TAX NEWSLETTER

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EDITORIAL NOTE

Welcome to the first issue of Tax Newsletter in 2015! In this issue, we highlighted several legal and legislative developments in the PRC and Hong Kong that can potentially impact your business both in the short term and the long term.

In the PRC, the Ministry of Commerce (**MOFCOM**) issued a draft of the PRC Foreign Investment Law for public comments (**FIL**) on 19 January. While the FIL is still in draft form, it is clear that once adopted, the FIL's impact on foreign investment in the PRC will be far-reaching and comprehensive. Foreign investors should stay tuned and provide any input on the current draft to ensure that the final FIL addresses your needs. Within the same month, the Legislative Affairs Office of China's State Council also released a draft of the revised Tax Collection and Administration Law for public comments. Unlike the current law, a taxpayer will be allowed to defer tax payments in dispute until the appeal process is complete although it remains to be seen whether the proposed changes will survive subsequent reviews.

On the other hand, the State Administration of Taxation (**SAT**) released a significant announcement on 3 February, which sets forth detailed rules regarding the treatment of indirect transfers of assets and equity interests of PRC resident enterprises. This announcement introduces the concept of a "valid business purpose" for any transfer of China Taxable Assets. Transactions that occurred before 3 February 2015 but have not been reported to and processed by the tax authority will also be caught. Furthermore, the State Administration of Foreign Exchange (**SAFE**) promulgated a circular to actively support the development of cross-border e-commerce business and to monitor risks associated with online foreign exchange payment. This legislation will certainly motivate both businesses and consumers to use the online platform more often as the transaction limit will be increased coupled with a safer online environment.

In Hong Kong, the Financial Secretary announced the 2015-16 Budget in February. Specifically on salaries tax and profits tax, it was proposed that a one-off reduction of profits tax, salaries tax and tax under personal assessment for the year of assessment 2014-15 by 75%, capped at $20,000. Moreover, the Stamp Duty (Amendment) Ordinance 2015 was gazetted such that stamp duty is waived for the transfer of shares or units of all ETFs, with effect from 13 February 2015. It will be interesting to see how it influences trading of ETFs in Hong Kong.

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

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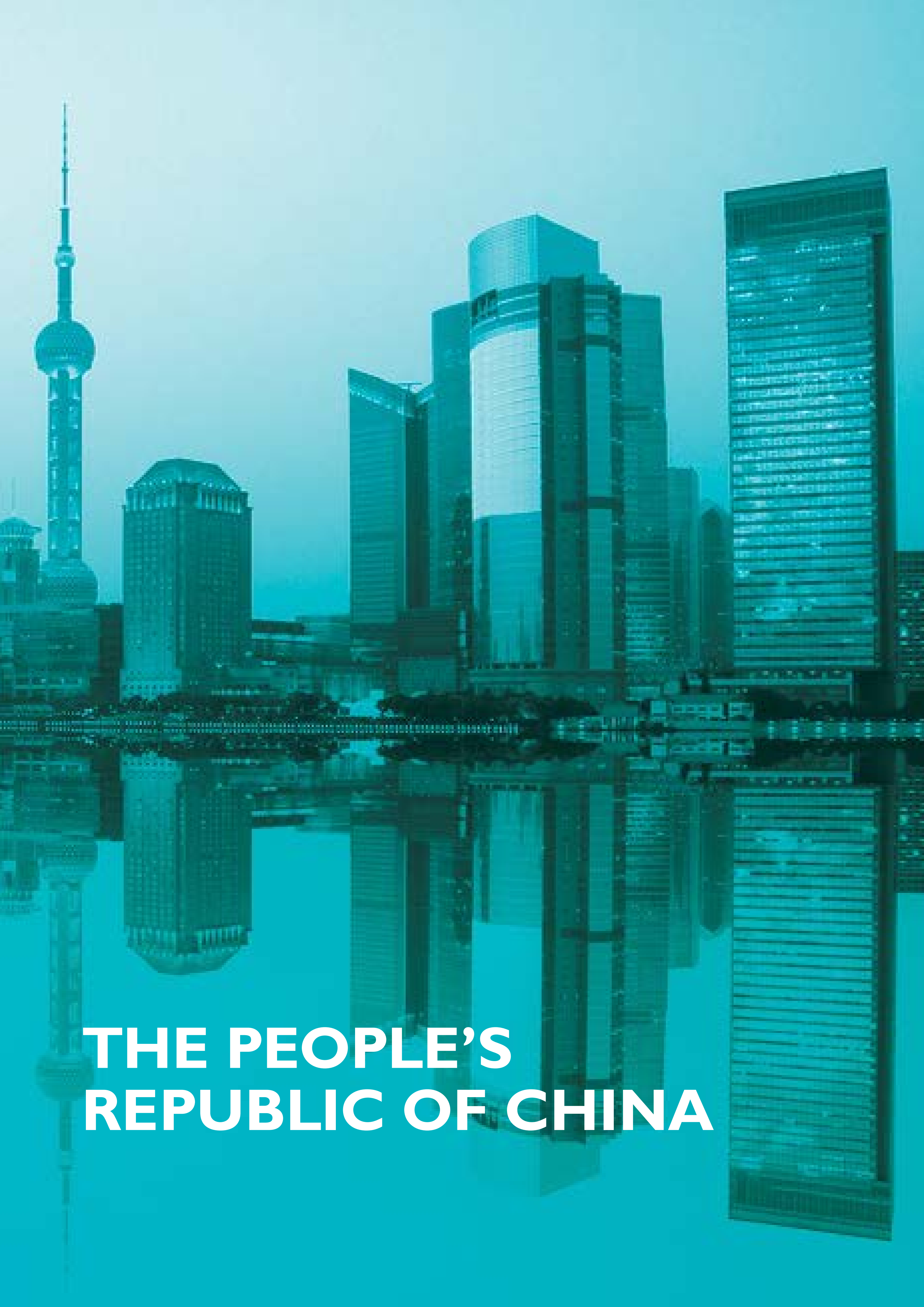

THE PEOPLE'S REPUBLIC OF CHINA

DRAFT FOREIGN INVESTMENT LAW

On 19 January 2015, Ministry of Commerce (**MOFCOM**) issued a draft of the PRC Foreign Investment Law for public comments (**FIL**). Below we highlight key features of the newly proposed foreign investment regime.

While the road to the actual passage of the FIL will likely take at least another eighteen months, it is clear that once adopted, the FIL's impact on foreign investment in the PRC will be far-reaching and comprehensive.

It is important to understand the FIL's key definitions in order to understand how they may impact foreign investment in China. For example, "Foreign Investors" refers to persons who do not hold Chinese nationality, enterprises established pursuant to the laws of other countries and regions, as well as government and organization of other countries. Any PRC enterprise that is under the control of a Foreign Investor will also be viewed as a "Foreign Investor". Adversely, "Chinese Investors" refers to persons of Chinese nationality, the Chinese government and its subordinated departments or agencies and any PRC enterprise which is under the control of a Chinese Investor. The FIL also defines "domestic enterprise" as any company established in the PRC, and "foreign invested enterprise" as a domestic enterprise solely or partially invested by Foreign Investors.

A key aspect of the FIL is the definition of what constitutes "control". Article 18 of the FIL provides quite an extensive definition of control including: the ability to appoint decision makers; influence over shares and voting rights which can affect the business; and, general influence over the operations, finance, personnel and technology of an enterprise. The legislative intent behind the FIL is not only to look at the place of incorporation and the nationality of investors, but also to establish who maintains control and whether that is by "Foreign" or "Chinese" investors.

The FIL covers traditional activities within the scope of foreign investment (e.g. green field investments and M&A), but it now extends to other areas such as the provision of financing for one year, the right to use domestic land, ownership of domestic properties and also control of a PRC enterprise through contracts and trusts. No doubt, the expansion of the types of activities that are considered foreign investment, especially offshore transactions, raises concerns for foreign companies, many of which have designed structures intended to provide flexibility and avoid entanglement in the PRC legal system.

Whilst the scope of activities covered by the FIL has been expanded, the PRC Government also intends to do away with the requirement for MOFCOM to approve all foreign investment activities in China. There will be, in its place, a dual system for market entry approval and reporting. The idea is that Foreign Investors in the PRC should be treated the same as Chinese Investors, unless otherwise stipulated in the Special Catalogue. Therefore, a Foreign Investor could go to the local Administration of Industry of Commerce and register a company just like a Chinese Investor. However, they would, unlike a Chinese Investor, be required to file a report to MOFCOM.

For Foreign Investors whose business falls within the Special Catalogue that is forbidden, restricted or encouraged industries, the procedures will remain largely the same as the current approval process for foreign investment. Market entry is granted to Foreign Investors based on impact on national security and whether the restricted conditions in the Special Catalogue are satisfied, amongst other aspects. In addition to approving or rejecting "restricted" foreign investment projects, the foreign investment authorities may issue an approval with specific conditions, such as divestment of certain assets, limits on shareholding percentage, operating term, geography and requirements on local employees.

However, if a foreign-invested company, which is ultimately controlled by a Chinese Investor, intends to engage in a restricted activity, the ultimate shareholder may apply to the foreign investment authorities to have its investment "deemed domestic investment". Presumably, such an investment would not then be considered a foreign investment and therefore not subject to restriction.

The FIL has also incorporated into the foreign investment legal framework a national security review process that reviews any foreign investment that looks to endanger, or may endanger, national security. The FIL provides a detailed outline of the procedures for the national security review process but will nonetheless introduce an element of uncertainty for foreign investment. The exact impact of such uncertainty will in large part be dependent on how the process outline will be implemented in practice.

It is also clear that under the FIL, variable interest entities (**VIEs**) which are contractual arrangements through which a foreign company gains control over a domestic company, would clearly be regarded as a type of foreign investment which would have to comply with the FIL. As such, the current rationale for implementing a VIE structure would likely no longer exist and it is likely that they would no longer be viable in many instances since contractual control would be treated the same as a foreign direct investment.

The FIL represents a new stage in the legal framework governing foreign investment activity in the PRC. While some elements can be viewed as a logical development and refinement of existing practices, others represent arguably a radical departure from the existing framework. It will be important for foreign investors to actively provide their views and input to try to ensure the final FIL adopted addresses any concerns they have on the current draft.

NEW DEVELOPMENTS ON INDIRECT TRANSFERS OF PROPERTIES BY FOREIGN INVESTORS

On 3 February 2015, the State Administration of Taxation (**SAT**) released the *Announcement on Issues concerning Enterprise Income Tax Treatment for Indirect Transfers of Assets by Non-resident Enterprises* (**Announcement 7**), which sets forth detailed rules regarding the treatment of indirect transfers of assets and equity interests of PRC resident enterprises. Some of the provisions in relation to the indirect share transfer of PRC resident enterprises under the famous Circular 698 would be repealed.

According to Announcement 7, where a foreign investor indirectly transfers China Taxable Assets (defined below) through an arrangement with no ***valid business purpose*** and mainly for avoidance of PRC income taxes, such indirect transfer should be re-characterized as a direct transfer of such ***China Taxable Assets*** and subject to PRC taxes on any gains so derived.

The following three types of assets are expressly defined as ***China Taxable Assets***:

- Assets owned by an establishment (e.g. a representative office) in China;
- Real properties in China;
- Equity interests of PRC resident enterprises.

For transactions that fall within the above scope, any of the seller, the buyer and the target PRC company may opt to report the offshore equity transaction to the PRC tax authority. Although the reporting is not mandatory, the relevant parties might have a strong incentive to conduct the reporting so as to secure a waiver or reduction of the potential penalties and punitive interests that may be imposed if the indirect transfer is deemed by the PRC tax authority as a direct transfer.

If the transaction is assessed to be in lack of a ***valid business purpose*** (except that specific exemptions apply according to Announcement 7) and thus be deemed to be a direct transfer, any capital gains derived by the seller from such transfer will be subject to PRC withholding tax. The buyer, as the withholding agent, is obligated to withhold any taxes due and pay the same to the tax authority.

Announcement 7 took effect since 3 February 2015 on the date of issuance. However, Announcement 7 also applies to transactions that happened before 3 February 2015 but have not been reported to and processed by the tax authority.

EXPOSURE DRAFT OF REVISED TAX COLLECTION AND ADMINISTRATION LAW RELEASED

On 5 January 2015, the Legislative Affairs Office of China's State Council released an exposure draft of the revised Tax Collection and Administration Law (**Draft Law**) for public comments. The Draft Law proposes various changes to the existing laws but the following are worth mentioning:

- **Introduction of an advance tax ruling regime** – A taxpayer may apply for an advance ruling with tax authorities for complicated transactions under consideration. The final ruling will be issued in writing. Furthermore, it will be binding on the requesting taxpayer unless facts change.
- **Deferred tax payment in tax administrative appeal** – Unlike the current law, a taxpayer will be allowed to defer tax payments in dispute until the appeal process is completed.

It remains to be seen whether these and other proposed changes will survive further reviews.

NOTICE REGARDING ENTERPRISE INCOME TAX TREATMENT FOR DEDUCTION OF FINANCIAL INSTITUTIONS' LOAN LOSS RESERVES

On 15 January 2015, the Ministry of Finance and State Administration of Taxation jointly released the *Notice Regarding Enterprise Income Tax Treatment For Deduction of Financial Institutions' Loan Loss Reserves* (**Notice**) to clarify deductibility of loan loss provisions in respect of financial institutions for enterprise income tax (**EIT**) purposes.

According to this Notice:

- Loan loss provisions in respect of financial institutions are allowed to be deducted for certain "loan assets", which include: a) loans (e.g. mortgage, pledge and secured loans); b) "risky assets" with loan characters (e.g. credit cards overdrafts, discounts, credit advance, import and export bills of exchange, inter-bank lending, finance lease receivable, etc.); and c) foreign loans on-lent by financial institutions which bear the repayment obligations.
- The formula of calculating the deductible loan loss provisions is determined in accordance with this Notice as below:
  (balance of those "loan assets" for which loan loss provisions are allowed at the end of this current year x 1%) – (balance of those loan loss provisions which were deducted at the end of the previous year).
- Financial institutions shall follow another tax circular Caishui [2015] No. 3 regarding the EIT treatment on loans in relation to agricultural industry or small and medium-sized companies.

This Notice took retroactive effect on 1 January 2014.

NEW CLASSIFICATION RULES GOVERNING ENTERPRISES ENTITLED TO EXPORT VAT REFUND/EXEMPTION

On 7 January 2015, the State Administration of Taxation (**SAT**) released the *Announcement of the State Administration of Taxation on Promulgating the Measures for the Classified Administration of Enterprises Subject to Export Tax Refund (Exemption)* (**Announcement 2**).

According to Announcement 2, all the enterprises entitled to export VAT refund/exemption will be classified into four categories and subject to different administrative measures. Those factors that will be considered in relation to the applicant taxpayers for such classification include net asset value of the previous year, credit rating result, co-operation with tax bureaus, soundness of the internal control systems, previous record of any violations, etc. All the enterprises entitled to export VAT refund/exemption should be classified by the in-charge State Tax Bureaus from Grade 1 (with the best credentials) to Grade 4 (with the worst credentials).

Different standards of administration measures apply to enterprises of different categories:

- Grade 1 enterprises only need to complete the online filings and do not need to submit the original vouchers for verification by the State Tax Bureaus;
- Grade 2 & Grade 3 enterprises should complete the online filings and submit the original vouchers and supporting documents for the tax bureaus' review;
- Grade 4 enterprises should complete the online filings, submit the original vouchers and supporting documents as well as the bank slips evidencing the receipt of foreign currencies for the tax bureaus' review.

The provincial-level State Tax Bureaus should be responsible for the above-mentioned classification (which will be revisited annually) and adoption of the administrative measures. This Announcement 2 took effect from 1 March 2015.

CHINA SAFE TO FURTHER LIBERALIZE THE FOREIGN EXCHANGE ADMINISTRATION FOR DIRECT INVESTMENT

On 13 February 2015, the State Administration of Foreign Exchange (**SAFE**) issued a Circular on *Further Simplifying and Improving the Direct Investment-related Foreign Exchange Administration Policies* (**Circular 13**), which will take effect on 1 June 2015.

With the gradual deepening of reforms on SAFE's administration system, SAFE will further liberalize its administration for direct inbound investment by foreign investors and direct outbound investment by Chinese investors. Among others, the most important change is that SAFE will delegate its authority to the banks to handle certain foreign exchange registrations for direct investment. Key points of Circular 13 are highlighted below:

- Foreign exchange registration for inbound foreign direct investment (**FDIs**) and outbound investment with SAFE will be replaced by foreign exchange registration with local banks.
- Cancellation of verification registration related to non-cash capital contribution by foreign investors.
- Cancellation of verification registration related to inbound acquisition of PRC shareholdings by foreign investors.
- Cancellation of foreign exchange recordal for outbound foreign re-investment.
- Cancellation of FDI's annual foreign exchange examination (but registration on equity status is still required).

CHINA FURTHER OPENS CROSS-BORDER PAYMENT SERVICES BY PAYMENT INSTITUTIONS TO SUPPORT CROSS-BORDER E-COMMERCE

The State Administration of Foreign Exchange (**SAFE**) promulgated a *Circular on Carrying Out Pilot Program for Cross-border Foreign Exchange Payment Services by Payment Institutions* on 20 January 2015 (Hui Fa 2015 No. 7, "**Circular**") to implement the nationwide expansion of the previous pilot program in five areas, including Shanghai, Beijing, Chongqing, Zhejiang Province and Shenzhen.

The Circular aims to actively support the development of cross-border e-commerce business and monitor risks associated with online foreign exchange payment. Specifically, SAFE allows payment institutions to provide foreign exchange receipt and payment as well as foreign exchange settlement and sales for both parties of the cross-border e-commerce transactions. Highlights of the Circular are as below:

- Increasing the payment limit of a single transaction from USD 10,000 to USD 50,000;
- Relaxing the restriction(s) imposed on the number of customer excess reserves accounts opened by the payment institutions;
- Regulating the relevant application procedures, e.g. payment institutions shall conduct registration with local SAFE before they can provide relevant payment services;
- Enhancing risk control, such that payment institutions are required to verify the authenticity of the relevant transactions; to keep proper record of the relevant information for five years for inspection and submit the requested data and information to SAFE on a timely basis.

The Circular came into effect upon promulgation and the previous circular regarding the pilot program would be abolished at the same time.

REVISED ADMINISTRATIVE MEASURES FOR TAX REGISTRATION RELEASED IN MARCH

The State Administration of Taxation (**SAT**) has passed the revised *Administrative Measures for Tax Registration* (**Revised Measures**) on 27 December 2014, which took effect from 1 March 2015 but would have a retroactive force since 1 February 2004.

Salient points of the Revised Measures are as follows:

- Contrary to previous registrations where each taxpayer would only have one tax registration certificate and two registration numbers with the respective in-charge state and local tax bureaus, the taxpayers would now have an unique tax registration number applying for state and local tax bureaus. The said tax registration number would indicate the district where the taxpayer is registered and its organizational code (or ID number for "individual industrial and commercial household" taxpayers).
- In principle, taxpayers shall perform tax registration within 30 days after obtaining its business license; and if business license is not applicable, then 30 days after obtaining the approval certificate, or 30 days after the relevant tax obligation arises.
- If application documents for a tax registration or an amendment of tax registration are in order, the tax bureau shall process and complete the application within the same business day and issue a new or updated tax registration certificate to the applicant taxpayer, or otherwise immediately inform the taxpayer as to the information or documents required to be supplemented or re-submitted.
- PRC tax authority would no longer issue separate certificates for tax withholding registrations. The new version of tax registration certificate shall bear its withholding matter, but the same taxpayer shall perform registration after 30 days after its withholding obligation arises.
- Taxpayers contemplate to perform business and operation activities in a location other than its registered district on a temporary basis shall apply for a tax certificate for outgoing operation for each location. The validity of this certificate will normally be 30 days but not longer than 180 days.

HONG KONG

2015/16 HONG KONG BUDGET: WHERE THE MONEY GOES?

On 25 February 2015, the Financial Secretary unveiled the 2015-16 Budget (the **Budget**). This year's Budget continues to focus on enhancing business competitiveness, improving people's livelihood and maintaining investor confidence. As a result, the Budget proposed the following main tax measures:

- ***Salaries tax and profits tax*** – The Financial Secretary proposed a one-off reduction of profits tax, salaries tax and tax under personal assessment for the year of assessment 2014-15 by 75%, capped at HKD 20,000. Profits Tax rate for corporations will remain at 16.5% and 15% for unincorporated businesses.
- ***Asymmetrical tax treatment faced by corporate treasury companies*** – The Inland Revenue Ordinance will be amended to allow, under specified conditions, interest deductions under profits tax for corporate treasury centres and a reduction in profits tax for specified treasury activities of up to 50%.
- ***Profits tax exemption for private equity funds*** – The government plans to table a bill in the Legislative Council to allow private equity funds to enjoy profits tax exemption currently only available to offshore funds. Further to the Financial Secretary's proposal in his 2013-14 Budget, the bill will allow such funds to conduct certain auxiliary business activities in Hong Kong as long as these do not amount to permanent establishment in Hong Kong. Funds will be allowed to hold Hong Kong properties as long as the value of the Hong Kong properties does not exceed 10% of the value of the total assets of the funds over a specified period of time.
- ***Others*** – The government will also consider extending the current scope of intellectual property rights qualifying for tax deductions and to promote aerospace financing in Hong Kong.

Please note that all of the above measures will require legislative amendments before coming into force.

CAN YOU PASS THE TAX RESIDENT CERTIFICATE TEST?

Previously, in order to obtain a Hong Kong tax resident certificate (**HKTRC**) and enjoy the benefits under any comprehensive double taxation agreements (**DTA**), Hong Kong-incorporated companies only needed to submit basic incorporation information to the Hong Kong Inland Revenue Department (**IRD**). With effect from 1 February 2015, companies incorporated both within and outside Hong Kong seeking to obtain a HKTRC are required to provide detailed information in the application form (IR-1313A). Evidently, the IRD is tightening its approach in assessing HKTRC application and requires the applicant to provide the following information:

- Name and address of the beneficial owner of the income concerned;
- Details of the business activities;
- List of staff in Hong Kong including their total remuneration;
- Place of management and control; and
- Principal bankers, bank accounts and their balance of cash in Hong Kong.

These factors will help the IRD to determine whether the applicant, in addition to satisfying the residence test, also fulfills conditions of the relevant DTA. The bottom line is that the IRD needs to be convinced of the company's beneficial ownership interests after evaluating the full picture of the companies' business operations and central management.

LONG-TERM INVESTMENT PURPOSE?

The Board of Review (the **Board**) of the Hong Kong Inland Revenue Department (**IRD**) reached a decision on 7 March 2014 concerning whether or not the profits obtained from the purchase and sale of the property should be subjected to profits tax.

If a property is classified as a trading asset, any profits obtained from the course of trading will be taxable whereas profits derived from the sale of a property that is classified as a capital asset will not incur tax. In this case, the Appellant contended that the profits derived from the sale and purchase of the property was not taxable because the intention at the time of acquisition was for long term investment, thus classifying the property as a capital asset. However, the IRD Assessor considered the property as trading asset in nature and the profits obtained should therefore be subjected to profits tax.

Ascertaining the intent of the Appellant at the time of acquisition of the property was an objective factual query of the person's subjective intent. The Appellant had the burden to prove her intention but she lacked the relevant information to support her own case. In fact, during cross examination of the Appellant, she evaded questions and could not properly prove that she had a sincere intent to hold the property for long term investment purposes. The Board also saw no evidence to prove that the Appellant had the financial ability to hold the property for long term.

The Board concluded that the Appellant acquired the property as a trading asset and therefore profits derived from the sale was taxable. The appeal was accordingly dismissed.

ETFS: NO MORE STAMP DUTY!

Further to our November/December Newsletter, where we discussed the proposed stamp duty waiver for Exchange Traded Funds (**ETFs**), the Stamp Duty (Amendment) Ordinance 2015 was gazetted on 13 February 2015 such that stamp duty is waived for the transfer of shares or units of all ETFs, with effect from 13 February 2015.

Previously, the stamp duty waiver for ETFs only applied to an ETF which tracked an index comprising no more than 40% of Hong Kong listed stocks. For those which did not fall within the scope of exemption, the seller and the purchaser each had to pay stamp duty at 0.1% of the value of the transaction. Hong Kong was the only city among the major international financial markets (such as Singapore, Australia, Mainland China, US and UK etc) which imposed a stamp duty on ETF transactions. This additional transactional cost had adversely affected the competitiveness and hindered development of the Hong Kong ETF market. This new waiver was introduced in hope of spurring the trading of ETFs in Hong Kong and fostering Hong Kong's position as an asset management centre.

According to the Hong Kong Stock Exchange website, a total of 26 ETFs are benefited under this new waiver, including the Tracker Fund of Hong Kong.

THE 2ND PROTOCOL TO THE DOUBLE TAXATION AGREEMENT BETWEEN HONG KONG AND VIETNAM

The Hong Kong Government confirmed that the 2nd Protocol to the comprehensive double tax agreement (**DTA**) between Hong Kong and Vietnam, which was signed in January 2014, has entered into force on 8 January 2015.

The 2nd Protocol only applies to the 2016/17 year of assessment and onwards.

The 2nd Protocol was signed to update the Exchange of Information Article (**Article**) in the DTA to ensure adherence to the OECD's latest standard. The Article requires either side, upon receipt of a request from the other, to exchange information even when there is no domestic tax interest involved.