



Annual China Tax Update

KPMG China
November 2009

TAX

AUDIT ■ TAX ■ ADVISORY

审计 ■ 税务 ■ 咨询



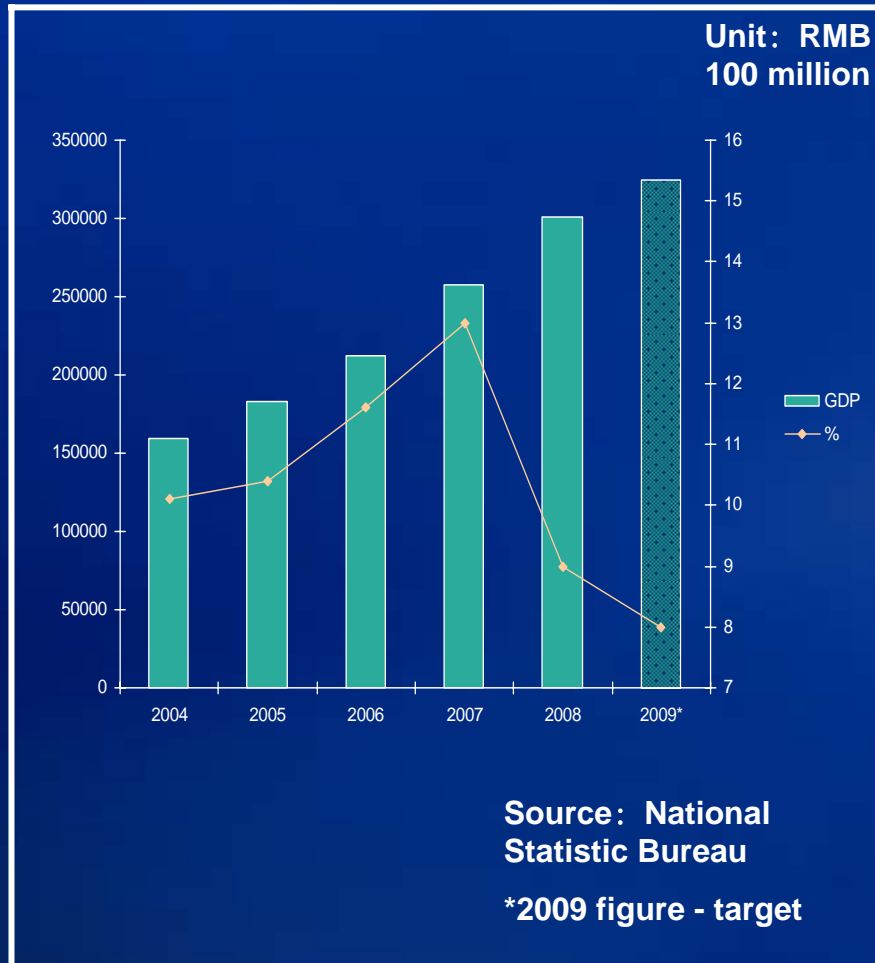
Agenda

- **Economic environment**
- **Key regulatory developments & trends**
- **Key issues**
 - Operation issues
 - Financing
 - Repatriation
 - M&A
- **Q&A**



Economic Environment

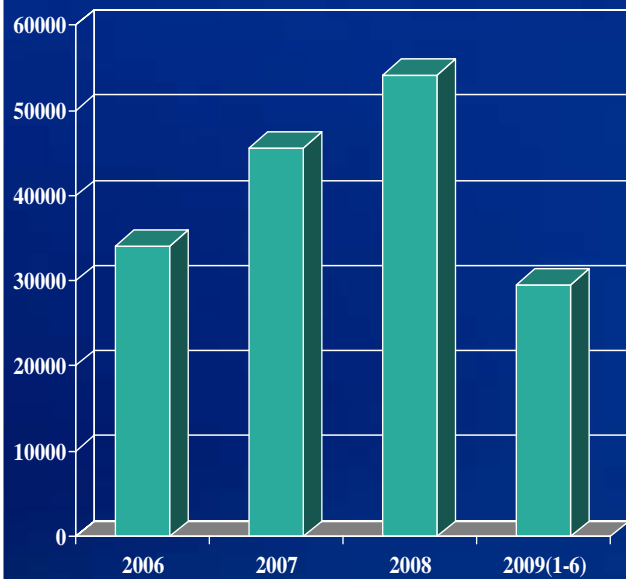
GDP



- **Overriding goal – Safeguard 8% GDP growth rate?**
- **Impact of RMB 4000 billion economic rescue package?**
- **Fiscal loosening moderately**
- **Reduction in export => stimulate domestic consumption**
- **How to balance budget?**

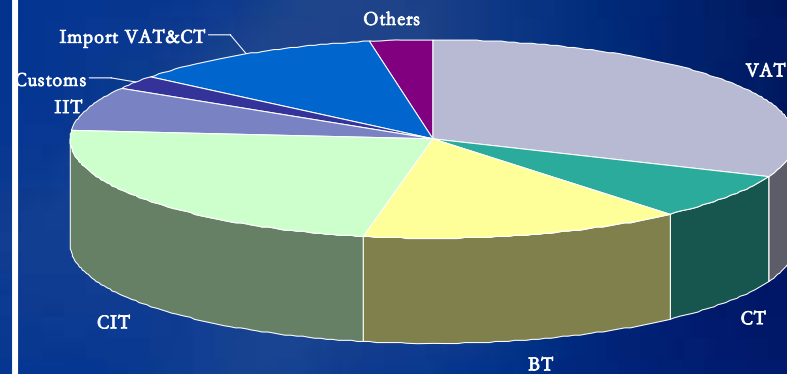
Tax revenues

Unit: RMB
100 million



Source: MOF, Tax Policy Division

Revenue to June 2009



Source: MOF, Tax Policy Division



Key Regulatory Developments & Trends

Taxation

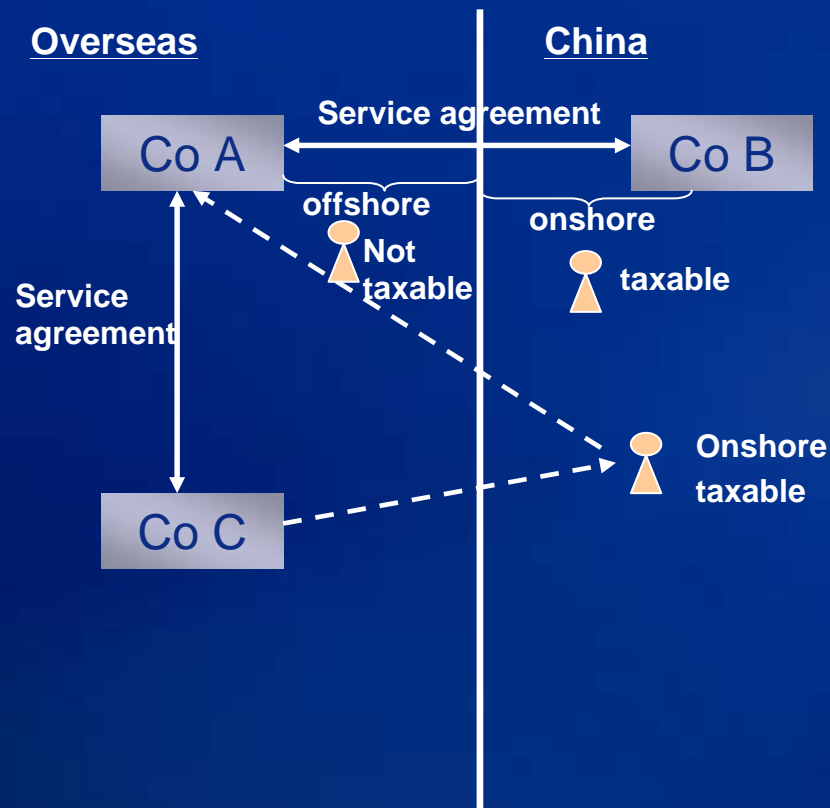
- **Indirect taxes**
 - VAT: Full input tax credit on fixed assets
 - Business Tax: Place of supply rules changed
 - Consumption Tax: Tax on distribution stage for special products
- **CIT**
 - Circulars to clarify rules in CIT Law effective from 1/1/2008
 - M&A regulations
- **Tax compliance & enforcement**
 - Tax registration for non-resident taxpayers
 - Approval / registration for tax treaty relief
 - Internal control guidance for Large Enterprises
 - Self tax audits

VAT

- **Full input tax credit on fixed assets**
- **Removal of prior beneficial treatments**
 - Exemption for imported equipment
 - Refund on domestically purchased equipment
- **Small scale taxpayer rate**

Business Tax – Services

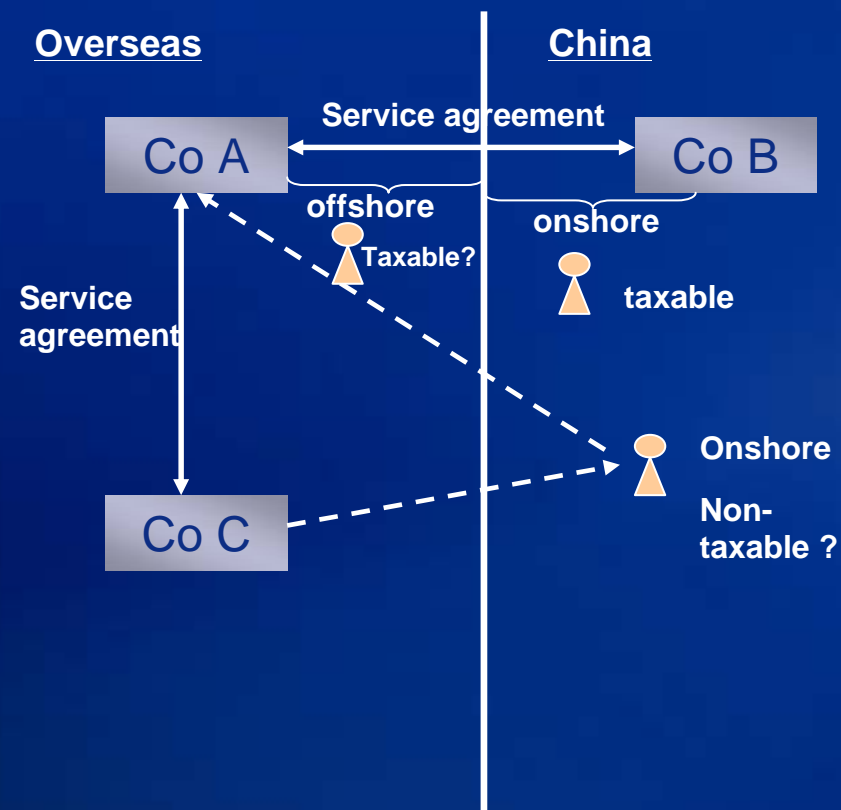
Before 1/1/2009



- Service provided in China = Service took place in China
- Onshore services in principle taxable even if both provider and recipient outside China

Business Tax – Services (Cont'd)

On / After 1/1/2009



- **Service provided in China = service provider or service recipient in China**

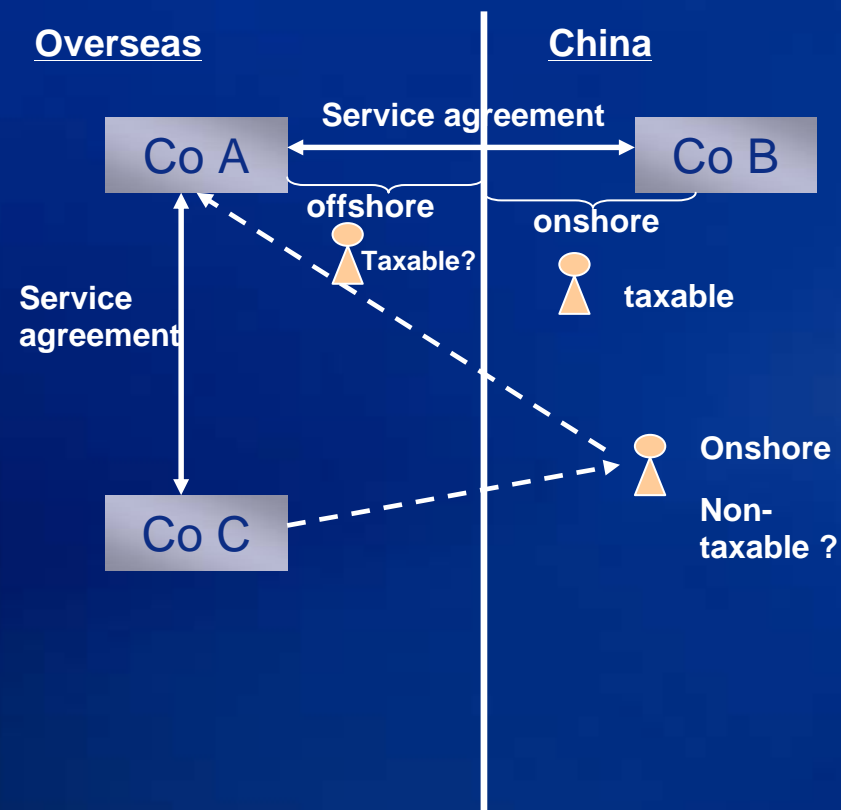
- **Service provider “In China”**

- Incorporated in China?
- Resident in China?
- With a PE in China?

- **No tax even if service takes place in China as long as provider and recipient are outside China?**

Business Tax – Services (Cont'd)

On / After 1/1/2009



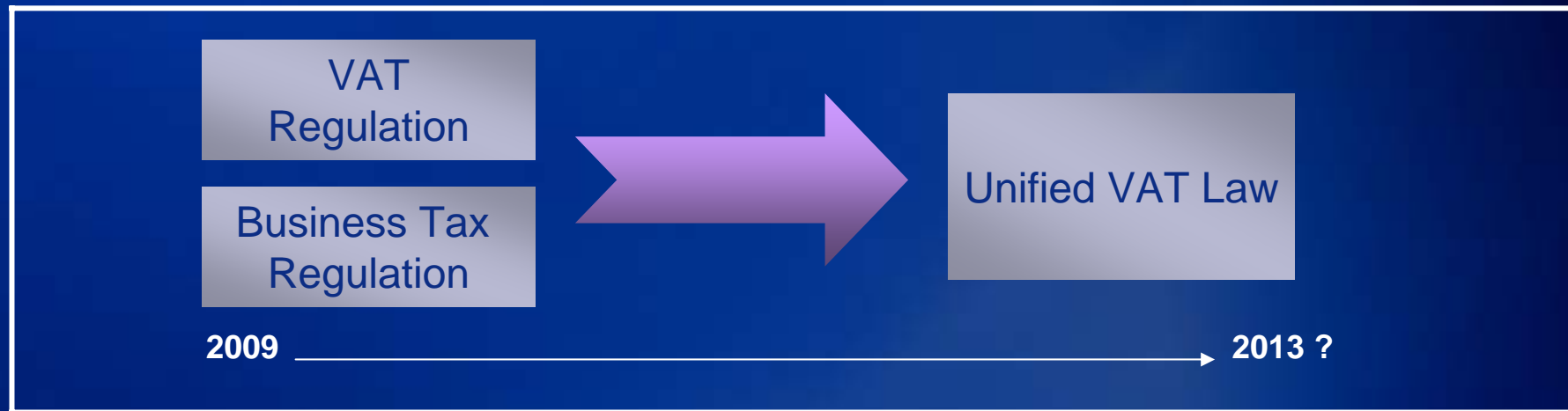
Cai Shui [2009] No. 111

- Services provided in China \neq services rendered completely offshore by enterprise or individual outside China?
- Provisional exemption offshore construction, culture & sports services

Cai Shui [2009] No. 112

- Pre-2009 contracts grandfathered up to end of 2009 in respect of:
 - Place of supply
 - Taxable amount

Indirect taxes – Future development

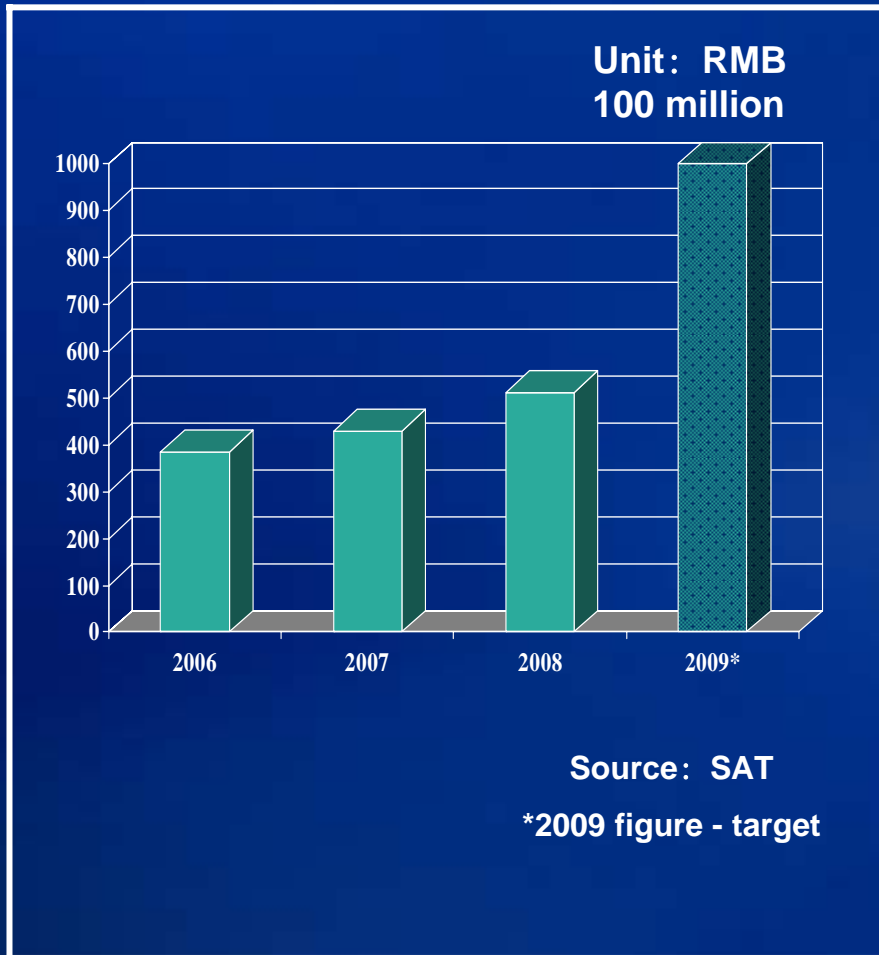


- To merge Business Tax with VAT
- To increase the tax threshold for VAT taxpayers
- To abolish the concept of small scaled taxpayers
- To make export of services zero rated
- To provide special treatments for certain industries including agriculture, financial services and real estate

CIT – Pending regulations

- **Deemed profit rates for permanent establishments**
- **Taxation of representative offices of foreign enterprises**
- **Taxation of capital gains from transfer of equity interest by non-resident enterprises**

Tax enforcement – Audits



Audits

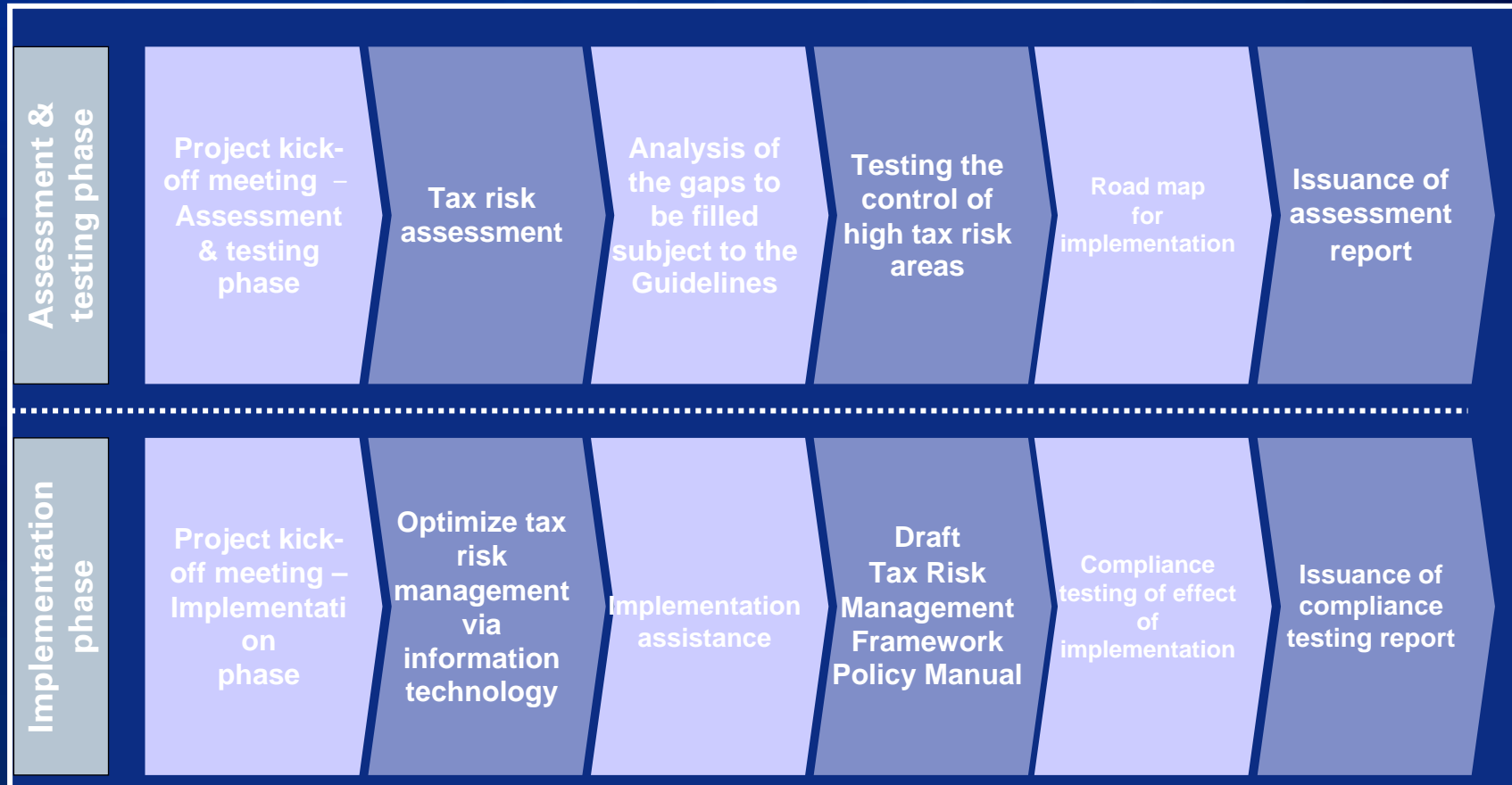
- By industry
- By region
- Large Enterprises

Tax risk management – Internal control for Large Enterprises



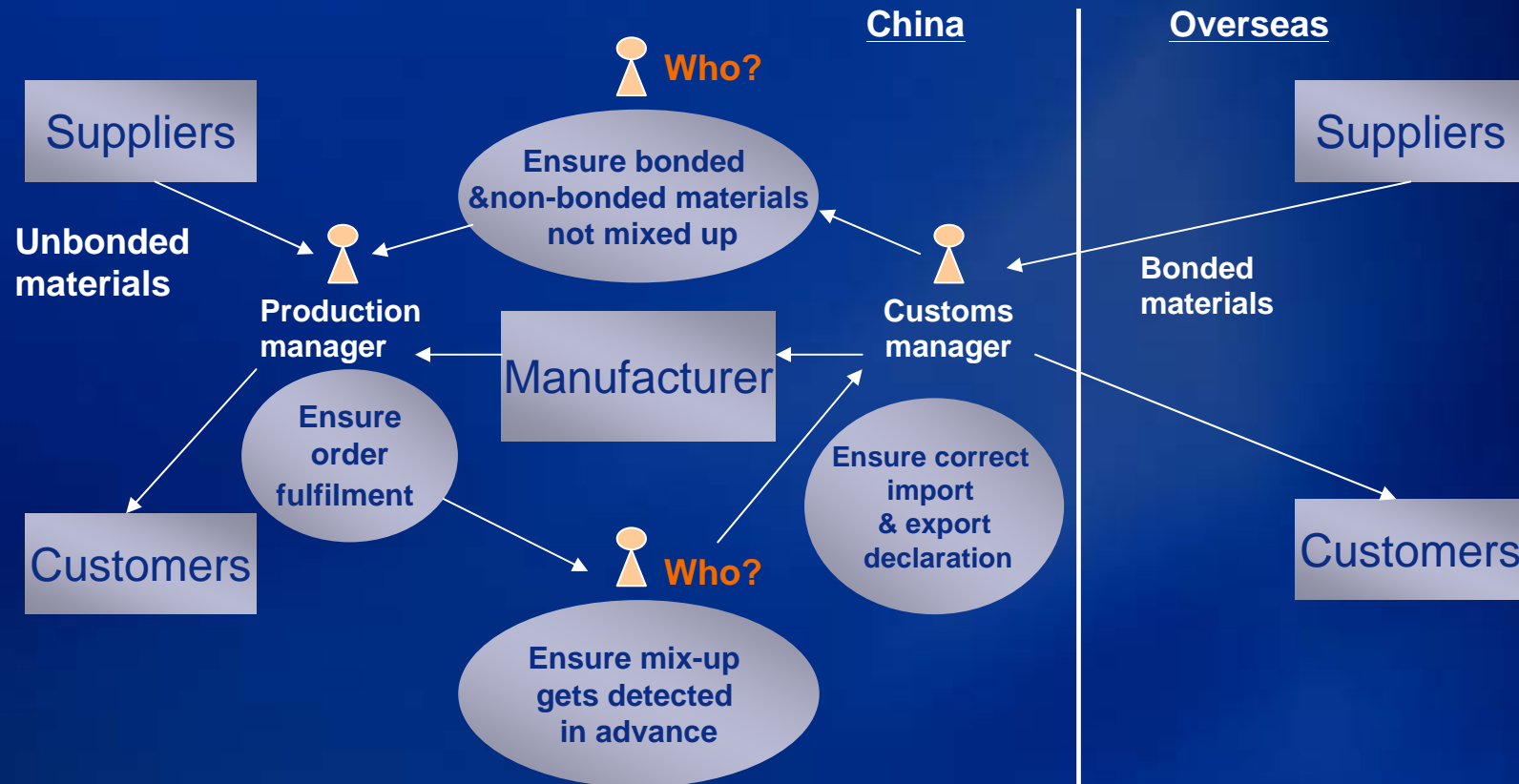
- **Guidelines but strong expectation on relevant taxpayers to follow**
- **Review & appraise tax internal control system, identify and fill gaps in system**
- **Intermediaries to issue report on state of system**

Process for tax internal control system



Tax risk management – Internal control for Large Enterprises (Cont'd)

Gap Analysis – Real Case on Mixing of Materials



New TP regime

TRANSFER PRICING FUNDAMENTALS

Compliance

- Disclosure
- Documentation
- Other Compliance

Enforcement

- Who to investigate
- What to investigate
- How to investigate

Risk Management

- Self-assessment

Advance Pricing Arrangement

- Further reduction of risk

Specific TP Issues (Services, IP, CSA)

Main trends in transfer pricing



Circ. No. 2 (01/09)

Main TP regulations

No. 86 (08/08)

Doc requirements for inter-company services

No. 121 (09/08)

Thin capitalization requirements

No. 114 (12/08)

Detailed forms for required annual filing

No. 134 (03/09)

Additional notice regarding annual filing

No. 363 (07/09)

Documentation for single-function entities

Compliance

No. 72 (02/09)

Increased investigation requirements & capabilities

No. 106 (03/09)

Briefing about 2008 audit work

No. 188 (04/09)

Intensified audit follow-up administration

Nos. 85 and 85

Specific industries to be targeted by authorities

Enforcement

No. 1064 (12/08)

Special TP treatment for certain large enterprises

No. 90 (05/09)

Tax risk management for large enterprises

Nos. 241 & 49

Audits of large enterprises

No. 507 (09/09)

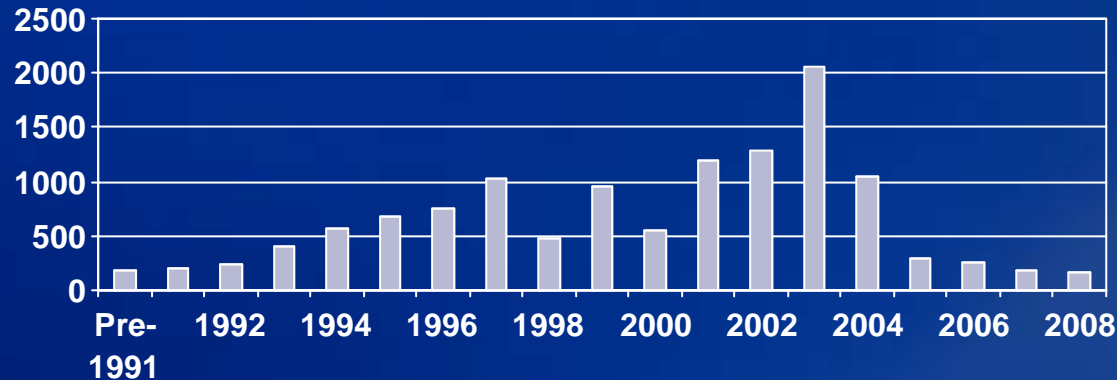
Royalty Payments

Risk Management

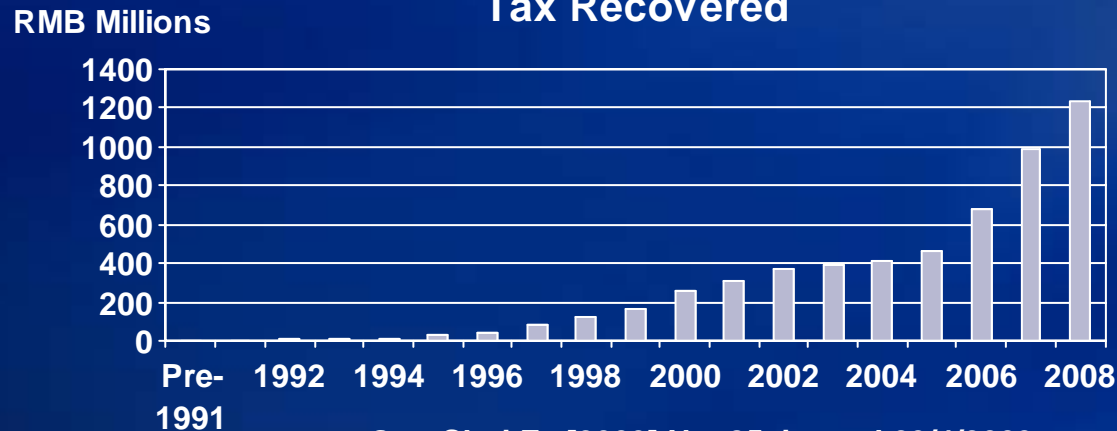


Number of TP audit cases vs. tax recovered

Number of Cases



Tax Recovered



Guo Shui Fa [2009] No. 85, issued 29/4/2009

Targeted Groups

Clothing and shoe manufacturers

Information technology system manufacturers, and contract manufacturers of computers

Fast food restaurants

Large-scale retailers

Manufacturers of drinks, elevator, and automobiles

Financing for highway constructions

Tyre manufacturers

Pharmaceuticals

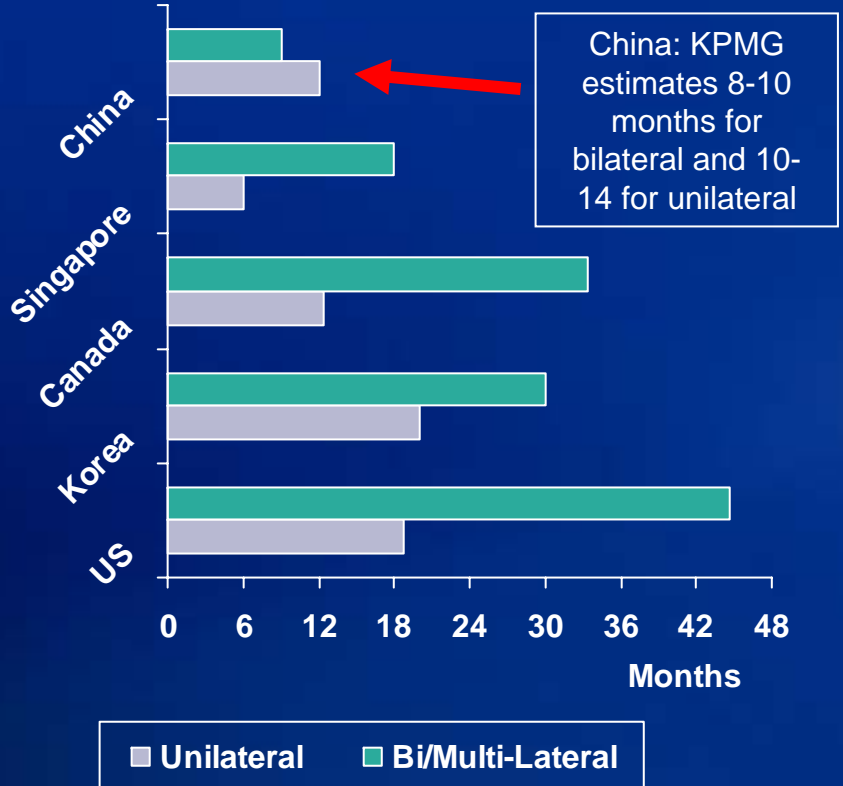
Hotel chains

Companies with outbound investment or overseas subsidiaries

APA statistics



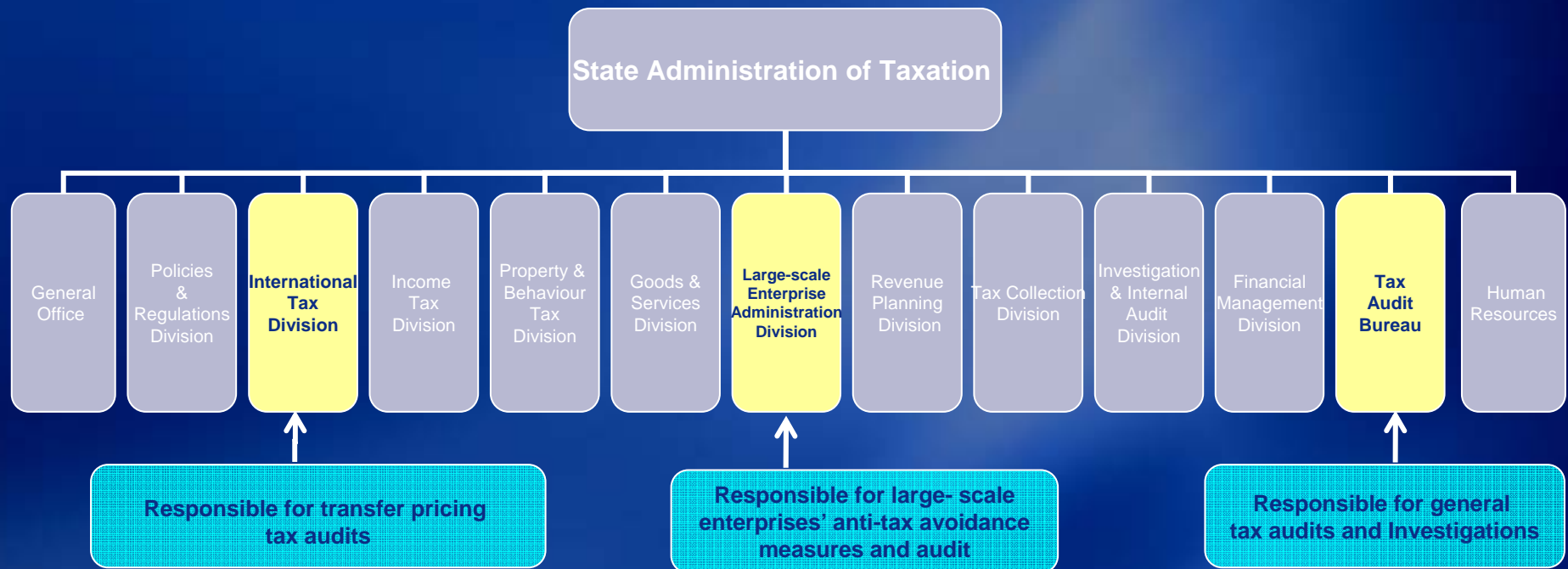
Processing Time



APAs	Documentation
- Proactive	- Passive
- Certain	- Uncertain
- Resource intensive	- Defensive
→ FORWARD LOOKING	

Tax audit – Internal restructure of State Administration of Taxation

Organisation Chart of State Administration of Taxation after restructuring:



Tax audit – 2009 high-risk tax audit targets

Mandatory industries	<ul style="list-style-type: none">• Large-scale chain supermarkets and “TV shopping” enterprises• Construction and installation enterprises• Key export enterprises entitled to export tax refunds or exemption
Recommended industries	<ul style="list-style-type: none">• Commercial, medical, and educational / training organizations• Agency industry• Brand distributors• Auction enterprises• Non-PRC resident enterprises• Enterprises that have not been inspected for more than three years• Real estate developers
Other anti-tax avoidance focuses	<ul style="list-style-type: none">• Abusive use of tax haven countries• Abusive use of double tax treaties• Foreign enterprises with permanent establishment

Tax audit methods

- To confirm information by visiting target's suppliers / clients / banks
- Immigration records
- Exchange of information
- Collecting publicly available information

Tax audit – practical approach to handle tax audit

- Negotiate for self-inspection before formal tax audit
- Research on the tax issues and apply for different tax treatments if there is technical basis
- Timing to conclude the case
- Use different calculation method
- To assess the long-term implications to both tax bureau and taxpayer

Regional / Local Subsidies

- **Preferential Treatments**

- Financial subsidies
- Preferential policy on land usage
- Government service
- Human resource subsidies

IT outsourcing

- **20 model cities**

Beijing, Tianjin, Shanghai, Chongqing, Dalian, Shenzhen, Guangzhou, Wuhan, Harbin, Chengdu, Nanjing, Xi'an, Jinan, Hangzhou, Hefei, Nanchang, Changsha, Daqing, Suzhou, Wuxi

- **Scope**

- Information technology outsourcing (ITO)
- Business process outsourcing (BPO)
- Knowledge process outsourcing (KPO)

Guo Ban Han [2009] No. 9, Cai Shui [2009] No. 63, effective 1/1/2009 – 31/12/2013

Final Checklist

Issues

Y

N

N/A

1. Do your HK/overseas entities have service contracts with mainland companies?

2. Will the service fee be subject to business tax?

3. Are any of your PRC entities currently subject to tax audit?

4. Are your PRC entities big enough or performing certain qualifying activities to enjoy tax holidays or local preferential treatments?

IT outsourcing (Cont'd)



Type of Tax	Incentive
CIT	
● Tax Rate	15%
● Deduction of Staff Education Expenses	≤ 8% x Total Wages
Business Tax	
● Revenue from Off-shoring Services	Exempt

Guo Ban Han [2009] No. 9, Cai Shui [2009] No. 63, effective 1/1/2009 – 31/12/2013

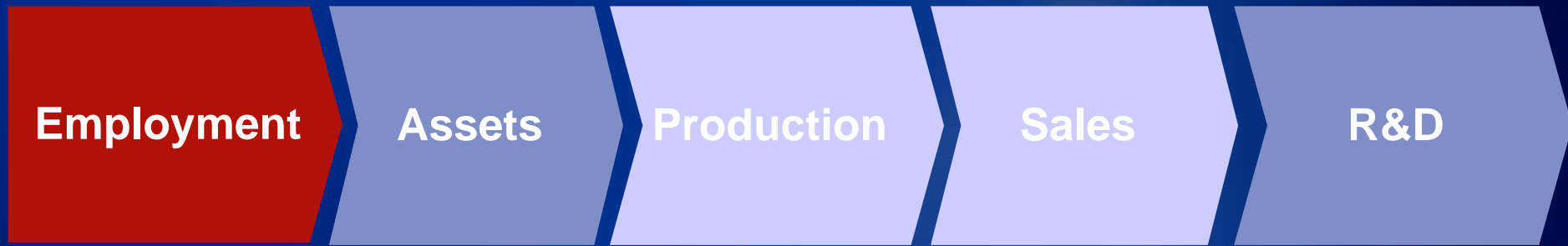


Key Issues

Key Issues



Operation Issues



Employment issues – IIT

- **Tax base**
 - New rules on director fees
 - Rules on share schemes clarified
- **Monthly deduction**
 - Definition of “Overseas Chinese” clarified
- **Tax rates**
 - No more stand-alone treatment for double pay
 - Averaging relief for share schemes clarified

IIT – Director fees

Old rules – Guo Shui Fa [1994] No. 89,
Guo Shui Fa [1996] No. 214

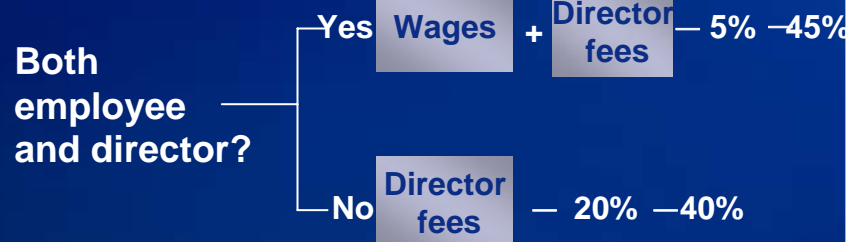
Wages ————— **5% - 45%**

Director fees ————— **20% - 40%**

IIT(RMB)



New rules – Guo Shui Fa [2009] No. 121,
issued 17/8/2009



Monthly wages	RMB 50,000
Monthly director fees	<u>20,000</u>
Total	<u>70,000</u>

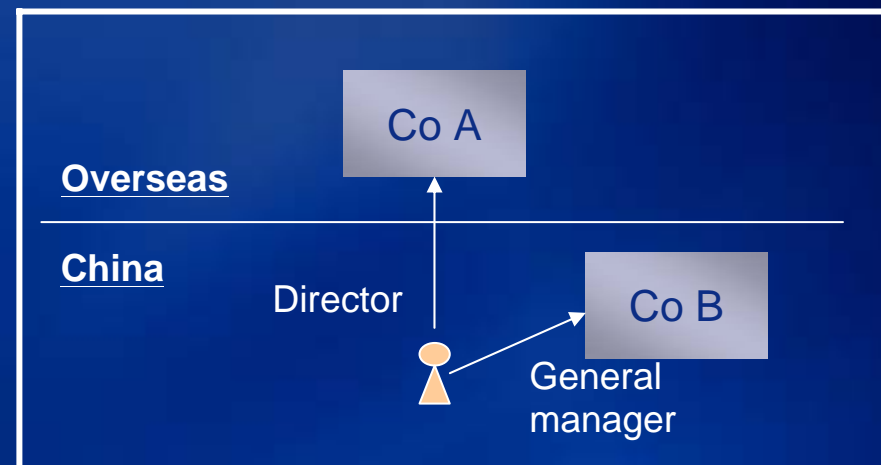
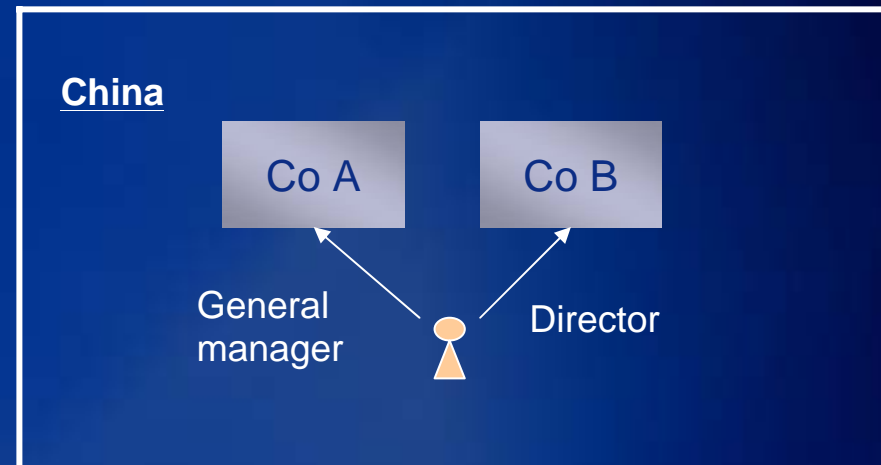
Employee bears own tax

IIT under new rules	16,445
IIT under old rules	<u>(13,385)</u>
Increase in IIT burden	<u>3,060</u>

IIT – Director fees (Cont'd)

● Issues

- How to define “related companies”?
- Bringing director fees from overseas companies into China tax net?
- Implications of tax treaties?



Guo Shui Fa [2009] No. 121, issued 17/8/2009

IIT – Tax base for share schemes



Stock appreciation rights

On recognition of rights

Share value on exercise date	x
Share value on grant date	(x)
	<u>A</u>

Taxable amount = A x no. of stock

Restricted stock

On release of restricted stock

Market price on registration date	x
Market price of current batch on Release date	<u>x</u>
	<u>A</u>

Average price (B) = A / 2

Number of stock currently released x average price (B)	x
Consideration paid by employee x (no. of stock currently released / total no. of stock granted)	(x)
Taxable amount	<u>x</u>

IIT – Averaging relief for share schemes

- Share scheme benefits may be spread over number of months corresponding to benefits subject to maximum of 12 months in identifying applicable tax rates
- Averaging out will be done on roll-forward basis where benefits are derived more than once during the year
- Averaging relief applied to combined benefits from stock options, restricted stock & stock appreciation rights

Guo Shui Han [2009] No. 461

IIT – Tax base for share schemes (Cont'd)



Conditions

- Staff of listed companies
- Share schemes not set up before listing
- Required documents & information on schemes already submitted to tax authority

Listed companies

- Holding of not less than 30%
- Only down to Sub 2
- 51% or more in Sub 1 treated as 100%

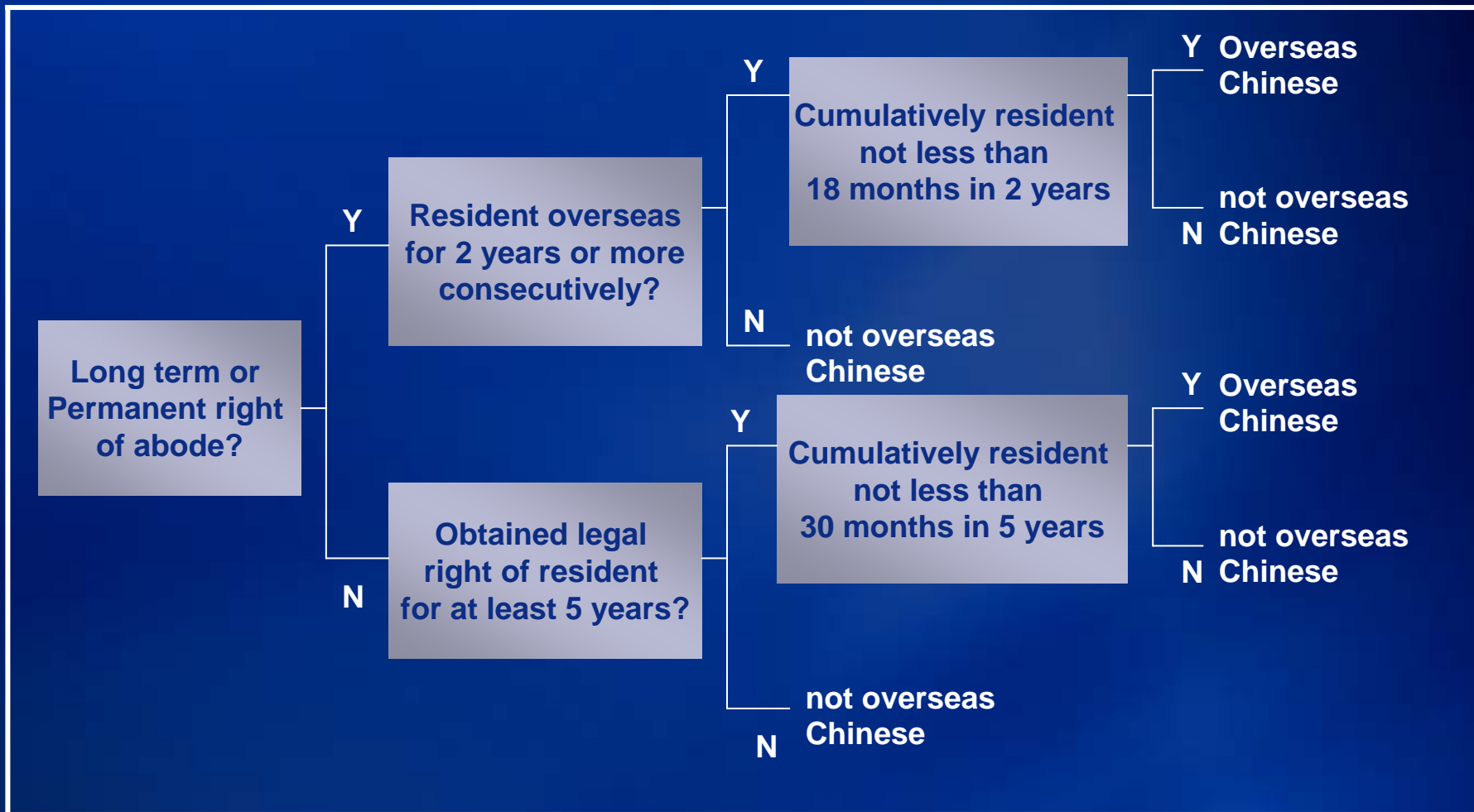
IIT – Monthly deduction for “Overseas Chinese”

Status	Monthly Deduction	Eligible for Exempt Benefits
Foreign nationals	RMB 4,800	Yes
“Overseas Chinese”	RMB 4,800	No
Chinese nationals	RMB 2,000	No

Exempt benefits for foreign nationals: Housing, meals, laundries, home passages, children’s education, etc

Guo Shui Fa [2009] No. 121, issued 17/8/2009

IIT – Monthly deduction for “Overseas Chinese” (Cont’d)



Guo Shui Fa [2009] No. 121, issued 17/8/2009

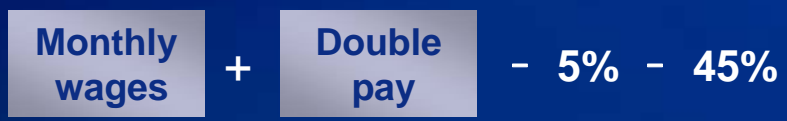
IIT – Tax rates for double pays



Old rules – Guo Shui Han [2002] No. 629



New rules – Guo Shui Fa [2009] No. 121, issued 17/8/2009



Monthly wages RMB 40,000
 Double pay RMB 60,000

Employees bear own tax

IIT under new rules 27,705
 IIT under old rules (22,050)
 Increase in IIT burden 5,655

What if double pay rolled into annual bonus?

Employment – CIT

- **Employers in China**
 - New reasonableness test for deduction
- **Foreign employers**
 - Permanent establishment exposures of secondment

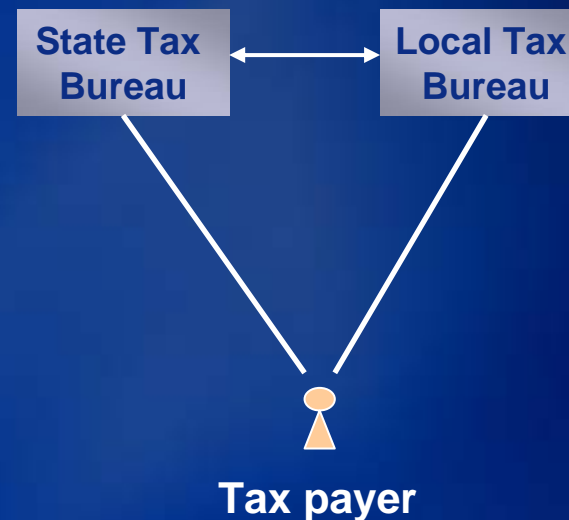
CIT – Deduction of employment costs

Criteria

- Employer has set up wage system
- Wage level consistent with relevant industry & region
- Payment of wages relatively certain & wage adjustments orderly
- **IIT withholding obligation fulfilled**
- Arrangement not for purpose of tax reduction or avoidance

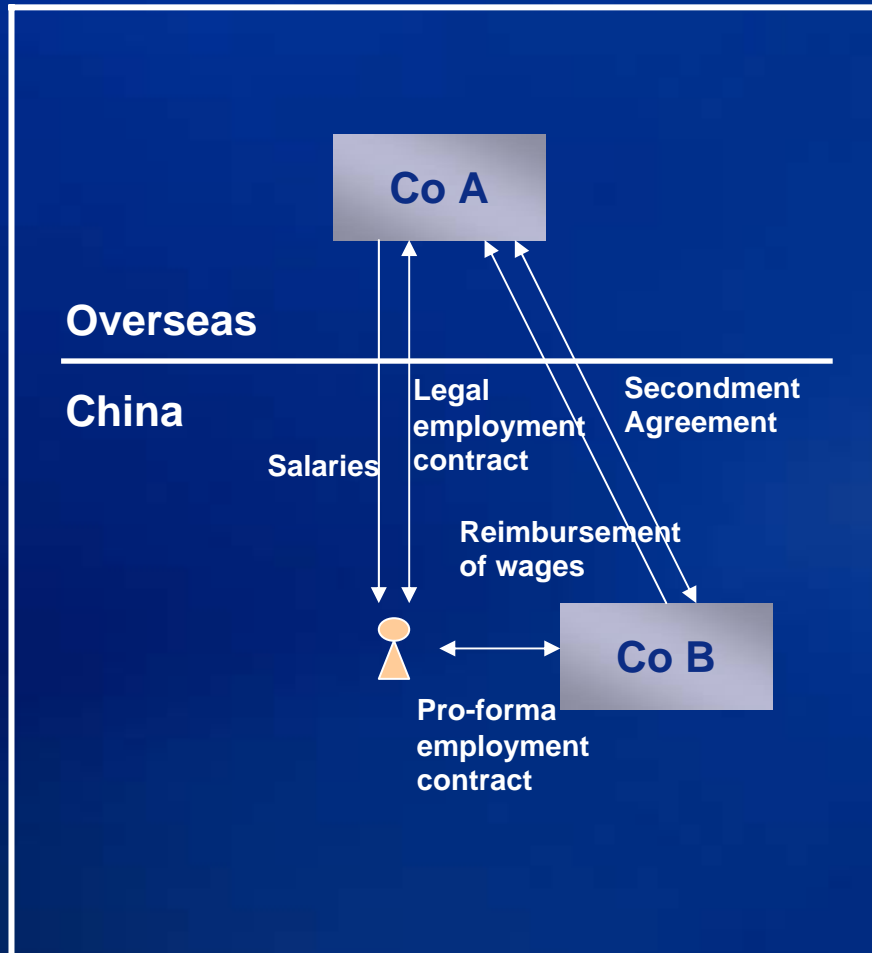
Guo Shui Han [2009] No. 3, effective 1/1/2008

STB & LTB exchanging info on taxpayers



Guo Shui Han [2009] No. 259

CIT – PE exposures of secondment



Possible features

- Co A, being legal employer, makes available employee (“seconded”) to Co B
- Operationally and economically, secondees are accountable to and under control of Co B
- Co A continues to pay all or part of remuneration to secondees
- Co B reimburses Co A for secondees’ remuneration

Is there a valid written secondment agreement?

CIT – PE exposures of secondment (Cont'd)

- **Background: Some foreign enterprises derive income from providing management or technical services to enterprises in China via secondment without accounting for CIT**

- **Targets: manufacturing and service sectors, especially auto industry**

- **Investigation method: review of tax files and remittance records**

- **Due date for commencement of investigation: 31/8/2009**

调查表	
1、企业名称：	2、所属行业：
3、境外企业名称：	
4、合同号：	
5、合同签订日期及履行方式：	
6、合同中有关员工派遣的条款（掌握派遣人员的姓名、护照号码、出入境时间、任职部门、从事的业务及生活条件等信息）：	
7、对本合同征免税判定意见	
8、企业2007至2008年对外支付款项情况以及纳税情况：	
9、备注：	
企业签章	调查人员签字

Ji Bian Han [2009] No. 103, issued 2/7/2009



CIT – PE exposures of secondment (Cont'd)

- No clear rules in CIT Law
- SAT may issue written guidance
- General consideration
 - Whether individual works under control and supervision of host entity
 - Whether host entity bears risks and responsibilities of individual's day to day work
 - Whether individual performs any other functions on behalf of his legal employer for other entities
 - Whether individual's work is reviewed and appraised by host entity
 - Whether payment for individual takes form of recharge of employment costs to host entity without mark-up

How about stewardship related activities?

CIT – PE exposures of secondment (Cont'd)

Implications of PE in China

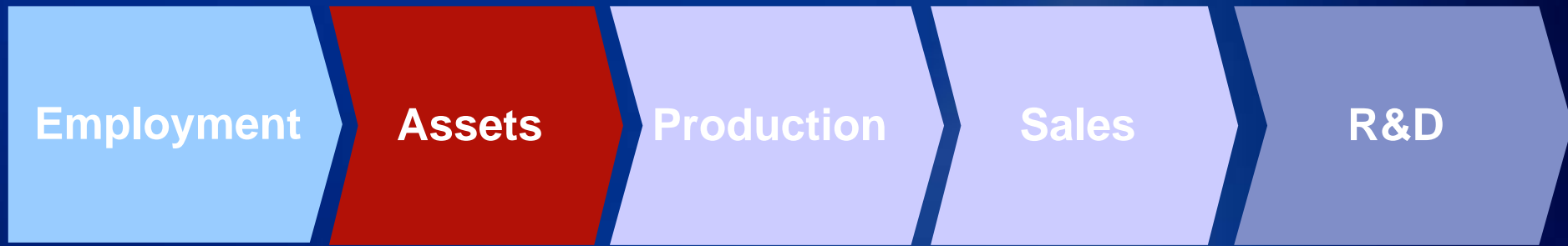
- **China**
 - Tax registration & filing under Decree 19
 - CIT: Service fees x deemed profit rate x 25%
 - Business Tax: Service fees x 5%?
- **Home jurisdiction**
 - Foreign tax credit may be denied

Checklist – Employment issues

Issues

	Y	N	N/A
1. Director's fees properly treated as wages?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. Share scheme benefits properly calculated?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. "Overseas Chinese" status ascertained?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. Double pay grouped into monthly wages?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. Salary expense matched with salary reported for IIT?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6. Secondment arrangement properly documented?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Operation Issues

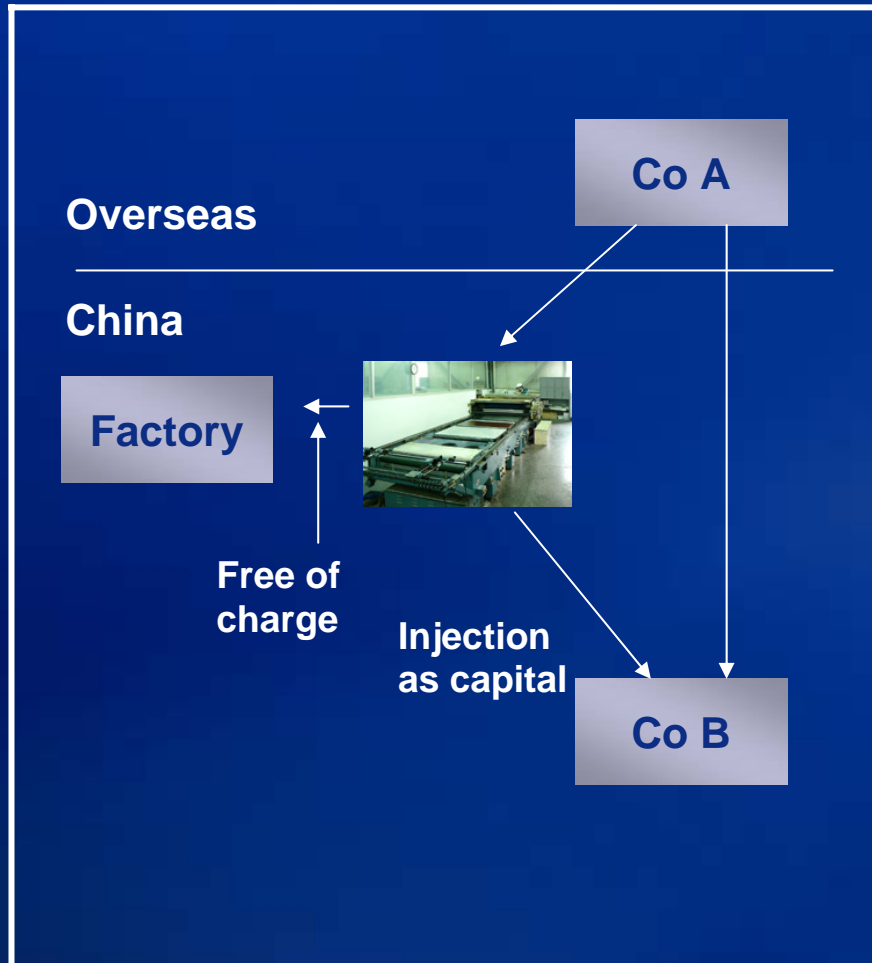


Acquisition of fixed assets – VAT credit

VAT payer	Before 1/1/2009 #		On/after 1/1/2009	
	VAT	Duty	VAT	Duty
Domestic assets				
● Encouraged projects	Refund	N/A	Credit	N/A
● Other projects	No credit	N/A	Credit	N/A
Imported assets				
● Encouraged projects	Exempt	Exempt	Credit	Exempt
● Toll manufacturing	Exempt	Exempt	Credit?	Exempt
● Other projects	No credit	Payable	Credit	Payable

There were special credit rules for companies in “pilot scheme” regions.

Acquisition of fixed assets – Injection of equipment as capital



- Processing factory is non-legal person
- Equipment made available free of charge to processing factories
- Processing Trade handbook lodged on / before 31/12/2008
- Equipment imported on / before 30/6/2009
- Still subject to customs supervision
- No need to make up import duty & VAT upon injection in legal entity
- Application by 30/6/2011

Non-creditable input tax on immovable properties



- **Immovable properties – Buildings, structures & articles attached to ground**
- **Include ancillary equipment and supplementary facilities that form part of buildings or structures**
 - Regardless of whether they are separately recorded for accounting purposes.
 - Used for water supply and sewage, heating, sanitation, ventilation, illumination, communication, coal gas, fire prevention, central air-conditioning, elevators, electricity and intelligent buildings.

Cai Shui [2009] No. 113, effective 1/1/2009

Disposition of fixed assets – Special used goods rules

Before 1/1/2009

- Normally charged VAT at 2% (i.e. 4% x 50%)
- VAT exemption if all the following three criteria were met
 - Asset was included in fixed assets registry of seller
 - Asset was managed and used by seller as fixed asset
 - Sales price of fixed asset did not exceed its original value

Guo Shui Han Fa [1995] No. 288, Cai Shui [2002] No. 29

On/after 1/1/2009

- Bought before 1/1/2009
 - Already enjoyed credit under pilot scheme
VAT on subsequent sale = sales price x 17%
 - Otherwise
VAT on subsequent sale = [sales price / (1 + 4%)] x 2%
- Bought on / after 1/1/2009
VAT on subsequent sale = sales price x 17%

Cai Shui [2009] No. 9, Guo Shui Han [2009] No. 90

VAT issues for Business Tax payers

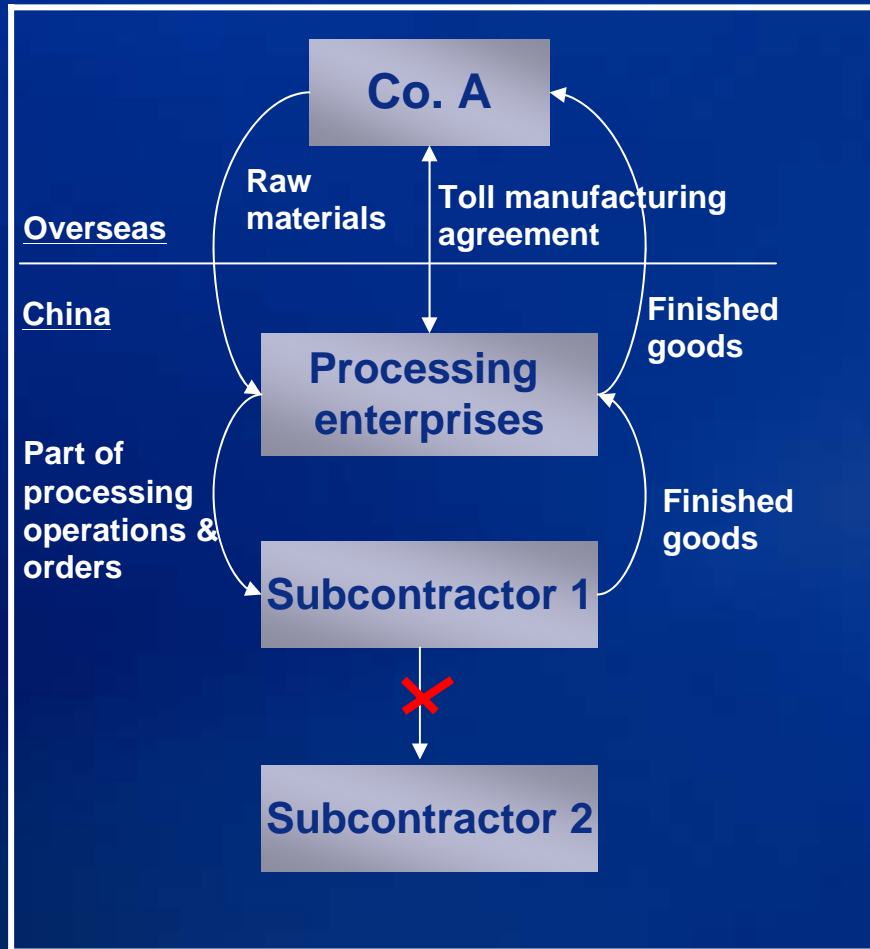


- R&D centres
 - Special exemption / refund for imported / locally produced equipment

Operation Issues



Subcontracted processing



- Processing enterprises to apply to customs where processing trade logbooks lodged for sub-contracted processing to another party
- Subcontractors may not sub-subcontract work to others
- Subcontractors should perform customs registration

Checklist – Operational issues



Issues

Y

N

N/A

1. VAT invoice obtained for fixed asset purchase?

2. Input claim on VAT paid on purchase of fixed assets?

3. VAT paid on proper rate on disposal of fixed assets?

4. Subcontracting arrangement properly registered/
approved?

Operation Issues



Sales recognition for CIT purposes

- **Accrual principle & substance over form principle**
- **Criteria**
 - Contract already signed & risks & rewards of ownership passed to buyer
 - No management right or effective control retained
 - Amount of revenue ascertainable with certainty
 - Costs can be calculated with certainty
- **Settlement method & timing of recognition of revenue**
- **Buy-One-Get-One-Free package**
 - Not treated as gifts
 - Sales prices attributed to each item = Total sale price x fair value of that item / Fair value of all items

Guo Shui Han [2008] No. 875



Promotion-related expenses



- **Relevant expenses**

- Entertainment expenses

- 60% of actual amount deductible, subject to the threshold of 0.5% of sales revenue

- Advertising and promotion expenses

- Deductible subject to the threshold of 15% of sales revenue
 - Exceeded portion could be carried forward

- **Basis for calculating limits**

- Deemed sales included in sales revenue for calculating tax deduction limits

Guo Shui Han [2009] No. 202, issued 21/4/2009

Operation Issues



CIT – Scope of R&D expenses

“Super-deduction” of R&D expenses for qualifying project under CIT Law

- 150% of qualifying R&D costs, OR
- 150% cost base uplift for amortization on capitalised R&D expenses



Expensed
Or
Capitalised
R&D costs

Following expenses related to R&D

- Direct and related expenses, e.g. labour and amortization; Design & formulation fees
- Materials & power supplies; Remuneration of R&D staff
- Depreciation or rentals on instruments & equipment; Amortisation of software, patents & proprietary technologies / knowhow
- Expenses for developing & producing moulds for experimentation; On-site experiment expenses
- Expenses for verifying & testing of R&D outcome upon handover

Guo Shui Fa [2008] No. 116, issued 10/12/2008, effective 1/1/2008

CIT – Information required by tax authorities on R&D expenses

- R&D project plan and budget
- R&D personnel information
- Summary of R&D expenses
- Resolutions of general management or board meetings on setting up of R&D projects
- R&D contracts
- Information on effects & results of projects

Guo Shui Fa [2008] No. 116, issued 10/12/2008, effective 1/1/2008

CIT – Compliance requirement for hi tech enterprises

- Enterprises that obtain hi tech company status after year end but before submission of annual CIT return should file following documents with tax authorities
 - Declaration that products / services fall within scope as determined by Hi Tech Areas Receiving Key Support of State
 - Detailed record on structure of R&D expenses
 - Info on ratio of hi tech revenue to total revenue in year (*Criteria: More than 60%*)
 - Info on ratio of staff with tertiary education / R&D staff to total staff (*Criteria: More than 30% / 10% of total staff in each case respectively*)
- Enterprises that has obtained hi tech status but fail to meet relevant criteria shall not enjoy tax incentives. If so, the tax authorities shall recover the underpaid tax.

VAT – Exemption for imported equipment for foreign-invested R&D centres

Parameters	Before 1/10/2009	On / after 1/10/2009
R&D expenses		
● Set up less than 2 years		
- Legal person	Total investment \geq USD 5 million	Total investment \geq USD 8 million (Note 1)
- Internal department / branch	Total R&D contribution \geq USD 5 million	Total R&D contribution \geq USD 8 million (Note 1)
● Set up for 2 years or more	Annual R&D expenses \geq RMB 10 million	N/A (Note 1)
Full time R&D personnel	≥ 90	≥ 150
Accumulated equipment value	\geq RMB 10 million	\geq RMB 20 million

Note 1: After 30/9/2009, it will not matter if a centre is set up less than 2 years.

Cai Shui [2009] No. 115, effective 1/7/2009 – 31/12/2010

VAT – Refund for locally produced equipment

Eligible domestic & foreign invested R&D centres:

- Institutions recognized under MOF, General Administration of Customs & SAT Decrees No. 44 & 45
- Foreign invested R&D centres that qualifies for VAT exemption on imported equipment

Cai Shui [2009] No. 115, effective 1/7/2009 – 31/12/2010

Checklist – Operational issues



Issues

Y

N

N/A

1. VAT exemption / refund for R&D equipment claimed?

2. Buy-one-get-one-free sales properly treated?

3. Claim on R&D bonus deduction properly supported?

Key Issues



Capital contribution – Loan interest due to late injection

- **Non-deductible interest in relevant period**

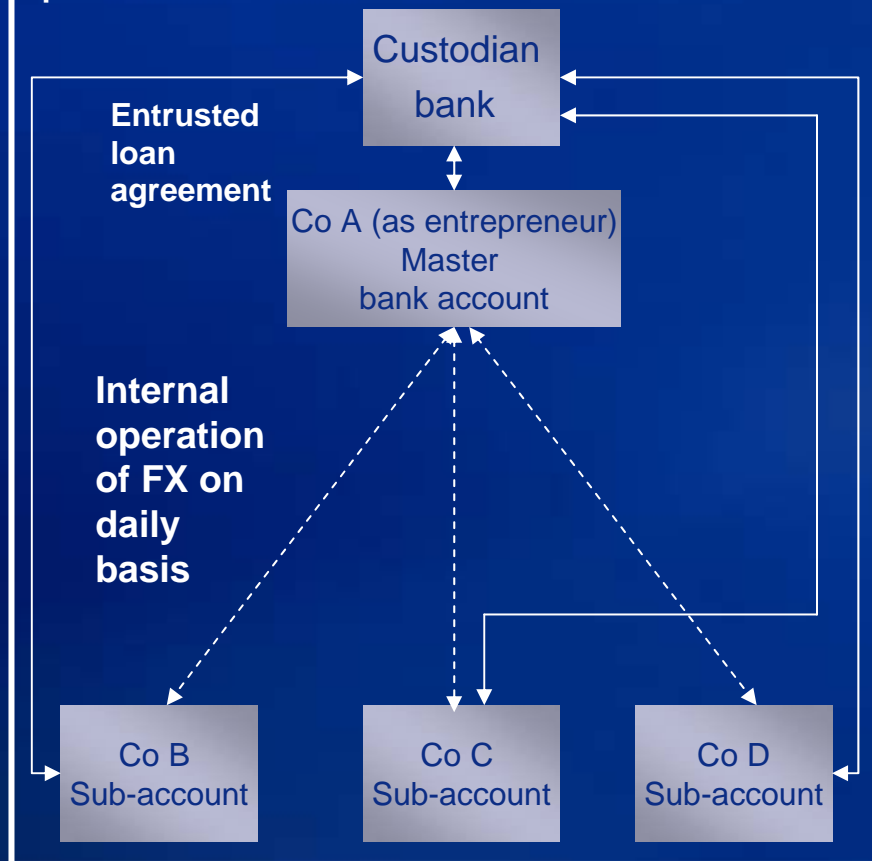
= Loan interest in relevant period x amount of capital shortfall in relevant / Total amount of loan in relevant period

- **Non-deductible interest for year = sum of non-deductible interest in all periods**

Guo Shui Han [2009] No. 312

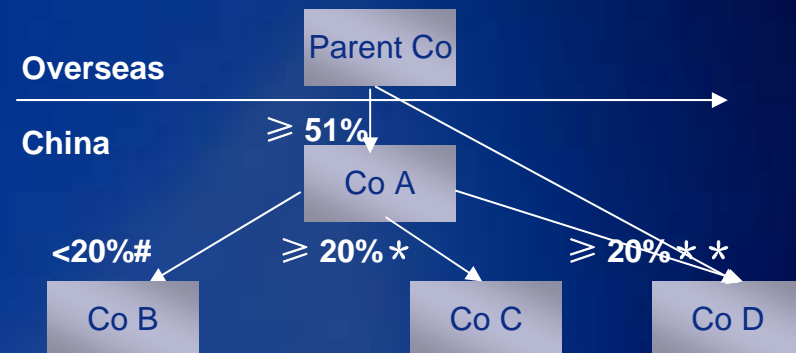
Cash pooling in foreign currency within China

↔ One entrusted loan agreement involves all qualified internal members.



Hui Fa [2009] No. 49, effective 1/11/2009

Group structure



$< 20\%$ but major shareholder

* Individually or collectively

** Co A & Parent Co collectively holding $\geq 20\%$

Impact

- Reasonable commercial interest should be charged
- Business Tax, CIT and Stamp Duty implications

Key issues



General compliance requirements

● Passive income

- Tax registration of contracts (Guo Shui Fa [2009] No. 3)
- Approval for tax treaty relief (Guo Shui Fa [2009] No. 124)

● Active income

- Tax registration of non-resident taxpayers (SAT Decree [2009] No. 19)
- “For-the-Record” filing for tax treaty relief on permanent establishment (Guo Shui Fa [2009] No. 124)

Passive income

- Dividends
- Interest
- Capital Gains
- Royalties

Active income – from:

- Consulting
- Construction projects
- Other services

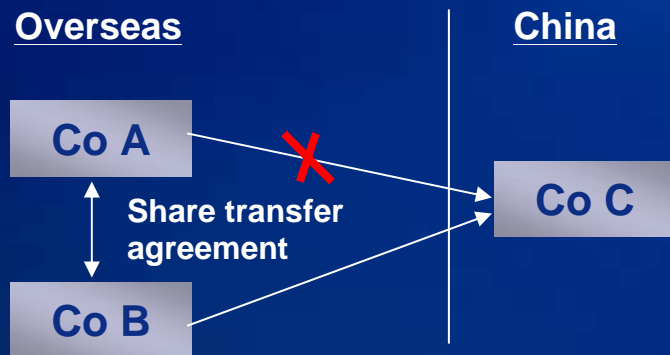
Tax registration under Circular 3 – Passive income

Dividends, interest, capital gains (transferee in China), royalties



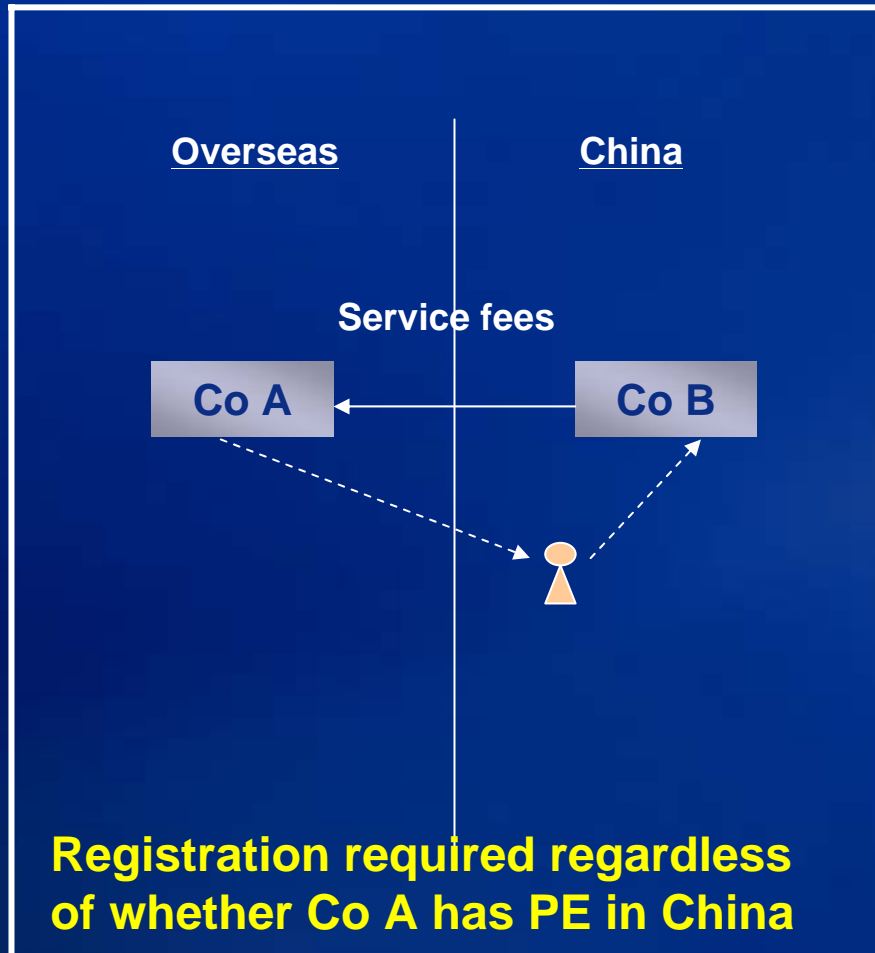
- **Co A – taxpayer**
 - No registration required
- **Co B – withholding party**
 - Registers within 30 days of conclusion of contract
 - Change registration within 30 days of revision of contract

Share transfer



- **Co A – primary taxpayer**
 - Obligation to report and settle WHT liability
- **Co B – acquirer; “residual” withholding party?**
 - “Residual” obligation to register contract and/ or withhold tax?
- **Co C – investee company to facilitate**
 - Lodge transfer contract when performing change of tax registration
 - Need to assist tax authorities to enforce tax payment

Tax registration under Decree 19 – Active income



Co A – Non-resident service provider / contractor

- Register within 30 days of contract conclusion

Feasible without business registration?

- De-register within 15 days of service / project completion

Co B – Resident service recipient / project owner

- Register within 30 days of arising of withholding obligation
- Notify tax authority within 30 days of receipt of invoices from Co A

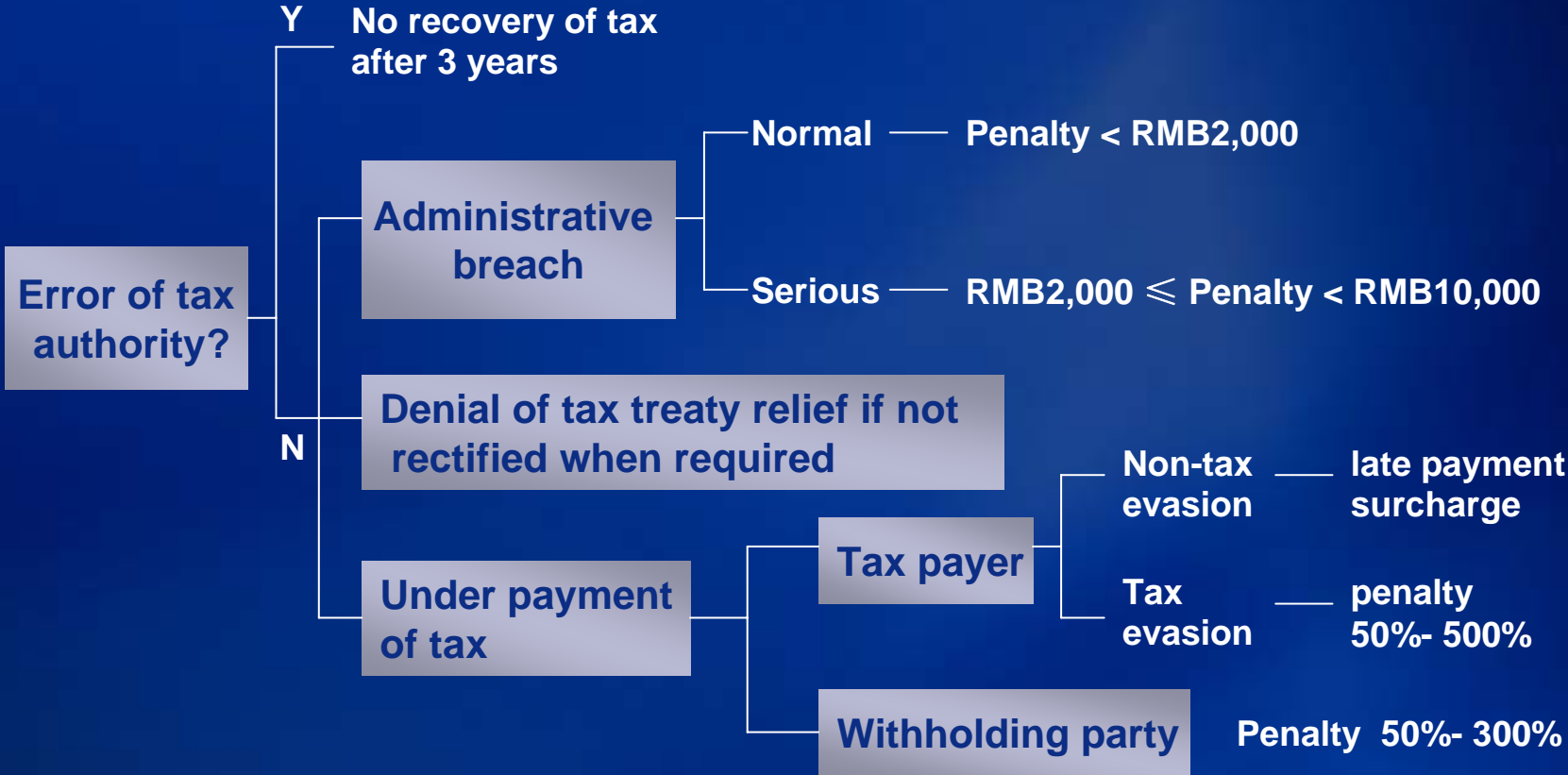
Effective 1/3/2009

Circular 124 on tax treaty relief – Passive income

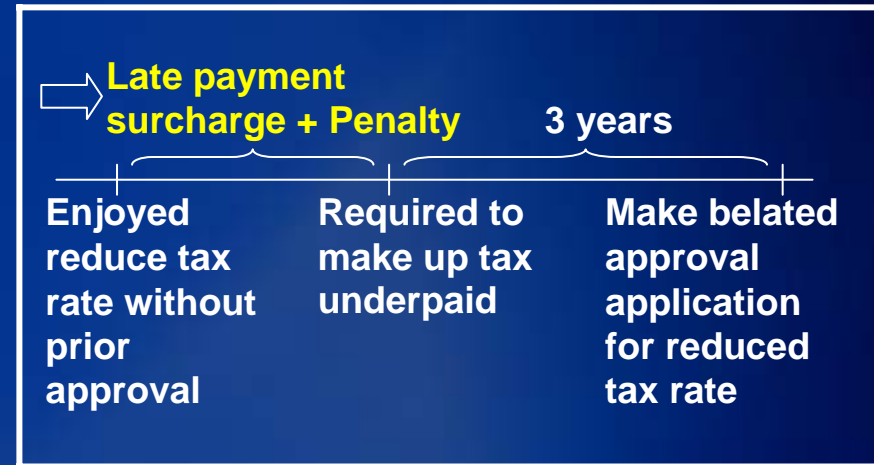
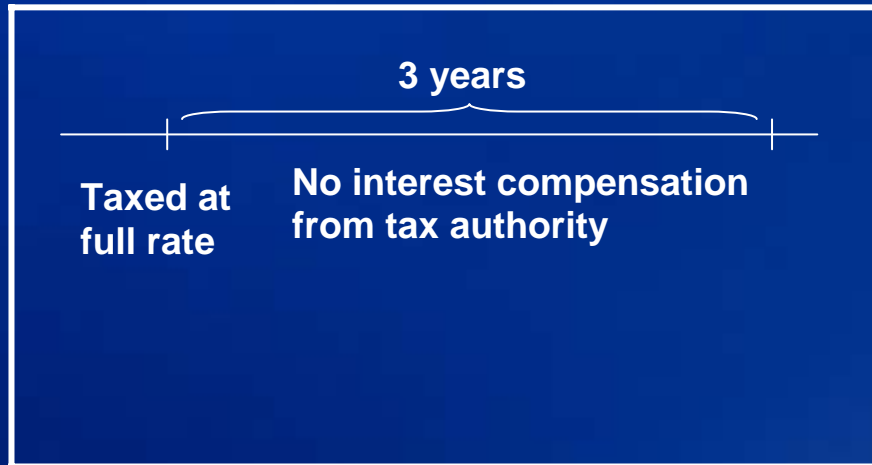
- **Effective 1/10/2009**
- **Tax treaty relief for passive income**
 - Reduced withholding tax rate
 - Reduced tax base
- **Approval from tax authority in charge**
- **Deemed approval if no reply within**
 - 20 / 30 / 40 days from county / district / provincial authorities
 - subject to extension by 10 days
- **Exempt from subsequent application for approval within 3 calendar years (including current year) on income**
 - from same payer
 - under same clause
 - in same treaty
- **Obligation to notify authority of change of circumstances**

附件 2 Annex 2		非居民享受税收协定待遇审批申请表										
Non-resident's claim for treatment under Double Taxation Agreement(DTA) (for approval)												
填报日期Date 年 月 日 Y/M/D												
1 纳税人名称 Taxpayer's name		2 纳税人识别号 Taxpayer's tax identification number			3 纳税人类型 Type of taxpayer <input type="checkbox"/> 企业 Enterprise <input type="checkbox"/> 个人 Individual							
4 纳税人境内地址 Address in China		5 境内联系电话 Telephone number in China			6 境内邮政编码 Postal code in China							
7 纳税人境外地址 Address in home country		8 境外联系电话 Telephone number in home country			9 境外邮政编码 Postal code in home country							
10 序号 No.	11 项目 Item	12 所得类型 Type of income	13 纳税方式 Approach of tax payment	14 支付人或扣缴义务人名称 Name of payer or withholding agent	15 支付人或扣缴义务人纳税人识别号 Tax identification number of payer or withholding agent	16 申请适用税收协定及条款 Applicable DTA and articles	17 是否属于关联交易 An associated transaction or not	18 收入额或应纳税所得额 Amount of gross income or taxable income	19 减免税额 Tax deduction or exemption	20 备注 Additional information		
21 符合享受税收协定待遇规定条件的理由 Reasons for enjoying treatment under DTA												
22 本次申请附报资料清单 List of documents attached to this application form		(1)										
		(2)										
		(3)										
		(4)										
		(5)										
23 与本次申请享受税收协定待遇有关但以前提交过的资料清单 List of documents that have been submitted before		(1)										
		(2)										
		(3)										
		(4)										
		(5)										

Circular 124 – Failure in compliance



Circular 124 on tax treaty relief – Passive income



Full rate first & then claim refund

- May make deferred approval application for reduced tax rate
- Deadline: End of 3 years from date of tax first paid

Reduced rate first & then full rate

- May still make belated approval application for reduced tax rate
- Deadline: End of 3 years from date of additional tax being made up

Circular 124 on tax treaty relief – Active income

- Effective 1/10/2009
- Tax treaty relief for active income
 - Identification of permanent establishment & computation of business profits
 - Independent personal services
 - Dependent personal services
- “For-the-Record” filing with tax authority in charge
- No need to apply for approval

附件 1 Annex 1		非居民享受税收协定待遇备案报告表									
Non-resident's claim for treatment under Double Taxation Agreement (DTA) (for record)											
填报日期 Date 年 月 日 YMD											
1 纳税人名称 Taxpayer's name		2 纳税人纳税人识别号 Taxpayer's tax identification number			3 纳税人类型 Type of taxpayer <input type="checkbox"/> 企业 Enterprise <input type="checkbox"/> 个人 Individual						
4 纳税人境内地址 Address in China		5 境内联系电话 Telephone number in China			6 境内邮政编码 Postal code in China						
7 纳税人境外地址 Address in home country		8 境外联系电话 Telephone number in home country			9 境外邮政编码 Postal code in home country						
10 纳税人是否构成任何第三方税收居民 Is the taxpayer a fiscal resident of a jurisdiction other than China & the other contracting party?					<input type="checkbox"/> 是 Yes <input type="checkbox"/> 否 No		11 如 10 栏选是, 请列示第三方名称 If "Yes" is in Blank 10, please specify				
12 序号 No.	13 项目 Item	14 所得类型 Type of income	15 纳税方式 Approach of tax payment	16 支付人或扣缴义务人名称 Name of payer or withholding agent	17 支付人或扣缴义务人纳税人识别号 Tax identification number of payer or withholding agent	18 适用的税收协定及条款 Applicable DTA and articles	19 是否属于关联交易 An associated transaction or not	20 收入总额或应纳税所得额 Amount of gross income or taxable income	21 减免税额 Tax deduction or exemption	22 备注 Additional information	
23 符合享受税收协定待遇规定条件的理由 Reasons for enjoying treatment under DTA											
24 本次备案附报资料清单 List of documents attached to this form											
25 与本次备案有关但以前已提交的资料清单 List of documents that have been submitted before											
26 声明 Declaration											
我谨声明以上呈报事项准确无误。 I hereby declare that the above information is true and correct.											
纳税人印章或签字 Stamp or signature of taxpayer: 年 月 日 YMD											
代理人印章或签字 Stamp or signature of attorney: 年 月 日 YMD											

General – Beneficial owners for tax treaty relief (Notice 601)

- **Beneficial owner**

- Has ownership & control over income or income-generating rights or properties
- Carries out substantive operational activities
- Can be individual, company or other group
- Cannot be agent or conduit company

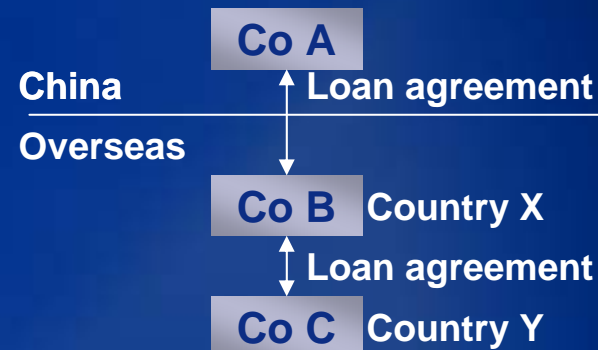
- **Substance over form**

- **Unfavourable factors**

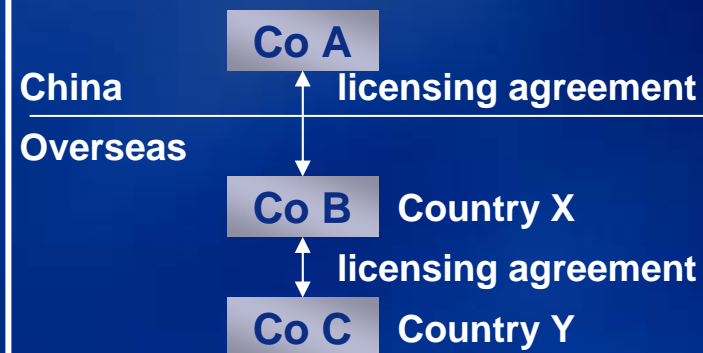
- Pass on substantive income (e.g. > 60%) to 3rd country over short period (e.g. 12 months)
- Limited assets, scale & staff
- Located in location with no / low effective tax

- **Taxpayer to prove status**

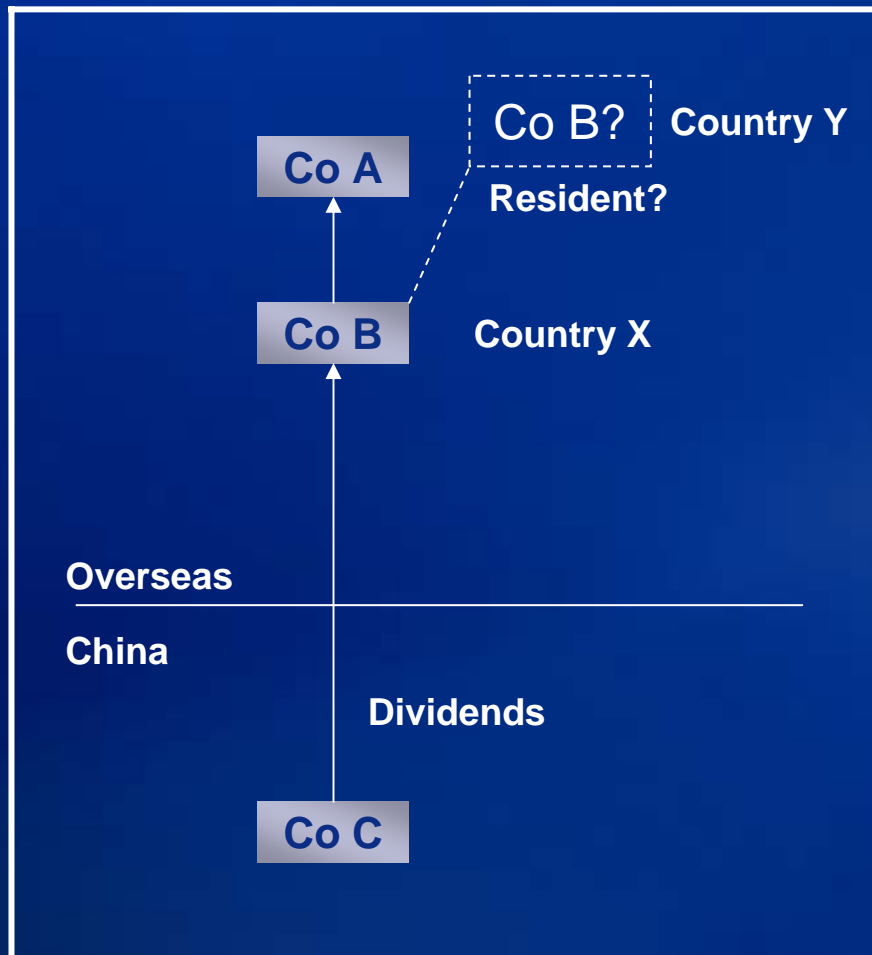
Loan interest



Royalties



Dividends (Notice 81) – From FIEs



Conditions

- Tax resident in Country X
- Beneficial ownership
- **Main purpose not to obtain preferential tax treatment**
- Meet minimum equity threshold throughout consecutive 12 months prior to distribution

Documents / information

- Tax residence certificate by Country X
- Confirmation re tax residence status in third country, say Country Y
- Confirmation re tax residence status in China
- **Proof of entitlement to dividends**

Dividends (Notice 82) – From Chinese-controlled Foreign Enterprises

Red chips



Listed Co as PRC tax resident

- Subject to CIT on worldwide income
- Exempt from CIT on dividends from investees in China

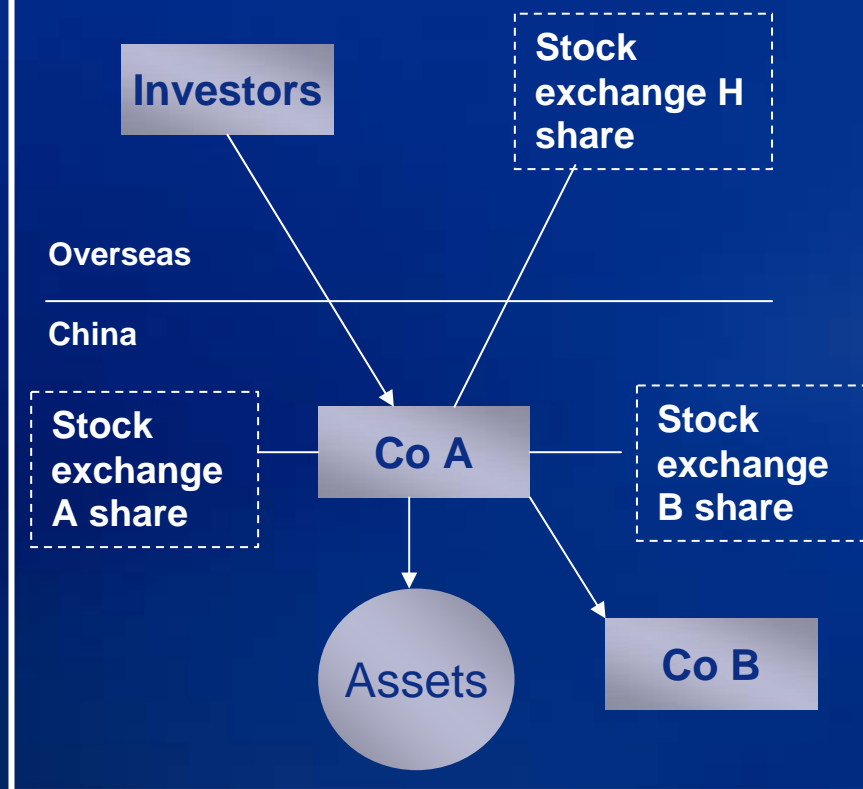
Investors

- Domestic
 - = Exempt from CIT on dividends from Listed Co
- Foreign
 - = Subject to withholding tax on dividends from Listed Co
 - = How about capital gains?

Guo Shui Fa [2009] No. 82, effective 1/1/2008

Dividends – From domestic enterprises

A, B, overseas shares (H, N, etc)



Before 1/1/2008

- Exempt on provisional basis

On / after 1/1/2008 – Guo Shui Han [2009] No. 394

- Subject to withholding tax at 10% unless tax treaty relief available
- How about scrip issues?

Interest



Co A

- **Withholding tax**

- Approval application under Circular 124 for tax treaty relief

- **Business Tax**

- Payable from 1/1/2009 as service recipient is in China?

Co B

- **Withholding tax**

- Tax registration under Circular 3

- **Business Tax**

- Start withholding from 1/1/2009?

Royalties – Withholding Tax

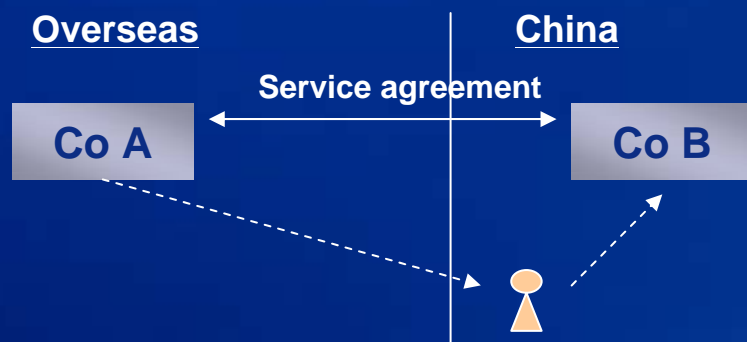


- **Proprietary technology / Knowhow**
 - Necessary for product production or replication
 - Not yet published
 - Pre-existing or subsequently developed by licensees under protection of confidentiality

Guo Shui Han [2009] No. 507, effective 1/10/2009

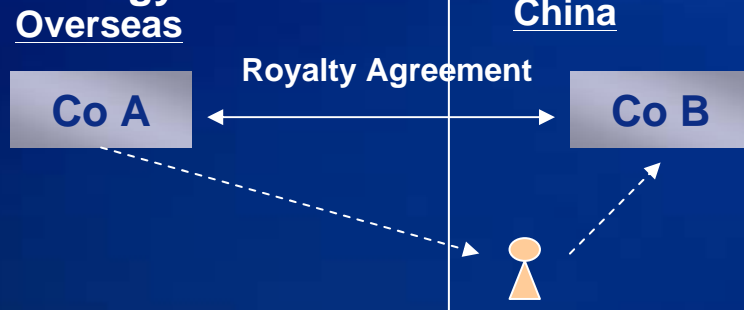
Royalties – Withholding Tax (Cont'd)

Use of technology in providing services



- Service that does not result in transfer or license of such technology \neq royalty
- Service which results in relevant outcome = royalty

Support & guidance provided for use of technology



- Fees for connected support and directional services = royalties
- Regardless of whether collected separately

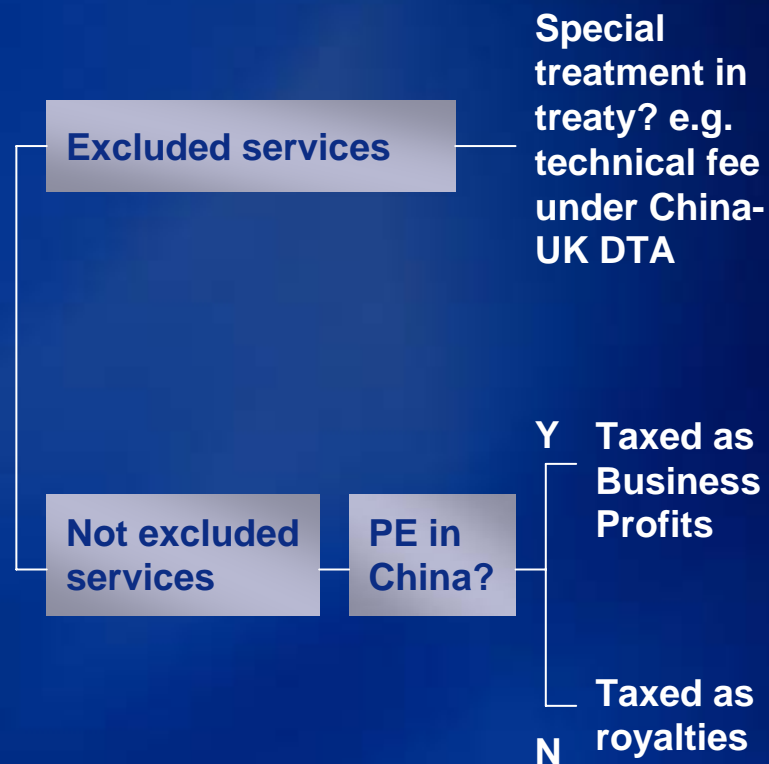
Royalties – Withholding Tax (Cont'd)

Services not treated as royalties:

- Pure after-sale services
- Services provided by sellers to buyers during warranty period
- Professional services such as engineering, management, consulting etc
- Other services as determined by SAT

Guo Shui Han [2009] No. 507, effective 1/10/2009

Determination of tax basis?



Checklist – Repatriation issues



Issues

	Y	N	N/A
1. Prior approval for treaty relief for dividends, etc obtained?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. “For-the-Record” filing in respect of permanent establishment threshold properly made?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. Tax registration properly conducted under Circular 3 in respect of dividends etc?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. Tax registration properly conducted under Decree 19 in respect of onshore services?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. Royalties agreements properly registered with MOFCOM?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Key issues



Acquisition issues



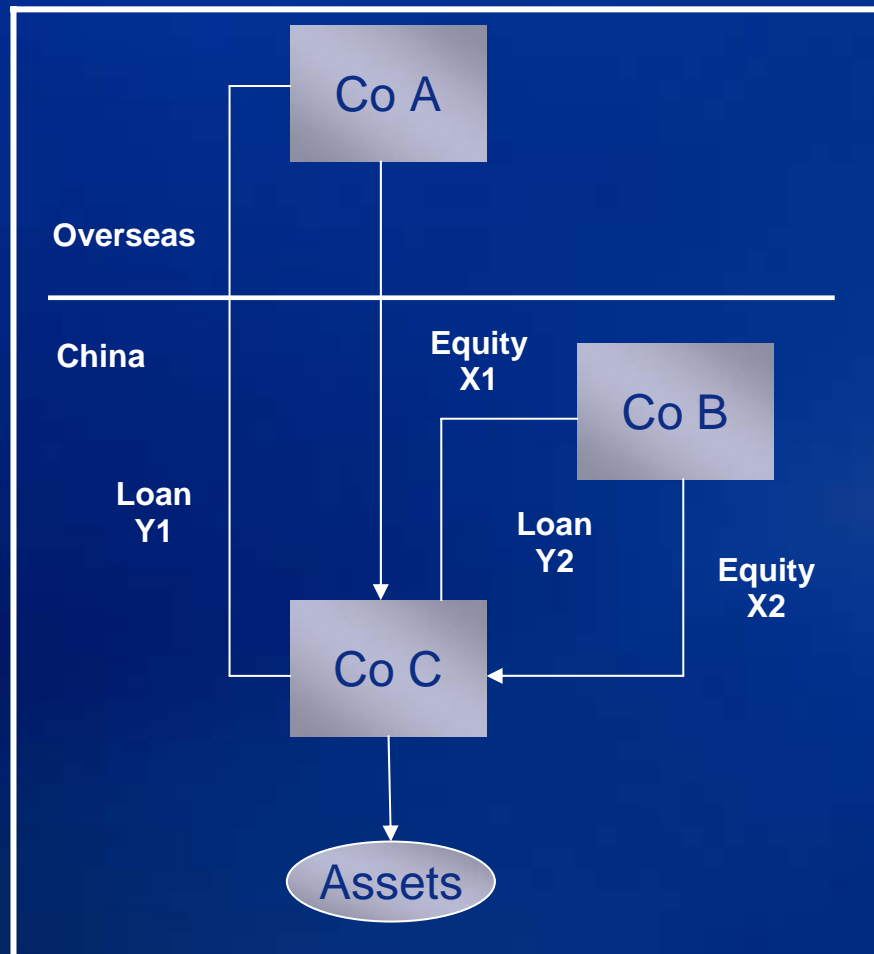
- **Financing**

- Thin-capitalisation rules

- **Withholding obligation**

- When need to withhold taxes for sale proceeds?

Shareholders' loans – Thin cap rules

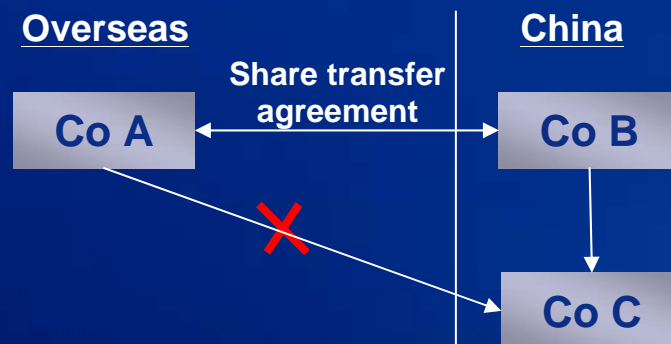


- **Non-deductible loan interest**
= Actual interest paid to related parties x (1 – standard ratio / Related party debt-equity ratio)
- **Related party debt-equity ratio for relevant period**
= (Y1 + Y2) / (X1 + X2)
- **Interest on direct and indirect loans include**
 - Loan interest
 - Guarantee fees
 - Pledge fees
 - Any payments of interest nature

Guo Shui Fa [2009] No. 2, effective 1/1/2008

Reporting obligation on acquisition – Onshore acquisition

Share transfer (offshore seller & onshore acquirer)



● Co A – taxpayer

- Secondary obligation to declare and settle tax liability

● Co B – acquirer

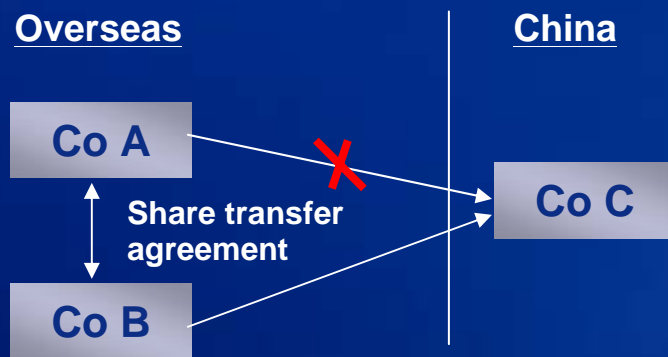
- Prime obligation to withhold tax or register sales and purchase contract

● Co C – investee company

- Lodge transfer contract when performing change of tax registration

Withholding obligation on acquisition – offshore acquisition

Share transfer (offshore transferor & transferee)



- **Co A – taxpayer**
 - Primary obligation to declare and settle WHT liability
- **Co B – acquirer; “residual” withholding party**
 - “Residual” obligation to register contract and/or withhold tax?
- **Co C – investee company to facilitate**
 - Lodge transfer contract when performing change of tax registration
 - Need to assist tax authorities to enforce tax payment

Issues to consider on disposal



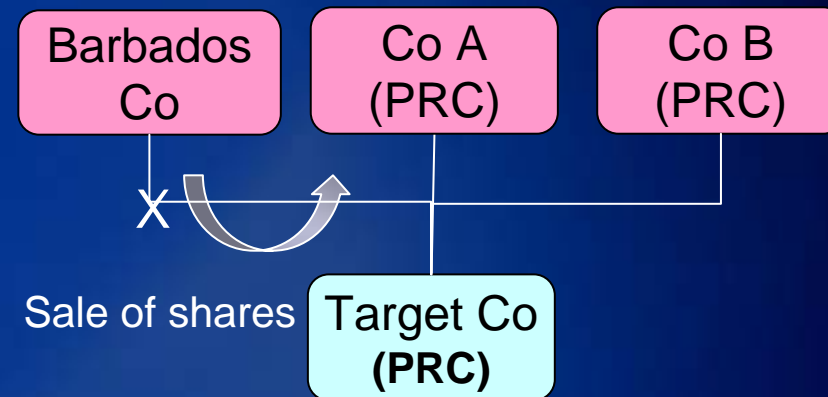
- **Entitlement to treaty relief**
- **General anti-tax avoidance provisions**
 - Case 1: Xinjiang case
 - Case 2: Chongqing case
- **Potential “look through” treatment (Draft circular)**
- **Filing requirements**
 - Withholding/ Reporting obligations under Circular 3
 - Requirements to claim treaty benefits under Notice 124

General Anti-Tax Avoidance Provisions

Case 1: Xinjiang case ruling – Notice 1076

Facts

- **March 2003:** Incorporation of Target Co
- **July 2006:** Barbados Co acquired 1/3 interest in Target Co from Co A
- **July/August 2006:** Co A applied all the proceeds to increase its registered capital in Target Co
- **June 2007:** Barbados Co transferred almost all (99%) its interest in Target Co to Co A, realising a gain of US\$12m



	Interest holding by		
	Barbados Co	Co A	Co B
Mar 2003	-	97.5%	2.5%
July 2006	33.32%	64.18%	2.5%
July/Aug 2006	24.99%	73.13%	1.88%
July 2007	1%	97.12%	1.88%

General Anti-Tax Avoidance Provisions

Case 1: Xinjiang case ruling – Notice 1076

- Barbados Co (with ultimate shareholders in US) claimed share transfer gain was exempt from PRC corporate tax under the PRC-Barbados DTA, which provides that Barbados has the exclusive taxing rights on the gain
- XJTB rejected the treaty application claim and imposed 10% PRC withholding tax (“WHT”) on the gain, determining that Barbados Co should not be regarded as tax resident of Barbados on the basis that:
 - No place of management in Barbados
 - No Barbados resident directors; all 3 registered directors were US nationals (with home addresses in the US)

General Anti-Tax Avoidance Provisions

Case 1: Xinjiang case ruling – Notice 1076

- A case ruling endorsing the tax treatment adopted by Xinjiang State Tax Bureau (“XJTB”) in administering an application of double tax treaty case issued by PRC State Administration of Taxation (“SAT”) on 30 December 2008
- SAT denied double tax treaty benefits to a Barbados company disposing of its investment in a PRC company within a short period after acquisition
- Rationale for denying treaty application appears to be based on XJTB’s concerns about the transaction’s apparent tax avoidance motivations (but the non-residency issues of the Barbados company also plays an important role in the case)

General Anti-Tax Avoidance Provisions

Case 1: Xinjiang case ruling – Notice 1076

- Other aspects of the transaction that amounted to abuse of DTA:
 - Transaction appeared “pre-determined” pursuant to a prior agreement with Barbados Co having a “locked-in” gain at the inception
 - Barbados Co was established 2 months prior to acquisition of interest in Target Co
 - Short period of holding of investment (< 1 year) implying that investment was opportunistic with no intention to partake in management of Target Co as a joint venture
 - Barbados Co’s establishment appeared to lack any overall commercial substance/benefits

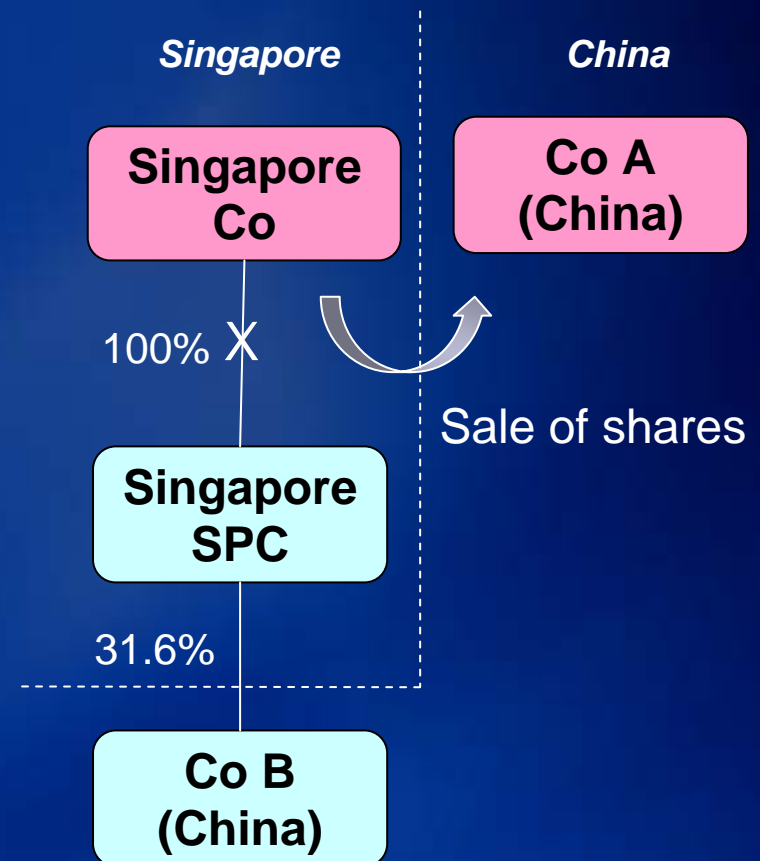
General Anti-Tax Avoidance Provisions

Case 2: Chongqing case ruling

Source: Chongqing SAT

Facts:

- PRC Co A acquired 100% of the share capital in a Singapore-incorporated special purpose company (“SPC”) which held 31.6% equity interest in PRC Co B from a Singapore company, realising a gain of over RMB9m
- Singapore SPC’s paid-up capital is SGD100 and has no other operations/activities other than holding PRC Co B

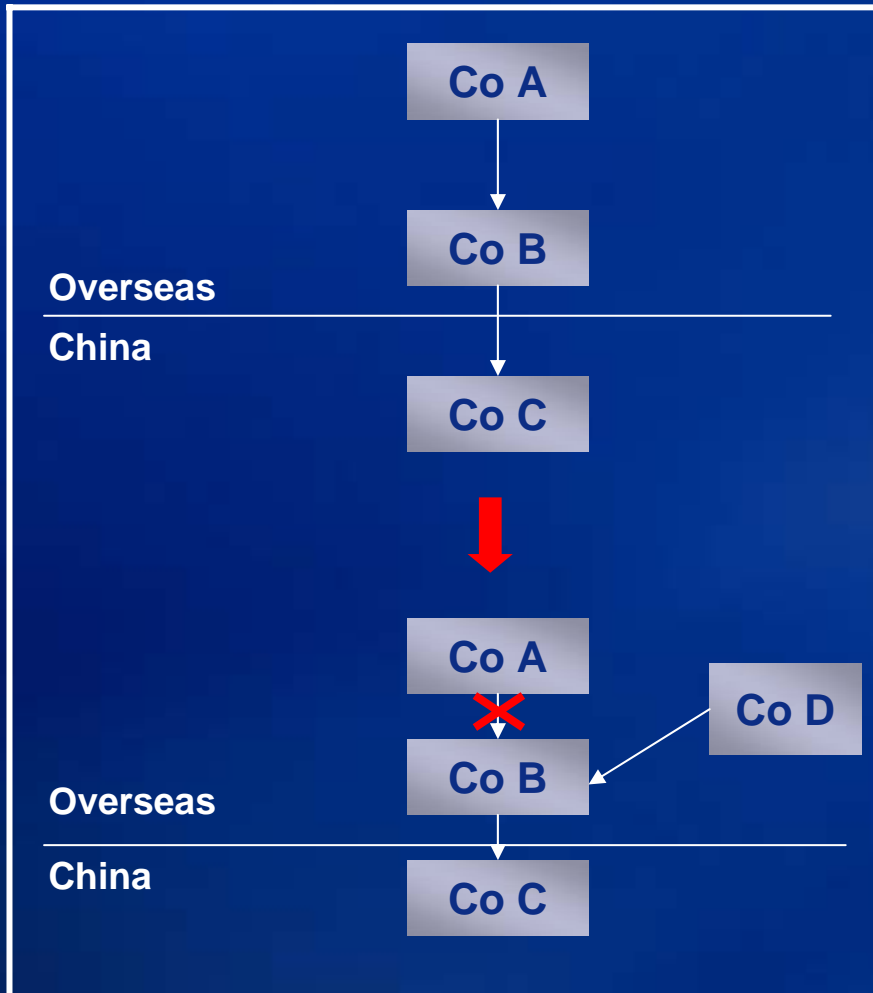


General Anti-Tax Avoidance Provisions

Case 2: Chongqing case ruling

- The Chongqing SAT treated the gains arising from sale of Singapore SPC as PRC-sourced income on the basis that:
 - Acquirer was a PRC entity (which could be expected to be able to acquire PRC Co B on an onshore level)
 - Singapore SPC was regarded as “lowly capitalised” (with SGD100 paid-up capital) and carried out no “substantive operational activities”
- Appeared to have applied a “look through” approach in taxing gains derived by the Singapore company
- Appeared to base on anti-tax avoidance concerns in dealing with offshore share disposal

Capital gains – Draft circular



Price for equity transfer	X
Cost of equity	(X)
Capital gains	<u>X</u>

- Retained earnings not deductible
- Price & cost converted into foreign currency of original contribution

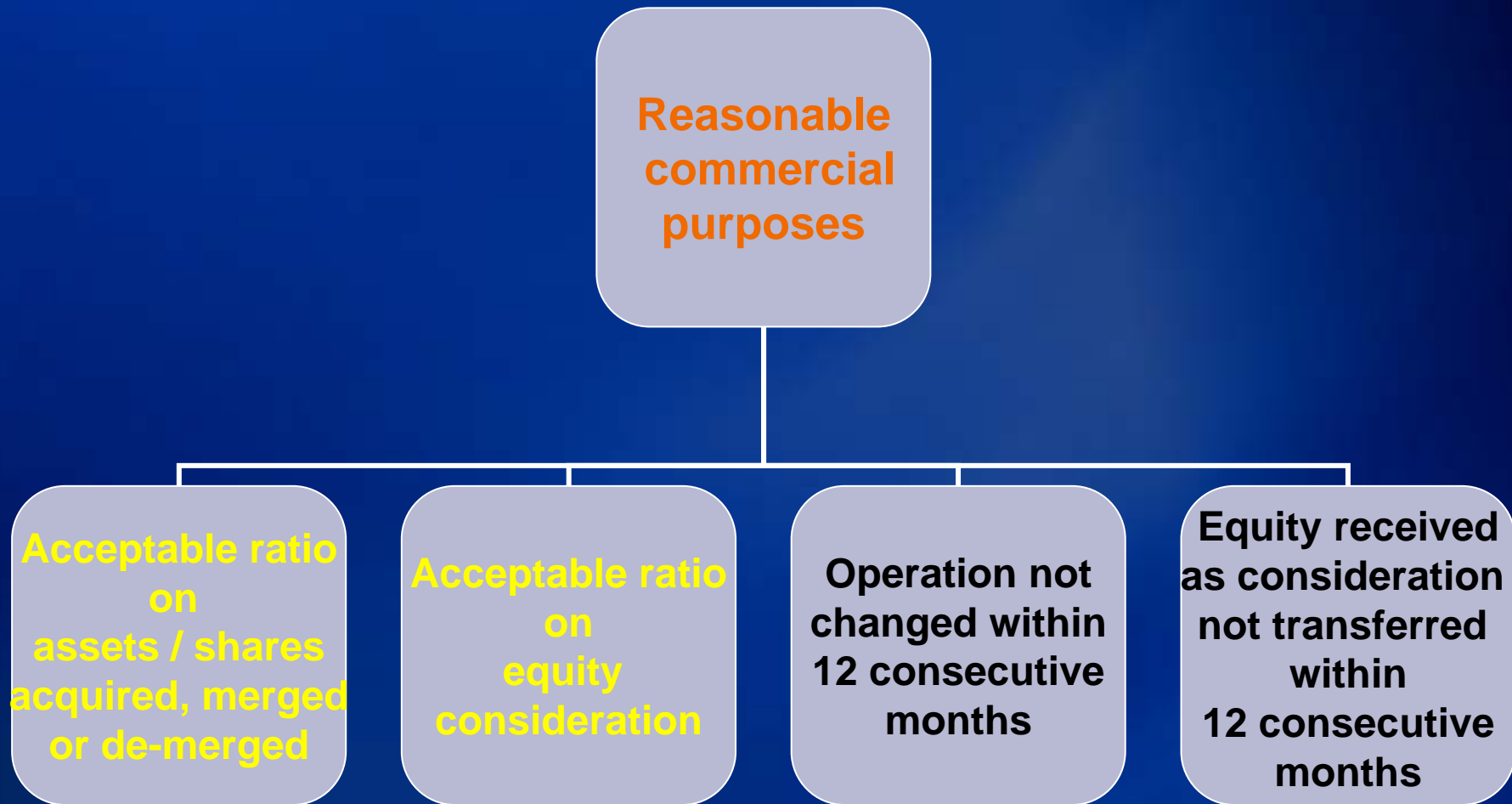
Key points

- Look through provisions
- Substance over form
- unfavourable indicators
 - = holding companies in low tax jurisdiction, e.g. tax rate < 12.5%
 - = no substantive operations in holding location

Corporate restructuring

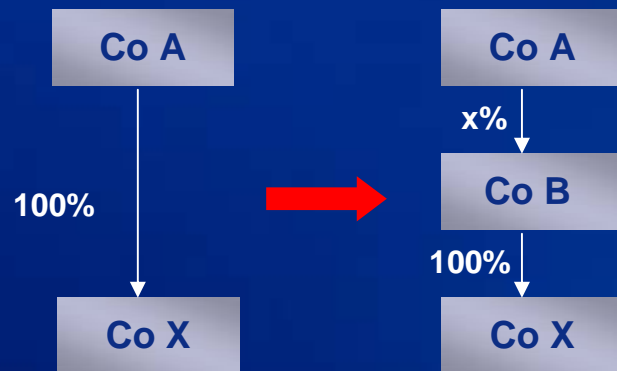
- **Corporate restructuring (Cai Shui [2009] No. 59, effective 1/1/2008)**
 - Change of legal form
 - Debt restructuring
 - Share acquisition
 - Asset acquisition
 - Merger
 - De-merger
- **Liquidation (Cai Shui [2009] No. 60, effective 1/1/2008)**

Special treatment – “Article 5” Conditions



Equity acquisition

Domestic equity acquisition

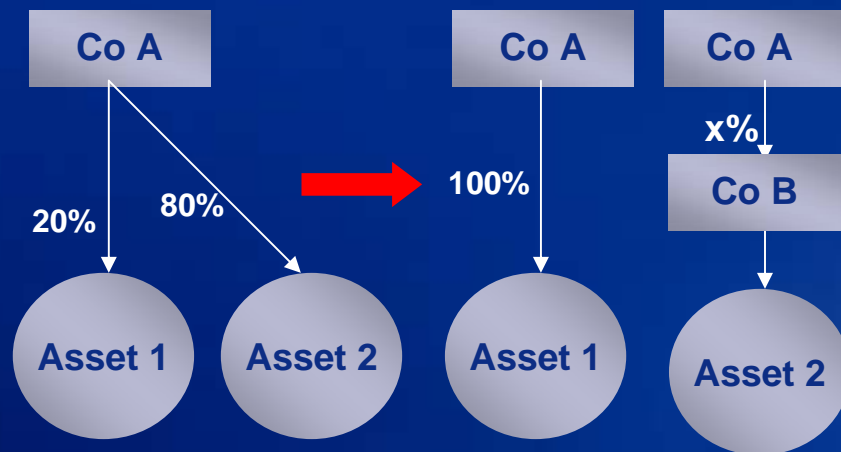


Conditions for special treatment

- Shares acquired by Co B
Shares acquired by Co B \geq 75% of shares of Co X
- Equity consideration by Co B
 \geq 85% of total consideration by Co B

Asset acquisition

Domestic asset acquisition

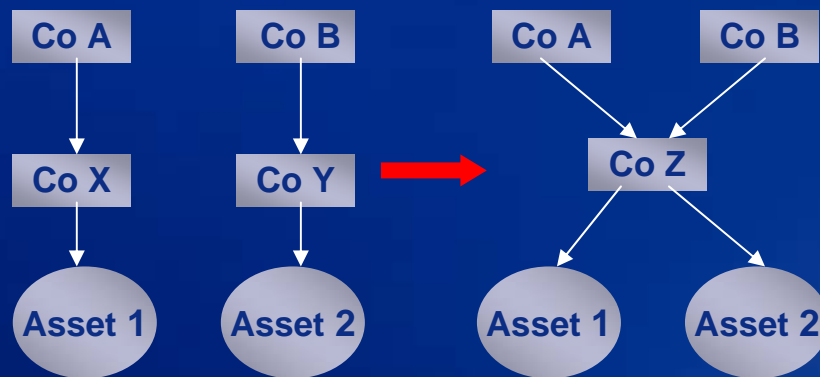


Conditions for special treatment

- Assets acquired by Co B \geq 75% of assets of Co A
- Equity consideration by Co B \geq 85% of total consideration by Co B

Merger

Merger of domestic companies

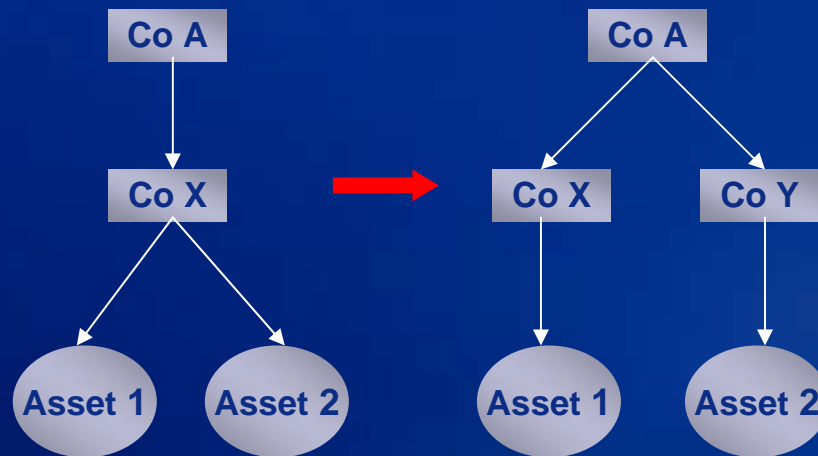


Conditions for special treatment

- Assets acquired by Co Z = 100% of assets of Co X & Y
- Equity consideration by Co Z \geq 85% of total consideration by Co Z and no consideration required due to common control

De-merger

De-merger of domestic companies



Conditions for special treatment

- Shareholders (if more than one) of Co X obtain shares in Co Y in original ratio
- Equity consideration by Co Y \geq 85% of total consideration by Co Y

Corporate restructuring – Special treatment

- Where the specified conditions are satisfied, corporate restructuring may apply the special tax treatment on assets corresponding to equity consideration:
 - Income / loss on transfer of equity / assets not recognized at time of transfer
 - Tax base of equity / assets unchanged at time of transfer

How to attribute non-equity consideration to assets?

Corporate restructuring – Special treatment

- **Assets corresponding to non-equity consideration**

- Income / loss on transfer of equity / assets recognized at fair value at time of transfer

$$\frac{(\text{Fair value of transferred assets} - \text{Tax base of transferred assets}) \times (\text{Non-equity consideration} \div \text{Fair value of transferred assets})}{\text{Fair value of transferred assets}}$$

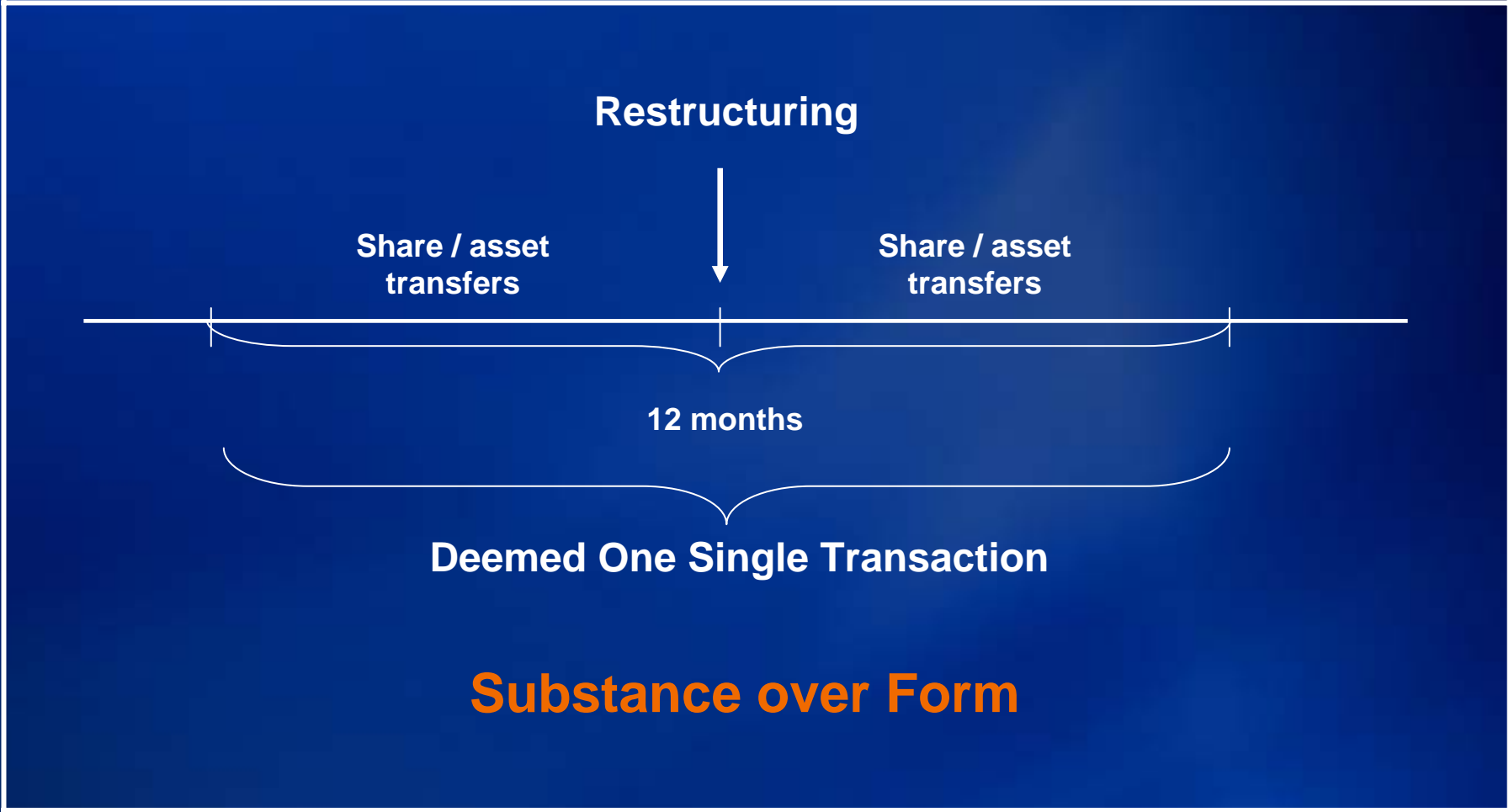
- Tax base of equity / assets corresponding to non-equity consideration or its fair market value
- How to attribute non-equity consideration to assets?

Corporate restructuring – Ordinary treatment

- Where the special tax treatment does not apply, the ordinary treatment on corporate restructuring would apply, i.e.:
 - Income / loss on transfer of equity / assets recognized at fair value at time of transfer
 - Tax base of equity / assets restated at fair value at time of transfer

How to determine fair value?

Linked transactions

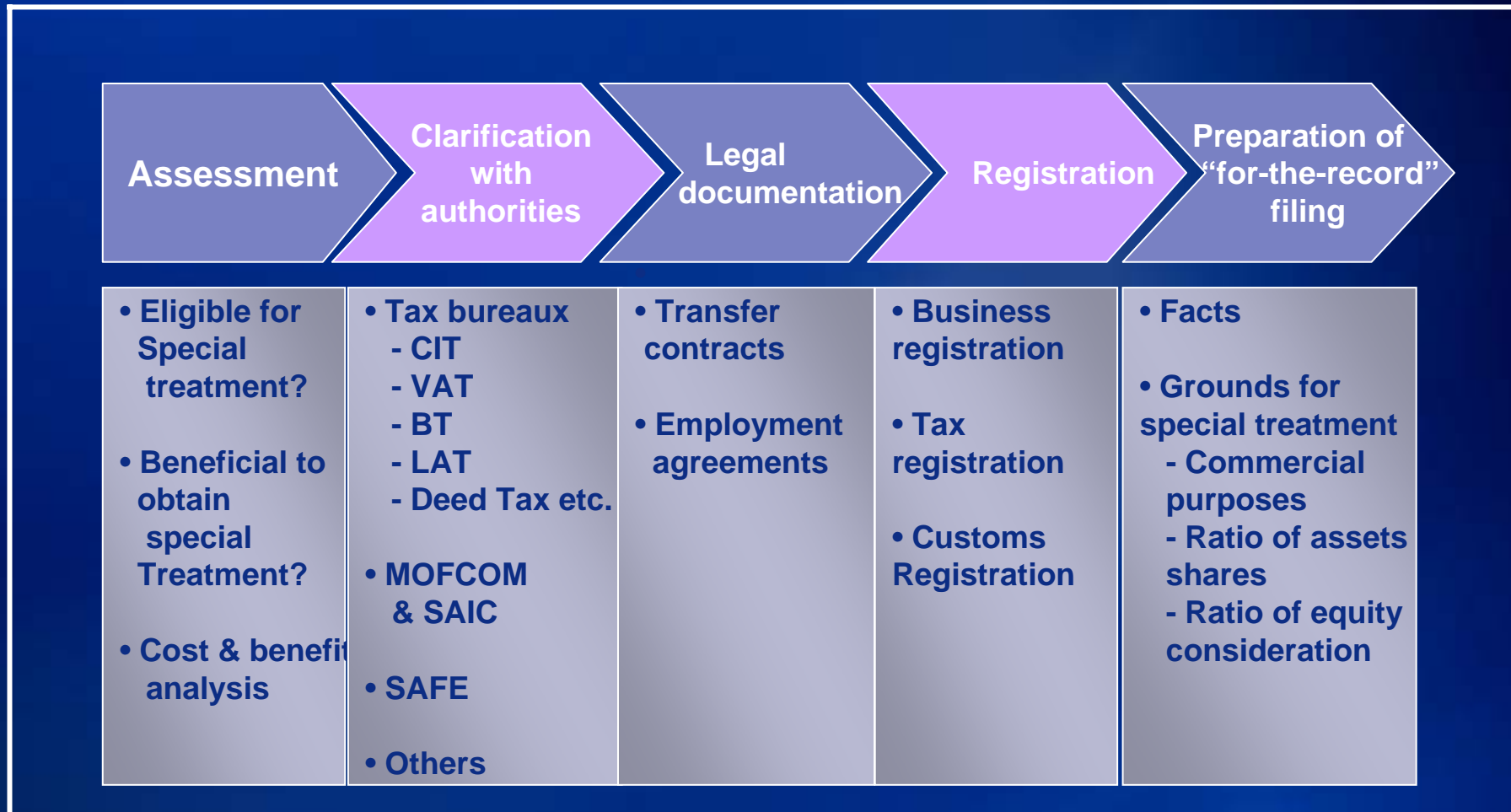


Procedure with tax authorities

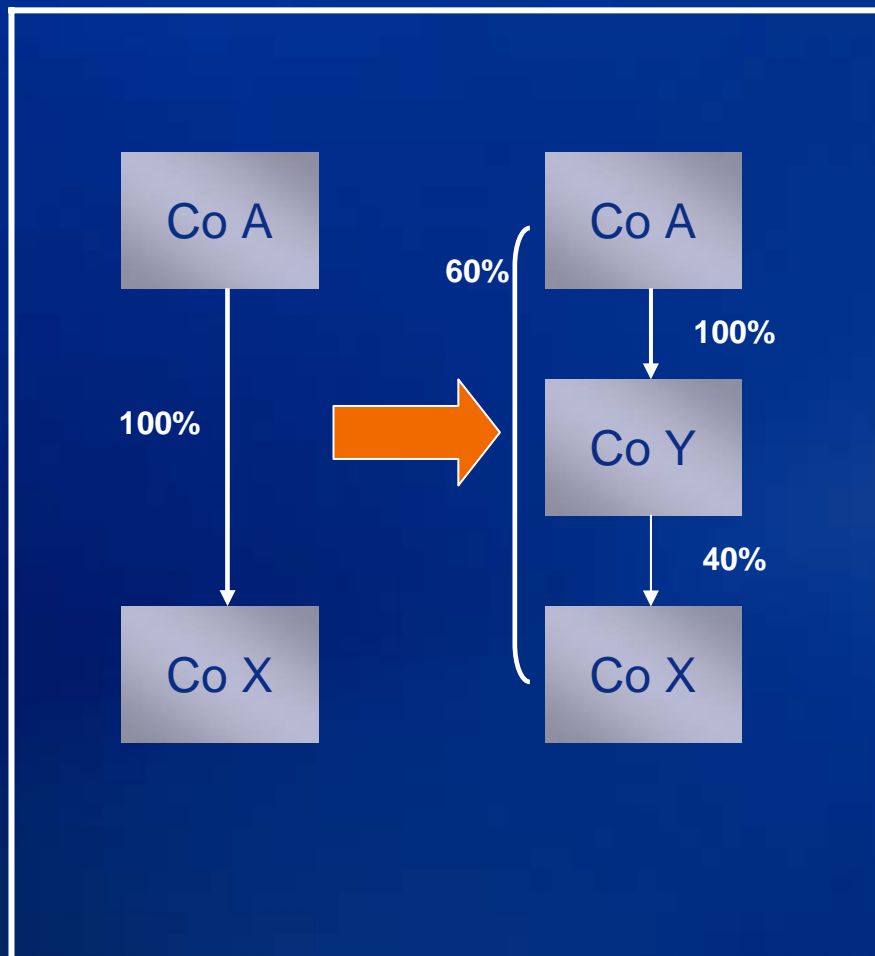


- No prior approval required
- “For-the-record” filing with tax authority in charge by 31/5/2010
- Otherwise special treatment denied

Managing M&A project from tax perspective



Capital contribution – Share Swap



● Equity for equity contribution by Co A shall not be permitted if:

- Registered capital of Co X has not been fully paid up
- Equity interest in Co X has been pledged or lawfully frozen
- Transfer of equity interest is prohibited under Articles of Association
- Approval for transfer of equity interest has not been obtained
- Other circumstances

● Verification on equity interest contributed

SAIC Decree [2009] No. 39

Final Checklist

Issues	Y	N	N/A
1. Proper secondment arrangement and keep travelling records of employees?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
2. All tax registrations of service contracts with PRC parties properly performed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
3. All prior approval & record filings for tax treaty relief properly obtained / performed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
4. Transfer Pricing documentation prepared?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
5. All key tax internal controls put in place?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
6. All major incentives available fully applied for/ utilised?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
7. All opportunities presented by new M&A regulations fully capitalised on?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Summary of issues

- Handling PRC tax audits - awareness of new tax regulations and tax authorities' focus
- Related party transactions – transfer pricing documents and risk assessment
- Improper secondment arrangements – potential PE exposures, IIT exposures and registration requirements
- Frequent travellers to China – potential PE exposures, IIT exposures and registration requirements
- Overseas companies receiving fees from PRC corporates and individuals – BT, contract registration and compliance requirements
- Foreign companies claiming double tax treaty benefits for receiving passive/ active income from China – compliance procedures and consideration of tax treaty entitlement
- Using SPVs for investment into PRC – “treaty shopping” and beneficial ownership requirements



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