax treaties signed between Hong Kong and Japan, and between Hong Kong and Italy, have both come into force. In addition, the long awaited offshore private equity funds exemption has been passed by Legislative Council and came into force in July.

The new quarterly Board of Review Decisions were issued in July. A total of 6 cases were published, which discuss a number of issues in relation to profits tax and reinforce some relevant principles. Each of the cases is summarized and discussed in this issue.

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

CHINA

CUSTOMS' REFORM ON CONSOLIDATED TAXATION ROLLED OUT NATIONWIDE

The General Administration of Customs (**GAC**) released *Announcement on the Promotion of Centralizing Tax Collection Nationwide* (**GAC Announcement 33**) on July 24, 2015, in order to promote trade and reduce overall customs clearance costs. Under the new tax consolidation program, qualified importers and exporters can pay taxes to Customs on a monthly basis rather than on a transaction basis. This tax consolidation program was previously implemented on a trial basis in certain areas and GAC has now decided to roll out the program nationwide.

The key features of GAC Announcement 33 are:

- ***Qualified Enterprises*:** Enterprises that are covered by the new tax consolidation program should be the importers/exporters of record and indicated as the "operating units" on the customs declaration forms. It is required that the qualified enterprise should be a user of the electronic tax payment system of Customs, and classified as a "general authorized enterprise" or above under the Chinese AEO certification system. The enterprise is required to have a good Customs compliance track record and should have at least four tax filings per month on average during the prior calendar year in order to be qualified for this tax consolidation program.
- ***Application:*** Qualified enterprises shall apply to their in charge customs office for consolidated tax payments. The tax consolidation is not limited to the taxes levied by the approving Customs. Rather, the qualified enterprises can elect in the application documents to consolidate the taxes levied by other customs offices directly under the GAC.
- ***Guarantee:*** Qualified enterprises which are approved by Customs to participate in the tax consolidation program are required to submit to the in charge customs office a general guarantee in form of cash bond or bank guarantee.
- ***Tax settlement:*** Qualified enterprises shall complete the tax payments for the preceding month by the fifth working day of the current month through the Customs' electronic tax payment system.

ADDITIONAL ITEMS ELIGIBLE FOR ZERO TARIFFS UNDER THE CLOSER ECONOMIC PARTNERSHIP ARRANGEMENT

The Customs Tariff Commission of the State Council issued a *Notice on Imposing Zero Tariffs on Certain Goods under the Closer Economic Partnership Arrangement in the Second Half of 2015* (**Notice**) which took effect from July 1, 2015.

According to the Notice, zero tariff will be applied on three items of goods originated from Hong Kong and four items from Macau for which agreements have been reached on the relevant rules of origin (**ROO**). The new ROO shall be applied to products imported/exported into and from China on or after July 1, 2015.

The three goods originated from Hong Kong are chloroform (tariff code 29031300), cotton wadding (56012100) and hearing aids (90214000). The four goods originated from Macau are centrifugal ventilators (84145930), machinery and equipment for making hot drinks, cooking or heating food (84198100), other industrial dust collectors for industry uses (84213929), and other filtering or purifying machinery and apparatus for gases (84213990).

DRAFT ENVIRONMENTAL PROTECTION TAX LAW

In June 2015, the State published and circulated for comments the *PRC Environmental Protection Tax Law (Draft for Comments),* which was drafted jointly by the Ministry of Finance, the State Administration of Taxation and the Environmental Protection Ministry for purposes of promoting environmental protection.

The highlights of the draft law are summarized as follows:

- **Taxpayers and Tax Rates**

  Taxpayers of environmental protection tax (**EPT**) include those enterprises, public institutions and other business operators directly discharging the "taxable pollutants" as prescribed in the draft law (including air pollutants, water pollutants, solid wastes, construction and industrial noises, etc.) within the territory of China.

  The normal EPT rates would be identical to the prevailing rates of pollutant discharge fees. However, companies discharging pollutants the concentration and/or volume of which exceed the national or local standards could be subject to an EPT of up to three times of the standard rates.

- **Preferential Treatments**

  EPT exemptions are granted under certain circumstances, such as pollutants arising from agricultural production, mobile pollution sources, urban sewage treatment plants or urban domestic garbage treatment plants, etc.

  In addition, local governments have the power to reduce the EPT amount of up to 50% for certain low-concentration discharges as specified under the draft law.

- **Tax Levying and Administration**

  Taxpayers shall declare and pay EPT to the competent tax authorities at the places where the taxable pollutants are discharged.

  Taxpayers are divided into two categories depending on the pollutants they discharge, i.e. i) taxpayers subject to key monitoring and ii) taxpayers not subject to key monitoring. The two categories are subject to different administrative measures, and taxpayers subject to key monitoring should follow a more strict tax filing procedure.

  Where taxpayers fail to declare and pay EPT in accordance with the draft law, they should be penalized in accordance with the *PRC Tax Levying and Administration Law*, the *PRC Environmental Protection Law*, and other applicable laws and regulations.

The government will make revisions to this draft law according to the comments collected from the public. It is anticipated that it will still take quite a long time before the draft law can be finalized and officially announced.

TRIAL IMPLEMENTATION ON ADMINISTRATIVE MEASURES FOR TAXATION OF COAL RESOURCE TAX

The State Administration of Taxation (**SAT**) issued the *Announcement on Promulgating the Administrative Measures for Coal Resource Tax (for Trial Implementation)* (**Announcement 51**) in July 2015.

Certain main points of Announcement 51 are as below:

- Taxpayers which are engaged in mining and selling taxable coal shall calculate and pay the resource tax under the ad valorem fixed rate method.
- The tax payable on coal resources shall be calculated based on the taxable sales amount of the raw coal or separation coal multiplying by the applicable tax rate.
- Where taxpayers sell taxable coal, they shall pay the resources tax at the sales stage.
- Where the selling price of the raw coal or separation coal reported by the taxpayers are obviously low without justifiable reasons, or where taxpayers are deemed to sell the taxable coal without selling prices, the competent tax authorities shall determine the assessable selling price in following sequence:

  a) based on the recent average selling price of similar raw coal or separation coal sold by the taxpayer;

  b) based on the recent average selling price of similar raw coal or separation coal sold by other taxpayers;

  c) based on the following composite assessable selling price:

  *Composite assessable selling price = cost * (1 + cost-profit ratio)/(1 – applicable resource tax rate)*

  d) other reasonable methods.

Announcement 51 took effect on 1 August 2015.

COLLECTION OF INDIVIDUAL INCOME TAX ON ELECTRONIC RED-ENVELOPS STRENGTHENED

The SAT issued the tax circular Guozonghan [2015] No. 409 (**Circular 409**) in July 2015 to reinforce individual income tax (**IIT**) administration and collection on red-envelops distributed by enterprises to individuals for business promotion purposes.

Circular 409 provides that:

- IIT shall be imposed on electronic red-envelops in cash distributed by enterprises to individuals under the category of "contingent income", and the enterprises distributing the red-envelops shall withhold and settle the relevant IIT on behalf of the concerned individuals.
- IIT shall not be imposed on (i) non-cash electronic red-envelops distributed to individuals by enterprises which can only be used to buy commodities or services of the enterprises, including various consumption coupons, tokens, vouchers, discount coupons, etc.; (ii) electronic red-envelops returned to individuals by enterprises in form of cash as a result of their purchases reaching a certain amount. Such arrangement is characterized as a sale discount or sale allowance and not taxable under IIT.
- IIT shall not be imposed on electronic red-envelops distributed among individuals.

CHINA ENHANCES RANDOM TAX INSPECTIONS

On August 25, 2015, the SAT released the *Notice on Implementation Measures for Enhancing Random Tax Inspection* **(Shui Zong Fa [2015] No. 104) (Notice)**. The new scheme under the Notice aims to further intensify random tax inspection in a more effective and organized manner. Highlighted below are the salient points for your attention.

a) Databases for Random Tax Inspections
Currently, tax inspections are conducted and managed by tax authorities at local levels separately. Under the Notice, the SAT requires tax authorities at national, provincial and county levels to build up two inspection target databases by the end of 2015, namely "Potential Inspection Target Catalogue" and "Potential Inspection Targets with Abnormal Compliance Records". These two databases would contain the taxpayers' financial, tax and compliance records for the last three years.

Specifically, inspection targets will be selected randomly from these two databases and inspections will be conducted by the tax authorities at the provincial and county levels under the supervision and coordination of the SAT and the provincial tax authorities. Generally, taxpayers with non-compliance records are likely to be listed in any of the above databases as the targets of the random tax inspections.

b) Frequency of Random Tax Inspections
It is anticipated that the random tax inspections would cover about 20% of key taxpayers every year. The inspection targets are selected randomly but certain factors would still be taken into account, such as industry sectors, profit levels, operation scales, applicable effective tax rates, etc. As such, every key taxpayer of a locality would expect to be subject to at least one tax inspection in every five years. On the other hand, only about three percentage of the non-key taxpayers and one percentage of non-enterprise taxpayers would be subject to such random tax inspection every year.

In addition, taxpayers which have recently been subject to tax inspections would be exempted from a second inspection in the following three years. The Notice also seems to indicate that enterprises which are in these two databases would have a higher chance of being selected for random tax inspections. Accordingly, it is possible that a key taxpayer with a high risk profile in these two databases be subject to a second tax inspection immediately after three year. Taxpayers also would be subject to a follow-up monitoring by the relevant local tax authority after completion of each tax inspection.

c) Self-inspection
Taxpayers can conduct their self-inspections prior to, or simultaneously with, the tax authority's inspection. Tax penalties may be reduced or waived if the taxpayers voluntarily identify and report any non-compliance matters pursuant to their self-inspection results and make up for any short payment of tax and/or late payment interest.

d) Public Disclosure
The random tax inspection result will have a direct impact on the relevant taxpayer's creditability in term of its tax compliance and social standing. Such information will be shared with the relevant government authorities via a "national credit information platform".

Last but not the least, the Notice mentions that the tax authorities might disclose to the public the random tax inspection results, however, it is unclear how much details will be provided in such disclosure. In any event, such disclosure would not be welcomed by any taxpayers.

ADDITIONAL CLARIFICATION ON ENTERPRISES' APPLICATION FOR TAX BENEFITS

Further to the *Official Reply of the State Council on Relevant Policies Supporting the Development and Opening-up of the Shenzhen Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone*, Shenzhen Qianhai Administration Bureau has recently released the implementation guidance for enterprises' application for the beneficial Enterprise Income Tax (**EIT**) benefits, i.e., reduction of the EIT rate to 15% (**Implementation Guidance**). The Implementation Guidance came into effect on 1 August 2015 and will be valid for five years. Major matters are covered as below:

- This Implementation Guidance applies to Qianhai enterprises which have applied and obtained the preferential EIT benefits.
- However, in the event that the tax authority has the difficulty in assessing whether the relevant Qianhai enterprise falls within the *Catalogue for enjoying the Qianhai Preferential EIT Benefits* (**Catalogue**), the enterprise shall provide certain documents as set out in the Implementation Guidance to the Qianhai Administration Bureau for further assessment as requested by the tax authority.
- Qianhai Administration Bureau shall then issue a certification to the relevant Qianhai enterprise within 15 days from receiving all the requested documents for purpose of obtaining the preferential EIT benefits.
- If the enterprise is assessed to be outside the Catalogue, Qianhai Administration Bureau shall issue a written reply to the enterprise.

ONE BELT ONE ROAD

"One Belt One Road"（一带一路）is an initiative first introduced by the government of the People's Republic of China, geographically mimic the route of the ancient Silk Road. It focuses on economic connectivity and development cooperation among the countries primarily in Eurasia, and represents a growth strategy promoted in the region.

In connection with the "One Belt One Road", the SAT published Shuizongfa [2015] No. 60 on 21 April 2015 *Notice regarding Implementing Strategic Development of "One Belt One Road" and Handling Taxation Services and Administration.* The SAT sets forth the following ten tax initiatives:-

- Further the implementation of the bilateral tax treaties and the relevant interpretation documents;
- Promote a mechanism of bi-lateral negotiation involving tax related disputes;
- Set up a country specific taxation information center;
- Set up webpages for tax information specifically dedicated to "One Belt One Road";
- Provide trainings to those enterprises involving outbound investment;
- Set up a special phone line under the current 12366 consulting hotline platform;
- Provide guidance to accounting firms to develop professional consultancy services to those enterprises which intend to engage in outbound investment;
- Perfect the administration of information filing for overseas taxation;
- Put more effort on taxation analysis about outbound investment; and
- Develop a mechanism for better risk control management in cross border taxation.

MAINLAND CHINA AND TAIWAN SIGNED DOUBLE TAXATION AGREEMENT

On August 25, 2015, the Mainland China and Taiwan signed *the Agreement between the Mainland China and Taiwan for the Avoidance of Double Taxation and Enhanced Collaboration in Tax Matters* (**DTA**) which will take effective upon completion of the relevant ratification procedures by both parties.

Below are the major points of the DTA:

- Withholding income tax rates applying to passive income including dividends, interests and royalties would be reduced to 10%, 7% and 7% respectively if certain conditions are satisfied. Current statutory withholding income tax rates for passive income received by Taiwan and Chinese investors are 10% and 20% (or 15%) respectively.
- The preferential tax treatments will apply to eligible tax residents under the DTA. Under the DTA, where an entity of a contracting state (say Taiwan) indirectly holds its investment in the other contracting state (say China) through a holding vehicle in another jurisdiction (say Hong Kong), that holding vehicle could be regarded as a tax resident (i.e. Taiwan tax resident) for entitlement of the preferential tax treatments under the DTA so long as the that holding vehicle is effectively managed and controlled by the Taiwan entity. Factors for determining "the place of effective management" are set out in the DTA.
- The taxation right on gains derived from the equity transfer of a "real property entity" (definition is provided in the DTA) shall be on the sourcing jurisdiction, whereas the taxation right on gains from the equity transfer in other situations shall generally be on the resident jurisdiction unless otherwise provided.

HONG KONG

GOOD NEWS FOR PURE OFFSHORE PRIVATE EQUITY FUNDS IN HONG KONG

As mentioned in our earlier issue (Please refer to our March/April 2015 issue), the Government has proposed to expand the scope of profits tax exemption available to offshore funds. The amendments were finally gazetted on 17 July 2015 with retrospective effect for any year of assessment commencing on or after 1 April 2015.

The scope of the new exemption is largely the same as that proposed in the Inland Revenue (Amendment) Bill 2015. The changes are summarized below:

- By expanding the definition of "securities" in the exemption, the exemption now covers offshore funds investing in "excepted private companies", which are companies incorporated outside Hong Kong and have minimal connections with Hong Kong as provided in the relevant sections.
- Under the new regime, if a fund is a "qualifying fund", it can enjoy the exemption without engaging a licensed person. "Qualifying fund" is a fund that has more than 4 investors who have collectively committed more than 90% of the capital at the final closing of sale, and the originator and his associates not being entitled to more than 30% of the net proceeds.
- Special purpose vehicles incorporated in or outside Hong Kong are exempted from profits tax in relation to the disposal of interposing special purpose vehicle or "excepted private companies".

Inland Revenue Department is yet to update its Departmental Interpretation and Practice Notes to reflect the new regime. We are awaiting to see how these new provisions will attract more private equity funds to invest in Hong Kong and enhance the competitiveness of Hong Kong in fund industry.

DOUBLE TAXATION AGREEMENTS UPDATES

a) Hong Kong – Italy DTA

The comprehensive double taxation agreements signed between Hong Kong and Italy on 14 January 2013 came into force on 10 August 2015. Taxpayers will be able to enjoy the benefits under this treaty in respect of tax for any year of assessment beginning on or after 1 April 2016.

We hope that, as wished by the Secretary for Financial Services and the Treasury, Professor K C Chan, the treaty will foster trade connections between Hong Kong and Italy, and Hong Kong will be removed from the "blacklist" of Italy in near future.

The following table sets out the withholding tax rates on passive income from the perspective of Hong Kong company receiving passive income from Italy:

	Italy (effective) tax rate	Treaty rate
Dividends	26%	10%
Interest	26%	0% (interest from Italian government)/12.5%
Royalties	22.5%	15%

b) Hong Kong – Japan DTA

You may recall that Hong Kong exchanged notes with Japan regarding the Exchange of Information Article of the Comprehensive Avoidance of Double Taxation Agreement last December (Please refer to our November/December 2014 issue). The purpose of the exchange of notes between the two Governments is to expand the coverage of tax types beyond income tax, i.e. inheritance tax, gift tax, consumption tax and any identical or substantially similar taxes. The agreement finally came into force on 6 July 2015 after the completion of ratification procedures on and notification by both Hong Kong and Japan. The exchange will have effect in respect of Hong Kong for any year of assessment beginning on or after 1 April 2016.

BOARD OF REVIEW DECISIONS – JULY EPISODE

a) Documents Please

In Board of Review decision D4/14, deductibility of expenses was in dispute. The taxpayer's appeal regarding the deductibility of sales commission/directors' bonus was dismissed because the taxpayer failed to provide the necessary evidential documents to support his claim. This case confirmed that a taxpayer appealing on incorrect or excessive tax assessment bears the burden of proof before the Board of Review. Although such an appeal is made against a determination, the hearing is a de novo because it is against an assessment and the taxpayer in effect is seeking a second opinion from the Board of Review. The taxpayer, without offering the necessary evidential documents does not discharge his duty to prove that the assessment appealed against is excessive or incorrect.

b) You Know Best What to Appeal On

Two Board of Review decisions D10/14 and D13/14 centered around the same rationale – an applicant, either a taxpayer or the Commissioner, appealing against a Board of Review decision, may request the Board of Review to state a case for the opinion of the Court of First Instance. To do so, the applicant has to first frame or identify a question of law. Upon receiving the proposed question of law from the applicant, the Board of Review's job is to assess whether it is a proper question to be considered by the Court of First Instance. If so, the Board of Review will submit a case stated to the Court of First Instance. Otherwise, the Board is duty bound to decline to state the case. An apparent reason for the rationale is that the parties of a case should know best the points they wish to appeal on. In D10/14 for example, the applicant's request to the Board of Review "to state a case on a question of law" to be considered by the Court of First Instance was rejected because the applicant had not even identified a question of law and that was not the responsibility of the Board of Review.

c) Trading or Not Trading

Under the Inland Revenue Ordinance (**IRO**), Hong Kong sourced profits arising from a 'trade, profession, or business' are taxable. The concept of 'trade' has not been precisely defined in the IRO. In most appeals of profits tax assessment, the Board of Review would apply the 'badges of trade' test to decide whether a transaction is a trade. The six badges of trade are:

1. The subject matter of the realization;
2. The length of the period of ownership;
3. The frequency of number of similar transactions by the same person;
4. Supplementary work on or in connection with the property realized;
5. The circumstances that were responsible for the realization; and
6. The motive for the realization.

A recent Board of Review decision (Case No. D11/14) applied the six badges of trade to consider whether the Appellant held a flat as a capital asset or for a trade. The Appellant, a Hong Kong incorporated company which was controlled and funded by Mr. B, acquired the property for self-use and letting for rental income and made improvements to the property to make it more attractive for tenants. The property was also booked as a capital asset of the Appellant. It was not until an unsolicited

tender for selling the site of the property was presented to the Appellant when the Appellant decided to sell the property. Upon submission of sufficient evidence that the Appellant did not acquire the property for trade, it was held that the property was a capital asset and the appeal was allowed.

In another Board of Review decision (Case No. D9/14), the profits arising from the disposal of a piece of land was held to be trading profits. The Appellant, a Hong Kong incorporated company, alleged that the intention at the time of acquisition of the land was to redevelop and hold it for long term rental income. However, it was evident that the Appellant was not financially capable to acquire the land for long term investment as the acquisition was funded by two loans secured by two mortgages and it is not financially capable of funding the redevelopment. Further, no income was derived from the land and it was sold upon realizing that its use could not be changed in the near term. Having considered all the circumstances of the case and evidence submitted, the board was of the view that the purchase of the land was a trading speculation and therefore the appeal was dismissed.

In light of the above decisions, stating an intention is not useful unless one can support it with evidence.

d) Feeble Attempt to Deduct Loan Interest?

In a recent Board of Review Decision (Case No. D14/14), the Appellant sought to claim deduction on interest expenses on the basis that the Appellant had obtained bank loan in order to repay loan from associated company. The Board of Review considered whether loan interest is deductible under section 16(1)(a) of the IRO, and in particular whether the deduction of expenses are incurred in the "production of profits".

Central to the parties' contention was the interpretation placed on *Zeta Estates Ltd v CIR (2007) 10 HKCFAR 196* (**Zeta's Case**). The crux of the issue in Zeta's Case focused on the reason the capital was raised, i.e. whether fresh capital was obtained in order to retain, or maintain, its profit-earning assets. As such, applying the same test to the facts of D14/14, the Board of Review held that the key is to adduce evidence correlating the loan to the need for fresh capital to fund the production of assessable profits. There is no point merely looking at the balance sheet as the Appellant suggested. The Appellant had to produce evidence correlating the loan with cash flow obligations, which the Appellant failed to do so.

The Board of Review dismissed the appeal, inter alia, on the basis that they are **not satisfied** that (i) the bank loan was to discharge the loan from the associated company (**Old Loan**); (ii) the Appellant had insufficient liquidity to repay the Old Loan; and (iii) the purpose of the bank loan was to "maintain an existing profit producing capacity".

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