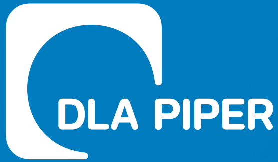

TAX NEWSLETTER

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EDITORIAL NOTE

Welcome to the latest issue of our Tax Newsletter. In the past two months, there are a number of developments in the tax world in the PRC and Hong Kong.

In the PRC, the State Administration for Industry and Commerce introduced a simplified deregistration procedure applicable nationwide, as opposed to the usual deregistration process with the company registration authorities which may take investors one year or more to complete. The relevant Guiding Opinions were released to detail various requirements. However, investors should still be aware that the practices may vary from different local authorities.

The Shanghai municipal government has recently issued and amended its policies in encouraging the establishment of regional headquarters ("**RHQs**"), which has lowered the threshold for the relevant certification requirements and introduced more benefits for RHQs. The new amendments took effect on 1 February 2017 and will be valid for 5 years.

The State Administration of Taxation ("**SAT**") laid out rules on the tax registration of representative offices of foreign non-government organizations ("**NGOs**"). Specifically, NGOs should conduct tax registration with the tax authority after registration with the public security authority.

The SAT reaffirmed its determination to improve the quality and efficiency of its advanced pricing arrangement ("**APA**") applications with its issuance of the annual APA report 2015. The report summarises the data for the years from 2005 to 2015 and sheds some light on the types of successful APAs.

The SAT released an *Announcement on the Timeline for Deducting the Land Price and Other Issues Concerning VAT Levying and Administration* to clarify matters in relation to tax circular Caishui [2016] No. 140 about VAT collection and administration in real estate development, education auxiliary service and finance service sectors.

What is more, the SAT and Ministry of Land and Resources issued an *Announcement of the State Administration of Taxation and the Ministry of Land and Resources on Several Matters relating to the Implementation of Preferential Policies on the Reform of Resource Tax* following various tax notices about the Resources Tax Reform, which covers major issues such as the preferential tax treatment for resources tax, its exceptions and its documentation requirements.

Last but not least, the State Administration of Foreign Exchange issued a *Circular on Further Advancing the Reform of Foreign Exchange Administration and Improving Examination of Authenticity and Compliance* to address capital and current account payments to further tighten outbound currency flow, whilst encouraging domestic enterprises to repatriate overseas funds back to the PRC.

In Hong Kong, a public consultation was carried out to discuss the requirement for companies to maintain a register of controllers. If the requirement becomes law, there is no need to go beyond looking at a company's own documents to trace its beneficial ownership.

As discussed in our previous issue of newsletter, the government is proposing a flat rate of 15% ad valorem stamp duty across all residential property transactions in a Stamp Duty (Amendment) Bill. This Amendment Bill was introduced into the Legislative Council on 8 February 2017 and would be subject to further debates before it becomes law.

The Departmental Interpretation and Practice Note No. 53 was issued with regards to the application of profits tax provisions relating to regulatory capital securities in the Inland Revenue (Amendment) (No. 2) Ordinance 2016. It clarifies the tax treatment of regulatory capital securities issued by financial institutions pursuant to the Basel III capital adequacy requirements.

The Hong Kong Institute of Certified Public Accountants and the Inland Revenue Department ("**IRD**") had their annual meeting at the end of last year and discussed about the issuance of the Certificate of Resident Status. The IRD reiterated its role to uphold the tax treaty and its consideration of beneficial ownership before issuing the Certificate of Resident Status.

Hong Kong entered into comprehensive agreements for the avoidance of double taxation ("**CDTAs**") with Belarus and Pakistan respectively on 16 January 2017 and 17 February 2017.

The 2017 – 2018 Budget was announced on 22 February 2017. Proposing a number of tax measures, in order to boost the economy and to improve Hong Kong's tax regime. One of the tax measures is to adopt a new dedicated tax regime to develop aircraft leasing business in Hong Kong and to acquire a bigger market share.

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

CHINA

POSSIBLE EASIER APPROACH TO EXIT CHINA – SIMPLIFIED DEREGISTRATION PROCESS

Foreign investors always have impression that it is not easy to liquidate or deregister a company in China. In some cases, the whole process could take the investor one to two years to complete, and paperwork and supplementary documents might be required to be provided from time to time during the application process.

In order to improve the administration efficiency in a market economy, the Chinese government has accelerated administrative reforms trying to cut off more red tapes in recent years. Among others, the State Administration for Industry and Commerce ("**SAIC**") introduced a simplified deregistration procedure which originally was implemented in certain areas (such as the Shanghai Pudong New Area and Shenzhen) on a trial basis and is now applicable nationwide.

Effective March 1, 2017, according to the *Guiding Opinions of the State Administration for Industry and Commerce on Comprehensively Advancing the Reform of the Simplified Deregistration of Enterprises* released in December 2016 ("**Guiding Opinions**"), qualified enterprises may opt to apply for deregistration by using the simplified deregistration procedures ("**Simplified Deregistration Procedures**") or to follow the usual deregistration process with the company registration authorities, namely, the AICs.

The highlights of this Guiding Opinions are as follows:

1. Qualified Enterprises

Under the Guiding Opinions, qualified applicants for adopting the Simplified Deregistration Procedures include limited liability companies, non-corporate enterprise legal persons, sole proprietorship enterprises and partnership enterprises that (i) have not carried out any business activity after obtaining a business license, or (ii) have no creditor's rights or debts or have settled all creditor's rights and debts before applying for deregistration, but are **NOT** among the following:

- foreign-invested enterprises subject to special administrative measures for market access;
- enterprises operating abnormally or having seriously breached the laws or are discredited enterprises;
- enterprises whose equities (investment interests) are frozen or pledged or have mortgaged movables;
- enterprises who are being placed on file for investigation or subject to any administrative enforcement, judicial assistance or administrative punishment;
- enterprises who have non-corporate branches that have not completed deregistration;
- enterprises who initiated the Simplified Deregistration Procedures before but failed to get through;
- enterprises for which approval prior to deregistration is required according to the laws, administrative regulations or decisions of the State Council;
- enterprises to which the Simplified Deregistration Procedure shall not apply otherwise.

2. Simplified Deregistration Procedures

Procedurally, the Simplified Deregistration Procedures shall operate as follows:

i. The enterprise should publicize its proposal for adopting the Simplified Deregistration Procedures and other required information via SAIC's official online system (except it is mandatorily liquidated or terminated by bankruptcy) for a period of 45 days.

ii. The enterprise may formally apply for adopting the Simplified Deregistration Procedures with the AIC upon expiry of the public announcement period, provided that no relevant interested party or governmental authority has raised objection via the online system.

iii. After completion a formality check and having verified the information submitted via the online system, AIC would issue its approval for applying the Simplified Deregistration Procedures within three working days after expiry of the announcement period if all requirements are satisfied.

3. Simplified Documentary Requirements

According to the Guiding Opinions, documents required by the AIC for completing the Simplified Deregistration Procedures include the completed standard AIC forms, business license of the company as well as an undertaking letter in AIC's format issued by all the investors to the company ("**Investor Undertaking Letter**"), and documents which are required by AIC under the normal deregistration procedures such as the liquidation report, shareholder resolutions, tax clearance certificate and evidence of newspaper announcement are no longer required.

4. Enterprises' Legal Liabilities to be Pursued

To ensure that the adoption of such a simplified procedure would not jeopardize the rights of the legitimate third parties, the Guiding Opinions provide for administrative, civil and even criminal liabilities applicable to false statements or fraudulent concealments by the investor(s) during the deregistration process, in the case of which, among other legal consequences (which could include civil or even criminal liabilities of the target and its investor(s)), the AIC is entitled to cancel the deregistration and resume the target's legal capacity to undertake the relevant legal liabilities. Even worse, the AIC could blacklist and discredit the enterprise which has seriously violated the laws.

In addition, the parties affected by such fraudulent conducts (e.g. creditors) may claim damages from the investor(s) of the enterprise through civil proceedings. In serious cases, the investor(s) of the enterprise may face criminal liabilities.

5. Our Observations

- Despite the promulgation of the Guiding Opinions, please be advised that enforcement practices and documents required by local AICs could vary by location, particularly during the initial period after the rules were newly promulgated.
- Please note that the Guiding Opinions were issued by SAIC only and it is not certain if and when other authorities (especially the tax authorities) will amend their respective deregistration/clearance procedures. According to our past experience, the tax clearance process is normally most time-consuming in an enterprise's deregistration process. As such, although the AIC may no longer require submission of the tax clearance certificate for completing the enterprise's deregistration procedures, we believe that timely completion of the tax deregistration procedures remains an important obligation of the enterprise as well as its investor(s) unless the other authorities including the tax authority issue supplemental circular to simplify the tax deregistration procedures as well.
- For purposes of the Investor Undertaking Letter, investor(s) should ensure that all creditor rights and debts (including tax liabilities) are settled before applying for the Simplified Deregistration Procedures. Furthermore, even if fewer documents will be required by the AIC for the deregistration under the Guiding Opinions, the applicant enterprise should ensure some key documents including resolutions, liquidation report and the relevant deregistration certificates issued by the local PRC authorities (such as the tax clearance certificate) be in place prior to applying for the Simplified Deregistration Procedures.

SHANGHAI ISSUES REVISED PROVISIONS ON ENCOURAGING MULTINATIONAL COMPANIES TO ESTABLISH REGIONAL HEADQUARTERS

For the past 15 years, Shanghai has been competing with other major PRC cities to attract multinational companies with extensive investments to make the city home for their regional headquarters ("**RHQs**"). By the end of 2016, 580 RHQs were established by multinational companies in Shanghai, many of them being Fortune 500 corporations.

The Shanghai municipal government has issued and amended its policies in encouraging the establishment of RHQs for several times. The previous amendments were issued in 2011 and expired on December 19, 2016 ("**2011 Rules**"). To further improve the environment for development of the RHQ economy to tackle new economic challenges, the Shanghai government released the *Provisions on Encouraging the Establishment of Regional Headquarters by Multinational Corporations* ("**2017 Amendments**") on January 27, 2017, which took effect on February 1, 2017 and will be effective for five years.

As compared with the 2011 Rules, the 2017 Amendments lowered the threshold for the relevant certification requirements and introduced more benefits for RHQs. In addition to the traditional RHQs, the 2017 Amendments introduced a new concept of "Headquarter Organizations" ("**HO**"), expanding the scope of entities which could be eligible to the preferential policies previously granted to RHQs by the Shanghai government.

Establishment Requirements and Certification Thresholds

Under the 2017 Amendments, an HO is defined to refer to a wholly foreign-owned enterprise ("**WFOE**"), or a branch office, which does not meet the requirements of being a RHQ, but carrying out functions of an RHQ including the provision of supporting services, such as management decision-making, capital management, procurement, sales, logistics, settlement, research and development and training services to enterprises under its management. Same as the 2011 Rules, an RHO is defined as a sole headquarter established in Shanghai through investment or authorization by a parent company incorporated outside China, which performs management functions and provides services to enterprises in a region consisting of more than one country.

As suggested in the definition above, unlike the RHQ, the HO under the 2017 Amendments include branch organizations established in Shanghai that do not necessarily need to have legal person status.

The certification threshold has been changed, as summarized below:

Applicable to a management company type of RHQ under the 2011 Rules, if not already an existing foreign investment holding company	*Applicable to an RHQ under the 2017 Amendments*	*Applicable to an HO under the 2017 Amendments*
(1) The applicant must be a WFOE with an independent legal person status.	Item (1), (3), and (4) remain unchanged under the 2017 Amendments.	(1) The applicant may either be a WFOE or a branch office.
(2) The foreign parent company shall have total assets of no less than USD 400 million.	For item (2), the total assets requirement on the parent company for service industries is reduced to USD 300 million.	(2) The parent company must have total assets of no less than USD 200 million, and must have already established no less than 2 foreign-invested enterprises in China, one of which must be located in Shanghai.

(3) (i) The total paid in registered capital by the parent company in all subsidiaries in China shall be no less than USD 10 million, and the total number of enterprises under management both inside and outside China from authorization of the parent company shall be no less than 3 enterprises; or (ii) the total number of enterprises under management both inside and outside China from authorization of the parent company shall be no less than 6. (4) The registered capital of the enterprise shall be no less than USD 2 million.		(3) The registered capital of the WFOE must be no less than USD 2 million. In the case of a branch, the operational funds allocated from the head company should be no less than USD 2 million.

More Flexibility in Provision of Services

Under the 2011 Rules, an RHQ is permitted to engage in the following operational, management and service activities:

(1) Decision making on investments and operations;

(2) Use of capital and financial management;

(3) Research and development, and technical support;

(4) Commodities purchase, distribution and marketing services;

(5) Supply chain management and other logistic operations;

(6) Sharing services within internal groups and outsourcing services of overseas companies;

(7) Staff training.

The 2017 Amendments do not have such a list of permitted activities, which may suggest that RHQs and HOs will have more flexibility to determine the services to be provided to the companies under its management.

Preferential Policies

The 2017 Amendments revised the preferential policies applicable to RHQs, and expanded the application of certain policies to HOs such as capital management, simplified exit and entry procedures, talent treatments, etc.

Certified RHQs and HOs may currently enjoy the following preferential policies, among others:

- Financial subsidies and rewards are applicable to RHQs on establishment cost and rental, business turnover and upgrade to higher level headquarters.
- RHQs and HOs may set up centralized fund management and operation of foreign exchange funds.

- Investment company type of RHQs are encouraged to set up finance companies to provide consolidated financing services for their domestic subsidiaries.
- RHQs and HOs are encouraged to conduct different cross-border RMB business activities, and to enhance capital usage efficiency through cross-border bidirectional RMB capital pools, consolidated collection and payment of current account cross-border RMB, and other channels.
- RHQs and HOs may enjoy simplified procedures for outbound payments in foreign exchange for non-trading items.
- Policies are available to RHQs and HOs to facilitate applications for visa, resident permits and working permits by their foreign employees.
- Policies are available to RHQs and HOs to facilitate the application of APEC business travel cards, passports, permits for travelling to Hong Kong, Macau and Taiwan by domestic employees.
- Domestic talents introduced by RHQs and HOs may acquire Shanghai household register if so qualified, and may enjoy convenience provided by the local district government in respect of school admission for children, medical treatment, and application for talent apartments, etc.
- Simplified procedures relating to customs and entry-exit inspection and quarantine are in place to facilitate import and export business of RHQs and HOs, which are encouraged to set up logistics distribution centers to consolidate the group logistics.
- District level government authorities are permitted for the first time to formulate preferential policies to support the development of RHQs and HOs within their jurisdictions.

These new policies would definitely be helpful to attract more quality multinational companies to conduct business in Shanghai.

SAT ISSUES NOTICE ON TAX REGISTRATION OF FOREIGN NGOS' REP OFFICE

On January 19, 2017, China's State Administration of Taxation issued a notice on handling tax registration of representative offices of foreign non-government organizations ("**Notice**").

According to the Notice, the representative offices ("**Rep Offices**") of foreign non-government organizations registered with the public security authority under the new NGO Law after January 1, 2017 should conduct tax registration with the tax authority after registration with the public security authority. The 18 digit unified social credit number of the Rep Offices will be registered as the taxpayer identification number with the tax authority.

The existing Rep Offices of foreign non-government organizations registered with the civil affairs authority must apply for new registration certificates with the public security authority and then update the relevant information with the tax authority before they could handle tax-related matters with the tax authority.

CHINA SAT ISSUES ANNUAL REPORT CONCERNING ADVANCED PRICING ARRANGEMENT FOR 2015

In December 2016, China's State Administration of Taxation ("**SAT**") issued the Annual Advanced Pricing Arrangement ("**APA**") Report for 2015 ("**2015 Report**"), which summarizes China's APA practice for the year of 2015 and reaffirms the PRC tax authority's determination to improve the quality and efficiency of APA applications in China.

According to the 2015 Report, the SAT concluded a total of 125 (76 unilateral and 49 bilateral) APAs for the years from 2005 to 2015, which means on average, about 10 to 13 unilateral and bilateral APAs were signed every year. The 2015 Report also indicates that 67% of the successful APAs were from the manufacturing sector and in relation to tangible products. Only about 15% of the successful cases were in relation to intangible transfer and use rights licensing, an another 18% of the successful cases were from the service sector. There was no successful case from the finance sector.

In addition, the 2015 Report indicates that it normally takes two years to complete a unilateral APA while a bilateral agreement can span more than three years. Please note that this timeline is counted starting from the date of submitting the formal application to the date of conclusion.

Because of the lack of public data and in-depth TP analyses, the *Transactional Net Margin Method* ("**TNMM**") was the methodology mostly adopted in the successful APA cases, i.e. around 78.4%.

Last but not the least, it is important to note that priority will be given to the following APA applications:

- cases where the applicants provide well prepared information and application documents;
- cases involving inter-company services, intangible transfer and licensing, and financing;
- cases where the *Resale Minus Method*, *Profit Split Method* or other *non-TNMM method* is used for pricing of the inter-company transactions.

FURTHER CLARIFICATION ON VAT COLLECTION AND ADMINISTRATION IN REAL ESTATE DEVELOPMENT AND FINANCE SECTORS

The State Administration of Taxation ("**SAT**") released an *Announcement on the Timeline for Deducting the Land Price and Other Issues Concerning VAT Levying and Administration* ("**Announcement 86**") on 24 December 2016 to clarify certain matters in relation to an earlier tax circular, namely Caishui [2016] No. 140 ("**Circular 140**") jointly issued by the SAT and Ministry of Finance about VAT collection and administration in real estate development, education auxiliary service and finance service sectors.

Announcement 86 cover the following key aspects:

- Real estate developers which have paid consideration for land use rights to the government or for the demolition compensation to other corporations or individuals, are allowed to deduct the relevant fees from the taxable revenue for VAT calculation purposes, so long as they have not been deducted in the past VAT filing periods. Such deductions shall be made from December 2016 under Announcement 86.
- VAT payers who had remitted VAT but later qualified for the VAT exemption or zero-rate items under Circular 140 would be allowed to deduct the relevant VAT payable from the taxable revenue in the subsequent months.
- Insurance companies engaged in co-insurance business shall issue VAT invoices as below:
  - Where the primary insurer enters into an insurance policy with a policy holder and thereafter enters another co-insurance contract with a co-insurer, the primary insurer shall issue the VAT invoice in respect of the full amount of premiums collected from the policy holder. On the other hand, the co-insurer shall issue the VAT invoice in respect of the amount of the co-insurance premiums to the primary insurer.
  - If the primary insurer and co-insurer enter into the insurance policies with the policy holder respectively, the primary insurer and co-insurer shall issue separate VAT invoices in respect of the respective amounts of premiums collected from the policy holder.
- When calculating the net land price for VAT deduction, the real estate developers shall exclude the land price representing the construction area of the underground parking from the total construction area.
- While VAT is exempted on immovable assets acquired as gifts or through inheritance, Announcement 86 waives the requirement on having the supporting documents notarized for the VAT exemption treatment.
- The arrangement for providing the rent free period to tenants will not be deemed as a sale of service for VAT purpose.

FOLLOW UP ON IMPLEMENTATION OF CHINA RESOURCES TAX REFORM

Subsequent to the promulgation of various tax notices about the Resources Tax Reform and the related preferential treatments, the State Administration of Taxation (**"SAT"**) and Ministry of Land and Resources issued *Announcement of the State Administration of Taxation and the Ministry of Land and Resources on Several Matters relating to the Implementation of Preferential Policies on the Reform of Resource Tax* ("**Announcement 2**") on 24 January 2017.

Below are some major issues under Announcement 2:

1. Resources extracted by way of filling mining may enjoy a 50% reduction on the resources tax payable while resources extracted from a depleting mine may enjoy a 30% reduction. The administration of the above preferential tax rate reduction treatments is subject to recordal.
2. Announcement 2 provides a more comprehensive definition and conditions for entitlement of the preferential tax treatments for the resources tax.

- For resources extracted by way of filling mining, the following conditions shall be met.
  - the filling shall be completed with advanced and applicable cement or paste;
  - the goaf shall be subject to full coverage of filling;
  - the underground aquifers and ecological environment at the earth's surface shall be subject to the required protection.
- For resources extracted from a depleting mine, they shall be extracted from a depleting mine with an actual extraction period of 15 years or longer.

3. Announcement 2 also provides a list of the required filling documents for taxpayers to apply the preferential treatments.
4. Announcement 2 does not apply to six items subject to the resources tax, namely crude oil, natural gas, coal, rare earth, tungsten and molybdenum. The preferential policies for these items shall still be subject to the prevailing regulations.

Announcement 2 takes immediate effect from 24 January 2017.

FOREIGN EXCHANGE OUTBOUND PAYMENTS FROM CHINA FURTHER TIGHTENED

Since the second half of 2016, China has been implementing various measures to tighten outbound capital and payment control to cope with the pressure of capital outflow and the shortage in foreign exchange reserve.

On 26 January 2017, the State Administration of Foreign Exchange (**"SAFE"**) issued the *Circular on Further Advancing the Reform of Foreign Exchange Administration and Improving Examination of Authenticity and Compliance* ("**Huifa [2017] No. 3**"). This Circular deals with capital and current account payments by further tightening outbound currency flow. At the same time, domestic enterprises are encouraged to repatriate their overseas funds back to China.

The following are highlights of the major changes introduced by this Circular.

1. Domestic export enterprises as borrowers could repay the relevant domestic foreign change loans with their foreign exchange proceeds received from goods export rather than by settlement of foreign exchange purchase.
2. Debts incurred under the "Onshore Security Offshore Debt" or "Nei Bao Wai Dai (内保外贷)" structure are now permitted to be repatriated back to and used in China. Under the previous regulations, such funds were not permitted to be used in China for making direct or indirect equity investments in China onshore entities or inter-company lending to China onshore entities, etc.

3. Threshold for domestic use of the deposits in the main foreign exchange account opened by multinational corporations under the *Centralized Operation of Foreign Exchange Funds of Multinational Corporations* has been increased from the previous 50% to 100% of the entity's average daily deposit balance of the past six months.
4. Foreign enterprises are allowed to settle foreign currencies in their foreign exchange accounts opened with domestic banks in pilot free trade zones. Please note that the use of the settled RMB in China Proper (as opposed to the pilot free trade zones) shall still follow the prevailing foreign exchange regulations for cross-border transactions.

This Circular also reiterates the important of complying to the current foreign exchange regulations in relation to outbound investments and inbound/outbound trade/service payments, as well as requiring banks to enhance examination of foreign exchange collection and payment, particularly in respect of verifying the authenticity of the relevant cross border transactions.

HONG KONG

A REGISTER OF CONTROLLERS FOR PUBLIC INSPECTION IN HONG KONG?

The Financial Action Task Force ("**FATF**") decreed that its member jurisdictions should focus on their efforts to combat money laundering and terrorist financing.

As a result, in late December 2016, the Hong Kong government responded to the call and released a 'Consultation Paper on Enhancing Transparency of Beneficial Ownership of Hong Kong Companies'. The two-month consultation ended on 5 March 2017. Subject to the views received, the government aims to swiftly introduce a bill into the Legislative Council in the second quarter of 2017 to require all Hong Kong private companies to maintain a register of beneficial owners and to allow law enforcement agencies to access such information when necessary.

It remains to be seen whether the register will be for public inspection.

Background

The current Companies Ordinance ("**CO**") focuses on the disclosure of legal ownership and does not require a non-listed company to ascertain, keep or file information about its ultimate beneficial owners. Therefore, it is indeed quite groundbreaking for Hong Kong to now introduce a register of beneficial owners.

Duty to Keep a PSC Register

The government proposes that all companies incorporated in Hong Kong (except listed companies regulated under the Securities and Futures Ordinance ("**SFO**") should keep and maintain a "Register of People with Significant Control" ("**PSC Register**").

An individual who meets one or more of the following conditions will have to be recorded in the PSC Register:

(a) directly or indirectly holding more than 25% of the shares;

(b) directly or indirectly holding more than 25% of the voting rights;

(c) directly or indirectly holding the right to appoint or remove a majority of directors;

(d) otherwise having the right to exercise, or actually exercising, significant influence or control; or

(e) having the right to exercise, or actually exercising, significant influence or control over the activities of a trust or a firm whose trustees or members satisfy any of the above conditions.

Public Inspection of PSC Register

The government proposes in its Consultation Paper that the PSC Register of a company should be available not only for its members and law enforcement agencies but also other members of the public.

Impact

Meeting the FATF standard on Transparency of Beneficial Ownership ("**Recommendation 24**") will undoubtedly involve changes in the current filing and disclosure requirements set out in the CO. Allowing law enforcement agencies easy access to PSC Register should bring positive outcomes in preventing money laundering and terrorist financing. However, given the need to strike a balance between transparency, privacy and business efficacy, our view is that the PSC Register should be maintained but should not be for public inspection. Public inspection is beyond the standard of Recommendation 24, it may expose personal information to unnecessary risks and may not bring substantive benefits to the overall AML regime.

As the two-month consultation ended on 5 March 2017, we should soon be able to know the final outcome especially in light of FATF mutual evaluation of Hong Kong's regime looming in 2018. Stay tuned.

FLAT RATE OF 15% AVD STAMP DUTY ON ITS WAY TO BECOME LAW

In order to cool down the property market, the government takes another round of demand-side management measures affecting the residential property market. A Stamp Duty (Amendment) Bill 2017 ("**Amendment Bill**") was announced on 4 November 2017, and gazetted on 27 January 2017. The Amendment Bill proposes to impose a flat 15% ad valorem stamp duty ("**AVD**") chargeable on residential property transactions which are concluded after 5 November 2017, as a replacement of the existing "doubled stamp duty" (i.e. Scale 1 AVD rates, "**DSD**"). The exemptions under the existing DSD regime will continue to apply under the new measures, that a Hong Kong permanent resident who do not own any other residential property in Hong Kong at the time of purchase is subject to the lower AVD rates at Scale 2, and the six-month refund mechanism will also be retained.

According to information provided by the Information Services Department, a government spokesman stated that except for specified exemptions, the new rate of 15% would apply to all transactions for residential property acquired by individuals or companies. The existing arrangement of applying DSD rates to nonresidential property transactions is not affected. "Our current policy is to accord priority to the self-use home ownership needs of Hong Kong permanent resident. Thus, the new measure will continue to adopt the exemptions provided for under the existing doubled ad valorem stamp duty regime, such that a Hong Kong permanent resident who does not own any other residential property in Hong Kong at the time of acquiring residential property will continue to pay AVD under the lower rates at Scale 2."

"To cater for the situation where a HKPR acquires a new residential property before disposing of his/her single residential property, [the Amendment Bill] also propose[s] to maintain the existing refund mechanism under the DSD regime for a Hong Kong permanent resident buyer who replaces his/her single residential property."

The Amendment Bill was introduced into the Legislative Council on 8 February 2017 and is subject to further discussions and debates.

DIPN 53

The Departmental Interpretation and Practice Note No. 53 ("**DIPN 53**") sets out the Inland Revenue Department's views on the application of profits tax provisions relating to regulatory capital securities in the Inland Revenue (Amendment) (No. 2) Ordinance 2016 ("**Amendment Ordinance**"). These provisions clarify the tax treatment of regulatory capital securities issued by financial institutions ("**FI**") to observe the Basel III capital adequacy requirements ("**Basel III Requirements**").

We set out below key concepts explained in DPIN 53:

1. **The Basel III Requirements:** Under the Basel III Requirements, FI must hold minimum regulatory capital. As a member of the Basel Committee, Hong Kong has implemented the Basel III Requirements through the Banking Ordinance and the Banking (Capital) Rules. To strengthen their regulatory capital, FI might issue Additional Tier 1 or Tier 2 capital instruments ("**AT1/T2 Instruments**") to investors.

2. **Regulatory Capital Securities:** Before the enactment of the Amendment Ordinance, AT1/T2 Instruments were not regarded as debt instruments. Their distribution was regarded as non-deductible appropriation of profit rather than a deductible interest expense. With the implementation of the Amendment Ordinance, a qualifying Regulatory Capital Security ("**RCS**"), which is defined to include AT1/T2 Instruments, will be taxed as if it were a debt instrument and therefore its payment (excluding repayment of principal) is to be treated as interest for deduction and taxation purpose.

3. **Transactions Involving Specified Connected Persons:** Noting that for distribution of RCS held by and for the benefit for a specified connected persons ("**SCP**") of FI and where the SCP does not fund the acquisition of RCS by corresponding external RCS, debenture or debt instrument, such distribution will be denied tax deduction. In any event, chargeable profits of SCP are to be determined as if fair value accounting were not generally acceptable accounting practice in relation to the RCS or part of the RCS.

4. **Arm's Length and Separate Enterprise Principles**: The arm's length principle provides that chargeable profits from a RCS transaction between FI and its associate will be determined with reference to the profits that would have accrued had the same transaction been carried out between parties who are not associates at arm's length terms. The separate enterprise principle sets out the basis for determining profits attributable to the Hong Kong branch of a non-resident FI with capital raised through the issuance of RCS. Under the principle, profits are to be attributed as if the Hong Kong branch were a distinct and separate enterprise. This is in effect an anti-abuse provision designed to limit excessive interest deduction claims in relation to RCSs.
5. **Special Holding Company of Authorized Institution:** The Hong Kong Monetary Authority might extend the Basel III Requirements to cover non-FI company incorporated in Hong Kong which is a holding company of FI. Provided that certain conditions are met, the RCS issued by those holding companies might be treated as debt securities for tax deduction purposes.

To know more about the application of the Amendment Ordinance, please refer to DIPN 53, available at http://www.ird.gov.hk/eng/pdf/e_dipn53.pdf.

RESIDENCY AND CERTIFICATE OF RESIDENCY

The Hong Kong Institute of Certified Public Accountants ("**Institute**") and the IRD had their annual meeting the end of last year, in which the Institute enquired about issues relating to the Certificate of Resident Status ("**Certificate**"). The Institute referred to item A4(g) of the 2015 annual meeting, where the IRD provided some factors that would be considered to determine whether a company's management and control is located in Hong Kong. The IRD added that it would also consider beneficial ownership.

The Institute noted that beneficial ownership may not always be interpreted in the same way by different countries. For example, the Mainland China does not follow the OECD guidelines on the interpretation of beneficial owner. Also, the residency requirement to qualify for a DTA benefit is not limited to the receipt of passive income only where beneficial ownership is considered. In some cases, beneficial ownership is irrelevant (e.g. where determining a permanent establishment under Article 5). Moreover, Commentary on Article 4 of the Model Tax Convention explains that the "place of effective management" has been adopted as the preference criterion to determine residency. The Institute believed that the factors considered by the IRD are consistent with the "place of effective management" test, and asked whether the IRD would consider having more emphasis on it rather than "beneficial ownership".

The Institute also asked how BEPS Action 6 – preventing the granting of treaty benefits in inappropriate circumstances – would affect the Hong Kong DTAs, and application for treaty benefits, and the application for the Certificate.

The IRD replied that the Certificate is issued to Hong Kong residents who required proof of resident status for the purposes of claiming tax benefits under the DTAs. The two matters involved are "Hong Kong resident" and "tax benefits". The IRD explained that it is committed to providing Hong Kong residents with assistance in claiming all tax benefits to which they are entitled under a DTA. Where it is clear that the person would not be entitled to those benefits, the IRD might refuse to issue a Certificate, because it is vitally important that the IRD upheld the terms and purpose of Hong Kong's DTAs.

The IRD explained that "beneficial ownership" is the pre-requisite for granting preferential tax treatment in the passive income articles of a DTA. If a person intends to claim benefits under those articles, that person has to demonstrate that all the criteria of the relevant articles, including "beneficial ownership" requirement, have been fulfilled, otherwise the Certificate may not be issued. The IRD's understanding of "beneficial ownership" given under the Commentary had been consistently followed by Hong Kong treaty partners. The general guideline is to make reference to the Commentary, and if a Hong Kong resident has been denied treaty benefits by the tax administration of the treaty partner, the Hong Kong resident may initiate the Mutual Agreement Procedure under the relevant DTA. According to the IRD, out of the 3,000 applications for Certificates in the previous year, less than 10% of applications were reject.

Regarding BEPS Action 6, the sample formulation of limitation-of-benefits provisions in the OECD Model Tax Convention and the specific anti-abuse rules in BEPS Action 6 were suggested to be applied to existing DTAs through multilateral instrument. The IRD would keep a close watch on the development.

PROPOSED DEDICATED TAX REGIME TO DEVELOP AIRCRAFT LEASING BUSINESS IN HONG KONG

The Panel on Economic Development of Legislative Council and the Secretary for Transport and Housing of Hong Kong discussed in depth on the new proposed dedicated tax regime for aircraft leasing businesses in Hong Kong on 23 January 2017.

Civil aviation is recognised as a long-term growth business. Globally, the demand for financing aircraft purchase is predicted to increase steadily. The objective of a dedicated tax regime is to attract aircraft leasing business to Hong Kong and to create a new professional service industry and job positions.

Hong Kong's existing tax regime for aircraft leasing business is not attractive when compared with Ireland (where aircraft leasing business was originated) and Singapore (one of Hong Kong's strongest competitors in the Asia Pacific region) due to the following reasons:

1. The current applicable tax rates for aircraft leasing business is higher (16.5% as oppose to Ireland's 12.5% and Singapore's 5% or 10%);
2. Aircraft lessors are not entitled to depreciation allowance on the costs of aircraft if the aircraft is leased to non-Hong Kong based airlines; and
3. Hong Kong has a smaller tax treaty network (36 tax treaties concluded as oppose to Ireland's 72 and Singapore's 84).

To tackle the abovementioned issues, the government proposed to:

1. Reduce the applicable tax rate to 8.25% (i.e. half the prevailing profits tax rate of 16.5%) for qualifying profits of qualifying aircraft lessors and qualifying aircraft leasing managers; and
2. Allow the taxable amount of rentals derived from leasing of an aircraft to a non-Hong Kong aircraft operator by a qualifying aircraft lessor to be 20% of the tax base, i.e. gross rentals less deductible expenses (excluding tax depreciation).

The government will also incorporate anti-abuse measures to protect the integrity of the profits tax system and cater for post-BEPS implementation:

1. Ensuring that the half-rate concession will apply to assessable profits in respect of which the corresponding payments made are not fully tax deductible in Hong Kong for preventing revenue loss;
2. Requiring qualifying aircraft lessors and qualifying aircraft leasing managers to be standalone corporate entities to prohibit loss shifting; ensuring that they conduct business transactions with associated parties on an arm's length basis; and
3. Requiring their central management and control as well as profit generating activities to be located in Hong Kong so as to ensure that they have commercial substance in Hong Kong, etc.

According to an analysis carried out by the Focus Group on Promoting Aerospace Financing, the forecast of bringing in the proposed tax scheme is very positive – Hong Kong could gradually capture up to about 18% of aircraft leasing business in the global aircraft leasing market in 20 years' time. Together with Hong Kong's many favourable conditions to develop aircraft leasing business, including well-established legal systems, well-developed markets and quality infrastructure, these changes can enhance Hong Kong's competitiveness among other financial leasing centres for sharing this growing global market.

It is likely that the government will realize its plans to introduce the relevant legislative amendments into the Legislative Council in around April 2017.

HONG KONG-BELARUS AND HONG KONG -PAKISTAN CDTAS SIGNED

The comprehensive agreement for the avoidance of double taxation ("**CDTA**") between Hong Kong and Belarus was signed on 16 January 2017. The CDTA between Hong Kong and Pakistan was signed on 17 February 2017.

They are respectively the 36th and 37th CDTA that Hong Kong has signed with a trading partner, showing the government's efforts in expanding Hong Kong's CDTA network. In particular, both Belarus and Pakistan are economies along the Belt and Road.

Under the CDTA, double taxation will be avoided in that any Belarusian/Pakistani tax paid by a Hong Kong company will be allowed as a credit against the tax payable in Hong Kong on the same profit, subject to the provisions of the tax laws of Hong Kong. Likewise, for a Belarusian/Pakistani company, the tax paid in Hong Kong will be allowed as a deduction from the tax payable on the same income in Belarus/Pakistan.

The CDTAs have also incorporated an article on exchange of information, enabling Hong Kong to fulfil its international obligations on enhancing tax transparency and combating tax evasion.

The CDTAs will come into force only after the completion of ratification procedures by both contracting parties.

2017 – 2018 BUDGET

The Financial Secretary Paul Chan announced the Hong Kong 2017 – 2018 Budget on 22 February 2017 (the "**Budget**"). In an attempt to boost the economy and to review Hong Kong's tax regime, a number of tax measures, both one-off and recurrent, were proposed.

Like past tax years, the Budget proposed measures covered:

1. **Reducing profits tax, salaries tax and tax under personal assessment for 2016/17:** A one-off reduction is proposed for assessment year 2016/2017 by 75%, subject to a ceiling of $20,000 per case. For profits tax, the ceiling is applied to each business. For salaries tax, the ceiling is applied to each individual taxpayer; except for jointly assessed couples whereas ceiling is applied to each couple. For personal assessment, single taxpayers will each be subject to the ceiling; whereas for married couples, the ceiling will apply to each couple. Noting that the proposed reduction will only be applicable to the final tax but not provisional tax for the year of assessment 2016/17.
2. **Waiving government rates for 2017/2018:** The proposed waiver is for four quarters of assessment year 2017/18, capped at $1,000 per quarter for each ratable property.
3. **Increasing disabled dependent allowance and dependent brother or sister allowance:** The disabled dependent allowance is proposed to be increased from $66,000 to $75,000 and the dependent brother or sister allowance from $33,000 to $37,500, effective from the year of assessment 2017/18.
4. **Raising the deduction ceiling for self-education expenses:** The ceiling is proposed to be increased from $80,000 to $100,000.
5. **Extending the entitlement period for home loan interest deduction**: It is proposed that the entitlement period be extended from 15 to 20 years of assessment commencing from assessment year 2017/18. Noting that current deduction annual ceiling of $100,000 will be maintained.

In addition, the Budget proposed new marginal tax bands for salaries tax:

6. **Increasing the width of marginal tax bands for salaries tax:** The marginal tax bands will be widened from HK$40,000 to HK$45,000, effective from assessment year 2017/2018 until superseded.

	Net Chargeable Income		**Rate**
	Present (2016/2017)	Proposed (2017/2018)	
First	$40,000	$45,000	2%
Next	$40,000	$45,000	7%
Next	$40,000	$45,000	12%
	$120,000	**$135,000**	
Remainder			17%

Looking forward, the Government is examining the possibility to offer profits tax concession to aircraft leasing and financing industry (see *Proposed Dedicated Tax Regime to Develop Aircraft Leasing in Hong Kong* on page 16 of this Newsletter), profits tax exemption to onshore privately-offered open-ended fund companies and tax deduction for the purchase of regulated health insurance products. On a broader perspective, the Financial Secretary proclaimed his plan to set up a tax policy unit in the Financial Services and the Treasury Bureau in order to examine the international competitiveness of the tax regime in Hong Kong and to address the problem of narrow tax base. We are excited to see the upcoming development.

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