



China Tax Seminar

New China Tax Rules Affecting Hong Kong Companies

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TAX

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Agenda



- **Reporting requirements for offshore indirect disposition of China companies**
- **New requirements for tax treaty benefits claims**
 - Approval procedures and filing requirements
 - “Beneficial ownership” and “commercial substance”
- **Other tax registration and filing requirements**
 - Passive and active income derived by non-residents
 - Projects and services performed by non-residents
- **Secondment and employee tax issues**



Offshore indirect disposition of PRC companies

Offshore disposition of PRC investments

Application and reporting requirements



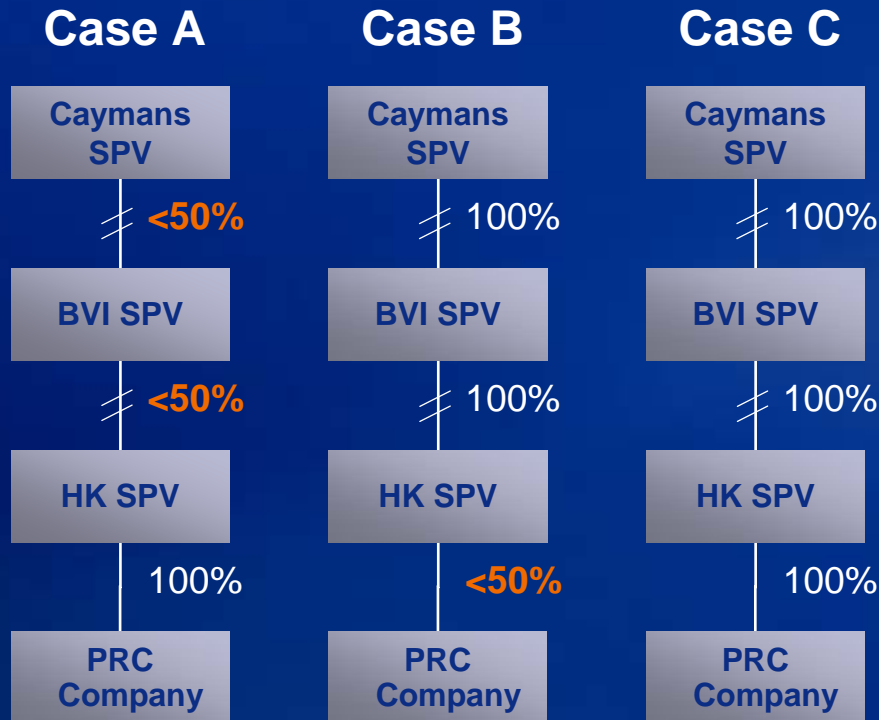
Guoshuihan [2009] No. 698 (“Notice 698”)

- Effective retrospectively from 1 January 2008
- Reporting applies to:
 - Offshore investors (effective controlling party) who “indirectly transfer” equity interest in PRC resident enterprise(s)
 - The jurisdiction of the offshore holding company being transferred has an effective tax rate of less than 12.5% or the jurisdiction of the offshore holding company exempts offshore income
- Requirements:
 - Report transaction to PRC tax authorities through submission of required documentation within 30 days of signing of share transfer agreement
 - Provide an explanation of “reasonable business purposes” with respect to the offshore share transfer

What dispositions are caught for reporting?



- What does “effective control party” mean?
- Are Cases A, B and C all caught by Notice 698?



SAT's indicates:

- Yes, all caught
- No tier restriction
- However, SAT may introduce some de-minimis rules in future so that minority holdings below certain thresholds will not be required for reporting

Offshore disposition of PRC companies

What investors are affected?



1. “Sellers” who have previously undertaken an “offshore indirect transfer of offshore holding companies” after 1 January 2008
2. Investors who currently hold PRC investments through offshore holding companies
3. Investors intending to acquire/ establish PRC companies in future
4. Investors in pre-IPO offshore structures

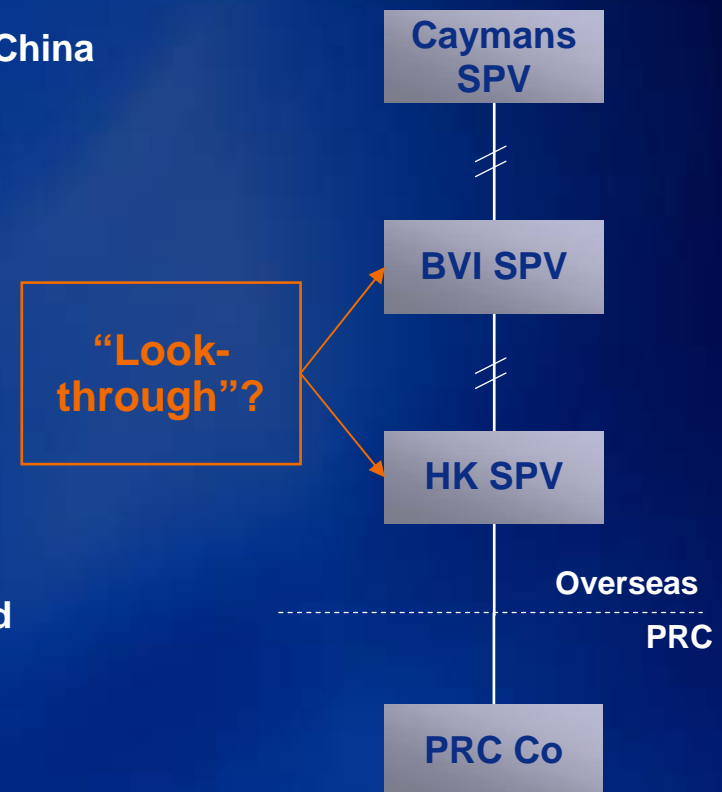
However, SAT indicated that they may consider not being active on going back to tax transactions that took place before 2010

Offshore disposition of PRC companies

Implications to reportable transactions



- PRC tax authorities can, upon SAT's approval, apply the PRC general anti-tax avoidance provisions to re-characterise offshore indirect disposition as an direct disposition of China companies where it is concluded that the structure has:
 - No “reasonable business purpose”
 - “abuse of business structure”
 - the result of avoiding PRC tax as its motives
- Effectively ignore “the existence” of offshore holding companies
- Therefore, Seller deemed to have derived a PRC sourced capital gain and subject to PRC taxation



Factors triggering for “looking through” an “offshore disposal”



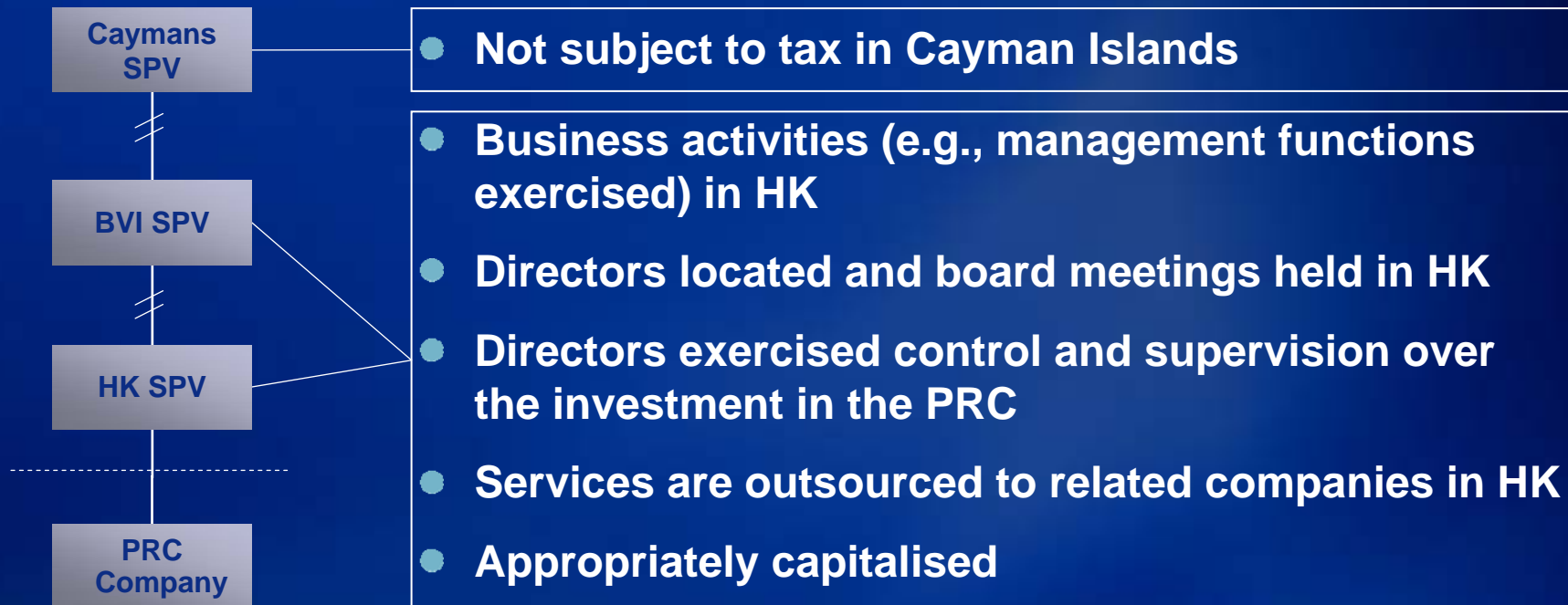
- Will SAT deny the existence of offshore holding company (e.g., BVI or Hong Kong SPV) under the following holding structure?



Offshore disposition of PRC investments

Factors for “looking through” an “offshore disposal”

- Will the following holding structure make any difference?



SAT indicates: Maybe ok; but better if HK SPV does more rather than outsources everything

How to substantiate business purposes?



- **Possible business reasons for SPV structures**

- Investment funds source financing from investors from different countries. SPV groups these investors who wish to invest in a particular portfolio
- Multiple SPV structures to facilitate:
 - introduction of new partners
 - different levels of debt/equity financing/bankruptcy remoteness etc.
- Funds have substantial operations but may not reflect in a particular SPV

Offshore disposition of PRC investments

How to calculate capital gains in the event of challenge?



- How to determine capital gain where PRC tax authorities apply a “look through” approach?
- What is the cost base for capital gains tax purposes?

SAT's indicates:

- Will use the value paid by seller as tax deductible costs (i.e., cost base)
- Will not go back to trace the value of previous transfers, if there were any
- If tax authorities have previously levied tax on capital gains from previous transfers based on a deemed MV, that deemed MV can be used as tax deductible costs

Offshore disposition of PRC investments

What are implications for non-compliance?



- Are there fines/ penalties for failing to report to the tax authorities?
- Will tax authorities apply the *Tax Collection and Administration Law of the PRC*?
- Are PRC subsidiaries subject to penalties and tax liabilities of the foreign investor seller?

SAT's indicates:

- **Sellers could be subject to tax penalties and late payment surcharges under the *Tax Collection and Administration Law of the PRC***
- **The SAT will go after the sellers, not the purchasers**



Tax treaty benefits claims

Tax treaty benefits claims

Compliance requirements – Passive income



Guoshuifa [2009] No. 124 (“Notice 124”)

- Effective from 1 October 2009
- Approval from in-charge tax authority required for treaty benefit claims in respect of dividends, interest, royalties and capital gains (excluding benefits under transportation treaty)
- Deemed approval if no reply after application within specific period from county / district / provincial authorities
- Exempt from subsequent application for approval in subsequent 3 calendar years (including current year) on income from dividends, interest or royalties (i) from same payer, (ii) under same clause, (iii) under the same treaty
- Obligation to notify authority of change of circumstances

Tax treaty benefits claims

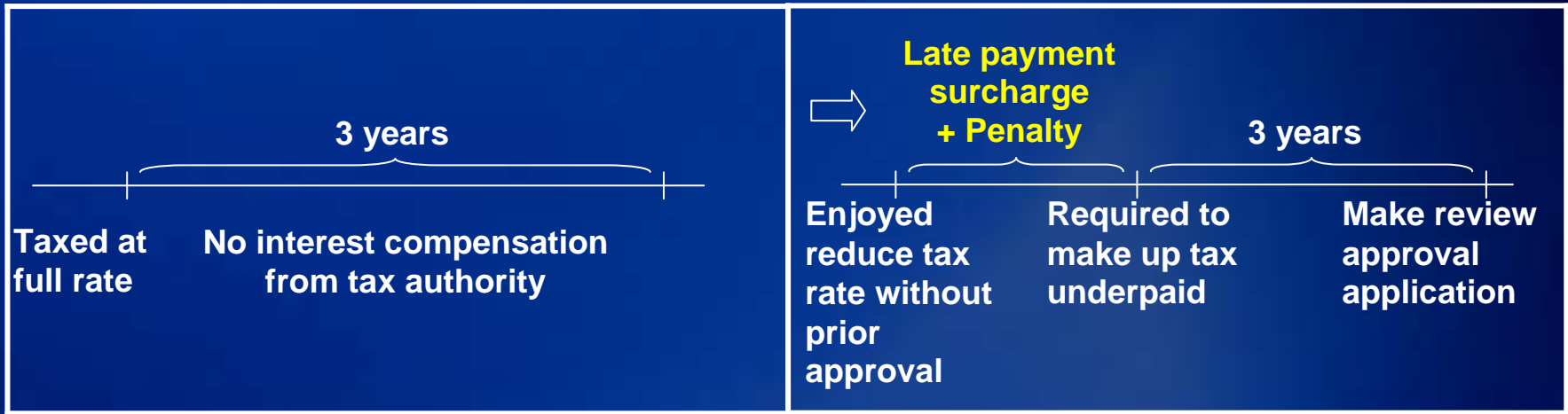
Compliance requirements – Passive income



- **Specified documents required to be submitted to responsible PRC tax authorities:**
 - **Application form for approval**
 - **Information reporting form which records information of non-resident enterprise claiming tax treaty benefits**
 - **Tax residency certificate issued by treaty jurisdiction**
 - **Supporting documents relevant to income concerned (e.g., shareholders/ loan/ licence agreements)**
 - **Other relevant documentation required by PRC tax authorities e.g. Notice 601 information**

Tax treaty benefits claims

Time limits on claim treaty benefits



- Full rate first & then claim refund**
- May make deferred application for reduced tax rate within 3 years
 - Deadline: End of 3 years from date of tax first paid
 - No refund of interest

- Reduced rate first & then full rate**
- May still make review application for incorrect treatment
 - Deadline: End of 3 years from date of additional tax being made up
 - No refund of late payment charge and penalties

Tax treaty benefits claims

Filing requirements – Active income



- **Tax treaty relief for other income**
 - permanent establishment & business profits
 - Independent personal services
 - Dependent personal services
 - Other benefits under DTA not covered above (e.g. income from immovable property)
- **For the record filing with tax authority in charge (No need to apply for approval)**

Tax treaty benefits claims

Compliance requirements – Active income



- **Specified documents required to be submitted to PRC tax authorities:**
 - **Information reporting form which sets out:**
 - **Reasons for enjoy treaty benefits**
 - **type of income received by non-resident enterprise**
 - **applicable DTA and article**
 - **amount of gross income, etc.**
 - **Tax residency certificate issued by treaty jurisdiction**
 - **Other relevant documentation required by PRC tax authorities**

Tax treaty benefits claims



- **Consequence of non-compliance**
 - Denial of tax treaty benefit claims
 - Potential penalty charges and late payment interest
- **Record keeping 10 years**

Tax treaty benefits claims

Requirements for dividends



Guoshuihan [2009] No. 81 (“Notice 81”) issued 20 Feb 2009

Conditions to satisfy:

- Tax resident of other treaty jurisdiction
- Beneficial owner of dividend
- Meet minimum ownership threshold through consecutive 12 months prior to distribution
- Main purpose not to obtain preferential tax treatment
- Dividend qualify as “dividend” under PRC tax law

Information to provide:

- Tax residence certificate issued by treaty jurisdiction
- Confirmation of tax residency status in treaty jurisdiction
- Confirmation of tax residency status in China or third country
- Proof of entitlement to dividends (e.g., share certificates, profit allocation agreements)

Tax treaty benefits claims

Beneficial ownership requirements



Guoshuihan [2009] No. 601 (“Notice 601”) issued 27 Oct 2009

- To enjoy treaty benefits, taxpayer needs to demonstrate “beneficial ownership” to claim tax treaty benefits on:
 - Dividends
 - Interest
 - Royalties
- **Beneficial owner**
 - Has ownership and 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

Notice 601 does not specifically apply to capital gains but SAT could make reference to Notice 601 in assessing availability of capital gains tax relief

Substance-over-form

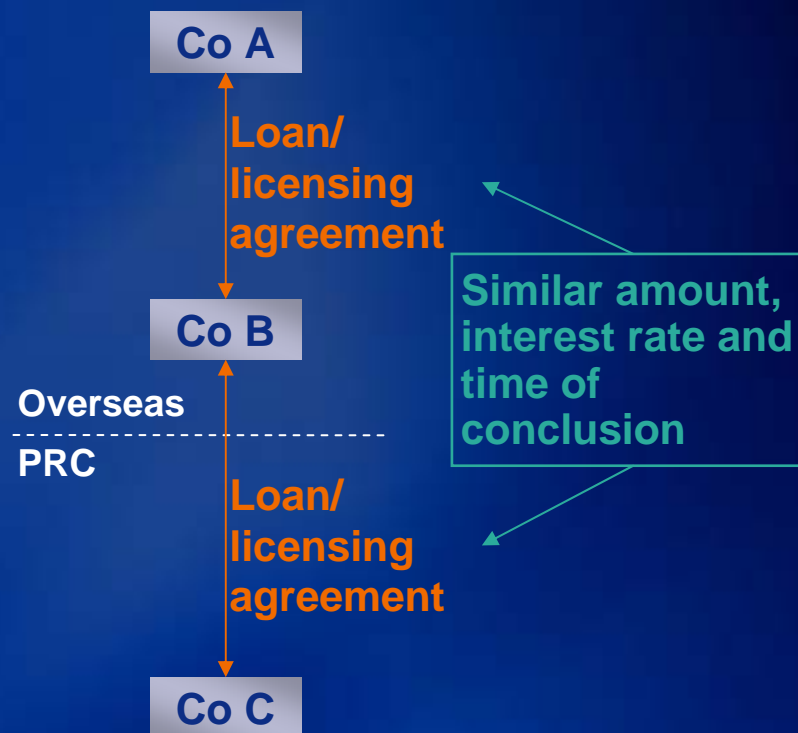
Tax treaty benefits claims

“Adverse” factors under Notice 601



- **Factors jeopardising beneficial ownership recognition:**

- Pass on substantive income (e.g., over 60%) to 3rd country over short period (e.g. 12 months)
- Few or no other business activities
- Limited assets, scale & staff
- Little / no control or disposition rights over income/ properties from which income is derived or bears little risk
- Located in location with no/ low effective tax
- Back-to-back loan/ licensing arrangement



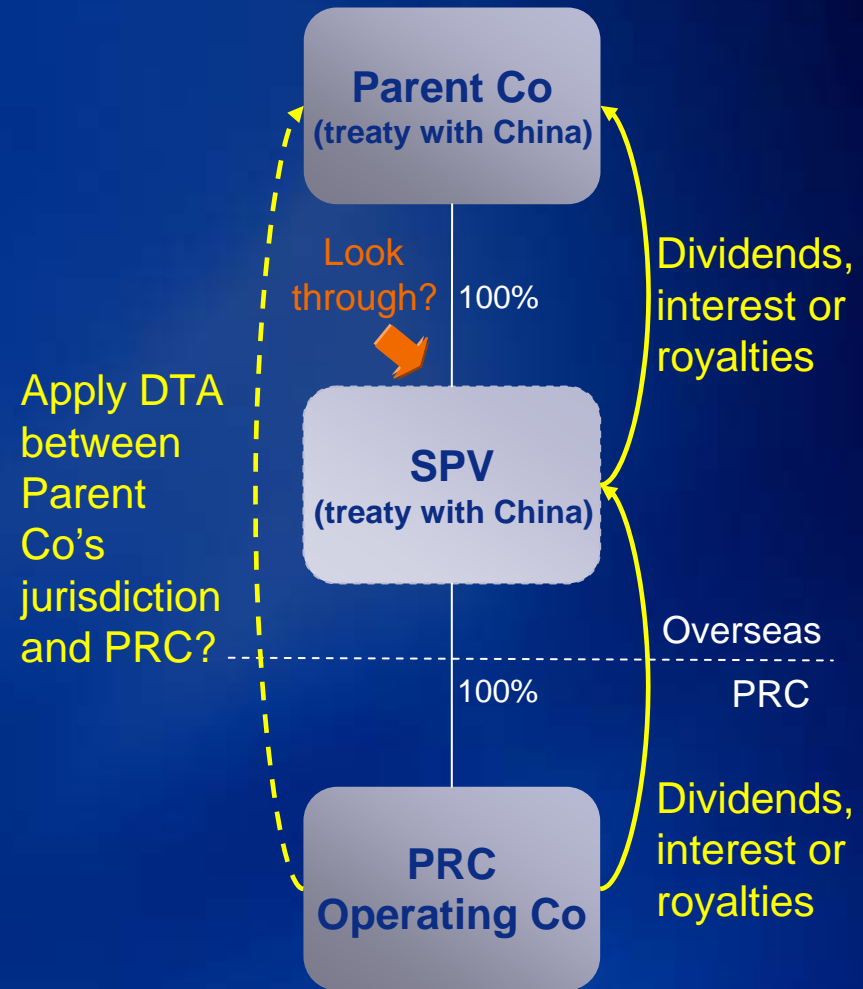
Failure of 1, 2, or 3... factors do not necessarily mean tax treaty not applicable “substance over form” principle applies

Tax treaty benefits claims

Practical issues under Notice 601



- If an applicant is denied as the “beneficial owner”, would SAT “look through” the conduit and apply the treaty applicable to the “ultimate” owner?
- If a “look through” approach is applied, how many layers will SAT “look through”?





Tax registration and filing requirements

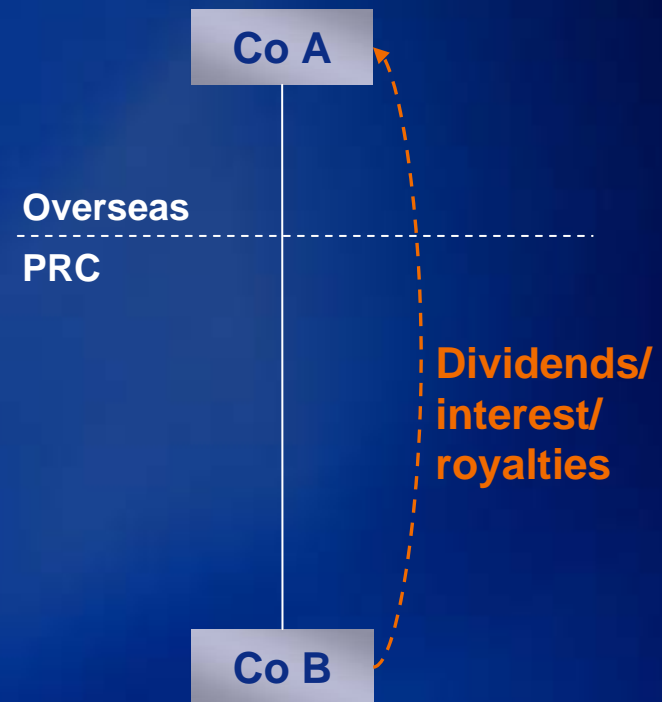
Tax registration and filing requirements

Passive income – Notice 3



Guoshuifa [2009] No. 3 (“Notice 3”)

- Effective from 1 January 2009
- Co A – Taxpayer/ income recipient
 - No registration required
- Co B – Withholding party/ payer
 - Registers within 30 days of conclusion of contracts giving rise to dividends, interest, royalties income from properties to non-residents
 - Change registration within 30 days of revision of contract
 - Filing with tax authorities and settle tax for non-residents



Tax registration and filing requirements

Direct transfer of onshore shares – Notice 3

- **Co A – Taxpayer**

- Secondary obligation to declare and settle tax liability

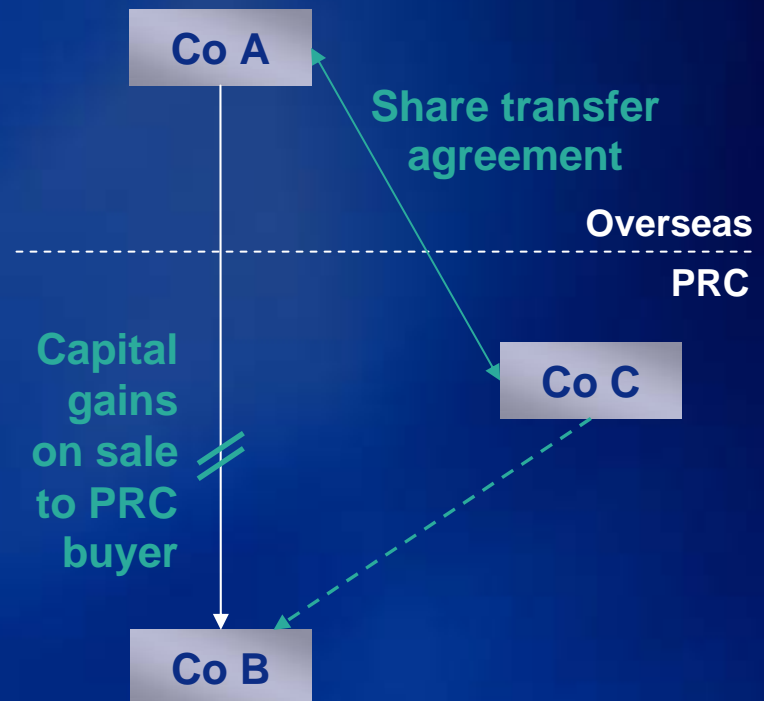
- **Co B – Investee company**

- Lodge transfer contract when performing change of tax registration

- **Co C – PRC Acquirer**

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

Offshore transferor and onshore transferee



Tax registration and filing requirements

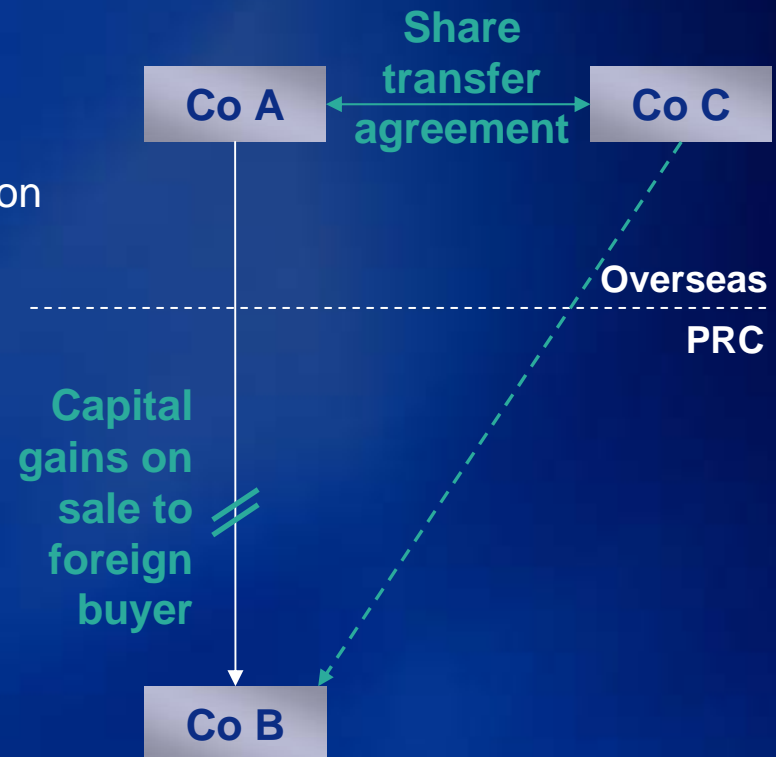
Direct transfer of onshore shares – Notice 3

- **Co A – Seller as primary taxpayer**
 - Obligation to report and settle Withholding tax liability
 - Can engage tax agent to settle tax
 - Failure to report could result in collective action from tax authorities

- **Co B – Investee company to facilitate**
 - Lodge transfer contract when performing change of tax registration
 - Need to assist tax authorities to enforce tax payment

- **Co C – Acquirer; “residual” withholding party?**
 - “Residual” obligation to register contract and/ or withhold tax?

Offshore transferor and transferee

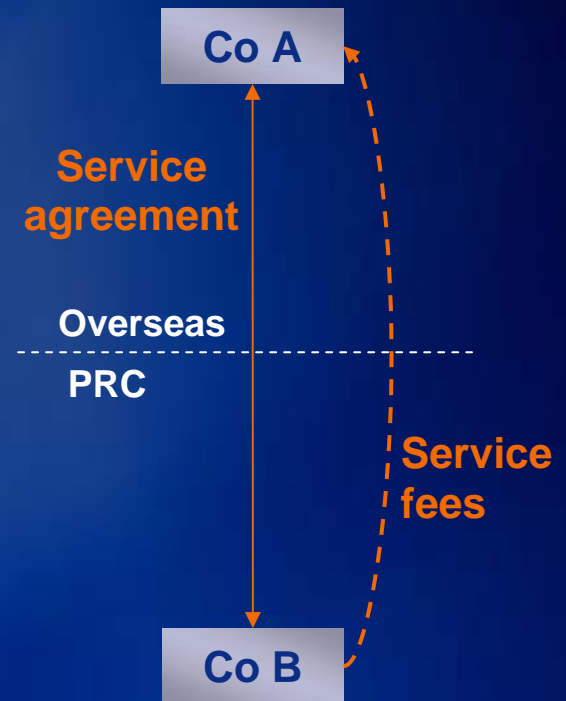


Tax registration and filing requirements

Projects and Services performed by non-residents

Order of SAT [2009] No. 19 (“Decree No. 19”) issued 20 Jan 2009

- Effective from 1 March 2009
- Applicable to projects and services in the PRC rendered by non-residents
- Aim to strengthen tax collection from such projects and services, including business tax and VAT as well as individual income tax
- Failure to comply could result in penalties



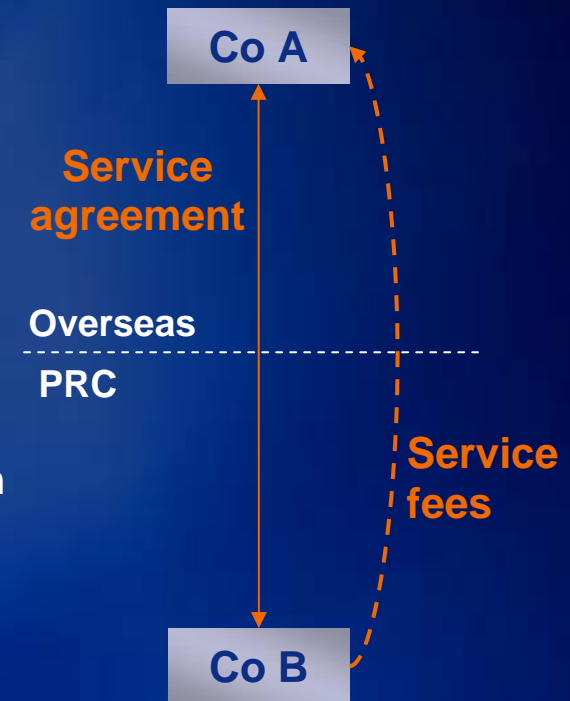
Tax registration and filing requirements

Services performed by non-residents



Order of SAT [2009] No. 19 (“Decree No. 19”) issued 20 Jan 2009

- **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



Registration required regardless of whether Co A has PE in China

What do these new requirements mean for taxpayers?



- **Increased monitoring on cross-border transactions by PRC tax authorities**
- **Greater compliance burden on reporting or disclosures**
- **Need to focus on and document “business substance” and “business purpose” when setting up investment holding structures and on investment exit**
- **Need to assess potential exposures and consider how the investment structure can be strengthened to mitigate potential challenges**
- **Significant uncertainty on how the rules (in particular Circular 698) would be interpreted and enforced**

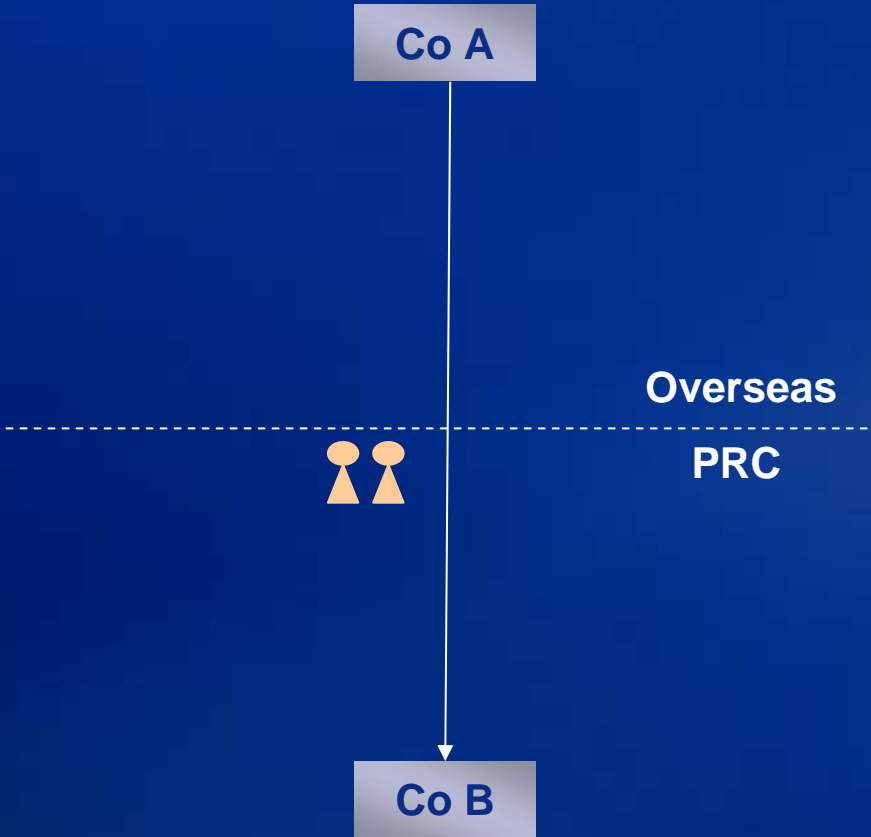


Cross Border Employment Service and Secondment Arrangement

Employees working in the PRC



- IIT?
- PE?



PRC IIT Exemption under PRC-HK DTA



Exemption Criteria

1. The individual is present in the PRC for a period or periods not exceeding 183 days in the calendar year*/any 12-month period** concerned;
2. The individual's remuneration is paid by, or on behalf of, an employer who is not a PRC resident; and
3. The individual's remuneration is not borne by a Permanent Establishment ("PE") or a fixed base which the employer has in the PRC.

* Effective until 31 December 2006

** Effective from 1 January 2007

How to count 183 days?



N-days rule (To ascertain chargeability to IIT)

- One PRC day is counted for:
 - PRC arrival date
 - PRC exit date
 - Multiple PRC arrival / exit date
- Example
 - Enter China at 10pm, have supper and come back to Hong Kong at 1 am
 - count as 2 days in China

PRC-HK DTA



- Requisite length of time test for full exemption under PRC-HK DTA has changed

- 1st DTA “... aggregate of 183 days or more in a calendar year...”
- Revised “... aggregate of 183 days or more in a 12-month period...”






PRC-HK DTA – PE



- **Situations giving rise to a PRC PE:**
 - (i) The HK company has a fixed place of business in the PRC;
 - (ii) The HK company is rendering services in China through its employees or other personnel in China for a period or periods aggregating more than 6 months (*projects commenced before 11 June 2008*) / 183 days (*projects commenced on or after 11 June 2008*) in any 12 month period; and/or
 - (iii) The HK company has a dependent agent in China who habitually concludes contracts on its behalf in China.
- Excludes preparatory or auxiliary activities

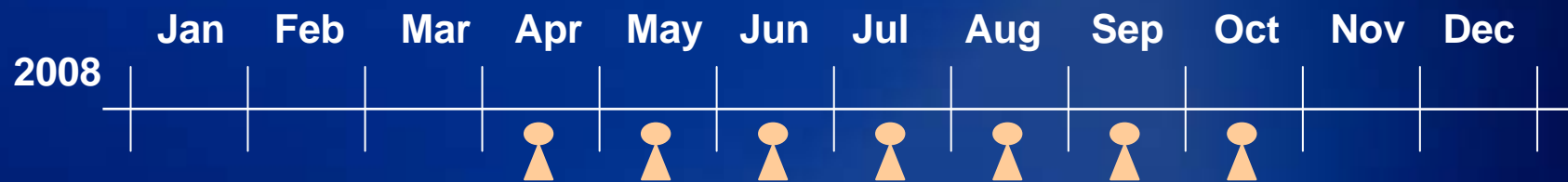
Illustrative case for PE - Post 10 June 2008



2009	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total 2009 PRC days
	1st -8th 8	1st -8th 8	1st -8th 8	1st -8th 8	1st -8th 8	1st -8th 8	1st -8th 8	1st -8th 8	1st -8th 8	1st -8th 8	1st -8th 8	1st -8th 8	96
	12th -20th 8	12th -20th 8	12th -20th 8	12th -20th 8	12th -20th 8	12th -20th 8	12th -20th 8	12th -20th 8	12th -20th 8	12th -20th 8	12th -20th 8	12th -20th 8	96
	21st -25th 5	21st -25th 5	21st -25th 5	21st -25th 5	21st -25th 5	21st -25th 5	21st -25th 5	21st -25th 5	21st -25th 5	21st -25th 5	21st -25th 5	21st -25th 5	60
Total PRC days	21	21	21	21	21	21	21	21	21	21	21	21	252



Illustrative case for PE – Pre 11 June 2008



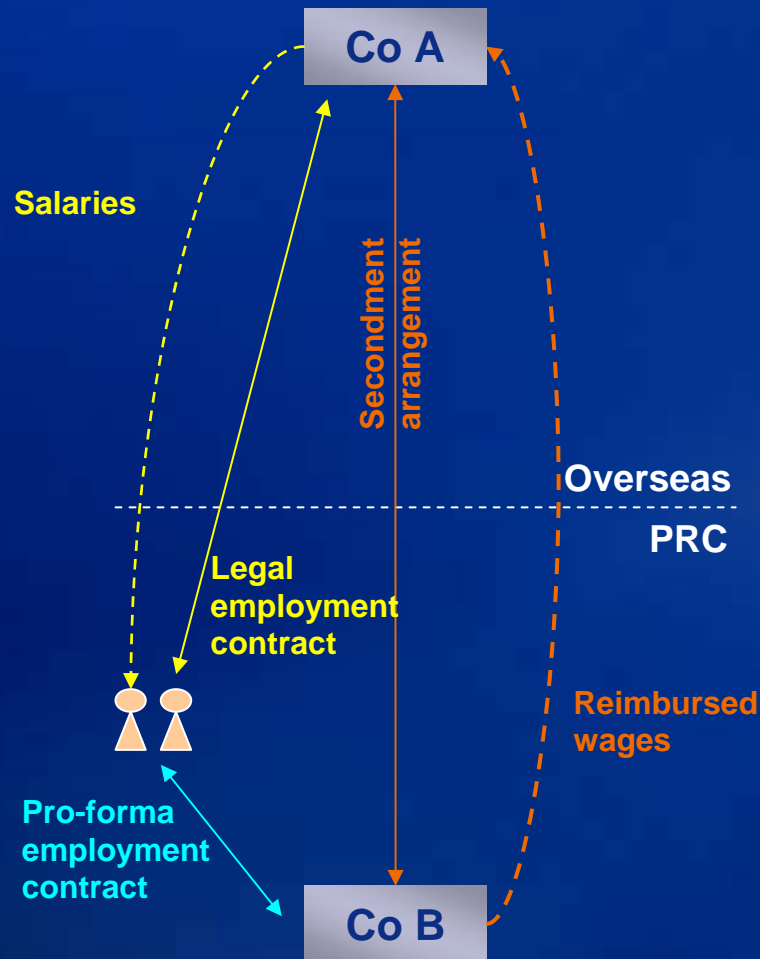
PRC tax implications where a PRC PE exists



- CIT
 - chargeable on the profit attributable to the PRC PE, usually on a deemed profit basis (*deemed profit rate to be negotiated with the local tax authorities*)
- IIT
 - expatriate employees working at the PRC PE will be subject to IIT regardless of their period of stay in China

[Note – BT liability is not affected by the PRC PE status of the FE]

Secondment arrangement



● Potential issues?

- Salary remittance
- Unclear role
 - Dual responsibilities
 - Reporting to home country
 - Decision making in China

PE exposures of secondment



- **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

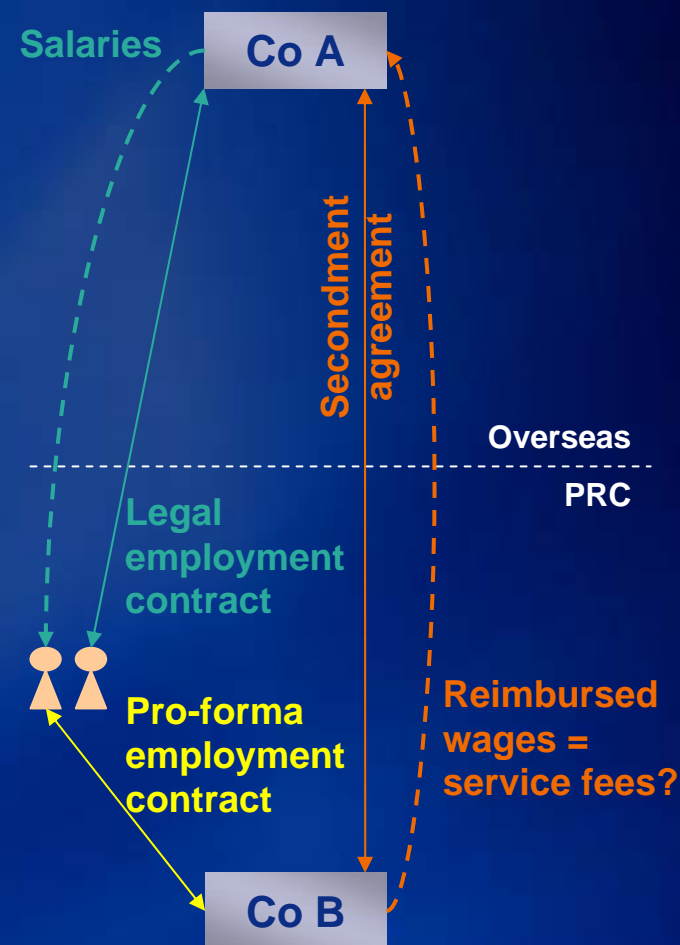
Ji Bian Han [2009] No. 103, issued 2/7/2009



Secondment or PE?



- Apply where “secondment arrangement” is regarded as a “disguised form” of “service provision” to Co B
- No clear rules in CIT Law, relevant factors:
 - Individual works under control and supervision of Co B?
 - Co B bears risks and responsibilities of individual's day to day work?
 - Individual's work is reviewed and appraised by Co B?
 - Payment for individual takes form of recharge of employment costs to Co B without mark-up?
 - Individual performs any other functions on behalf of Co A for other entities?





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