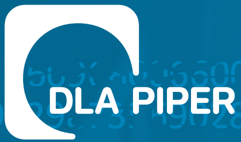

TAX NEWSLETTER

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EDITORIAL NOTE

Welcome to our redesigned Tax Newsletter.

You will notice we have streamlined the publication and will now publish bi-monthly instead of quarterly. For major developments that may be highly relevant to investments and operations in the People's Republic of China (**PRC**), we will separately publish more detailed alerts to discuss the relevant implications.

The redesigned newsletter will highlight legal developments in tax and foreign investment in the PRC and Hong Kong in the preceding two months. We will also have a dedicated section when there are significant legal updates from other parts of the world.

In the past two months, the PRC and Hong Kong have experienced several important changes which may have far-reaching impact on local and international businesses.

In the PRC, the State Administration of Taxation (**SAT**) has specifically allowed foreign trade service operators to claim VAT refunds for exportation of goods. Further, the government has relaxed regulations on cross-border security and included the telecommunications sector in the VAT Pilot Reform regime effective from June 1, 2014. The SAT has also clarified the determination of taxable income for Enterprise Income Tax purposes and the concept of "beneficial owner" under the "entrusted investment arrangement" in the context of tax treaty benefits. In addition, the PRC and Germany have recently entered into a new tax treaty to facilitate investments between the two countries.

In Hong Kong, there have been recent developments in the exchange of tax information between Hong Kong and the United States (**US**), including an agreement to facilitate the implementation of the US Foreign Account Tax Compliance Act (**FATCA**). Hong Kong is also strengthening its ties with ASEAN with a proposed bilateral Free Trade Agreement. Domestically, the Hong Kong government is considering proposals to ease restrictions placed on the property market. The Inland Revenue Department has also reported a number of tax avoidance cases during the last two months and changes regarding the Inland Revenue (Amendment) Bill and Stamp Duty (Amendment) Ordinance 2014 are underway.

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

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THE PEOPLE’S REPULIC OF CHINA (PRC)

SAFE RELEASED RULES REGARDING CROSS-BORDER SECURITY

On May 19, 2014, the State Administration of Foreign Exchange of the PRC (**SAFE**) formally issued the *Foreign Exchange Administration Rules on Cross-border Security* and its corresponding implementation guidelines (Huifa [2014] No. 29, collectively the **Rules**), which came into effect on June 1, 2014.

The Rules classify cross-border security and guarantee into three categories:

- Guarantee or security provided by an onshore entity or individual to an offshore creditor to secure the obligations of an offshore principal debtor (**Onshore Security Offshore Debt** or **Nei Bao Wai Dai**);
- Guarantee or security provided by an offshore entity or individual to an onshore creditor to secure the obligations of an onshore principal debtor (**Offshore Security Onshore Debt** or **Wai Bao Nei Dai**); and
- Other types of cross-border security and guarantee not included above.

Prior to the promulgation of the Rules, SAFE's cross-border security regime involves substantive review and approval requirements. For example, the provision of outbound security was subject to SAFE's review in relation to the satisfaction of a set of onerous requirements, such as the principal debtor's profitability and the security provider's net assets position, total foreign currency revenues, and affiliation with the principal debtor. In many cases, the difficulty to surmount these requirements effectively prohibited outbound security arrangements or rendered them impractical or cost inefficient. The Rules take on a more pragmatic procedural, registration-based approach by removing a number of the previous restrictions on Onshore Security Offshore Debt and Offshore Security Onshore Debt. Furthermore, registration with SAFE is not a condition to the validity of the guarantee or security interest.

The Rules bring substantial changes to the pre-existing cross-border security regime and significantly ease restrictions on cross-border security and guarantee. Such changes are likely to impact the structure of cross-border financing involving the PRC.

DETERMINATION OF BENEFICIAL OWNER UNDER DOUBLE TAX TREATIES IN ENTRUSTED INVESTMENT

The concept of "beneficial owner" is key to a non-PRC-resident applying for reduced withholding tax rates on dividends, interests and royalties under Double Tax Treaties (**DTA**) between the PRC and other countries (**Tax Treaty Benefits**). In this context, "beneficial owner" refers to a person having ownership and the right of control over the income or the right or property derived from the income.

Over the years, the SAT has issued regulations including Circular 601 and Announcement 30 to define "beneficial owners" for the purpose of applying for Tax Treaty Benefits. Recently, on April 21, 2014, the SAT promulgated another circular, the *Announcement on Issues Concerning the Recognition of Beneficial Owners in Entrusted Investment* (**Announcement 24**), which came into effect on June 1, 2014.

In accordance with Announcement 24, an "entrusted investment" arrangement essentially refers to those investments where a non-resident directly entrusts its own funds to overseas professional institutions for investment in resident entities in the PRC. In order to become eligible for Tax Treaty Benefits, the non-resident applicants must prove to the satisfaction of the PRC tax authority that the relevant benefits and risks from the entrusted investment are solely attributed to the non-resident principals. Among others, service fees or commissions charged by such overseas professional institutions should not have any connection with the outcome of the entrusted investment.

Like Circular 601 and Announcement 30, the PRC tax authority adopts a "substance-over-form" principle in assessing all applications for "beneficial owner" status and thus the relevant Tax Treaty Benefits.

NEW TAX TREATY SIGNED BETWEEN THE PRC AND GERMANY

On March 28, 2014, the PRC and Germany entered into the Treaty for the *Avoidance of Double Taxation and Prevention of Fiscal Evasion and Related Protocol* (**Treaty**). The Treaty needs to be ratified according to the legislations of both the PRC and Germany. Upon notification of completion of the ratification procedures, it will enter into force on the 30th day following the date of the later notification.

The Treaty contains a variety of new features, including:

- Change of threshold in relation to 'service' permanent establishment from "six months within any twelve-month period" to "183-days within any twelve-month period"
- Reduction of the dividend withholding tax from 10% to 5% for corporate beneficial owners (other than partnerships) having a direct shareholding of at least 25% in the dividend paying company
- Revised taxing rights on capital gains in favour of German investors
- Insertion of a new general provision expressly counteracting "treaty shopping" by denying treaty benefits in situations where the main purpose for entering into certain transactions or arrangement is to take advantage of the treaty benefits
- Updated arrangement of exchange of information

Please refer to our recently published client alert for further details.

CHENGDU TAX AUTHORITY NEGATES TRADEMARK ROYALTY BASED ON ECONOMIC CONTRIBUTION ANALYSIS

The Chengdu State Tax Bureau (**Chengdu STB**) recently concluded a transfer pricing audit against an unidentified foreign invested company engaging in distribution of luxury goods (**Company**). At the end of this audit, the Chengdu STB negated the reasonableness of the Company's trademark royalty payment to the overseas trademark owner, and imposed an additional tax of RMB 23 million.

This audit is noteworthy not merely because it resulted in a record high transfer pricing adjustment on a cross-border trademark royalty payment, but it is also an exemplary audit case based on the following perspectives:-

- Circumstances triggering the audit

  It has been reported that the Company had been paying a substantial and increasing amount of trademark royalty payments to its overseas affiliate trademark owner located in BVI (**BVI Company**). However, the Company has never disclosed it as an inter-company transaction in its PRC tax filing and its profit level is also lower than the average amount payable by similar taxpayers in Chengdu. According to Chengdu STB, they were skeptical as to whether there was potential manipulation of transfer prices, thus triggering a transfer pricing audit on the Company.

- Emphasis placed on economic substance

  The Company demonstrated that the legal ownership and origin of trademark was outside of the PRC to justify the reasonableness of the royalty payment amount. The Chengdu STB, on the other hand, took another approach by reviewing the substance of the economic activities conducted by the Company in the PRC. Specifically, in the Chengdu STB's view, the Company should have benefitted from the return derived from its continuous spending on marketing activities in the PRC which in turn contributes to the trademark value.

- Tax adjustment imposed on entire royalty payment

  In previous audit cases in connection with trademark royalty payment, tax adjustments were normally calculated based on a profit split method. The original value of the trademark and the contribution of the overseas trademark owner towards the trademark value would generally

be recognized. In the absence of the full details of the present Chengdu case, it appears that the Chengdu STB has taken a fairly aggressive position and denied the full amount of the trademark's original value and the contribution made by the BVI Company towards the trademark in question. As a result of this audit, it seems difficult for the Company to make any trademark royalty payment overseas in the future.

We believe the significance of this audit case is that the PRC tax authority has become more sensitive to tax base erosion and profit shifting through trademark royalty arrangements. As such, while maintaining a trademark policy to justify a cross-border and inter-company trademark royalty payment, multinational companies should also consider the PRC affiliated entity's contribution to the trademark value from a risk mitigation perspective.

SAT RELEASED RULES REGARDING VAT REFUND TO ENTERPRISES ENGAGING IN FOREIGN TRADE COMPREHENSIVE SERVICES

The SAT issued the *Announcement of the State Administration of Taxation on Issues Concerning Tax Refund (Exemption) of Export of Goods by Enterprises Engaging in Foreign Trade Comprehensive Services* (SAT Announcement [2014] No. 13, **Announcement 13**), which came into effect on April 1, 2014.

Announcement 13 allows a foreign trade comprehensive service provider, generally a trading enterprise providing logistics, customs clearance, credit and guarantee, financing foreign exchange collection and value-added tax (**VAT**) refund services, to claim VAT refund (exemption) for exportation of domestically sourced goods that are produced by domestic manufacturers to overseas companies or individuals that entered into purchase agreements with the manufacturers. The foreign trade comprehensive service provider in this transaction is viewed as a self-operating enterprise which purchases goods from the domestic manufacturers and sells the same to the designated overseas buyers. The purpose of such new development is to promote export trade and encourage small and medium-sized enterprises to explore the international market.

TELECOMMUNICATIONS SECTOR INCLUDED IN VAT PILOT REFORM

On April 29, 2014, the Ministry of Finance and the SAT promulgated Cai Shui [2014] No. 43 (**Circular 43**), which includes the telecommunications sector in the VAT Pilot Reform regime effective as of June 1, 2014. This means telecommunications services are now subject to VAT instead of business tax.

Telecommunications services are divided into two major categories: (1) basic telecommunications services such as voice call services and activities of transferring or leasing bandwidth and wavelength (basic telecommunications services are subject to VAT at 11%); and (2) value-added telecommunications services such as short message services, multimedia message services, transmission or application of digital data and information, Internet access services, satellite television signal ground transfer services (value-added telecommunications services are subject to VAT at 6%).

Telecommunications service operators providing free goods (such as handsets and SIM cards) and/or free telecommunications services to customers when furnishing telecommunications services are required to separately account for turnover (including extra charges) for the respective services and goods provided and apply the applicable VAT rates accordingly. Historically, free goods and telecommunications services provided by telecommunications service providers were not considered taxable events for turnover tax purposes. Circular 43 requires telecommunications service providers properly categorise business turnover among goods and different types of telecommunications services in a bundled sale (involving telecommunications services and goods in a single transaction) and apply the corresponding tax rates to calculate the VAT payable . If the telecommunications service operator

fails to separately account for different types of services that are subject to different VAT rates, the tax authority will have the right to apply the highest tax rate on the entire business turnover and impose VAT accordingly.

Circular 43 also makes it clear that free telecommunications services earned by redeeming points will not be subject to VAT and telecommunications services provided by domestic entities or individuals to overseas entities are also exempted from VAT.

General VAT taxpayers engaging in voice call services and transmission of digital data and information via satellite can choose to adopt the simplified tax calculation method up until December 31, 2015.

CERTAIN CLARIFICATIONS ON TAXABLE INCOME FOR ENTERPRISE INCOME TAX PURPOSES

On May 23, 2014, the SAT promulgated Bulletin [2014] No. 29 (**Bulletin 29**) to clarify certain issues related to taxable income for Enterprise Income Tax (**EIT**) purposes.

State-owned assets provided to an enterprise and earmarked as capital investment from the government shall be booked as state capital (including capital reserve) of the enterprise rather than revenue. State-owned assets provided by the government to an enterprise for special purposes and without consideration shall be booked by the receiving enterprise as its revenue, which may be excluded from taxable income if the enterprise can (a) provide the official documents and legal basis to support the special purposes of the assets granted by the financial department of the government, and (b) separately account for the expenditures related to the assets obtained. Other assets received by the enterprise from the government shall be treated as taxable income for EIT purposes.

An enterprise receiving assets that are deemed by the relevant contract and agreement to be capital (including capital reserve) injected by its shareholders (including assets donated by shareholders, equity abandoned by shareholders in the reform of non-tradable shares of listed companies, etc.) shall exclude such assets received from its total revenue if the assets have been properly booked as capital investment in its accounting books. The enterprise may determine the tax bases of such assets according to their fair value. Other assets provided by shareholders without consideration shall be included in the revenue of the enterprise and subject to EIT based on the fair value of the assets received.

Bulletin 29 also reiterates the tax treatment of the fixed assets' depreciation expenses. In short, enterprises shall calculate the tax deductible depreciation expenses based on the minimum depreciation years of fixed assets stipulated by tax laws and make proper tax adjustments when filing EIT returns. No tax adjustment is required if the useful life of the fixed assets on accounting books is longer than the minimum depreciation years provided under tax laws.

HONG KONG

EXCHANGE OF TAX INFORMATION AGREEMENT WITH THE US

On June 20, 2014, the Tax Information Exchange Agreement (**TIEA)** between Hong Kong and the US entered into force. The TIEA was formally signed in March 2014 to facilitate the implementation of the US Foreign Account Tax Compliance Act (**FATCA**), which was enacted by the US in 2010 to combat tax evasion by US taxpayers.

The TIEA will allow US tax authorities to file a request for exchange of information to the Hong Kong Inland Revenue Department (**IRD**), to obtain financial accounts information of US persons. The TIEA has effect for requests in respect of any period that starts on or after June 20, 2014, and for all charges to tax arising on or after the same date.

In May 2014, Hong Kong and US also agreed on the substance of an Intergovernmental Agreement (**IGA**) to facilitate the compliance with FATCA. Under the (model 2) IGA, financial institutions in Hong Kong will need to seek their US clients' consent to report their account information to the US Inland Revenue Service (**IRS**) directly. For non-consenting clients of the institutions, the IGA will be supplemented by the TIEA for exchange of information at a government level on a need basis.

STAMP DUTY UPDATES

On February 22, 2013, the Financial Secretary announced that the Government would double the original ad valorem stamp duty (**AVD**) rates for all properties, subject to exemptions. Another measure was to advance the charging of AVD on non-residential property transactions from the conveyance on sale to the agreement for sale, to tally with the existing arrangement for residential properties. The proposals are set out in the Stamp Duty (Amendment) Bill 2013 which is now being scrutinized by the Bills Committee of the Legislative Council.

In May 2014, the government suggested adjustments to the proposed measures above. In the original proposal, permanent residents who would sell their old property (being their only property then) within six months of purchasing the new one would be exempted from the double stamp duty. It was suggested that such six-month grace period be extended by one to two months. Further, it was suggested that such six-month period to be taken to commence from the conveyance on sale instead of the agreement for sale and purchase of the newly acquired property. For those who acquire a second-home which is still under construction, this period could be prolonged by up to three years.

On the other hand, the Stamp Duty (Amendment) Ordinance 2014 (**Ordinance**) was gazetted on February 28, 2014. In particular, the Ordinance introduced a Buyer's Stamp Duty (**BSD**) and required all companies and non-Hong Kong permanent residents acquiring residential properties to pay a tax of an amount equivalent to 15% of the prices of the properties. The commencement date of the Ordinance has been set retrospectively at October 27, 2012. The Ordinance provides for an exemption to purchasers who are Hong Kong Permanent Residents acting on their own behalf in acquiring the property. These exempted purchasers shall have produced a statutory declaration on or before 30 April 2014 in support of their exemption applications.

TAX EVASION AND TAX AVOIDANCE CASES

The IRD has been committed to combat tax evasion and tax avoidance. In May and June 2014, a number of tax evasion and tax avoidance cases were reported. Among the cases, a taxpayer was sentenced to 4 weeks' imprisonment and a couple in another case was sentenced to community service orders.

INLAND REVENUE (AMENDMENT) BILL 2014

The Bill, which includes 2 major concessionary revenue measures proposed in the 2014-2015 Budget, was passed on June 25 by the Legislative Council. The first measure is a one-off tax reduction in salaries tax, tax under personal assessment and profits tax for the year of assessment 2013/14 by 75%, subject to a ceiling of HKD10,000 per case. About 1.74 million taxpayers will benefit from this reduction. The reduction of profits tax will benefit around 126,000 tax-paying companies and unincorporated businesses. The other measure is the increase of allowances for maintaining a dependent parent or grandparent, and raising the deduction ceiling for elderly residential care expenses under salaries tax and tax under personal assessment.

The one-off tax reduction is automatic and application is not required. It will be reflected in the taxpayers' final tax payable for the year of assessment 2013/14. The IRD will apply the enhanced dependent parent/grandparent allowances and deduction ceiling for elderly residential care expenses when calculating the provisional tax for the year of assessment 2014/15.

FREE TRADE AGREEMENT (FTA) WITH THE ASSOCIATION OF SOUTHEAST ASIAN NATIONS (ASEAN)

Hong Kong has agreed with ASEAN to pursue a bilateral FTA on April 26, 2014. The FTA will strengthen economic partnership with the 10 member states of ASEAN, which comprises of Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. Collectively, ASEAN countries are Hong Kong's second largest commodity trade partner and fourth largest trade partner in terms of services.

The FTA is expected to cover the following areas: (i) elimination/reduction of tariffs and non-tariff barriers; (ii) preferential rules of origin; (iii) liberalization of trade in services; (iv) liberalization, promotion and protection of investment; and (v) dispute settlement mechanism.

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

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