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In this Issue

1. **Anti-avoidance and Transfer Pricing**
   - 1.1 China Issues Long Awaited Indirect Transfer Regulation Replacing Notice 698
   - 1.2 Internal Government Guideline on Indirect Transfers
   - 1.3 Shandong Case: Innovative but Questionable Tax Collection Approach for Indirect Share Transfers
   - 1.4 Bulletin 16: China Makes a Pre-Emptive Strike against BEPS!
   - 1.5 Zhejiang Case: Transfer Pricing Adjustments to Outbound Royalty Payments
   - 1.6 Shandong Case: China's First Controlled Foreign Corporation Anti-avoidance Case
   - 1.7 Jiangxi Case: Loans Treated as Dividends for Withholding Tax Purposes
   - 1.8 An Anti-Avoidance Case Against Foreign Individuals
   - 1.9 China Releases its 2013 APA Annual Report
2. **Corporate Restructurings**
   - 2.1 New PRC Tax-Free Restructuring Rules
   - 2.2 Preferential Deed Tax and Land Appreciation Tax Policies for Corporate Restructurings
3. **Tax Treaties**
   - 3.1 Fourth Protocol to the China-Hong Kong Double Taxation Arrangement Signed
   - 3.2 Qingdao Case: Tax Authorities Retrospectively Revoke Approved Treaty Benefits
4. **Individual Income Tax**
   - 4.1 New Guidance on IIT Treatment of Share Transfers by Individuals
   - 4.2 China Clarifies IIT Treatment of In-kind Contributions by Individuals
5. **Miscellaneous**
   - 5.1 China's Central Government Urges Clean Up of Local Subsidies and Tax Incentives
   - 5.2 China Enforces Taxation of Previous QFII and RQFII Transactions
   - 5.3 Proposed Amendments to the Tax Collection and Administration Law
   - 5.4 Draft Foreign Investment Law: Issues from a Tax Perspective

In this midyear issue of the China Tax Monthly, we present the most interesting and most important regulatory changes and administrative cases from the first six months of 2015. Two major trends are worthy of note. First, the PRC tax authorities are continuing to strengthen transfer pricing enforcement and anti-avoidance practice. Second, though cross-border restructurings still face challenges, China offered various preferential tax policies to domestic corporate restructurings during the first half of the year. Other major tax developments in the past six months include the taxation of share transfers and in-kind contributions by individuals, amendments to the China-Hong Kong Double Taxation Arrangement, the clean-up of local subsidies and tax incentives, taxation of previous QFII and RQFII transactions, proposed amendments to the Tax Collection and Administration Law and proposed amendments to the foreign investment law.

1. Anti-avoidance and Transfer Pricing

1.1 China Issues Long Awaited Indirect Transfer Regulation Replacing Notice 698

In late 2009, the PRC tax authorities issued their most influential and also most controversial anti-avoidance tool, Notice 698[1], to combat indirect transfers designed by offshore investors to avoid paying the 10% capital gains tax on the direct transfer of equity interests in Chinese resident enterprises. On February 6, 2015, the State Administration of Taxation ("**SAT**") finally released the long-awaited replacement rules for Notice 698 ("**Bulletin 7**")[2]. While, as expected, Bulletin 7 provides a safe harbor for intragroup reorganizations, Bulletin 7 introduces many other significant and controversial measures, such as imposing a withholding obligation on offshore buyers potentially before the tax authorities have even determined taxability, expanding the scope to tax indirect transfers of real

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1 *State Administration of Taxation's Notice on Strengthening the Administration of Enterprise income Tax on Income From Transfers of Equity Interests by Non-resident Enterprises*, Guo Shui Han [2009] No. 698, dated 10 December 2009, retroactively effective as of 1 January 2008. For a detailed discussion of Notice 698, please refer to the February 2010 issue of our Client Alert.

2 *State Administration of Taxation's Bulletin on Several Issues of Enterprise Income Tax on Income Arising from Indirect Transfers of Property by Non-resident Enterprises*, SAT Bulletin [2015] No. 7, dated 3 February 2015, effective as of the same date.

properties and properties owned by an "establishment or place"[3], deeming certain indirect transfers as lacking reasonable commercial purpose without going through a more full analysis and requiring sellers to pay tax while imposing penalties even before the tax authorities have determined whether the underlying transaction is taxable.

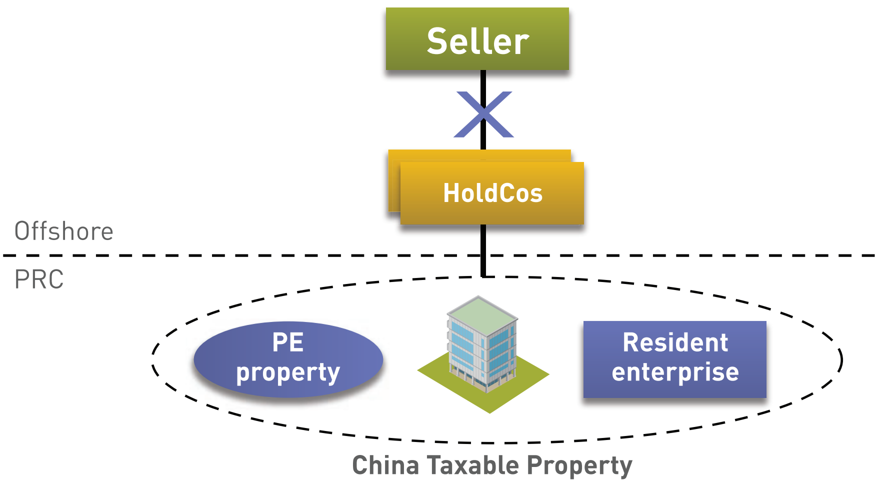
Transactions affected by Bulletin 7

Multinational corporations ("**MNCs**") engaging in cross-border M&A transactions and intragroup reorganizations involving China are expected to be significantly affected by Bulletin 7. Previously, Notice 698 only covered the indirect transfer of equity interests in Chinese resident enterprises. Bulletin 7 now extends to indirect transfers of: (i) the property of an "establishment or place" situated in China; (ii) real property situated in China; and (iii) equity interests in Chinese resident enterprises ("**China Taxable Property**[4]").

An indirect transfer of China Taxable Property refers to a transaction where a foreign company transfers equity interests in a foreign enterprise ***and other similar interests*** that in turn directly or indirectly holds China Taxable Property. Notably, Bulletin 7 for the first time covers the transfer of interests other than equity interests. This may mean that under Bulletin 7, the transfer of partnership and other forms of interests could be subject to tax in China as the transfer of equity interests does.

A typical indirect transfer is depicted in Diagram One below.

Diagram One



Bulletin 7 is effective from 3 February 2015, but it also applies to indirect transfers that occurred before 3 February 2015 but have not received tax

3 "Establishment or place" is a domestic concept which is analogous to the treaty concept of permanent establishment.

4 China Taxable Property is defined as property directly held by a non-resident enterprise and whose transfer results in enterprise income tax liability for the non-resident enterprise in accordance with PRC tax law.

assessment from the tax authorities. Since the general anti-avoidance rule ("**GAAR**") was first introduced in the Enterprise Income Tax Law ("**EIT Law**")[5] on 1 January 2008, any cross-border M&A transaction or restructuring implemented on or after 1 January 2008 but that has not received formal tax assessment from tax authorities under Notice 698 could technically be covered by Bulletin 7 and may be subject to tax pursuant to Bulletin 7.

What is reasonable commercial purpose?

According to Article 1 of Bulletin 7, an indirect transfer shall be recharacterized as a direct transfer of China Taxable Property and subject to Chinese tax if:

- a non-resident enterprise transfers equity interests in an intermediate holding company or other similar interests that directly or indirectly holds China Taxable Property;
- the result of the transfer is in substance the same as or similar to the direct transfer of the China Taxable Property;
- the transfer is conducted by the non-resident enterprise through arrangements lacking reasonable commercial purpose; and
- the non-resident enterprise avoids enterprise income tax ("**EIT**") liability through the transfer.

Article 3 of Bulletin 7 now provides a list of factors to determine whether the indirect transfer lacks reasonable commercial purpose. The first few factors listed still heavily focus on economic substance, such as whether all or most of the value of the offshore holding company's equity is directly or indirectly derived from Chinese property; whether all or most of the assets of the offshore holding company comprise of direct or indirect Chinese equity investments; and whether all or most of the revenue of the offshore holding company is sourced from China. However, it is welcome to see that some factors such as the functions performed and risks assumed by the offshore holding company, and the substitutability of indirect transfer and direct transfer, have taken into account commercial purposes other than economic substance. The totality test approach under Article 3 seems to allow taxpayers more room to argue for reasonable commercial purpose even when the offshore holding company does not have sufficient economic substance.

However, Article 4 of Bulletin 7 provides that certain indirect transfers shall be ***deemed*** to lack reasonable commercial purpose without a further Article 3 type analysis if:

(1) 75% or more of the value of the offshore holding company's equity is derived from Chinese property;

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5 *Enterprise Income Tax Law of the People's Republic of China*, adopted March 16, 2007, effective from January 1, 2008.

(2) 90% or more of the total assets (excluding cash) of the offshore holding company are direct or indirect investments located in China, or 90% or more of the revenue of the offshore holding company is sourced from China;

(3) the offshore holding companies perform limited functions and assume limited risks that are insufficient to prove its economic substance; and

(4) the foreign income tax payable on the indirect transfer is lower than the possible China tax payable on the direct transfer.

From a technical perspective, we believe that above characteristics should only been considered factors for deciding when an indirect transfer investigation is warranted. Further review on whether a transaction ultimately has reasonable commercial purpose should be conducted to determine its taxability. Unfortunately, Article 4 is structured to deem a lack of reasonable commercial purpose without a more comprehensive analysis of all factors.

Safe harbors

One major criticism of Notice 698 has been that it is overly broad. Many legitimate transactions with reasonable commercial purposes, particularly intragroup reorganizations, have been held up or even caught by Notice 698. Multiple draft versions of Bulletin 7 have addressed this criticism by including a safe harbor for intragroup reorganizations. Under Bulletin 7, intragroup reorganizations are exempt from EIT if:

(1) the shareholding relationship[6] between the transferor and the transferee meets any of the following:

 a. the non-resident transferor holds directly or indirectly more than 80% of the equity of the transferee,

 b. the transferee holds directly or indirectly more than 80% of the equity of the non-resident transferor, or

 c. the same party holds directly or indirectly more than 80% of the equity of the non-resident transferor and transferee;

(2) the China tax burden on any subsequent indirect transfer conducted after the indirect transfer in question would not be less than the China tax burden on the same or a similar indirect transfer if it were conducted before the indirect transfer in question; and

(3) the transferee pays all consideration in equities (exclusive of equities in listed enterprises) of the transferee itself or its controlled enterprises.

6 The shareholding percentage shall be 100% if 50% or more of the value of the offshore holding company's equity is directly or indirectly derived from real property situated in China.

Though the safe harbor for intragroup reorganizations is welcome news for MNCs, there are still some uncertainties. For example, it is unclear whether an intragroup reorganization will qualify for the safe harbor if no consideration is paid. There are also debates on whether a spin-off will qualify for the safe harbor.

Besides the intragroup reorganization safe harbor, Article 5 provides additional safe harbors in the following two situations:

- The income from the indirect transfer would have been exempt from EIT in China in accordance with applicable tax treaties if the indirect transfer had been conducted as a direct transfer; and
- The non-resident enterprise buys and then sells, in the public securities market, the equity interests in a single foreign, listed company.

One key question that will likely be debated for years to come is whether the elements of a safe harbor, even if a taxpayer falls short of the precise standards, would still be of relevance in assessing reasonable commercial purpose under Article 3.

Recharacterization

Once an indirect transfer is found lacking reasonable commercial purpose and no safe harbor applies, the indirect transfer will be recharacterized and taxed as follows:

- the gain from an indirect transfer of the property of an "establishment or place" situated in China will be treated as income that is effectively connected with that "establishment or place" and subject to 25% EIT;
- the gain from an indirect transfer of real property situated in China will be treated as China-sourced income and subject to 10% withholding tax; and
- the gain from an indirect transfer of equity interests in Chinese resident enterprises will be treated as China-sourced income and subject to 10% withholding tax.

Under the EIT Law, a non-resident enterprise is subject to 25% EIT only on its income effectively connected with its "establishment or place" in China, and a non-resident enterprise without an "establishment or place" in China can be taxed only on its China-sourced income at 10%. Under Bulletin 7, when taxing an indirect transfer of property of an "establishment or place" situated in China, the capital gains derived by an offshore seller are included in the taxable income of the "establishment or place". Article 1 of the EIT Law provides that only enterprises who obtain revenue are taxpayers for EIT purposes. Since the "establishment or place" of a foreign company does not obtain any revenue in an indirect transfer, it is questionable whether Bulletin 7 or even the GAAR can authorize such treatment.

A major disappointment from the final version of Bulletin 7 is that the provisions addressing tax basis in previous draft versions were deleted. While seeming to be an area that should have been easily addressed with little to no downside for China, the deletion once again introduces uncertainty of whether the tax authorities will recognize the tax paid in prior indirect transfers when determining the tax basis in subsequent direct or indirect transfers.

Withholding obligation for offshore buyers

Bulletin 7 now provides that the payors, without distinguishing between payors that are resident enterprises and payors that are non-resident enterprises, have a withholding obligation on indirect transfers of real property situated in China and equity interests in Chinese resident enterprises. Article 8 of Bulletin 7 appears to suggest that if neither the withholding agent nor the offshore seller withholds or pays the taxes due, the PRC tax authorities may impose a penalty ranging from 50% to three times the amount of the unpaid tax on the withholding agent.

The problem is that offshore buyers in most instances are not able or in a position to determine whether the indirect transfer is taxable in China. Except in limited situations described in Articles 4 to 6, a review and analysis on whether a transaction has reasonable commercial purpose must be conducted to determine an indirect transfer's taxability.

In addition, like Notice 698, Bulletin 7 still does not put an obligation on the tax authorities to issue a formal decision on the taxability of the transaction. Therefore, a buyer who in good faith agrees with the seller that a transaction has reasonable commercial purpose and decides to not withhold taxes must still operate under the threat that the transaction could be recharacterized at any time during the next 10 years, which is the statute of limitation for anti-avoidance cases. In the worst-case scenario, tax authorities might simply hold offshore buyers liable for the seller's unpaid taxes by imposing a penalty on the offshore buyers for indirect transfers incurred after 1 January 2008. The interest of buyers and sellers will be challenging to align, as the risk for a buyer who is ultimately "wrong" has become much higher.

Reporting requirements

Previously, Notice 698 required a seller to report an indirect transfer of a Chinese resident company to the Chinese tax authority. Instead, under Bulletin 7, both buyers and sellers of an indirect transfer, and the underlying Chinese subsidiary, may voluntarily report the transfer by submitting a standard set of documents to the in-charge tax authority.

The documents required to voluntarily report the indirect transfer include: (i) equity transfer agreement, (ii) corporate ownership structure charts before and after the equity transfer, (iii) prior two years of financial and accounting statements for all intermediate holding companies, and (iv) a statement that the indirect transfer is not taxable. These documents are required for any voluntary report of an indirect transfer, including intragroup reorganizations that qualify for the safe harbor.

Although reporting is voluntary, the offshore buyer still has a strong incentive to report within 30 days from the date when the equity transfer contract or agreement is signed in order to secure a potential exemption from or reduction in future penalties for any failure to properly fulfill the withholding obligations on the transfer. Voluntary reporting by the offshore seller will also exempt it from the additional 5% punitive interest levy.

In addition to the voluntary reporting regime, Bulletin 7 empowers the in-charge tax authorities to request various documents from buyers and sellers of an indirect transfer, and the underlying Chinese subsidiary. The documents subject to request have a broad and unclear coverage and include all decision-making and "implementation processes" information for the whole arrangement relating to the indirect transfer.

Timing of making tax payments

Under Notice 698, the offshore seller was only obligated to pay tax when the tax authorities issued an assessment notice that recharacterized the indirect transfer. Bulletin 7 imposes an obligation on the offshore seller to file a tax return and pay tax within seven days from the date when the tax liability arises[7] if the withholding agent fails to withhold the tax.

If the offshore seller fails to pay tax in full within the prescribed time limit, the offshore seller is subject to a daily interest rate equal to the benchmark rate published by the People's Bank of China plus 5%. The additional 5% punitive interest charge will be waived if the offshore seller voluntarily reports to the tax authorities as described above.

For the indirect transfer of the property of an "establishment or place" situated in China, the "establishment or place" must include the capital gains in its tax taxable income of the tax year. It is unclear whether the "establishment or place" will be imposed a 0.05% daily late payment interest and a penalty ranging from 50% to five times the amount of the unpaid tax if the "establishment or place" fails to include the capital gains from an indirect transfer into its EIT returns.

The key problem with this approach is that in most cases the offshore seller and the "establishment or place" are not able to determine whether the indirect transfer is taxable in China within the prescribed time limit and the tax bureau has no obligation to make a determination on taxability.

What actions should MNCs consider?

Bulletin 7 will significantly influence how cross-border M&A deals are negotiated and conducted in China. In response to Bulletin 7, MNCs should consider the following actions to safeguard their interests in China:

- Review any open tax positions on indirect transfers that occurred on or after 1 January 2008;

7 Bulletin 7 now explicitly provides that the tax liability arises at the later of (i) the equity transfer contract/agreement taking effect or (ii) the change in equity ownership of the target company being complete.

- Negotiate and draft contractual terms for offshore share purchase agreements in light of the Bulletin 7;
- Weigh the costs and benefits of voluntary reporting and tax withholding for each transfer;
- Evaluate the qualifications for the safe harbors;
- Maintain detailed documentations to defend the reasonable commercial purpose and economic substance of indirect transfers;
- Look at each transaction holistically to include history of the entities, substance, functions, as well as availability of potential for treaty protection; and
- Respond to investigations and informal inquiries from tax bureaus with great care and involve an experienced tax advisor at the earliest stage to increase the chance for a successful outcome.

1.2 Internal Government Guideline on Indirect Transfers

On 13 May 2015, the SAT issued Shui Zong Fa [2015] No. 68 ("**Notice 68**"), which is an internal government guideline addressing the implementation of Bulletin 7. For a detailed discussion of Bulletin 7, please refer to Section 1.1 above.

Notice 68 clarified several issues on the implementation of Bulletin 7 and establishes procedures for implementing Bulletin 7.

Voluntary reporting encouraged

According to Notice 68, all tax authorities should encourage and assist parties to voluntarily report indirect transfers in accordance with Article 9 of Bulletin 7. Also, Notice 68 officially clarifies that the in-charge tax authority receiving such voluntarily report of an indirect transfer should timely issue a written receipt.

Despite this progress, the tax authorities still have no obligation to confirm the taxability of an indirect transfer. In other words, taxpayers and withholding agents still face uncertainty over the taxability of an indirect transfer for the 10-year statute of limitation period on anti-avoidance cases.

Tax authorities to proactively identify indirect transfers

Even if an indirect transfer is not voluntarily reported, the tax authorities still possess many tools to identify it. Notice 68 requires tax authorities to remain vigilant and use all available resources to identify indirect transfers. These resources include annual enterprise income tax filings, tax evaluations, transfer pricing documentation, outbound payment recordals, tax treaty benefit applications, news reports and corporate announcements. Many local tax authorities have already established special teams to actively monitor public information and identify potentially taxable indirect transfers.

General anti-avoidance procedures apply in Bulletin 7 investigations

Notice 68 further confirms that Bulletin 7 investigations and adjustments shall follow procedures prescribed under China's general anti-avoidance procedural rules[8]. Generally, the in-charge tax authority has the power to make a preliminary determination on whether an investigation should be launched. If it determines no investigation is required, the in-charge tax authority should create an analysis report and archive relevant documents. If it determines an investigation is required, the in-charge tax authority must report to the higher level tax authorities and receive approval from the SAT before launching the investigation. Although Notice 68 requires in-charge authorities to finish the investigation within nine months of its launch, Notice 68 does not provide a deadline for the SAT to make its decision. Therefore, a Bulletin 7 investigation can still be potentially time-consuming.

Single reporting when multiple in-charge tax authorities involved

When multiple Chinese companies located in different cities or provinces have been indirectly transferred, multiple in-charge tax authorities will be involved. Under Bulletin 7, it is not entirely clear whether the reporting parties have to report indirect transfers to all in-charge authorities involved when they conduct voluntary reporting in accordance with Article 9 of Bulletin 7 .

Notice 68 clarifies that the reporting parties only need to choose one in-charge authority to report to. This tax authority will then be solely responsible for the preliminary determination of whether a GAAR investigation should be launched. Although the pre-Bulletin 7 scheme provided in SAT Bulletin [2011] No. 24 permitted parties to choose which tax authority to report to, the determination on whether tax should be levied and whether to report to the provincial authority or the SAT was jointly made among all the tax authorities with jurisdiction. Notice 68 clarifies that communication among and a joint determination by all the tax authorities with jurisdiction the transaction is no longer required; instead, the tax authority who receives the indirect transfer report has the power to individually review the transaction and make all preliminary determinations.

Observations

Notice 68 clarifies the procedures for how local tax authorities will handle indirect transfers. However, many substantive issues under Bulletin 7 remain unclear. For example, (i) whether an intragroup reorganization will qualify for the safe harbor if no consideration is paid; (ii) whether the tax authorities will recognize the tax paid in prior indirect transfers when determining the tax basis in subsequent direct or indirect transfers; and

8 For a detailed discussion of the relevant rules, please refer to the December 2014 issue of our client alert.

(iii) whether offshore buyers should be subject to penalties for failure to withhold tax for indirect transfers completed before the issuance of Bulletin 7.

1.3 Shandong Case: Innovative but Questionable Tax Collection Approach for Indirect Share Transfers

On 9 January 2015, China Taxation News[9] reported that tax authorities collected approximately RMB1.9 million on an indirect transfer of a Sino-foreign joint venture company ("**China JV**") established in Shandong province through an innovative but questionable tax collection approach.

The indirect transfer was a sale of a Hong Kong company ("**Target**") that held 0.85% equity interest in the China JV through two BVI companies ("**BVI Sellers**"). The China JV was acquired by a HK HoldCo from another Hong Kong company in a direct transfer on 17 August 2011. The indirect transfer was completed on 6 August 2014, and the tax authorities learned about the indirect transfer on 20 August 2014 through an inquiry from a non-resident enterprise and monitoring of online information. The tax authorities issued *Tax Matters Notifications* to BVI Sellers, requesting relevant documents, and received the documents on 27 August 2014. In reviewing the documents, the tax authorities found: (i) the Target had no assets or equity interests other than the equity interests in the China JV; (ii) the Target had no business income other than dividend and foreign exchange earnings; (iii) the Target's only expenses were audit fees, legal fees, registration fees, etc.; (iv) the Target's financial statements did not record salary expenses paid for its board of directors, chief finance officer and chief operation officer; (v) the Target represented and warranted in the share transfer agreement that it no employees other than the corporate secretary and no assets or liabilities other than the 0.85% equity interest held in the China JV; and (vi) the Target's only working capital was from shareholder loans and equity contributions provided by the BVI Sellers, who held 42.86% and 57.14% ownership.

In deciding whether the transfer should be subject to EIT in China under Notice 698[10], the tax authorities examined the Target's operational substance and purpose. The tax authorities concluded that the Target was a conduit company with no operational substance and that its only purpose was to indirectly transfer equity interests in the China JV in order to reduce the tax burden on the transfer. The tax authorities reached this conclusion because: (i) the documents supplied by the BVI sellers showed the Target had merely completed corporate registration formalities and

9 See http://www.ctaxnews.net.cn/images/2015-01/09/07/zgswb2015010907_b.jpg (China Taxation News is a newspaper indirectly owned by the SAT).

10 *State Administration of Taxation's Notice on Strengthening the Administration of Enterprise income Tax on Income From Transfers of Equity Interests by Non-resident Enterprises*, Guo Shui Han [2009] No. 698, dated 10 December 2009, retroactively effective as of 1 January 2008 (superseded by SAT Bulletin [2015] No. 7).

other legal requirements without engaging in substantive operational activities, such as manufacturing, sales, management, services, etc.; and (ii) the offshore buyer's parent company had announced on its official website that the substance of the acquisition was to acquire the 0.85% equity interests in the China JV. Therefore, the tax authorities decided that the indirect transfer should be subject to 10% EIT in China.

During the tax assessment negotiations, the tax authorities sought concessions from the BVI Sellers by threatening to order the China JV to withhold back taxes and late payment surcharges from dividend payments to the Target (and ultimately the purchaser). Although the dividends belonged to the purchaser and not the BVI Sellers, the threat was effective because the BVI Sellers presumably had agreed to indemnify the purchaser for any tax liability levied against the Target or the purchaser on the sale (which the tax authorities knew after reviewing the share purchase agreement). The BVI Sellers settled the assessed tax in September 2014 by self-filing with the tax authorities.

Interestingly, the tax authorities did not have the authority to order the China JV to withhold the back taxes and late payment surcharges from the dividend payments to the Target. The tax authorities cited Notice 3 issued in 2009 as the legal basis on which they could issue the order. But Notice 3 only authorizes the tax authorities to require Chinese entities to withhold tax from payments to non-resident enterprises that have failed to settle EIT and late payment surcharges. Thus, there is no legal or factual support to such withholding because the dividends are paid to the Target that is not the legal taxpayer.

MNCs conducting M&A transactions should be alert to the tax authorities using this withholding threat and plan accordingly when negotiating contractual terms and communicating with the tax authorities.

1.4 Bulletin 16: China Makes a Pre-Emptive Strike against BEPS!

On 18 March 2015, the SAT introduced measures to deny income tax deductions for certain service fees and royalties paid by Chinese companies to their overseas affiliates. These highly controversial measures were published in Bulletin 16[11] and appear to stem from China's initiatives[12] to implement rules that it views as related to the OECD Base Erosion and Profit Shifting ("**BEPS**") Project. Bulletin 16 targets service fee and royalty payments made to affiliated companies outside China that do not undertake functions and risks and/or lack economic substance. In the case of royalties, the focus is also on payments to companies that have legal ownership of the underlying intangible assets, such as intellectual

11 *State Administration of Taxation's Bulletin on Enterprise Income Tax Issues Related to Outbound Payments by Enterprises to Overseas Related Parties* (SAT Bulletin [2015] No. 16), dated March 18, 2015.

12 The SAT has an internal plan to convert proposals under the OECD BEPS Project into Chinese domestic tax rules.

property ("**IP**"), but have not contributed sufficiently to the creation of value in the intangibles.

Bulletin 16 appears to be retroactive at least to 1 January 2008 and possibly as far back as 10 years, which is the statute of limitations for special tax adjustment cases.

The new measures in Bulletin 16 will likely have a significant impact on holding structures, supply chain planning and cash repatriation strategies of MNCs. At the same time, certain aspects of Bulletin 16 may be open to principled legal challenge depending on how the SAT and local tax bureaus interpret and implement the new measures.

What payments are not deductible under Bulletin 16?

Bulletin 16 introduces four categories of payments by Chinese companies to their overseas affiliates that are non-deductible from the taxable income of the Chinese company. These categories of payment are as follows:

- Outbound payments to overseas affiliates that do not perform functions, assume risks, and/or do not engage in substantive operational activities;
- Outbound payments to overseas affiliates for services that do not directly or indirectly give an economic benefit to the Chinese company;
- Outbound royalty payments to overseas affiliates that have legal ownership of the intangible property but have not made contributions to the creation of value in such intangible property, where the payments do not conform to the arm's length principle; and
- Outbound royalty payments to overseas listed vehicles in exchange for incidental benefits arising from the listing activities.

These categories are broadly drafted and give a great deal of discretionary authority to tax officials about how to interpret and apply them. For example, it is not clear with respect to the legal owner of intangible property whether the funding of R&D activities or brand development, as opposed to the actual conduct of such activities, will be treated as a sufficient contribution to value creation to justify deduction of the royalty payment by the affiliated licensee in China. At the same time, however, the vagueness of these categories creates room for taxpayers to make legal arguments in favor of deductibility.

The new rules also highlight the importance of strong transfer pricing analysis to support that service fee and royalty payments meet the arm's length standard even where such payments are not deemed to be non-deductible under Bulletin 16.

Transfer pricing rule or deductibility rule?

Although Bulletin 16 states in its introductory paragraph that it is a transfer pricing regulation, three of the four categories of non-deductible outbound payments do not refer to the arm's length standard and therefore could be interpreted as deductibility rules. If the tax authorities apply these as transfer pricing rules, they must conduct a transfer pricing investigation and determine that the payments in question fail to meet the arm's length principle before they can make a transfer pricing adjustment by denying the tax deductions. Furthermore, such a transfer pricing adjustment would result in the Chinese company that made the payment having to pay the additional income tax plus interest at prevailing rates, but would not subject the company to late payment surcharges or penalties. If, however, the tax authorities apply the Bulletin 16 categories as deductibility rules, the outbound payments in question may automatically become non-deductible without any transfer pricing analysis by the tax authorities. In this case, a tax authority might also make the Chinese company liable for late payment surcharges (at an annual rate of about 18.25%) and penalties (ranging from 50% to 500% of the tax).

We believe that Bulletin 16 should be interpreted and applied as a transfer pricing regulation and therefore that the tax authorities must conduct a transfer pricing investigation and conclude that payments do not meet the arm's length principle before they can deny the tax deductions. The concern, however, is that local tax authorities may apply the vague wording of Bulletin 16 to simply deny deduction of outbound payments without conducting transfer pricing analysis. In a worst case scenario, the tax authorities may seek to impose late payment surcharges and penalties.

If a tax authority treats Bulletin 16 as providing deductibility rules and denies deduction of outbound payments without first determining that payments fail to satisfy the arm's length principle, the decision may be subject to legal challenge based on the EIT Law and its implementing regulations. For example, the decision may violate Article 8 of the law, which provides that "reasonable expenditures incurred by an enterprise in connection with the deriving of revenue" are deductible. The decision may also fail to meet the standard in Article 41 of the law and Article 111 of the implementing regulations that a transfer pricing adjustment must be based on "reasonable methods" that are "consistent with the arm's length principle".

Value creation requirement for IP under Bulletin 16

Article 5 of Bulletin 16 provides that "when an enterprise makes royalty payments to related parties that only enjoy legal ownership of the intangible property, but have not made contributions to value creation in such intangible property, if such payments do not conform to the arm's length principle, such payments should not be deductible when calculating the amount of taxable income of the enterprise".

Bulletin 16 uses the concept of "value creation" for IP. The Official Explanatory Note to Bulletin 16 provides guidance regarding the definition of "value creation".[2] Specifically, it provides that the analysis of contributions to "value creation" should take into account the functions performed, assets used and risks assumed by relevant parties in the development, enhancement, maintenance, protection, application and promotion of the intangible assets, such as technology or brands. The Official Explanatory Note also states that royalties should be proportional to the "value created" by the recipient of the royalties.

To some extent, Article 5 of Bulletin 16 appears to be in line with proposals under the OECD BEPS Project. The OECD BEPS Action Plan 8, *"Guidance on Transfer Pricing Aspects of Intangibles"* issued on 16 September 2014, states that the legal ownership alone does not entail a right to retain all income attributable to IP; instead, the party performing functions, contributing/using assets and undertaking risks related to developing, enhancing, maintaining and protecting ("**DEMP**") IP, that is, the economic owner, should retain a portion or in some cases all of the returns attributable to the IP.

China's position on value creation is not new. In fact, the SAT's view is that China is the location where economic activities occur and has offered MNCs location saving and marketing intangibles and thus should be compensated as such. In the case of IP ownership, China has long taken the view that the traditional compensation mechanism whereby all residual profits are paid to the legal owner of IP is not supportable. Because of its lack of strong IP enforcement regime, China is typically not a jurisdiction where MNCs would choose to hold their IP. Rather, China's contribution to IP lies in the fact that it is where R&D takes place, where local marketing intangibles are created by virtue of the brand building and marketing undertaken by strong sales and marketing teams in China that have unique or specialized local knowledge.

Given the above, the value creation requirements in Article 5 of Bulletin 16 may pose problems for IP holding companies that only fund and assume all of the risks associated with the development of IP, but outsource all of the other functions, such as R&D work or brand building, to other entities. Bulletin 16 is unclear as to whether the legal owner has to physically perform these functions to be treated as contributing to "value creation" in the intangible asset. The OECD position is that "it is not essential that the legal owner physically perform all of the functions, but control is a minimum".

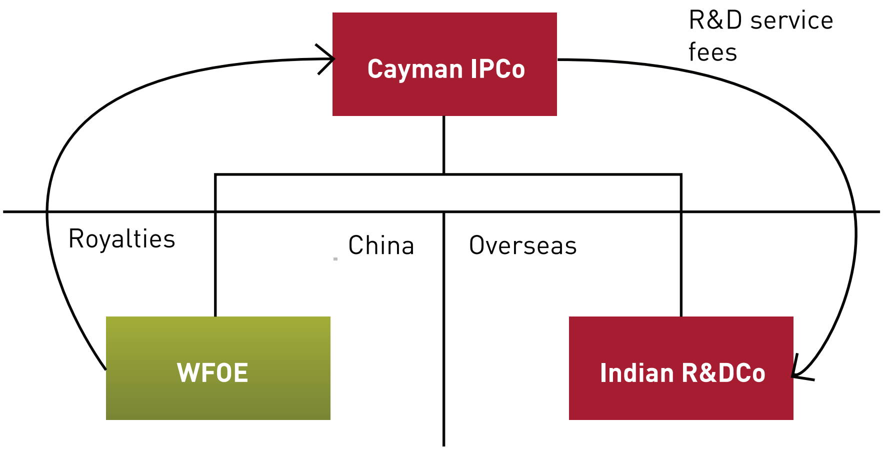
It remains to be seen where, and if, a balance will be struck on how "value creation" will be understood and accepted by the international tax community and by the Chinese tax authorities as they implement Bulletin 16. At a minimum, we expect that the Chinese tax authorities will be looking at royalty payments and asking if China is paying too much, or even if China should be receiving royalties for its value creation.

Continued application of the arm's length standard

Pursuant to the wording of Article 5, tax authorities technically may not deny deductions for royalties, even if the legal owner has not made contributions to value creation in the IP, as long as the royalty payments conform to the arm's length principle. As such, Article 5 of Bulletin 16 technically can only attack circumstances where Chinese royalty payers had made a significant contribution to the IP value, while the foreign legal owner had not performed any DEMP functions related to the IP. An example below is useful to illustrate the aforesaid arm's length argument.

Cayman IPCo funds all R&D activities of Indian R&DCo and legally owns all the IP resulting from those activities. Except for this funding, Cayman IPCo does not perform or control any functions related to the IP, while Indian R&DCo performs all DEMP functions related to the IP. Cayman IPCo licenses the IP to WFOE, its PRC subsidiary, in exchange for an arm's length royalty payment. The corporate structure of this example is depicted in Diagram Two below.

Diagram Two



The above hypothetical case appears to be a typical BEPS example, and Cayman IPCo. should not be entitled to residual profit related to the IP. However, WFOE should not be entitled to the residual profit either because the royalty payments are arm's length. Therefore, there should be no denial of deduction of the royalty payments made by the WFOE. The OECD takes the position that Indian R&DCo., as the economic owner, shall be entitled to the residual profit related to the IP. India may make a transfer pricing adjustment to Indian R&DCo.'s profits pursuant to its domestic law, but China should not take up the initiative to tax any profits that India has yet to tax.

What actions should MNCs consider?

Bulletin 16 is the latest in a series of steps the SAT has taken to aggressively scrutinize payments to overseas related parties. On 29 July 2014, the SAT issued Notice 146 requiring tax authorities at all levels to participate in a nationwide search for and investigation of all large payments of service fees or royalties from Chinese resident enterprises to overseas related parties. For a detailed discussion of Notice 146, please refer to our client alert in August 2014. In its April 2014 letter[13] to the United Nations working group on transfer pricing issues, the SAT also took a firm stance on intragroup service payments, calling for scrutiny of the benefits to the Chinese service recipients. For further discussion of recent cases involving transfer pricing adjustments for service fees and royalties, please refer to the January & February 2014 issue and the May & June 2014 issue of our China Tax Monthly.

In response to Bulletin 16, an MNC group that is charging service fees or royalties to Chinese affiliates should consider taking the following actions to safeguard its tax interests in China:

- Prepare or review cross-border service or license agreements to ensure that the service fees or royalties are charged at arm's length in accordance with Chinese transfer pricing rules;
- Prepare detailed documentation to defend the reasonableness of service fee or royalty payments;
- Ensure that the overseas affiliate receiving service fee or royalty payments from China has sufficient substance;
- Review the contributions to "value creation" by the legal owners of intangible assets for which royalties are charged to affiliates in China;
- Avoid paying service fees or royalties to overseas affiliates in traditional tax havens; and
- Be well-prepared to challenge tax authority decisions on a principled legal basis, including the possibility of administrative review and litigation or competent authority procedures when necessary and commercially feasible.

1.5 Zhejiang Case: Transfer Pricing Adjustments to Outbound Royalty Payments

On 22 May 2015, China Taxation News[14] reported that the Jiaxing State Tax Bureau ("**JSTB**") of Zhejiang province made a transfer pricing adjustment to outbound royalty payments and collected RMB15 million in EIT and interest from a foreign invested enterprise ("**FIE**").

According to the news report, the FIE was investigated because it had stable income growth but fluctuating profit since 2005 and had a huge loss in 2008. During the initial phase of the investigation, the tax authority found nothing improper with the FIE's related-party sale. It then shifted the focus of the investigation to the FIE's royalty payments to the parent company for use of licensed technology and trademarks. The tax authority relied on the BEPS Action Plan 8, the *Guidance on Transfer Pricing Aspects*

13 See http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-tp-CommentsPRC.pdf.

14 See http://www.ctaxnews.net.cn/images/2015-05/22/06/zgswb2015052206_b.jpg.

of Intangibles to insist that the economic profit should be distributed among related parties based on their contribution to the profit margin. The tax authority compared the FIE's profitability with comparable companies and found the FIE's mark-up percentage under a full cost plus pricing model to be less than the median of comparable companies. The tax authority therefore determined that the FIE overvalued the licensed technology and trademarks and that it was unreasonable for the FIE to pay the high royalties. However, the news report was not clear about how the tax authority chose comparable companies or whether the FIE had made significant contribution to the licensed technology and trademarks.

Observations

The news report did not provide a date for the case, so we do not know whether it predates the issuance of Bulletin 16[15], which imposes value creation requirements for intangibles and appears to be consistent with the BEPS guidelines. However, the analysis in this case does bear some similarity to an unstructured Bulletin 16 analysis. For a detailed discussion of Bulletin 16, please refer to Section 1.4 above.

Regardless of whether Bulletin 16 influenced the outcome in the case, MNCs should take care in how aggressively they structure IP holding structures. If an aggressive IP holding structure ensures profits are earned in a low tax jurisdiction where no employees work or no key functions related to the IP occur, the Chinese-related party should be properly compensated based on an in-depth functional and risk analysis. Now more than ever, strong transfer pricing documentation will be key to defend against challenges to IP royalty payments.

MNCs should also take the opportunity to evaluate their current IP structures to ensure long-term sustainability. MNCs should plan where possible for the foreign IP owner to perform and control some of the key functions related to the IP, and build up as much substance as possible.

1.6 Shandong Case: China's First Controlled Foreign Corporation Anti-avoidance Case

In a recently reported case[16], Shandong tax authorities attributed the undistributed profits of a Hong Kong company ("**HK HoldCo**") to its Chinese resident parent company ("**ParentCo**"). The tax authorities attributed the profits based on China's controlled foreign corporation ("**CFC**") rules and collected more than RMB80 million in taxes from the ParentCo. This is the first case on record of China enforcing CFC rules.

15 *State Administration of Taxation's Bulletin on Enterprise Income Tax Issues Related to Outbound Payments by Enterprises to Overseas Related Parties* (SAT Bulletin [2015] No. 16), dated 18 March 2015.

16 See http://www.bjsat.gov.cn/bjsat/qxfj/zsefj/zcq/jdal/201505/t20150505_224848.html.

Background

The CFC rules have been in existence since 1 January 2008 when the EIT Law took effect. But these rules were rarely if ever enforced during the past seven years. According to the CFC rules, the profits of a CFC established in a low-tax jurisdiction will be included in the Chinese corporate shareholder's taxable income in the current year if the CFC does not distribute profits without **reasonable commercial need**. A low-tax jurisdiction refers to a jurisdiction where the effective income tax rate is lower than 50 percent of the EIT rate (i.e., lower than 12.5 percent). An overseas company is treated as a CFC if:

- each shareholder that is a Chinese resident enterprise or an individual directly or indirectly holds at least 10 percent of the voting shares of the foreign company, and those shareholders with 10 percent or more of voting shares jointly own more than 50 percent of all shares; or
- the Chinese-resident enterprise or individual has actual control over the foreign company by virtue of shares, capital, business operations, or purchases and sales in any other situation.

Case facts

HK HoldCo was a wholly owned subsidiary of ParentCo, which registered in a Shandong industrial park. HK HoldCo indirectly owned a 90 percent stake in three different FIEs through its wholly owned Hong Kong subsidiary ("**HK SubCo**").

In 2011, HK HoldCo indirectly transferred its shares in the three FIEs by selling the HK SubCo to a Dutch company for RMB300 million. The gain derived by HK HoldCo was not taxable in Hong Kong. Under Article 26 of the EIT Law, qualified dividends from a resident enterprise to another are exempt from EIT.

In 2012, HK HoldCo filed an application to become a resident enterprise of China so that the gain derived by HK HoldCo could be distributed to ParentCo without subjecting ParentCo to EIT in China. The SAT, however, denied the application.

After which, the Shandong tax authority launched an investigation when the HK HoldCo did not distribute the 2011 profits. Without providing detailed analysis, the Shandong tax authority concluded that the RMB300 million gain derived by HK HoldCo should be included in the ParentCo's taxable income in current year because:

- HK HoldCo was a CFC since it was wholly owned by the ParentCo;
- HK HoldCo was established in Hong Kong where the effective income tax rate is lower than 12.5 percent, which was HK Holdco's effective tax rate rather than its Hong Kong headline rate; and
- HK HoldCo only derived passive income and did not distribute profits without reasonable commercial need.

After several rounds of negotiations, ParentCo eventually agreed to pay more than RMB50 million in EIT and more than RMB30 million in individual income tax ("**IIT**"). The report leaves many questions unanswered. Why did ParentCo have to pay IIT? Was HK HoldCo subject to any Chinese capital gains tax on its gain derived from the 2011 indirect transfer? If HK HoldCo was subject Chinese capital gains tax on the transfer, could ParentCo receive a credit for it?

Observations

Previously, it had been unclear whether the tax authorities would use a company's effective income tax rate or the headline rate in a particular jurisdiction when applying the CFC rules. Since the headline income tax rate in Hong Kong is 16.5%, the Shandong tax authorities seemingly used HK HoldCo's effective income tax rate rather than the headline rate in Hong Kong. Further, the key condition of applying CFC rules, i.e., without reasonable commercial need, was not explained at all.

In addition to indicating how the tax authorities will apply the CFC rules, this case may more generally indicate their increasing willingness to enforce the CFC rules. Greater enforcement of the CFC rules seems a likely part in a broader trend in China's tax enforcement, which seems to be expanding beyond its historically narrow focus on inbound international taxation to include outbound international taxation as well. Recently, a Foreign Tax Division dedicated to outbound taxation was established within the International Tax Department of the SAT. Enforcing the CFC rules could play an important role in this outbound focus. Moreover, the tax authorities have indicated that new CFC implementing rules will be formulated in the near future. This shows that the tax authorities probably have deepening interest in working with and enforcing the CFC rules.

1.7 Jiangxi Case: Loans Treated as Dividends for Withholding Tax Purposes

The SAT on 25 August 2014 issued an internal guideline, i.e., Shui Zong Han [2014] No. 317 ("**Notice 317**"), to require all tax bureaus to examine dividends paid to non-residents. Among other requirements, tax bureaus must search for dividends being distributed to non-residents in a disguised form (such as in the form of a loan)[17]. This directive is controversial because dividends by nature should be treated differently from loans for tax purposes. Nonetheless, on 29 April 2015, China Taxation News[18] reported that the Jiangxi tax bureau treated related party loans as dividends paid to foreign shareholders and collected RMB5 million in dividend withholding tax.

According to the news report, the company ("**JiangxiCo**") under investigation was registered in 2002. The tax authority discovered that it

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17 See http://www.nbtax.gov.cn/hsqgsj/xxgk/tzgk/sstz/201408/t20140805_260450.htm.

18 See http://www.ctaxnews.com.cn/fazhi/shuofa/201504/t20150429_59262.htm.

had never distributed dividends to its shareholders. By the end of 2013, it had more than RMB100 million in undistributed profits and approximately the same amount in loans to related parties.

The tax authority began investigating JiangxiCo for what it believed was JiangxiCo's failure to account for the interest it should have been receiving on the RMB100 million in related party loans. The focus of the investigation shifted when tax officials were told by JiangxiCo that one of the related parties receiving a loan had already been dissolved. The tax authority found it suspicious that JiangxiCo had not written off this bad debt and had instead kept it booked as a receivable. Pursuing this suspicion, the tax authority discovered that all the debtors were actually controlled by a Hong Kong shareholder of JiangxiCo. Faced with this discovery, JiangxiCo admitted that the loans were in fact a distribution of dividends and agreed to pay the unpaid dividend withholding tax.

Observations

From the news report, it is unclear whether the loans were properly documented or the loans were indeed dividends even from a documentation perspective. If the loans were properly documented, the tax authorities technically have no power to deem the loans as dividends unless that determination is made after a GAAR investigation. This case shows that the PRC tax authorities may in practice ignore this technical restraint and challenge a perpetual loan as a dividend distribution, which subjects it to the 10 percent (unless reduced under tax treaties) dividend withholding tax.

1.8 An Anti-Avoidance Case Against Foreign Individuals

On 25 March 2015, China Taxation News[19] reported that three foreign individuals paid to the Xi'an Local Tax Bureau ("**XLTB**") approximately RMB3 million in IIT on the transfer of shares in a Chinese resident enterprise. This is the first anti-avoidance case against foreign individuals concluded in Shaanxi province.

The transferred company ("**Company**") was a foreign-invested enterprise located in Xi'an. The Company specialized in property development and had three foreign shareholders ("**Shareholders**"). The Company won a bid on a piece of land for the purpose of commercial development, but for various reasons never initiated the project. In June 2010, the three Shareholders transferred 100% interest in the Company for no consideration to a holding company incorporated in Hong Kong. The holding company was held by two of the three Shareholders. The suspicious nature of the transfer triggered an investigation by the XLTB.

19 See http://www.ctaxnews.net.cn/images/2015-03/25/09/zgswb2015032509_b.jpg.

In the first round of negotiations, the Shareholders argued that no gain was derived from the transfer because they sold the Company's shares to themselves and therefore derived zero income. The XLTB did not accept this argument. Instead, the XLTB considered the Company to be a distinct legal person that was separate from the Shareholders. This meant the transfer should have been made at arm's length price.

In the second round of negotiations, the Shareholders argued that no gain was derived because the Company had been operating at a loss. Although the XLTB accepted that the Company had been operating at a loss because the development project was never initiated, the XLTB rejected the notion that this precluded a gain. The XLTB determined that the Shareholders had incorrectly used the net book value of the land when calculating the appropriate gain. Instead, the Shareholders should have used fair market value to capture the appreciation in the value of the land.

In the third round of negotiations, the Shareholders notified the authorities that one of the Shareholders had passed away and inquired whether the obligation to pay IIT survives his death. The XLTB responded that IIT attaches to the receipt of income, so the obligation to pay survives the death of the taxpayer. Accordingly, the heirs of the taxpayer were liable for the tax up to the value of the estate under PRC Inheritance Law.

Observations

This case shows that Chinese tax authorities are willing to pursue foreign individuals who attempt to avoid tax in China. If a transfer of shares is not accompanied by consideration or not conducted at arm's length, the transaction will attract suspicion and likely be investigated by local tax authorities. Additionally, the local tax authorities will consider the fair market value of a property development company's land use rights when calculating taxable gain. Furthermore, the case shows that the obligation to pay IIT survives the death of the recipient of the income.

1.9 China Releases its 2013 APA Annual Report

On 5 December 2014, the SAT released the *2013 China Advance Pricing Arrangement* ("**APA**") *Annual Report* ("**Annual Report**").[20] This fifth annual report focuses on China's APA mechanisms, procedures and practices, and provides statistics for 2005 through 2013 accompanied by an analysis of the statistics. The Annual Report came after the SAT declared publicly in September 2014 that it would suspend APA negotiations with treaty partners through 2015. Many had anticipated that the SAT would delay publishing its annual report as well because the SAT is short-handed. The release of the Annual Report, although later than the customary target date of July 1, shows that the SAT is still committed to the APA program and the suspension is only temporary.

20 The English version of the 2013 APA Report may be downloaded via http://www.chinatax.gov.cn/n810219/n810724/c1371141/part/1371156.pdf .

The Annual Report follows the framework of the previous reports, providing a general overview of the APA system and developments from 2005 to 2013. Although it does not have yearly statistics for most of the parameters like the report published in the United States[21], a comparison with the 2012 and 2011 annual reports nevertheless enables us to use the information to paint a picture of taxpayer activities and the SAT's endeavors with respect to APAs during 2013.

Although the SAT communicates its detailed strategy to the local offices every year, it is internal and not available to the public. However, the SAT has traditionally set forth its general, although not detailed, transfer pricing strategy for the years to come in the preface of the Annual Report. The Annual Report is the only place where the public can get a rough sense of what the SAT's strategy is in the years to come. Not surprisingly, the SAT's strategy was heavily influenced by the OECD BEPS project. In the Annual Report, the SAT calls for attention to "peculiar market characteristics in developing countries" and "fairer and more reasonable international taxation rules as the guidance for transfer pricing, advance pricing arrangement." In addition, the Annual Report expressly states that "a submission that presents innovative application of transfer pricing methods or high quality quantitative analysis for intangibles, cost savings or market premiums will merit the SAT's prioritized consideration".

APA requests riled in 2013

Taxpayers filed 6 bilateral and 7 unilateral APA requests in 2013, significantly lower than the 42 bilateral and 3 unilateral requests filed in 2012. This highlights the impact that the OECD BEPS project has had on the SAT. The uncertainty created by the OECD BEPS project caused many taxpayers to consider proactive measures including APAs. However, starting from 2012, the OECD BEPS project has diverted a lot of the SAT resources away from the APA program[22]. The influx of APA requests in 2012, and the reduced throttle in handling APAs ever since has deterred many potential applicants from filing APA requests. Taxpayers remain hopeful that this trend will end in 2015 when the SAT turns its attention back from the OECD BEPS project to the APA program.

APAs completed

A record of 19 APAs (11 unilateral and 8 bilateral) were executed in 2013, a 58 percent increase from the 12 APAs (9 bilateral and 3 unilateral) completed in 2012. This is a significant increase since 2005 when the

21 In the United States, the report is issued in March of every year. The report, titled "Announcement and Report Concerning Advance Pricing Agreements", is issued pursuant to § 521(b) of Pub. L. 106-170, the Ticket to Work and Work Incentives Improvement Act of 1999, which requires the Secretary of the Treasury to report annually to the public on APAs and the APA Program. The first report covered calendar years 1991 through 1999. Subsequent reports covered separately each calendar year 2000 through 2013.

22 The APA program had only six staff members in 2013 at the SAT Headquarters.

APA program was first introduced in China. Of the 8 bilateral APAs, 4 are renewals and involve comparatively less effort from SAT.

Open inventory of cases

As of December 31, 2013, there is an open inventory of 121 cases that are comprised of 110 bilateral and 11 unilateral APA requests. The open inventory of cases as of the end of 2012 was 127 cases, comprised of 112 bilateral and 15 unilateral APA requests. The statistics indicate that the open inventory of bilateral APA requests are significantly more than the unilateral APA requests. The authors expect this trend to continue going forward.

Industries covered

The Annual Report provides seven main categories of industries represented by executed APAs from 2005 to 2013: manufacturing (86); commercial services (5); wholesale trade and retail (6); transportation, warehousing, and postal services (2); scientific and technical services (2); electricity, thermo, gas and water generation and supply (1); and information transmission, software and information technology services (2). Although most of the APAs (74% in 2013) executed still involve the manufacturing industry, there is a new industry (i.e., scientific and technical services) covered in 2013. The other major industries covered by the APAs executed in 2013 are commercial services, wholesale and retail. The detailed statistics for each industry in 2013 are set out in Table One below.

Table One

Industry covered (for APAs executed in 2013)	Number
Manufacturing	14
Commercial Services	2
Wholesale trade and retail	2
Transportation, warehousing, and postal services	0
Scientific and technical services	1
Electricity, thermo, gas and water generation and supply	0
Information transmission, software and information technology services	0
Total	**19**

Transfer pricing methods

Transfer pricing methods used in executed APAs have typically been dominated by the transactional net margin method ("**TNMM**"). In 2013, all executed APAs used the TNMM with one exception in which the comparable uncontrolled price ("**CUP**") method was utilized. As of December 31, 2013, the total number of APA cases in which the CUP method has been utilized since the inception of the APA program is 5.

Term length

The Annual Report notes that most of the APAs, be it unilateral or bilateral, were completed within two years, and 62 percent of all executed bilateral APAs from 2005 to 2013 were completed within one year. Among the 8 bilateral APAs executed in 2013, 6 were completed within one year[23]. Therefore, the key in terms of overall timing is to get the APA application accepted by the SAT after the pre-filing meeting. Once an APA application has been formally accepted by the SAT, the APA could be executed within as little as one year.

Bilateral APAs

Among the 8 bilateral APAs executed in 2013, 5 were executed with Asian countries, 2 were executed with European countries, and 1 was executed with a North American country. Consistent with the previous years' data, most of the APAs were executed with Asian countries.

What to expect in 2015

It is expected that the SAT will turn its attention back to the APA program in September 2015. The fewer bilateral APAs executed in 2013 compared to the number of 2012 is attributable, in part, to the limited personnel and resources that the SAT has available to deal with bilateral APAs. That being said, the SAT is currently evaluating the creation of a separate division to deal with mutual agreement procedures for transfer pricing issues. Once that division is created, more resources would be devoted to the APA program and the length of time it takes to consummate an APA may be reduced.

2. Corporate Restructurings

2.1 New PRC Tax-Free Restructuring Rules

On 25 December 2014, China issued Cai Shui [2014] No. 109 ("**Notice 109**") to provide a new form of tax-free corporate restructuring, i.e., internal transfers (划转) of equity and assets.

As background, the general rule for corporate restructurings is that gain or loss should be recognized when the corporate restructuring occurs. Previously, the tax treatment on corporate restructurings was predominately governed by Cai Shui [2009] No. 59 ("**Notice 59**"), which was issued on 30 April 2009 and took retroactive effect as of 1 January 2008. Six types of corporate restructurings are covered by Notice 59: change of legal form, debt restructuring, share acquisition, asset acquisition, merger, and de-merger. For a detailed discussion of Notice 59, please refer to the May 2009 issue of our client alert.

23 The time starts to run only if the APA request is accepted by the SAT.

Four types of internal transfers qualify for tax-free treatment

Article 3 of Notice 109 provides tax-free treatment for internal transfers (i.e., no gain or loss is recognized for EIT purposes) if:

(4) the internal transfer is conducted between two resident enterprises, one of which directly holds a 100 percent ownership interest in the other enterprise, or both enterprises are directly 100 percent owned by the same resident enterprise or enterprises;

(5) the equity or assets are transferred at net book value;

(6) the internal transfer has reasonable commercial purposes, with reduction, exemption or deferral of taxes not a major purpose of the transfer;

(7) the original substantial business activities with respect to the assets transferred remain unchanged within 12 consecutive months after the transfer; and

(8) no accounting gain or loss has been recognized by the transferor or transferee.

On 27 May 2015, the SAT issued Bulletin 40 to further clarify and supplement Notice 109. According to Article 1 of Bulletin 40, Notice 109 covers only the following four types of internal transfers:

(1) the transfer of equity or assets by a parent company to a directly 100 percent owned subsidiary where the parent receives from the subsidiary, solely, equity consideration equal to the net book value of the transferred equity or assets (i.e., the parent's long-term equity investment in the subsidiary is increased by the net book value of the transferred equity or assets while the subsidiary's paid-in capital, including capital surplus, is increased by the net book value of the transferred equity or assets, and the parent's tax basis for the equity received from the subsidiary is determined by the original tax basis of the transferred equity or assets) ("**Compensated Downward Internal Transfer**");

(2) the transfer of equity or assets by a parent company to a directly 100 percent owned subsidiary where the parent receives neither equity nor non-equity consideration (i.e., the parent's paid-in capital, including capital surplus, is decreased by the net book value of the transferred equity or assets while the subsidiary's paid-in capital, including capital surplus, is increased by the net book value of the transferred equity or assets) ("**Gratis Downward Internal Transfer**");

(3) the transfer of equity or assets by a directly 100 percent owned subsidiary to its parent company where the subsidiary receives neither equity nor non-equity consideration (i.e., the parent's long-term equity investment in the subsidiary is decreased by the net book value of the transferred equity or assets while the subsidiary's paid-in capital, including capital surplus, is decreased by the net book value of the transferred equity or assets, and the parent's tax

basis for the long-term investment in the subsidiary is decreased by the net book value of the transferred equity or assets) ("**Upward Internal Transfer**"); and

(4) the transfer of equity or assets between two subsidiaries that are directly 100 percent owned by the same parent company or companies in which the transferor receives neither equity nor non-equity consideration (i.e., the owner's equity in the transferor's accounting books is decreased by the net book value of the transferred equity or assets while the transferee's paid-in capital, including capital surplus, is increased by the net book value of the transferred equity or assets) ("**Horizontal Internal Transfer**").

Shareholding relationship must continue for 12 months after transfer

Although Notice 109 does not impose any requirements on the continuance of the shareholding relationship between transactional parties, Bulletin 40 provides that retroactive tax adjustments will be made if the conditions for tax-free internal transfers are no longer met as a result of a change in the shareholding relationship within 12 consecutive months after the completion of the internal transfer. Bulletin 40 also clarifies that an internal transfer is completed on the later date of (i) the internal transfer agreement or the approval of the internal transfer taking effect, or (ii) the accounting treatment of the internal transfer by both parties being complete.

Corporate considerations for internal transfers

As mentioned above, an internal transfer is a new form of corporate restructurings such as merger and demerger prescribed under Notice 109 and Bulletin 40. However, unlike demerger or merger, China currently does not have any specific corporate rules or concepts for an internal transfer (the only exception is for state-owned enterprises). Rather, Chinese corporate rules currently offer capital reduction, distribution, capital increase, etc. From a corporate law perspective, taxpayers cannot simply transfer relevant equity/assets and directly adjust their long-term equity investment, paid-in capital, capital surplus or undistributed profits in their accounting books. Instead, accounting treatment should follow relevant accounting rules and certain corporate actions should be conducted to effectuate the proper accounting treatment. In other words, in order to conduct a tax-free internal transfer that meets all conditions under Notice 109 and Bulletin 40, taxpayers should conduct corresponding capital increase, capital reduction, distribution or a combination thereof as required by relevant corporate rules.

Observations

For corporate, accounting and Administration for Industry and Commerce ("**AIC**") registration purposes, the taxpayer should conduct capital increase, capital reduction, distribution or a combination thereof in order to qualify for a tax-free internal transfer. However, there are numerous conflicts and practical hurdles among these different set of corporate, accounting and AIC rules. It remains to be seen how these conflicts and practical hurdles will be resolved. Ideally, China will issue further accounting and corporate guidance on internal transfers.

2.2 Preferential Deed Tax and Land Appreciation Tax Policies for Corporate Restructurings

In a real estate transfer, the transferor is generally subject to land appreciation tax ("**LAT**") at a progressive rate of 30 percent to 60 percent while the transferee is generally is subject to deed tax of 3 percent to 5 percent (depending on the location). In order to facilitate corporate restructurings, China issued Cai Shui [2015] No. 5 on 2 February 2015 ("**Notice 5**") and Cai Shui [2015] No. 37 on 31 March 2015 ("**Notice 37**") to provide preferential deed tax and LAT policies for corporate restructurings. Both Notice 5 and Notice 37 are effective from 1 January 2015 to 31 December 2017.

Change of corporate legal form [24]

According to Notice 5, a change of corporate legal form is exempt from LAT if the accompanying restructuring does not result in a change of investors of the original company and rights and obligations of the original company will be inherited by the new company. Additionally, according to Notice 37, a change of corporate legal form is exempt from deed tax if (i) the investors of the original company survive the restructuring and hold more than 75 percent of the new company; and (ii) the rights and obligations of the original company are inherited by the new company.

Mergers

Under both Notice 5 and Notice 37, a merger is exempt from LAT and deed tax as long as the investors of merged company survive the merger.

De-mergers

Under both Notice 5 and Notice 37, a de-merger is exempt from LAT and deed tax if the investors of the resulting company are the same as the investors of the demerged company.

In-kind contribution

According to Notice 5, an in-kind contribution of real estate in exchange for equity in the invested enterprise is exempt from LAT. Unfortunately, Notice 37 does not provide a similar deed tax exemption for an in-kind contribution.

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24 A change of corporate legal form includes when an unincorporated enterprise restructures into a limited liability company or a joint stock company, a limited liability company changes into a joint stock company, and a joint stock company changes into a limited liability company.

Internal transfers (划转)

Notice 37 provides a deed tax exemption for internal transfers between parent companies and subsidiaries, and between subsidiaries that have a common parent company. All companies involved must be incorporated under Chinese law. However, unlike Bulletin 40, Notice 37 does not define "internal transfers" and is unclear on what constitutes an internal transfer for deed tax purposes. In particular, it is unclear whether consideration is prohibited in an internal transfer in order to qualify for deed tax exemption.

Exclusion of real estate development companies

The LAT exemption provided under Notice 5 does not apply to real estate development companies. This exclusion is largely due to the concern that real estate development companies may avoid LAT liabilities through corporate restructurings because the transfer of shares in a company that holds real estate is not subject to LAT.

Observations

Notice 5 and Notice 37 were both issued in response to the State Council's call for more favorable policies for corporate restructuring. Coupled with other recent developments, domestic restructurings can proceed in an increasingly favorable environment. However, cross-border restructurings involving China still face many challenges.

3. Tax Treaties

3.1 Fourth Protocol to the China-Hong Kong Double Taxation Arrangement Signed

On 1 April 2015, China and Hong Kong signed the Fourth Protocol ("**Fourth Protocol**")[25] to the China-Hong Kong Double Taxation Arrangement of 2008 ("**China-HK DTA**"). Key amendments introduced by the Fourth Protocol are set out below.

Capital gains

The Fourth Protocol further enhances the capital gains exemption provided under the existing China-HK DTA. According to Article 3 of the Fourth Protocol, the gains derived by a resident of one treaty partner from the sales and purchase of shares in a listed company, which is a resident of the other treaty partner, traded in a recognized stock exchange shall be taxable only in the place where the transferor is a resident. Meanwhile, the capital gain exemption will also be applicable to qualifying investment funds (i.e., the fund is authorized and regulated in its resident jurisdiction,

25 The full text of the protocol is available at http://www.ird.gov.hk/chi/pdf/Protocol_Mainland_HongKong.pdf (Chinese only).

the fund manager is formed and regulated in the resident jurisdiction and more than 85 percent of the fund capital is funded in the market).

Royalties

The Fourth Protocol reduces the withholding tax rate on royalties from leasing of ships and aircraft from 7 percent to 5 percent. The 5 percent rate is among the lowest found in any current tax treaty signed by China. The withholding tax rate remains 7 percent for all other royalties under the Fourth Protocol.

Revenue from international transportation

Revenue from international transportation derived by a Hong Kong company is exempt from EIT and business tax in China under the existing China-Hong Kong DTA. Under the Fourth Protocol, this exemption extends to Chinese value-added tax.

Anti-avoidance provision

The Fourth Protocol introduces an anti-avoidance provision that states "a benefit under Articles 10 to 13 [i.e., provisions concerning dividends, interests, royalties and capital gains] shall not be granted in respect of an item of income if obtaining that benefit was one of the main purposes of any arrangement or transaction that resulted in that benefit".

Exchange of information

The Fourth Protocol extends the scope of information exchange between the two jurisdictions. Under the existing China-Hong Kong DTA, the information exchange only cover income taxes in China. Under the Fourth Protocol, the scope of information exchange extends to cover value added tax, business tax, consumption tax, land appreciation tax and real estate tax in China.

Observations

We expect that the Fourth Protocol will make Hong Kong a more attractive jurisdiction for bringing global investments into China. The Fourth Protocol also shows that China is committed to preventing tax treaty abuses by identifying and adjusting improper tax arrangements.

3.2 Qingdao Case: Tax Authorities Retrospectively Revoke Approved Treaty Benefits

On 27 May 2015, China Taxation News[26] reported that the Qingdao tax authority in 2015 retrospectively denied beneficial owner status, which was previously granted in 2009 and 2010 to a Hong Kong company ("**HK Company**") for dividend withholding tax purposes, and recovered RMB4.79 million in dividend withholding tax from the HK Company.

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26 See http://www.ctaxnews.net.cn/images/2015-05/27/09/zgswb2015052709_b.jpg.

Case facts

The HK Company had three wholly owned PRC subsidiaries. The shareholders of the HK Company included a Cayman company and a Dutch company. In 2009 and 2010, the Qingdao subsidiary ("**QingdaoCo**") distributed dividends to the HK Company. The normal dividend withholding tax rate under Chinese law is 10 percent, but a reduced rate of 5 percent would apply by way of the China-HK DTA provided that the HK Company was the beneficial owner of the dividends received. The HK Company applied to the in-charge tax authority and successfully received written approval to enjoy the 5 percent reduced withholding tax rate in 2009 and 2010.

In 2015, the 2009 and 2010 reduced withholding tax rate somehow came under review of the Qingdao tax authority. The Qingdao tax authority questioned the HK Company's beneficial owner status because the HK Company's income was mainly passive income. The Qingdao tax authority eventually determined that the HK Company did not qualify as the beneficial owner because:

(5) the HK Company's employees had no substantive position and the number of employees were insufficient considering the scale of the HK Company's assets and profits. The HK Company's three directors did not hold executive positions in the HK Company or any of its subsidiaries, and the only two other employees were an Asia-pacific HR manager and a greater-China sales and training manager. None of the employees were directly involved in the HK Company's investment activities. The tax authority determined that the number of employees were insufficient for the Company's RMB600 million registered capital and its tens of millions in annual profit. It is unclear how many employees and what corporate structure would have been sufficient for the HK Company's scale of assets and profits so that the HK Company could have passed the tax authority's examination. Inherently, some businesses require fewer employees to operate a large asset portfolio. But the Qingdao case is not the first time tax authorities have rejected the argument that a business could operate a large asset portfolio with a small number of employees. In a similar Qinghai case, the Chinese tax authority rejected an explanation that an investment management firm could require fewer employees and few active business operations. The case was discussed in the September & October 2014 issue of our China Tax Monthly.

(6) the HK Company (i) had no right of control or disposal over the relevant income or over the right or asset that generated the income and (ii) bore few operational risks. The facts cited by the news report on which the Qingdao tax authority apparently based these conclusions were that the HK Company distributed all its dividend income from QingdaoCo to its shareholders and that it conducted no substantial investment activities other than holding shares of PRC subsidiaries.

(7) the HK Company's income was primarily passive, and the HK Company had no or little operational activity other than holding shares of the PRC subsidiaries.

(8) the effective control over the HK Company was questionable because the legal jurisdiction over the HK Company was inconsistent with its place of incorporation. The fact cited by the news report on which the Qingdao tax authority apparently based this conclusion was that the HK Company was incorporated in Hong Kong but signed multiple contracts in which it chose Belgium law as the applicable law.

Observations

In order to enjoy a reduced withholding rate under a tax treaty, the recipient of a dividend, interest or royalty must be a beneficial owner. The Chinese tax notice Guo Shui Han [2009] No. 601 ("**Notice 601**") issued in 2009 elaborates on this beneficial owner status. The first three reasons described above essentially correspond to the negative factors provided under Notice 601. However, the fourth reason described in the news report technically should not be relevant to the determination of beneficial owner status. According to the principle of freedom of contract, parties should have the right to choose applicable law unless otherwise prohibited under applicable law.

Regardless of whether the Qingdao tax authority correctly conducted the beneficial owner analysis, it should have been barred by the applicable three-year statute of limitations from pursuing underpaid tax from 2009 and 2010. According to Article 52 of the *PRC Tax Collection and Administration Law*, the statute limitation is three years for underpayment due to tax authority mistake. Since the Qingdao tax authority had already granted written approval for the beneficial owner status in 2009 and 2010, the underpayment (if any) of the RMB4.79 million in dividend withholding tax for those years was caused by tax authority mistake. Therefore, the Qingdao tax authority should likely have been barred in 2015 from recovering the underpaid dividend withholding tax from 2009 and 2010.

4. Individual Income Tax

4.1 New Guidance on IIT Treatment of Share Transfers by Individuals

On 7 December 2014, the SAT issued SAT Bulletin [2014] No. 67 ("**Bulletin 67**") to clarify the IIT treatment of share transfers in Chinese companies by individuals (including residents and non-residents). Bulletin 67 took effect from 1 January 2015 and replaced Guo Shui Han [2009] No. 285 and SAT Bulletin [2010] No. 27.

Taxable share transfers

Under Bulletin 67, the following share transfers are subject to IIT:

- sale of shares
- share buyback by a company
- sale of shares by a shareholder in an initial public offering
- court or government-ordered transfer of shares
- transfer of shares to effect a capital contribution or a nonmonetary transaction
- transfer of shares to repay debt
- Any other transfer of shares

However, Bulletin 67 does not apply under circumstances where an individual transfers shares listed on the Shanghai or Shenzhen stock exchanges if such shares were obtained through trading or a public offering, transfers of restricted stock, or share transfers otherwise regulated under specific regulations.

Taxable income from share transfer

According to Article 4 of Bulletin 67, the gain from a share transfer by an individual should be recognized as income. The gross income from the transfer minus the original share cost and reasonable transfer expenses should be taxed at 20%. Reasonable transfer expenses include the payment of relevant taxes and surcharges as a result of the share transfer.

Gross income from the transfer includes cash, tangible assets, securities, liquidated damages or compensation, and other interests. Any subsequent revenue obtained by the taxpayer upon fulfilment of the transfer contract conditions shall be treated as gross income for tax treatment purposes.

Gross income must be determined at fair market value. The authorities may reassess the taxpayer's gross income if the authorities believe it is "obviously low" without a "proper reason". The taxpayer has the burden to prove a proper reason for an obviously low gross income.

Gross income would be deemed obviously low in the following scenarios:

- Gross income is less than the value of the net assets corresponding to the shares
- Gross income is less than the initial investment cost or the initial acquisition price
- Gross income is less than the revenue from a share transfer conducted by the same or another shareholder under identical or similar conditions
- Gross income is less than the revenue from a share transfer conducted by another enterprise in the same industry under identical or similar conditions
- Shares are transferred for no consideration without proper reason; and
- Other circumstances as specified by the competent tax authority.

An obviously low gross income would be deemed as having a proper reason in the following scenarios with valid supporting documentation:

- a low-price share transfer is necessary because a change in state policy significantly impacts the invested entity's business operations;
- shares are inherited or transferred to the transferor's siblings, offspring, parents or grandparents or someone responsible for providing for and supporting the transferor; or
- restricted shares that cannot be sold outside the company are transferred between employees for a reasonable and true price under relevant government regulations or the company's laws or bylaws.

Withholding and reporting obligations

For share transfers regulated under Bulletin 67, the transferor is the taxpayer and the transferee is the withholding agent. The transferee must report the share transfer to the tax authorities where the investee enterprise is located within five working days after the share transfer agreement is concluded. The investee enterprise must then submit board resolutions and shareholder meeting minutes to the tax authorities within five working days after the board or shareholder meeting.

The transferee or transferor must then file a tax return if:

- The payment for the share transfer has been paid in full or in part by the transferee;
- The share transfer agreement has entered into force;
- The transferee has performed shareholder duties or enjoyed shareholder rights and interests;
- The share transfer has been given effect through completion of the government registration or announcement procedure;
- Completion of the relevant transfer action (by a court or government-mandated transfer, capital contribution, etc.); or
- Any other event as determined by the tax authorities has occurred.

The tax return must be filed on or before the 15th day of the month following the month in which the transfer occurred.

Observations

Bulletin 67 will significantly impact China M&A deals when the seller is an individual. Specifically, Bulletin 67 accelerates the timeline for IIT filing[27] and may require the transferor or the transferee to settle the share

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27 Under previous notices, the transferor or transferee was only required to file a tax return after the share transfer deal and share transfer agreement were completed and prior to the new shareholder ownership information being registered.

transfer's IIT liability before the deal is completed or payment is made. The filing and settlement will need to occur in the month after the share transfer agreement enters into force, which usually occurs at signing, even if the deal is completed or payment made much later. As such, transferor and transferee should take this into consideration during the planning of the share transfer transaction and the drafting of the share transfer agreement.

4.2 China Clarifies IIT Treatment of In-kind Contributions by Individuals

China issued Cai Shui [2015] No. 41 on 30 March 2015 ("**Notice 41**") and SAT Bulletin [2015] No. 20 on 8 April 2015 ("**Bulletin 20**") to clarify IIT treatment of in-kind contributions.

As a general principle under the PRC IIT Law, capital gains from in-kind contributions derived by individuals are subject to IIT at a standard rate of 20 percent. However, PRC tax authorities largely have not enforced this tax because no implementing rules were in place; therefore, many Chinese individuals have not been paying IIT on their in-kind contributions.

Both Notice 41 and Bulletin 20 clarify that gains (defined as the difference between the fair market value and the investment cost basis) on the in-kind contributions of non-monetary assets shall be subject to 20 percent IIT. Nonetheless, there are no withholding obligations on the in-kind contributions by individuals, and these individual taxpayers shall file IIT returns with respect to capital gains from the in-kind contributions. In addition, pursuant to Notice 41 and Bulletin 20, individual taxpayers are allowed to pay in equal instalments over a period of up to five years the IIT due on capital gains arising from in-kind contribution of non-monetary assets upon making a recordal filing with the in-charge tax authority.

5. Miscellaneous

5.1 China's Central Government Urges Clean Up of Local Subsidies and Tax Incentives

The State Council and the Ministry of Finance ("**MOF**") issued Guo Fa [2014] No. 62 in November 2014 ("**Notice 62**") and Cai Yu [2014] No. 415 in December 2014 ("**Notice 415**"), which urge local government authorities to clean up local subsidies and tax incentives that have no legal basis. On 11 May 2015, the State Council further issued Guo Fa [2014] No. 25 ("**Notice 25**") to address problems and practical difficulties that arose under Notice 62.

Many local governments provide tax incentives and subsidies to attract investment (from both international and Chinese investors). Notice 62 and Notice 415 aim to prohibit this practice unless the tax incentives or subsidies are established in laws or regulations approved by the central government.

Under Notice 62, no local government may promulgate a preferential tax policy unless the policy is rooted in special tax laws and regulations approved by the State Council. Notice 62 also requires local governments and authorities to investigate existing preferential tax policies and repeal those that violate laws and regulations.

Under Notice 415, local authorities must similarly clean up and standardize their preferential tax policies. Notice 415 urges financial departments at all levels to work with tax departments and investigate preferential tax policies that may have been implemented improperly.

These notices have been met with great resistance at the local level due to their perceived economic impact. On 11 May 2015, the State Council partially relented to local pressure and issued Notice 25 to soften the blow of the notices. First, Notice 25 allows existing local incentives to continue until their agreed end dates or for an appropriate period of time if no agreed end date exists. Second, Notice 25 suspends until further notice the special investigations of existing incentives called for under Notice 62 and Notice 415.

Despite these concessions, Notice 25 reaffirmed the government's resolution to clean up local tax subsidies and incentives. It requires any new local incentive not solidly grounded in national laws or regulations to be approved by the State Council. And Notice 25 immediately prohibits local authorities from granting cash-based subsidies associated with taxes or non-tax revenue paid by enterprises.

Observations

Local tax and government authorities are being pressured to clean-up preferential tax incentives formulated without proper legal basis or authority. Any enterprise currently enjoying a preferential policy should discuss the policy with the relevant authorities to determine how the policy may be affected by Notices 25, 62 and 415. Regardless of whether the authorities assure the enterprise that the preferential policy will continue, the enterprise should understand the risk that the preferential policy may be challenged as not sufficiently grounded in relevant tax rules and regulations even though the threat of challenge is not immediate.

5.2 China Enforces Taxation of Previous QFII and RQFII Transactions

On 1 March 2015, PRC tax authorities reportedly rolled out a plan ("**Plan**") to levy 10 percent EIT on capital gains derived by Qualified Foreign Institutional Investors ("**QFIIs**") and Renminbi Qualified Foreign Institutional Investors ("**RQFIIs**") during the period from 17 November 2009 to 16 November 2014.

Background

Under the general principles of the EIT Law, capital gains derived from the disposal of shares in a Chinese resident enterprise are subject to 10% EIT. But no guidance had been issued by the central government specifically addressing QFIIs and RQFIIs; therefore, PRC tax authorities did not enforce the 10 percent EIT on the disposal of shares by QFIIs and RQFIIs.

On 14 November 2014, China finally issued guidance on EIT for QFIIs and RQFIIs, i.e., Cai Shui [2014] No. 79 ("**Notice 79**"). Pursuant to Notice 79, disposal of shares in Chinese resident enterprises by QFIIs and RQFIIs on or after 17 November 2014 will be exempt from EIT. However, the exemption does not apply to capital gains arising from transactions before 17 November 2014 because Notice 79 specifically provides that EIT will apply to past transactions. For a detailed discussion of Notice 79, please refer to November 2014 issue of our client alert.

EIT reporting and settlement deadlines

According to the Plan, QFIIs and RQFIIs will be required to submit information (e.g., custodian bank account, annual audit report, assurance report, information on each share disposal and tax clearance information) to the in-charge tax authorities before 31 July 2015 and settle all overdue EIT by 30 September 2015. The EIT levied on the gain from disposal of shares in Chinese resident enterprises will be withheld at a rate of 10 percent, but late payment surcharges will be waived. Losses from one disposal cannot be used to offset the gains from another disposal. However, QFIIs and RQFIIs are allowed to apply for tax treaty exemptions on their capital gains following the relevant requirements as set out in Notice 124.

Actions to consider

The Plan will greatly affect QFIIs and RQFIIs that have invested in China during the past five years. Fund managers can expect the local tax authorities to actively request information on accounts and transactions. QFIIs and RQFIIs should proactively review past transactions and prepare information to be submitted to the in-charge tax authorities. Also, QFIIs and RQFIIs should seek available exemptions under tax treaties.

5.3 Proposed Amendments to the Tax Collection and Administration Law

On 5 January 2015, the Legislative Affairs Office of the State Council announced a Revised Draft ("**Draft Law**")[28] of the *Tax Collection and Administration Law of the People's Republic of China* ("**TCAL**") and sought more public comments. The Draft Law consists of 139 articles in 11 chapters with 45 newly added articles. The Draft Law made major amendments to the existing law.

Late payment interest

Under the current version of the TCAL, a late payment surcharge of 0.05% per day is levied against a taxpayer that fails to file a tax return.

28 Full text of Draft Law is available (in Chinese) at http://www.chinalaw.gov.cn/article/cazjgg/201501/20150100397930.shtml

The Draft Law would instead impose late payment interest, which would be determined by the State Council with reference to the PBOC's basic interest rate and the reasonableness of prevailing market RMB loan rate.

Voluntary disclosure

Although Chinese laws and regulations are silent on what (if any) incentives are available for voluntary disclosure of undeclared non-compliance, the tax authorities have for many years waived penalties informally. The Draft Law seeks to standardize these practices by specifically permitting tax authorities to reduce or waive penalties or late payment interest for voluntarily disclosure of undeclared non-compliance.

Statute of limitation

Under the current TCAL, various statute of limitations apply to underpayment due to taxpayer mistake and no statute of limitation applies to tax evasion and taxes in arrears. Under the Draft Law, the statute of limitation for underpayment due to taxpayer mistake is 5 years in all cases. For tax evasion cases, the statute of limitation is 15 years. And for pursuing taxes in arrears, the statute of limitation is 20 years.

However, the Draft Law no longer recognizes non-filing due to taxpayer mistake. All non-filing has the same statute of limitation as tax evasion, which is 15 years. This is a significant change from Guo Shui Han [2009] No. 326 ("**Notice 326**"), which expressly states that non-filing due to taxpayer mistake is not treated as tax evasion and should be subject to the same five-year statute of limitation period as underpayment due to taxpayer mistake.

Advance ruling mechanism

The Draft Law introduces an advance ruling mechanism through China's tax administrative system, which would be separate from the advance ruling system available in transfer pricing cases. Under the new advance ruling mechanism, taxpayers would be able to apply for an advance ruling from the tax authorities on complex tax matters involving significant tax assessment amounts. Taxpayers who pay tax according to an advance ruling would be exempt if the ruling resulted in underpaid tax. Tax authorities above the provincial level would be permitted to issue the advance rulings.

The main objectives of this advance ruling mechanism are to provide certainty to taxpayers when contemplating transactions with complex tax issues and to increase consistency among tax authorities. A greater degree of certainty and consistency would help reduce disputes between tax authorities and taxpayers.

Increased disclosure of tax-related information

Under the Draft Law, taxpayers and other third parties will be required to provide tax-related information to the tax authorities in certain circumstances.

Entities or individuals engaged in production or business should disclose the payment amount and the payee's name and taxpayer identity number ("**TIN**") to the in-charge tax authorities for any payment over RMB5,000. If the payment exceeds RMB50,000, the disclosure should be made within five days of the payment.

For banks and other financial institutions, the minimum threshold for tax-related information disclosure would be payments of RMB50,000 instead of RMB5,000. Banks and financial institutions would also need to provide additional information, such as account numbers, investment income, and account balances.

Government authorities would also be required to provide tax-related information disclosures to the finance and tax authorities when making payments to natural persons. The disclosure would need to include the identity of the payee and the payee's professional qualifications, income, property, expenditures, and other relevant information.

These disclosure rules increase the compliance burden on taxpayers. The rules are especially burdensome for banks and financial institutions. Nonetheless, taxpayers need to be prepared to meet the increased compliance workload if the law is promulgated in its current draft form.

TIN system

The Draft Law introduces a TIN system. All enterprises and citizens must receive a unique and permanent TIN, which the tax authorities will use to conduct tax administration. Each taxpayer must disclose its TIN when concluding contracts, paying social insurance, registering real-estate and handling other tax-related matters.

Observations

The Draft Law seeks to revamp crucial parts of China's tax administration system, including its statutes of limitation and general tax administration governance, and to introduce new parts into the system, such as the advanced tax ruling mechanism. As the TCAL will remain an important and integral part of China's tax administration system, we will monitor further updates and revisions and announce the eventual release of the final draft of the TCAL.

5.4 Draft Foreign Investment Law: Issues from a Tax Perspective

On 19 January 2015, the PRC Ministry of Commerce ("**MOFCOM**") released a draft of the new foreign investment law ("**Draft FIL**") for public comment. For a detailed discussion of the Draft FIL, please refer to February 2015 issue of our corporate client alert. From a tax perspective, the Draft FIL intends to bring investment from offshore to onshore, and may create tax implications for common indirect holding structures, such as the variable interest entity ("**VIE**"). Furthermore, new reporting requirements may increase information exchange between governmental departments and spawn more anti-avoidance investigations.

Bulletin 7[29] and Draft FIL implications for VIE structures

The Draft Law introduces the concept of "effective control" to determine whether an investment is controlled by a foreign investor. Effective control by a foreign investor would allow the authorities to deem a domestic enterprise as a foreign investment. This foreign investment designation would affect foreign investors with investment structures that were designed to circumvent foreign investment restrictions, such as the VIE structure.

In a VIE structure, an offshore holding company establishes an onshore wholly foreign owned enterprise ("**WFOE**"). The WFOE enters into a contractual relationship with a domestic enterprise owned by Chinese individual shareholders who have some sort of relationship with or ownership stake in the offshore holding company. The domestic enterprise generally holds key licenses and rights not available to the foreign investors.

Although the Draft FIL's change to corporate rules technically should not affect any tax rules, the effective control principle may be used from a tax perspective to help clarify value and basis when calculating a gain from an indirect transfer. Currently, under Bulletin 7, an indirect transfer of shares in a VIE structure would often be valued on both the onshore WFOE and the VIE domestic enterprise. However, the tax basis, upon which the gain is calculated, would only include the investment cost in the WFOE because the offshore holding company has no direct shareholding relationship with the domestic enterprise. One might argue that the Draft FIL changes this Bulletin 7 analysis to include the investment cost in a domestic enterprise in the tax basis when calculating the gain if the domestic enterprise is effectively controlled by foreign investors and considered as a foreign investment. However, since tax determination normally does not refer to corporate rules, it remains to be seen whether the tax authorities will accept this argument.

Reporting changes in indirect share ownership

The Draft FIL introduces new reporting requirements for foreign investments. Specifically, any establishment or change in the ownership of a foreign investment must be reported to MOFCOM. The information reported should include the foreign investor's basic information, name, residential address, registered address, person in effective control, group structure, primary business, and contact details. Any change in indirect share ownership would also need to be recorded with MOFCOM according to the Draft FIL.

The new reporting requirements create further obligations for a foreign investor in an indirect share transfer. In an indirect share transfer, the

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29 *State Administration of Taxation's Bulletin on Several Issues of Enterprise Income Tax on Income Arising from Indirect Transfers of Property by Non-resident Enterprises*, SAT Bulletin [2015] No. 7, dated 3 February 2015, effective as of the same date.

transferor will have to file information with MOFCOM in addition to voluntary reporting pursuant to Bulletin 7. The Draft FIL may allow for additional channels of information gathering and common information sharing between governmental departments. From a tax perspective, this access to additional information may lead to the tax authorities launching more Bulletin 7 investigations. Foreign investors in China may be subject to more stringent information requests and should be prepared.

www.bakermckenzie.com

To find out more about how we can add value to your business, please contact:

Beijing

Jon Eichelberger (Tax)
+86 10 6535 3868
jon.eichelberger@bakermckenzie.com

Jinghua Liu (Tax and Dispute Resolution)
+86 10 6535 3816
jinghua.liu@bakermckenzie.com

Shanghai

Brendan Kelly (Tax)
+86 21 6105 5950
brendan.kelly@bakermckenzie.com

Glenn DeSouza (Transfer Pricing)
+86 21 6105 5966
glenn.desouza@bakermckenzie.com

Nancy Lai (Tax)
+86 21 6105 5949
nancy.lai@bakermckenzie.com

Amy Ling (Tax)
+86 21 6105 8517
amy.ling@bakermckenzie.com

Hong Kong

William Marshall (Trade and Customs)
+852 2846 2154
william.marshall@bakermckenzie.com

New York

Shanwu Yuan (Tax and Transfer Pricing)
+1 212 626 4212
shanwu.yuan@bakermckenzie.com

Beijing

Suite 3401, China World Office 2
China World Trade Centre
1 Jianguomenwai Dajie
Beijing 100004, PRC

T: +86 10 6535 3800
F: +86 10 6505 2309

Hong Kong

14/F Hutchison House
10 Harcourt Road
Central, Hong Kong

T: +852 2846 1888
F: +852 2845 0476

Shanghai

Unit 1601, Jin Mao Tower
88 Century Avenue, Pudong
Shanghai 200121, PRC

T: +86 21 6105 8558
F: +86 21 5047 0020