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EDITORIAL NOTE

The tax arena in both China and Hong Kong has been a buzz since the last issue of our Tax Newsletter. In this edition, we draw your attention to certain recent developments that may carry legal and tax implications for your business.

In the PRC, the State Administration of Taxation ("**SAT**") recently released a tax circular on Cost Sharing Arrangement ("**CSA**"), which simplified the procedures for implementing CSA in China. The SAT also released an announcement providing further guidance on tax deduction and exemption. Another circular issued by the SAT seeks to provide guidance on matters relating to entitlement of the special tax treatments available for intra-group share/asset transfer. The circular also stipulates written submission and reporting requirements for certain cases. Furthermore, the SAT and the Ministry of Finance jointly issued a circular which introduces incentives for qualified "High and New Technological Enterprises" on tax deduction of statutory employee education funds, which has come into effect retroactively on 1 January 2015.

On the other hand, a circular on cigarette consumption tax may be grim news to the tobacco industry as the rate of ad valorem duty on cigarettes at the wholesale stage has been raised from 5% to 11% while the specific duty imposed is now RMB0.005 per cigarette. Regarding the reporting of outbound investments and foreign-sourced income by PRC resident enterprises, a circular was issued by the SAT on 18 June 2015, providing much clearer guidance on the filing requirements and also lessening the tax compliance burden of taxpayers.

The reputation of the Hong Kong's tax regime had suffered a blow as it was listed as one of the "non-cooperative tax jurisdictions" by the European Commission ("**EC**") in its corporate tax reform action plan published on 17 June 2015. The Hong Kong government promptly issued a statement in response to defend Hong Kong as a tax cooperative jurisdiction. One might argue that efforts of the government do indeed support its contentions in the statement – the city's Chief Executive recently gave executive orders to implement the respective Comprehensive Agreements for the Avoidance of Double Taxation ("**CDTA**") with South Africa and the United Arab Emirates as well as ordered to implement the notes exchanged between Hong Kong and Japan regarding the exchange of information article of the CDTA with Japan.

The Court of Appeal recently confirmed that license fees received by a non-Hong Kong resident from a Hong Kong taxpayer in respect of rights to exhibit television programmes outside Hong Kong is taxable in Hong Kong. On the legislative side, a bill was gazetted on 12 June 2015, seeking to improve the tax appeal mechanism and the efficiency and effectiveness of the Board of Review ("**Board**") by giving taxpayers more flexibility in their appeals against the Board.

We welcome your feedback and any questions you may have about this issue.

THE PEOPLE'S REPUBLIC OF CHINA

NEW ADMINISTRATION MEASURES ON COST SHARING AGREEMENT

The China State Administration of Taxation ("**SAT**") recently released a new tax circular (Announcement [2015] No 45, "**Circular 45**") on Cost Sharing Arrangement ("**CSA**")[1]. Under Circular 45, taxpayers are no longer required to go through an advanced application and approval procedure for implementation of their CSA in China. Instead, they are only required to file a recordal with the tax authority which will be playing a role in follow-up administration and supervision.

Prior to the promulgation of Circular 45, CSA was subject to stringent management and control of the China tax authorities. For instance, according to the *Special Tax Adjustment Implementation Measures*:-

- CSA was generally restricted to activities including joint R&D, group procurement and group marketing activities;
- CSA was subject to advanced review and approval by the SAT before implementation; and
- Taxpayers had to undergo a lengthy application procedure.

Under Circular 45, taxpayers are no longer required to obtain approval from the China tax authorities before implementing their CSA. Instead, taxpayers only need to file a recordal with the tax authority within 30 days after entering into the CSA and subsequently report the "CSA status" in their annual income tax filings.

Having said that, the issuance of Circular 45 also encourages the China tax authorities to conduct special tax investigations on any CSA if the costs and benefits under such CSA are found as incompatible and the participating parties fail to conduct corresponding adjustments on a timely basis.

Circular 45 does not elaborate on the scope of information to be submitted for the recordal and annual income tax filings. Besides, it is unclear whether CSAs are now applicable to activities other than R&D, group procurement and group marketing activities. These are issues that remain to be clarified by the SAT in future.

We understand that Circular 45 is part of the SAT's efforts to introduce BEPS (i.e. Base Erosion and Profit Shifting) legislations in China. In fact, the SAT may release an update of the *Special Tax Adjustment Implementation Measures* in the second half of 2015. It is likely that the updated *Special Tax Adjustment Implementation Measures* will introduce more detailed rules and guidelines on implementation of CSA in China. We will keep a close eye on the development and provide updates in due course.

NEW RULES GOVERNING TAX DEDUCTION AND EXEMPTION

On 8 June 2015, the State Administration of Taxation ("**SAT**") released the *Announcement of the State Administration of Taxation on Promulgating the Administrative Measures for Tax Deduction and Exemption* ("SAT Announcement [2015] No. 43", "**Announcement 43**"), which provides detailed guidance on the implementation and administrative measures in relation to tax deduction and exemption treatments. This Announcement 43 will come into effect on 1 August 2015.

[1] CSA is a framework agreed among enterprises (normally related parties) to share costs and risks of developing, producing, or obtaining assets, services, or rights, based on the nature and extent of interests for each participating enterprise.

According to Announcement 43, tax deduction and exemption cases are classified into two categories:-

1) tax deduction/exemption subject to approval by the tax authority; and
2) tax deduction/exemption **not** subject to approval but subject to recordal filing with the tax authority.

Taxpayers shall either submit an application for approval or file a recordal for the alleged tax deduction or exemption treatment pursuant to the stipulated rules and regulations. For tax deduction/exemption applications subject to approval, the tax authorities shall issue an official reply to the relevant applicant to provide reason(s) for approving or rejecting the application.

Taxpayers should complete tax filings according to the official reply in relation to the tax deductions/ exemption treatment.

Last but not the least, applications for export VAT refund and any tax deduction/exemption governed by the Ministry of Finance are not covered within the scope of this Announcement 43.

NEW GUIDANCE ON SPECIAL TAX TREATMENTS ON INTRA-GROUP TRANSFER

In December 2014, the State Administration of Taxation ("**SAT**") and Ministry of Finance jointly issued *Circular on Issues concerning Enterprise Income Tax Treatments for Promotion of Enterprise Restructurings* ("**Circular 109**") to clarify various matters relating to entitlement of the special tax treatments available for intra-group share/asset transfer (which essentially is a deferral of enterprise income tax payment). Recently, the SAT issued *Announcement on Levy and Administration of Enterprise Income Tax on Assets (Equity) Transfer* (Announcement [2015] No. 40, "**Circular 40**") on 27 May 2015 to provide further guidance on certain provisions under Circular 109.

Below are the salient points of Circular 40:

- Special tax treatments shall be available in an intra-group share/asset transfer conducted between (i) resident enterprises under 100% direct control; and (ii) resident enterprises 100% directly owned by the same enterprise(s) specifically in the four situations as described under Circular 40. Circular 40 also provides for the relevant tax treatments in each of these four situations.
- Upon conducting the annual enterprise income tax reporting following the transfer, both parties to the eligible transaction shall submit a written statement to their respective in-charge tax authorities that their original substantial business activities in relation to the relevant share/asset transferred have not changed within 12 consecutive months after the date of completion of the share/asset transfer.
- Where any change occurs in the production and operation business, company's nature, asset or equity structure of any party to the transaction within 12 consecutive months after the date of completion of the transfer and thus resulting in the disqualification of the special tax treatment, the party subject to such change shall report to its in-charge tax authority within 30 days upon the occurrence of such change and shall notify the other party in writing. The other party shall report the relevant change to its in-charge tax authority within 30 days upon receipt of such notice. Within 60 days of the change, both parties shall make the appropriate tax adjustments and amend their tax returns for the previous year(s) accordingly.

Circular 40 applies to those qualified enterprises which filed their enterprise income tax returns for 2014 and thereafter, as well as those intra-group share/asset transfers whose tax treatments have not been finalized, if applicable.

MORE INCENTIVES FOR HIGH-TECH ENTERPRISES

On 9 June 2015, the State Administration for Taxation ("**SAT**") and the Ministry of Finance ("**MOF**") jointly issued Caishui [2015] No. 63, entitled *Circular on Pre-tax Deduction Policies Concerning Employee Education Funds of High-tech Enterprises* ("**Circular 63**"), which introduces further incentives for qualified "High and New Technological Enterprises" ("**HNTEs**") on tax deduction of the statutory employee education funds.

In 2011, the MOF Announcement 62 repealed Caishui [2006] No. 88 (*Circular on Preferential Enterprise Income Tax Policies for Enterprises with Technology Innovations*), which previously allowed deduction of the employee education funds from the enterprise's taxable income for the part that is not in excess of 2.5% of the aggregate taxable wages.

Under Circular 63, with regard to deduction of the employee education funds, the portion that represents not more than 8% of the enterprise's total salaries and wages may be deducted when calculating its taxable income; and the portion that is in excess of 8% can be carried forward to the following years for further deduction, if any.

Circular 63 came into effect retroactively from 1 January 2015.

CHINA ADJUSTS CIGARETTE CONSUMPTION TAX

Effective from 10 May 2015, China has started to adopt the new consumption tax rate for cigarettes according to the *Circular of the Ministry of Finance and State Administration of Taxation on Adjusting the Cigarette Consumption Tax* (Caishui [2015] No. 60, "**Circular 60**"), which provides that:

- The rate of ad valorem duty on cigarettes at the wholesale stage shall be raised from 5% to 11%, and the specific duty shall be imposed at RMB0.005 per cigarette.
- Taxpayers who are engaged in both wholesale and retail of cigarettes shall calculate the sales volume and quantity of cigarettes at wholesale and retail stages separately. If such amounts are not separated, consumption tax shall be imposed at the wholesale stage based on the total sales volume and quantity of cigarettes.

We believe this new Circular 60 would pose considerable challenges to the tobacco industry not only due to the increased tax cost, but also a potential drop in sales in the market.

INFORMATION REPORTING ON FOREIGN INVESTMENT AND INCOME BY RESIDENT ENTERPRISES FURTHER CLARIFIED

Under the current PRC Enterprise Income Tax ("**EIT**") regime, PRC resident enterprises are subject to PRC EIT on their worldwide income. The State Administration of Taxation ("**SAT**") issued SAT Announcement [2014] No. 38 ("**Announcement 38**") on 30 June 2014 which sets out the requirements for the PRC resident enterprises to report their outbound investments and foreign-sourced income. Announcement 38 provides the applicable situations, information and documents to be provided for reporting, timeline, as well as the legal consequences for non-compliance.

Prior to the promulgation of Announcement 38, such reporting of outbound investment by PRC resident enterprises was covered under the related party transaction reporting as part of the enterprise's annual EIT filing requirements. With Announcement 38 coming into effect, new filing forms have been adopted by the SAT to collect information at both the quarterly provisional EIT filing and annual EIT filing stages.

Following the implementation of Announcement 38 and to reinforce the SAT's intention to improve cross-border tax collection and management, the SAT further clarified certain issues in relation to implementation of Announcement 38 by issuing Circular Shuizonghan [2015] No. 327, *Circular of the SAT on Implementing the Reporting of the Information on Foreign Investment and the Income by Resident Enterprises* ("**Circular 327**"). Circular 327 aims to provide clearer guidance on the filing requirements provided in Announcement 38 and to lessen the tax compliance burden on taxpayers.

Circular 327 was issued by the SAT on 18 June 2015 and has taken effect on the same date.

HONG KONG

IS HONG KONG A TAX HAVEN?

On 17 June 2015, the European Commission ("**EC**") released its action plan ("**Action Plan**") to reform the European Union ("**EU**")'s corporate tax framework in a move to improve the EU's corporate tax environment. One of the key areas for action is to further enhance the tax transparency within the EU and vis-à-vis non-EU jurisdictions. As an immediate first step of this item, EC has published together with the Action Plan a list of third country (i.e. non-EU) non-cooperative tax jurisdictions ("**Blacklist**"), which it said to be used for developing a common approach against external threats to the tax revenues of the EU member states. There are 30 jurisdictions on the Blacklist, and Hong Kong is one of them.

The jurisdictions on the Blacklist were identified by at least 10 EU member states as a non-cooperative tax jurisdiction in their own national blacklists. Hong Kong is included in the Blacklist as it is currently on the national blacklist of Bulgaria, Croatia, Estonia, Greece, Italy, Latvia, Lithuania, Poland, Portugal and Spain. Some criteria leading to a jurisdiction's inclusion in the national blacklists are "compliance with transparency and exchange of information standards", "absence of harmful tax measures" and "other criterion". However, it is never entirely clear as to the exact criteria that each of the EU member states had adopted in making their national blacklists.

The Hong Kong Government promptly issued a response statement on 18 June 2015, expressing its regret and disappointment over such inclusion. The Hong Kong Government seriously refuted the allegation of Hong Kong as a tax haven and stated that such allegation is "totally unfounded". It has mentioned a few grounds to defend Hong Kong as a tax cooperative jurisdiction:-

- Two phases of the peer review conducted by the Global Forum on Transparency and Exchange of Information for Tax Purposes ("**Global Forum**"), which were completed in 2011 and 2013 respectively, had duly recognised Hong Kong's commitment to meeting the international standard on tax transparency;
- Hong Kong has been continuously making effort in expanding its network of Comprehensive Avoidance of Double Taxation Agreements ("**CDTAs**") and standalone Tax Information Exchange Agreements ("**TIEAs**"). In particular, amongst the 28 EU member states, Hong Kong has signed thirteen (13) CDTAs and two (2) TIEAs, and negotiations on CDTAs/TIEAs with five (5) other EU member states are also under way. The Hong Kong Government noted that some of the EU member states which have featured Hong Kong on their national blacklist had actually signed or are negotiating CDTAs/TIEAs with Hong Kong; and
- In September 2014, Hong Kong indicated to OECD its support for implementing the new standard on Automatic Exchange of Financial Account Information in Tax Matters (AEOI). Such commitment was not only mentioned in the EC's Annual Report (April 2015) on Hong Kong, it was also one of the discussion items on the agenda for the annual EU-Hong Kong structured dialogue meeting held in Brussels in November 2014.

The response statement further added that Hong Kong has been denied any opportunity to comment on or clarify its position before the release of the Blacklist, and that the listing was "unilateral and procedurally unfair". The Hong Kong Government urged EC to review the Blacklist and stated that it would continue dialogue with the EU and its member states in this regard.

CONSTANT ACHIEVEMENT

In line with Hong Kong's determination to be a cooperative global citizen, the Hong Kong Chief Executive gave executive orders to implement the respective Comprehensive Agreements for the Avoidance of Double Taxation ("**CDTA**"s) with South Africa and the United Arab Emirates ("**UAE**") on 15 May 2015. On top of that, he also ordered to implement the notes exchanged between Hong Kong and Japan regarding the exchange of information ("**EOI**") article of the CDTA with Japan.

Hong Kong signed the CDTAs with South Africa and the UAE in October 2014 and December 2014 respectively. According to the Government spokesperson, the goal of such CDTAs is to not only achieve tax savings but also to help investors from South Africa and the UAE to clarify their tax liabilities when they engage in trade and investment activities with Hong Kong and vice versa.

Hong Kong exchanged notes with Japan in December 2014 in hopes of expanding the coverage of tax types under the EOI arrangement of the existing CDTA Agreement with Japan. This is a gesture by Hong Kong to further fulfill its obligation to meet global standards for enhancing tax transparency.

ROAD TO QUICKER RELIEF

The Board of Review ("**Board**") is an independent statutory body constituted under the Inland Revenue Ordinance to hear and determine appeals lodged by taxpayers. On 12 June 2015, the *Inland Revenue (Amendment) (No. 3) Bill 2015* was gazetted and the Bill seeks to amend the *Inland Revenue Ordinance (Cap. 112)* in order to improve the tax appeal mechanism and the efficiency and effectiveness of the Board in four general areas.

The proposals were made public and received positive acceptance in January 2014 from both the Legislative Council Panel on Financial Affairs and the Joint Liaison Committee on Taxation.

The key features of the Bill are as follows:

a) Allowing the taxpayer to appeal against the decision of the Board directly to the Court of First Instance (or the Court of Appeal, if leave has been granted to leapfrog) if the appeal is on a question of law. The main justification is to improve (i) time costs, (ii) legal fees, and (iii) the Board's capacity to hear other appeals.

b) Empowering the Board to issue directions on the provision of documents and to sanction non-compliance. This is to streamline the Board's proceedings by reducing the situations of late submissions and rescheduling of hearings.

c) Providing privileges and immunities to the Chairman, Deputy Chairman and other members of the Board, as well as other persons appearing before the Board. This is in line with the arrangement of other statutory appeal boards, such as Administrative Appeals Board and the Appeal Tribunal Panel (Buildings).

d) Raising the ceiling of costs to be paid by the appellant as may be ordered by the Board from HKD5,000 to HKD25,000, to strengthen the deterrent effect against frivolous tax appeals. The current ceiling has not been adjusted since 1993.

The legislative timetable for the First Reading and commencement of the Second Reading debate was on 24 June 2015 and the Resumption of the Second Reading debate, committee stage and the Third Reading is to be notified.

A TWIST TO TAXABLE DEDUCTIONS

On 28 May 2015, the Court of Appeal affirmed a decision of the Court of First Instance to the effect that license fees received by a non-Hong Kong resident from a Hong Kong taxpayer in respect of rights to exhibit television programmes outside Hong Kong was taxable in Hong Kong.

Let's explore the facts of this case. The appellant is a non-Hong Kong company registered under the *Companies Ordinance (Cap 622)* and carried on business in Hong Kong to provide products and services relating to general and family entertainment. The appellant was granted licences by Muse (a company engaged in the distribution of animation programming for television and other audio-visual businesses in Taiwan but did not carry on any business in Hong Kong) under two agreements, to exhibit four series of Mandarin language television programmes in Taiwan between 2005 and 2009. Under the agreements, the appellant was to pay Muse certain amounts of money under the category of 'licence fees'. In its Profits Tax Returns for the years of assessment 2005/06 to 2007/08, the appellant claimed an expense described as "amortization of licensed programming rights/subtitling costs" as an allowable deduction, which included the 'licence fees' paid to Muse. However, the Assessor was of the view that the licence fees received by Muse from the appellant should be chargeable to Profits Tax and requested the appellant to file Profits Tax Returns for Muse for the years of assessment.

As regards the licence fees, the appellant claimed that the amount was not taxable under the relevant section of the *Inland Revenue Ordinance (Cap 112)* ("**IRO**") which governs sums chargeable to tax for the right to use copyright material outside Hong Kong because it was not for the "use" of, or for the "right to use" any copyright material. The appellant further claimed that in any case, "media works" is excluded from the ambit of the section. The Court of Appeal did not support the appellant's contentions and held that the relevant section of the IRO does indeed govern "media works", that the licence fees paid was for the use of copyright material, and that since the appellant claimed deductions for the licence fees, such fees will become chargeable under the particular IRO section.

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