TAX NEWSLETTER

A REVIEW
OF PRC AND HONG KONG TAX DEVELOPMENTS

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IN THIS ISSUE…

EDITOR'S COLUMN

Welcome to the second edition of our 2013 *Tax Newsletter*.

First of all, we would like to announce the addition of a new element to our newsletter – International Tax Corner. As businesses go international, international tax is gaining importance and so we believe it is useful for us to keep informed. In this edition, we are pleased to have our UK International VAT partner Richard Woolich to educate us on the indirect tax traps when supplying goods to EU customers: *Indirect Tax Traps for the Unwary: Part 1 Sale of Goods*.

We begin our review of China[1] with *Headquarter and Branches VAT Filing under the VAT Pilot Program*, which provides guidance on VAT consolidation under the VAT Pilot program. In *Further Clarification on Beneficial Ownership of Dividends under DTA with Hong Kong*, we discuss the usefulness of the PRC State Administration of Taxation's attempt to clarify the types of Hong Kong companies which may qualify as a beneficial owner. *PE on Secondment Arrangement?* discusses whether secondment arrangement may create a permanent establishment of the seconding entity, thereby being subject to Enterprise Income Tax. *Strengthening the Administration of Value-added Tax and Consumption Tax upon Export* highlights the major amendments and provisions relating to export VAT and consumption tax treatments. *Administrative Measures for Registration of Foreign Debts* provides a summary of the main clarifications and changes Hua Fa [2013] No. 19 set forth. The China review ends with an update on the newly signed tax treaty with Netherlands.

Continuing with our Hong Kong Review, *Staying (Safely) Behind the Curve* critically analyses the impact of Inland Revenue (Amendment) Bill 2013 on liberalization of exchange of information regime in Hong Kong. *Mixed Messages* raises and tackles the question of whether the Inland Revenue Department's scrutiny of offshore fund managers undermines Hong Kong's attractiveness to the funds industry. We conclude the Hong Kong Review with updates on the latest double taxation treaties.

[1] As usual, we caution that, under the current Chinese regulations, foreign lawyers such as DLA Piper are not formally admitted to practice law in the People's Republic of China and, as a result, we are not permitted to render legal opinions on matters of PRC law. Our comments herein should not be construed as legal advice on any of the topics discussed herein. Furthermore, there is no official enterprise of the *enterprise Income Tax law*, the Implementing Rules or the notices or circulars referred to herein; the translations from Chinese are our own rather than official translations. We do not take any responsibility on whether or not the translation expressions properly convey the exact meaning of their Chinese counterparts. Ultimately, only the Chinese version is relevant and you should not act upon anything you may read herein without further consultation with a proper advisor.

We welcome your feedback and any questions you may have about this edition of our Tax Newsletter.

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CHINA

HEADQUARTER AND BRANCHES VAT FILING UNDER THE VAT PILOT PROGRAM

It has been one and half years since the VAT Pilot Program[2] was initially launched in Shanghai on January 1, 2012. Under the current regulations, headquarters and branches are separate VAT payers if they are located in different counties or cities, and are therefore required to report their VAT with the relevant local tax authorities. A consolidated VAT filing at the headquarter level is only available upon special approval from the Ministry of Finance ("**MOF**") and the State Administration of Taxation ("**SAT**").

To provide guidance on VAT consolidation under the VAT Pilot Program, the MOF and the SAT have recently promulgated two tax circulars on the detailed implementation rules[3] ("**Circulars**"). Upon approval of the MOF and the SAT, companies whose headquarters are recognized as pilot VAT payers shall consolidate and pay VAT at the headquarter level according to the prescribed rules under these Circulars.

Under the Circulars, the branches in areas not subject to VAT Pilot Program ("**non-pilot areas**") shall pay business tax ("**BT**") in respect of the services subject to BT as usual while the branches in areas subject to VAT Pilot Program ("**pilot areas**") are required to pay VAT for the same services based on the prescribed collection rate, rather than applying the standard VAT rate and the "credit mechanism".

A detailed explanation of how the above VAT consolidation works under the VAT Pilot Program is set out below.

VAT PAYABLE BY BRANCHES

For a branch that is located in a pilot area ("**Pilot Branches**") and renders services covered by the VAT Pilot Program ("**VATable Services**"), the following formula should be applied for calculation of VAT payable at the locality of the branch.

- VAT Payable = Revenue of VATable Services x Provisional Collection Rate ("**PCR**")

The Circulars do not specifically provide how a branch's revenue of VATable Services would be determined. The SAT seemingly assumes that every branch should keep a separate book for recognition of its own revenue, or a taxpayer should be able to reasonably allocate its revenue from VATable Services to each individual branch.

According to the Circulars, the PCR is to be determined by the MOF and the SAT and may be adjusted from time to time.

For branches that are located in a non-pilot area ("**Non-pilot Branches**"), they should still file BT returns and pay BT at their localities on revenue arising from the relevant VATable Services.

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[2] The reform is aimed to replace the business tax with VAT in China and Shanghai was the first city to roll out the VAT pilot program in certain designated industries on January 1, 2012.

[3] The *Announcement on Certain Issues related to VAT Filing by Pilot Taxpayers with Head Office and Branches under the Pilot VAT Program* (Announcement of the SAT [2013] No. 22), which has become effective since June 1, 2013; and the *Provisions Measures of Calculating and Paying VAT by Pilot Taxpayers with Head Office and Branches* (Circular Caishui [2012] No. 84), which has become effective since December 31, 2012.

VAT PAYABLE BY HEADQUARTER

On the other hand, a headquarter located in a pilot area should follow the formula below to calculate its VAT on a consolidated basis in light of the VAT/BT paid by branches at their localities.

- VAT Payable by Headquarter = (Total VAT payable from VATable Services) – (Input VAT from rendering the VATable Services + VAT paid by Pilot Branches + BT paid by Non-pilot Branches)

In calculating the VAT, the headquarter should note:

- Total VAT payable from VATable Services is calculated on a consolidated basis based on the applicable VAT rate, revenue earned by the headquarter, Pilot Branches as well as Non-pilot Branches.
- Revenue of Non-pilot Branches need to be consolidated, as if they were located in pilot areas. When calculating the VATable Service revenue of the Non-pilot Branches, the following formula needs to be adopted for converting the BTable revenue recognized by the Non-pilot Branches to the VATable service revenue:

  VATable Service revenue of Non-pilot Branches = /Business revenue recognized/(1 + applicable VAT rate)

- Input VAT from rendering the VATable Services include input VAT credit derived by the headquarter and the branches.
- VAT paid by Pilot Branches and BT paid by Non-pilot Branches are both deductible for calculating VAT payable of the headquarter.
- Excessive input VAT credit and VAT paid by branches can be carried forward to the following period.

SUMMARY

The Circulars require taxpayers to conduct proper revenue recognition at both the headquarter and branch levels, and to separately file VAT returns at different localities. This apparently would add on the tax administration burden of taxpayers, especially those taxpayers with multiple branches in and outside of VAT Pilot Program areas, as well as those which have not set up separate books for their branches.

11 Chinese airline companies have been approved by the SAT and MOF to conduct consolidated VAT filing at the headquarter level for services covered by the VAT Pilot Program.[4] The PCR for this purpose is 1%. With the adoption of the special consolidation mechanism, the VAT burden of airline companies may be reduced and the tax revenue of the local tax authorities in charge of the headquarter and different branches could also be more evenly distributed and stabilized.

It remains to be seen, however, whether more companies with similar BT/VAT situations will be approved by the SAT and the MOF to conduct consolidated VAT filing in the future.

Since the VAT Pilot Program will be expanded to the whole nation effective from August 1, 2013, there may be further changes in the above branch VAT filing rules. Thus, it is advisable that taxpayers providing VATable Services should keep alert of the foregoing changes to ensure compliance at both the headquarter and branch levels.

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[4] *Circular on Partial Airline Companies' Implementation of the Interim Measures for the Computation and Payment of VAT for Head Offices and Their Branches as Pilot Taxpayers* (Cai Shui [2013] No. 9)

FURTHER CLARIFICATION ON BENEFICIAL OWNERSHIP OF DIVIDENDS UNDER DTA WITH HONG KONG

On 12 April 2013, the PRC State Administration of Taxation ("**SAT**") released guidance on implementing the dividends provision under the Tax Arrangement between Mainland China and Hong Kong in cases involving beneficial ownership (*Shui Zong Han [2013] No. 165*, hereinafter referred to as "**Circular 165**") in response to inquiries from local-level tax bureaus. The inquiries concern cases involving several Hong Kong companies applying for beneficial owner status under the dividends provision of the Double Taxation Avoidance Agreement ("**DTA**") between Mainland China and Hong Kong.

BACKGROUND

The SAT issued two regulations in 2009 and 2012, i.e., Circular 601 and Announcement 30:

- *Notice Concerning the Meaning and Determination of the Identity of "Beneficial Owner" in Tax Treaties* (Guo Shui Han [2009] No. 601), hereinafter referred to as "**Circular 601**", effective October, 2009; and
- *Announcement on the Identification of "Beneficial Owners" in Tax Treaties* (Announcement [2012] No. 30), hereinafter referred to as "**Announcement 30**", effective June, 2012.

Circular 601 defined the "beneficial owner" and provided seven "adverse factors" in determining whether a person can be identified as a "beneficial owner". Announcement 30 builds on Circular 601 to make it simpler to obtain the beneficial owner status.

"Beneficial owner" refers to a person having the ownership and right of control over the income or the right or property derived from the income. In order to enjoy reduced withholding tax rates on dividends, interests and royalties under DTAs between China and other countries, the non-resident applicant must be qualified as the "beneficial owner" of the income.

CLARIFICATIONS OF CIRCULAR 601

Circular 165 clarifies the following points in relation to the seven "adverse factors" for assessing the beneficial owner status for Hong Kong tax residents:

(1) Distribution obligation

The applicant is obliged to pay or distribute all or substantially all (for example, more than 60%) of his income to a resident in a third country (region) within the stipulated time (for example, within 12 months from the date of receipt of the income).

Clarification under Circular 165

When determining whether the applicant is obliged to distribute dividends within a stipulated time-frame, tax authorities should require applicants to provide relevant materials that can reflect its profit distribution situation, as well as the rights and obligations between the applicant and its holding company, including valid articles of association as well as relevant contracts, agreements, or corporate resolutions with its holding company.

This factor is irrelevant if the applicant does not distribute profits to a non-Hong Kong resident.

(2) Business activity

Apart from holding the property or right derived from the income, the applicant has not or has barely engaged in any other operating activities.

Clarification under Circular 165

Business activities include the investment activity of "holding the property or right from which the income is derived." In order to establish this adverse factor, the applicant would have to have no other investment items or other types of business activities.

Investment companies established solely for a single project should not be disqualified from their beneficial owner status merely because of the existence of this adverse factor, but should be given comprehensive consideration based on other factors.

(3) Assets/staffing to income ratio

If the applicant is an entity such as a company, its assets, scale of operation, and staff allocation is too small as compared to its income.

Clarification under Circular 165

The assets of the applicant should be analysed comprehensively in determining whether they are "incongruent with the income amount," and "assets" should not be considered as equivalent to registered capital. Applicants with low registered capital amounts should be comprehensively evaluated based on their sources of funding and the degree of investment risk it bears.

When analysing staff allocation, the emphasis should be on the employees' work responsibilities and substance, rather than the staff size or whether the applicant bears the labour expenses. Applicants will be required to provide relevant materials.

(4) Level of control and risk

The applicant has no or almost no right of control or disposal on the income or the property or right derived from the income, and assumes little or no risk.

Clarification under Circular 165

In deciding whether the applicant possesses the right to control or dispose of its investments, the tax authorities should focus on the following three factors:

- whether the provisions of the articles of association or other legal documents grant the applicant such rights;
- whether the applicant has exercised such power to use the dividends other than further distribution, e.g. to invest in projects, to subscribe for shares in other companies, to increase investment in existing companies, to do merger and acquisition, or to invest in venture capital; and
- whether the decision on the usage of dividends was made by the applicant through resolutions of its board of directors or shareholders.

The tax authorities should not preclude that the applicant possesses the right of control or disposal merely because the applicant's equity is controlled by another company.

(5) Low/no tax jurisdiction

The country (region) that is the other party to the treaty does not impose or exempt tax on the income or imposes tax at a very low effective tax rate.

Clarification under Circular 165

Since Hong Kong adopts the territorial source principle of taxation, whereby only profits sourced in Hong Kong are taxed, this fact should not be considered a key adverse factor when determining beneficial owner status.

CLARIFICATIONS OF ANNOUNCEMENT 30

Circular 165 further clarifies the following points under Announcement 30

Article 3 of Announcement 30: an applicant that is a listed company in the other contracting state, or is 100% directly or indirectly owned by a listed company in the other contracting state (except where the shares of the applicant are indirectly held by the listed company through a resident company of a third state which is neither a resident of China nor the other contracting state), is automatically considered beneficial owner of dividend income as long as the dividends are derived from the shares owned by the listed company.

Clarification (Circular 165):

The above stipulation should not be interpreted as disqualification of the beneficial owner status in the following circumstances:

- The applicant is 100% directly or indirectly owned by a non-listed Hong Kong resident enterprise; or
- An intermediate holding company registered overseas exists between the applicant and the ultimate Hong Kong holding company.

Circular 165 stipulates that different local tax bureaus should achieve consistent results when dealing with the same applicant with respect to its investment activities that fall under the same category.

If an applicant undergoes substantial changes in its business, tax bureaus are required to accept its application to enjoy the beneficial treatment, verify the changes, and determine its beneficial owner status accordingly.

SUMMARY

Circular 165 provides important principles and guidelines for the Chinese tax authorities to identify beneficial owner status on dividends under the DTA between Mainland China and Hong Kong.
For applicants from treaty jurisdictions other than Hong Kong, Circular 165 cannot be automatically applied. Notwithstanding, it is understood that the principles clarified in Circular 165 could provide a better reference, and help applicants to manage the beneficial ownership status for beneficial treatment purposes.

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PE ON SECONDMENT ARRANGEMENT?

On 19 April 2013, the China State Administration of Taxation ("**SAT**") released SAT Bulletin [2013] No. 19 ("**Circular 19**") to provide further guidance as to whether an arrangement that a non-resident enterprise sends personnel (i.e. secondees) to provide labour services (e.g. management or technical services) by way of a secondment arrangement will constitute a taxable presence of a permanent establishment ("**PE**") (if the relevant tax treaty applies). Circular 19 builds on the circular Guo Shui Fa [2010] No. 75[5] where SAT previously provided its guidance on the secondment arrangement in the context of interpreting China – Singapore tax treaty. Circular 19 takes effect on 1 June 2013.

In a typical secondment arrangement, the employees of a non-resident enterprise[6] ("**Dispatching Entity**") will be temporarily seconded and transferred to a tax resident enterprise in China ("**Receiving Entity**"), who may or may not sign a local employment contract with the Receiving Entity. The secondees will remain primarily employed and paid by the Dispatching Entity. The Receiving Entity will reimburse the Dispatching Entity on the secondees' salaries and remuneration and/or pay any additional fees to the Dispatching Entity for the "services" provided by the seconded employees.

So far as China tax is concerned, the issue, in the view of the PRC tax authorities, is whether the Dispatching Entity, through the secondment arrangement, is being regarded as providing labor services to the Receiving Entity, and thus creating an establishment being a taxable presence under the *PRC Income Tax Law*, or a PE within China where a tax treaty applies, so to trigger the PRC Enterprise Income Tax ("**EIT**").[7]

Circular 19 provides the following guidance on this issue.

1. DETERMINATION OF ESTABLISHMENT/PE

Circular 19 sets forth the analysis consisting of (i) **one** primary factor focusing on employer/employee relationship and (ii) **five** reference factors focusing on the financial arrangement between the Dispatching Entity and Receiving Entity, in order to determine whether the Dispatching Entity causes an establishment or PE in China by the activities of the secondees:

(i) Primary factor

If the Dispatching Entity undertakes partial or whole responsibilities and risks for the work performed by the secondees and regularly evaluates their performance, it will, *in principle*, be considered to create an establishment/PE (by reference to the relevant tax treaty) in China.

(ii) Reference factors

- The Receiving Entity pays the Dispatching Entity fees in the nature of management or service fee.
- The sum that the Receiving Entity pays the Dispatching Entity exceeds the costs of the Dispatching Entity for paying the secondees their salaries, remuneration, and social security etc.

[5] *Interpretations of the Provisions in the Agreement between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and its Protocols* ("Circular 75") issued by the SAT on 1 September 2010.

[6] A China tax non-resident enterprise refers to an enterprise incorporated pursuant to foreign laws which does not have its actual pace of management within China. A non-resident enterprise is subject to EIT in China on the profits attributable to an establishment in China as well as its China sourced income (such as dividend, rentals, interests and royalties etc.), subject to any beneficial treatment under a tax treaty. See also footnote 3.

[7] The term "establishment" includes, among other things, sites for furnishing of services, under the *PRC Income Tax Law*. Where a tax treaty applies, the non-resident enterprise may be taxed in China but only to the extent the income is attributable to a PE.

- The Dispatching Entity does not employ the full amount of receipt from the Receiving Entity to compensate the secondees, but rather retains to itself a certain amount.

- The part of the secondees' salaries and remuneration borne by the Dispatching Entity is not fully subject to the Individual Income Tax ("**IIT**") in China.

- The Dispatching Entity decides the number, qualification and remuneration standard of the secondees as well as their work locations.

(iii) Exception

Circular 19 excludes the scenario from a finding of an establishment/PE where the Dispatching Entity dispatching personnel to China merely to exercise its shareholder rights or to protect the shareholder's legal interests. Such activities contemplate providing investment advice to the Receiving Entity, attending shareholder or board meeting etc.

2. COMPLIANCE

On a finding of an establishment/PE by the local tax authorities, Circular 19 requires the Receiving Entity and Dispatching Entity perform the tax registration and recordal, conduct tax filing and settle tax payment, in compliance with SAT Decree [2009] No. 19.[8]

The Dispatching Entity is required to accurately account for its income derived from the services provided by the secondees, report and settle the EIT. If the income cannot be accurately calculated, the tax authority is empowered to impose the EIT calculated on a deemed profit basis.

3. DOCUMENTATION

The SAT instructs the local tax authority to focus its review on the following documentation[9] with a view to assess the secondment arrangement's economic substance to determine the relevant EIT obligation, which also sheds light on the type of documentation to be kept by the entities in order to withstand an audit:

- agreements among the Dispatching Entity, the Receiving Entity and the secondees;
- protocol for managing the secondees that provides the job scope, duties, evaluation, risk bearing etc;
- records of payment and the accounting treatments in relation to the payment made by the Receiving Entity to the Dispatching Entity as well as the relevant IIT filing documentation;
- information indicating payment offsetting, debt write-off, related party transaction or disguised payment/expenses in relation to the secondment arrangement.

4. OBSERVATIONS

While Circular 19 provides needed guidance to the secondment arrangement as stated above, the following, in our view, invites thinking or otherwise is worthy of attention from multinational companies:

- Sound documentation in line with the guidance provided under Circular 19 are always recommended to at least identify any existing issues for remedy.
- As Circular 19 bases its finding of an establishment/PE primarily on an employer-employee relation plus a support from any of the reference factors, it seems that a strict reimbursement arrangement (even without involving any mark-up or charge of management or service fee) cannot be viewed entirely safe according to Circular 19.

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[8] Decree 19 is a tax circular early published by the SAT that sets forth the detailed provisions concerning the tax administration of contract projects and provision of labor service by non-resident enterprises.

[9] Circular 19 covers EIT only and does not specifically address the tax items such as business tax ("BT"), VAT and individual income tax ("**IIT**") which could also be triggered under a secondment arrangement. The local authorities in charge of EIT are instructed to coordinate with those in charge of BT and IIT to exchange the information concerning the dispatched employees for cross reference.

- It is not clear under Circular 19 whether the local tax authorities may base a finding of an establishment/PE solely on the reference factor(s) in the scenario where the primary factor is not satisfied. Further clarification from the PRC tax authorities is needed.
- Using the full settlement of the secondees' PRC IIT as one of the reference factors to buffer the finding of an establishment/PE does not appear to be entirely reasonable, particularly in the case where the secondees themselves are eligible to a tax exemption from IIT perspective.

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STRENGTHENING THE ADMINISTRATION OF VALUE-ADDED TAX AND CONSUMPTION TAX UPON EXPORT

On 13 March 2013, the State Administration of Taxation ("**SAT**") issued the *Announcement on Relevant Issues Regarding the Administrative Measures on the Value-added Tax ("VAT") and Consumption Tax Applicable to the Export of Goods and Labor* ("**Announcement [2013] No. 12**"), which is to implement and supplement *the Administrative Measures on the VAT and Consumption Tax Applicable to the Export of Goods and Labor* ("**Administrative Measures**") issued in 2012.

- Due to new administration requirements and subsequent regulatory changes, Announcement [2013] No. 12 includes certain amendments to the Administrative Measures, and major amendments are as follows:

	Administrative Measures	Announcement [2013] No. 12
Qualification Accreditation	An Application Form for Qualification Accreditation Regarding Export Tax Exemption (Refund) ("**Application Form**") is to be filled in, together with other supporting documents, to confirm the exporter is qualified to obtain tax exemption/refund upon export	Electronic data of the Application Form should also be provided
Documents Required for VAT Refund/Exemption	The Verification Slip for the Receipt of Foreign Exchange ("**Verification Slip**") should be provided	The Verification Slip is not required

- Announcement [2013] No. 12 also supplements the Administrative Measures by including new requirements in relation to the export VAT and consumption tax treatments, and major provisions include the following:

Export Tax Refund Declaration System	■ The Export Tax Refund Declaration System ("**System**") should be used by exporters to deal with declarations for export tax refund/exemption applications and relevant certification applications; ■ The System could be downloaded from the SAT website for free or provided by the in-charge tax authority for free; ■ All electronic data should be generated through the System.
Timeline for Export Tax Refund/Exemption Declaration	■ The export tax refund/exemption should be filed within the filing deadline of the month subsequent to the month in which the export entity books the relevant export sales revenue on book; ■ Within the last filing deadline before 30 April of the following year, the exporter must collect all the requested application documents and submit the hard copies to the relevant tax authority for export tax refund/emption application.

Refund/Exemption in case of Lack of Required Documentation	▪ If (i) there is a genuine export of goods or labor service, (ii) the required documents for export tax refund/exemption is not available (iii) the occurrence of certain events (e.g., events of force majeure, theft, robbery, death, serious sickness or resignation of tax personnel), an application (together with relevant evidence) should be submitted to the in-charge tax bureau before the declaration deadline; ▪ In-charge tax bureau will review and verify the documents provided and pass the documents to the higher level tax bureaus. A final approval for export tax refund/exemption will be issued by the provincial level State Tax Bureau; ▪ Effective from 1 January 2011; ▪ For events that occurred prior to 1 January 2011, the application deadline would be 30 June 2013.
Self-inspections	▪ If the tax authority has doubts regarding the export tax refund/exemption, the exporter should entertain interviews at the request of the in-charge tax bureaus, provide written clarifications and submit self-inspection forms; ▪ Vendors of exporters should submit self-inspection forms at the request of in-charge tax bureaus.
Suspension of Export Tax Refund/Exemption	▪ Export tax refund/exemption applications will be suspended in certain scenarios (such as export smuggling investigations, tax audit investigations regarding export refund, use of higher export VAT refund rate ("**EVRR**") for export declarations etc.); ▪ If export tax refund/exemption for a particular export shipment (later found to be questionable) has already been granted: – An amount equivalent to the export tax refunded/exempted of other unquestionable export shipment could be withheld; – If there is no other shipment, or the amount of other shipment is less than the amount in question, a deposit should be paid by the exporter.
Exporters change the Export VAT Treatment Method	Exporters which choose to change from "exemption but no refund" method to "pay and refund" method must fill out a specific form for recordal purposes.
Free Reminder Service	Exporter may fill in a Reminder Information Application Form, and the in-charge tax bureau will provide the following information to the contact person for free: ▪ Changes to export tax refund/exemption policy; ▪ Upgrades to the EVRR database; ▪ Export customs declaration forms showing export tax refund/exemption application deadlines; ▪ Issues relating to fund transfer; ▪ Exemption, set-off and refund applications, import processing handbook verifications etc.; ▪ Daily administration issues and requirements.
Pre-declaration	Exporters must file a pre-declaration with the tax authority. Formal export VAT refund/exemption can be filed only after the pre-declaration is confirmed.
Mismatch of Price	Exporters must file a form to explain if there is any discrepancy between export invoice price and export declaration form price.

Scenarios where VAT must be paid upon Export	In 15 scenarios as stipulated in Announcement [2013] No. 12 (mainly due to untruthful documents or fraudulent forms), the export sales must be subject to VAT.

On one hand, the Administrative Measures and Announcement [2013] No. 12 benefit taxpayers by way of setting up more efficient reporting systems, information sharing channels and a "substance over form approach" for the taxpayers and tax authorities to follow. On the other hand, it is expected that taxpayers should provide genuine documents to the tax authority and be ready for more stringent supervision or audit from the tax authority.

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ADMINISTRATIVE MEASURES FOR REGISTRATION OF FOREIGN DEBTS

On April 28, 2013, the State Administration of Foreign Exchange (SAFE) released the Administrative Measures for Registration of Foreign Debts (Hui Fa [2013] No. 19) ("**Circular 19**"), effective from May 13, 2013.

The main purposes of Circular 19 are:

1. To simplify the administration process for the registration of foreign debts;
2. To clarify the approval principles/conditions in a systematic way; and
3. To improve the registration and statistical monitoring of foreign debts.

Set forth below is a summary of the main clarifications and changes that are applicable to foreign invested enterprises ("**FIEs**") with respect to the foreign debts.

1. ABOLISHMENT OF CERTAIN SAFE APPROVALS RELATED TO FOREIGN DEBT

The following procedures have been abolished by Circular 19:

- Approval for opening of foreign debt accounts

  No approval from SAFE will be required for opening the foreign debt accounts any more. As long as the non-bank borrower completes registration of the foreign debt with SAFE, which shall be conducted within 15 business days after execution of the foreign loan agreement, the non-bank borrower may open the foreign debt accounts with the bank directly.

- Registration for withdrawal of the foreign exchange loan proceeds

  Prior to Circular 19, FIEs are required to register with SAFE for withdrawal of the foreign exchange loan within 5 business days upon receipt of the loan proceeds, but this requirement is removed by Circular 19.

- Approval for each conversion of the foreign debt into Renminbi

  Each conversion of the foreign debt proceeds into Renminbi now can be conducted at the banks without SAFE approval.

- Approval for repayment of the foreign debt

  Circular 19 provides that the banks now can verify and handle the repayment of the foreign debt directly.

2. CLARIFICATION OF THE APPROVAL PRINCIPLES

Circular 19 has clarified and refined the following rules for an FIE to borrow foreign debts:

1. Borrowing Cap Limitation

   The difference between the total investment and the registered capital represents the maximum amount of foreign debt that the FIE can undertake, covering the total amount of the cumulative amount of medium to long-term foreign debts and balance of short-term foreign debts (i.e. the amount of not-yet-repaid short-term foreign debts).

2. Completion of Capital Injection

Circular 19 requires that an FIE shall make the first installment of the capital injection prior to any borrowing of foreign debt.

In addition, if the FIE's registered capital has not yet been fully paid in, the foreign debt quota of the FIE should be calculated on a pro rata basis. In other words, foreign debts obtained by the FIE are capped at the percentage of foreign capital injected multiplied by the difference between its total investment and registered capital.

3. Permitted Usage of the Foreign Debt Proceeds

Circular 19 confirms the foreign debt proceeds can be used for trade and services within the FIEs' business scope and for eligible financial transactions. However, in any event, foreign debts are not allowed to be converted into Renminbi to refinance the Renminbi loans.

4. Late Registration

If a borrower takes out a loan from abroad, but fails to register the relevant loan agreement, the Guidelines allow such borrower to make up the foreign debt registration. However, in such case the foreign debt amount which can be registered is only limited to the actually booked and not yet repaid amount as verified by the competent SAFE. The said registration can only be made up after the relevant penalties have been imposed on the borrower for failure in conducting the foreign debt registration on time by the competent SAFE.

5. Domestic Debt with Foreign Security

In the case where enterprises in China (including FIEs) apply for loans with domestic banks using guarantees from foreign entities or individuals, Circular 19 requires that the borrowers should satisfy the following in order to qualify for these kind of loans:

- The borrower is in an "encouraged" industry;
- The borrower has been in a profitable position for the past three years;
- The borrower has sound financial management and internal control systems;
- The borrower has a net asset to total asset ratio of no less than 15 percent; and
- The borrower's aggregate foreign borrowings and foreign guarantee should not exceed 50 percent of its net asset.

3. OBSERVATION

After the implementation of Circular 19, banks will have more burden and responsibilities in managing and controlling the foreign currency settlements. Since banks all have their own internal risk management system, this may result in different interpretations and practice from bank to bank. The process and documentation requirements may vary across different banks, especially in the preliminary implementation stage of Circular 19. As such, it is advisable for FIEs to keep regular contact with the banks and make appropriate enquires with the banks for foreign debt related handlings.

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UPDATE ON NEWLY SIGNED TAX TREATY

China and the Netherlands entered into a new double taxation agreement ("**DTA**") on 31 May 2013 to replace the existing DTA. Highlights of the new DTA are as follows:

CAPITAL GAINS ON SHARES:

1. If the shares being disposed of derive more than 50% of their value directly or indirectly from immovable property situated in one country, say China, China shall have taxing rights on the gains derived from the disposal by a resident of the Netherlands.

2. If the shares of a company which is a resident of a country, say China, are being disposed of and the recipient of the gains which is a resident of the Netherlands has directly or indirectly held at least 25% of the capital of the company at any time 12 months before the disposal, China shall have taxing rights on the gains derived from the disposal by the Netherlands resident.

3. Taxing rights on the gains from the disposal of shares of a listed company shall rest with the country where the disposer is a resident, say the Netherlands, provided that (a) no more than 3% of the listed shares were sold by the disposer in the relevant fiscal year collectively; or (b) the shares were held by the Netherlands government or a state-owned enterprise.

- **Dividends:** If the beneficial owner of the dividend is a company which holds at least 25% of the capital of the company paying the dividend, the withholding income tax rate is reduced to 5%. If the beneficial owner is the state government or a state-owned enterprise, the withholding income tax rate is 0%.
- **Royalties from Equipment Rental**: The withholding income tax rate for royalties from industrial, commercial or scientific equipment rental is reduced to 6% (currently 10%).
- **Permanent Establishment:** Building sites or construction projects will constitute a permanent establishment only when it lasts for more than 12 months (currently 6 months). Also, furnishing of services will constitute a permanent establishment only when it lasts for more than 183 days (currently 6 months) within any 12-month period.
- **Tax sparing credit for interest and royalties:** Tax sparing credit for interest and royalties is no longer available under the new DTA.

The new DTA shall apply to income derived from 1 January of the year following its entry into force upon ratification by both countries. It will take place on 1 January 2014, the earliest.

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HONG KONG

STAYING (SAFELY) BEHIND THE CURVE

Previously, Hong Kong's regime of exchange of information ("**EoI**") under comprehensive double taxation agreements ("**CDTA**") was based on the 2004 version of the Organisation for Economic Cooperation and Development Model Tax Convention on Income and on Capital. While the world is now in a heated discussion on the automatic exchange of information[10], Hong Kong has only recently enacted amendments to incorporate into our regime tax information exchange agreements ("**TIEAs**"), a model agreement first released by the OECD in 2002.

On 10 July 2013, Hong Kong Legislative Council passed the Inland Revenue (Amendment) Bill 2013. The Bill amends the Inland Revenue Ordinance (Cap. 12) and the Inland Revenue (Disclosure of Information) Rules (Cap. 12 sub. leg. BI) to make significant changes to our current regime of EoI with other jurisdictions. It enables Hong Kong to enter into TIEAs with other jurisdictions and to enhance the existing EoI arrangements under CDTAs.

BACKGROUND

In 2011, the Global Forum on Transparency and Exchange of Information for Tax Purposes of the Organization for Economic Co-operation and Development[11] completed its phase one peer review[12] on Hong Kong. Although concluding that Hong Kong has generally implemented the necessary legal and regulatory framework for EoI, the Global Forum recommended that Hong Kong should put in place a legal framework for entering into TIEAs as the latest international standard is that a jurisdiction should make available both CDTA and TIEA as instrument for EoI with other jurisdictions.

In December 2012, the Global Forum launched its phase two peer review[13] and is expected to finish the review in September 2013. The Global Forum indicated that whether Hong Kong will pass the phase two peer review will largely depend on the availability of a legal framework for TIEAs. The Hong Kong government believes that *failing the phase two peer view, Hong Kong may run the risk of being labelled as an uncooperative jurisdiction, which is highly undesirable for Hong Kong's international reputation and may in turn undermine our position and competitiveness as an international business and financial center.* Further, *other jurisdictions may also impose unilateral sanctions on Hong Kong*[14].

Further, the Hong Kong government stressed that current limitations in CDTAs have posted *practical difficulties in further expanding Hong Kong's CDTA network*[15] and that we need to at least adopt a *minimum necessary approach* in respect of TIEA to give incentive to jurisdictions with complex tax systems to enter into CDTAs with Hong Kong. Currently, Hong Kong has entered into CDTAs with 11 of Hong Kong's top 20 trading partners[16]. It is also said that Hong Kong is facing pressure from existing CDTA partners to remove such limitations. It is against the above background the Hong Kong government introduced the Bill.

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[10] Automatic exchange of information (also called routine exchange by some countries) involves the systematic and periodic transmission of "bulk" taxpayer information by the source country to the residence country.

[11] Hong Kong is committed to enhancing tax transparency and preventing tax evasion and is one of the 120 members of the Global Forum.

[12] It is an evaluation of jurisdictions' compliance with the international EoI standard.

[13] It is an evaluation of Hong Kong's implementation of the EoI standard in practice and examination of whether Hong Kong has taken forward the recommendations proposed by the Global forum during the phase one peer review.

[14] Paragraph 4 of the Legislative Council Brief on the Bill, which is available at http://www.legco.gov.hk/yr12-13/english/bills/brief/b14_brf.pdf

[15] Paragraph 5 of the Legislative Council Brief on the Bill

[16] Paragraph 6 of the Legislative Council Brief on the Bill

The Amendments

The Bill brings about the following main changes:

1. EoI pursuant to TIEAs without Reliance on CDTAs

   Previously, the IRO only provided for entering into CDTAs by the Hong Kong government and EoI with another jurisdiction could only be made pursuant to and within the scope of a CDTA. The Bill separates the two regimes by enabling Hong Kong to enter into stand-alone TIEAs with other jurisdictions simply for the purpose of exchanging tax information.

2. Widen the Scope of Tax Information

   Hong Kong has a simple tax system under which only three direct taxes are imposed, namely profits tax, salaries tax and property tax. Considering that EoI for the purposes of these direct taxes would suffice, the Hong Kong government had previously undertaken to restrict EoI article to similar direct taxes in the CDTAs. Other than the specified taxes in the CDTAs, other taxes which most jurisdictions with a complex tax system impose, such as value-added tax or inheritance tax, were not generally within the boundary for EoI. The Bill removes such limitation and allow Hong Kong to enter into TIEAs with another jurisdiction for exchange of information on any tax imposed by Hong Kong or by the other jurisdiction. Further, the Hong Kong government will also no longer seek to restrict the scope of EoI under a CDTA going forward.

3. Relaxation of Limitation of Applicable Period

   Before the passage of the Bill, information that relates to any period before the CDTA comes into effect could not be exchanged. The Bill relaxes this rule by providing that information in relation to a prior period may be exchanged if it relates to (i) the carrying out of the provisions of the CDTA/TIEA concerned after the CDTA/TIEA comes into operation; or (ii) tax assessment in respect of any period after the CDTA/TIEA comes into effect.

4. Persons Obligated to Provide Information

   Previously, the IRO and the Rules only require persons who have *possession* of the information requested to provide the information to the IRD. The Bill extends this scope to persons who do not possess but have *control* of the information requested.

SAFEGUARDS ON TAXPAYERS' PRIVACY AND CONFIDENTIALITY OF INFORMATION EXCHANGED

As mentioned above, our previous EoI regime under CDTAs was generally based on the 2004 version of the OECD Model Tax Convention on Income and on Capital. The safeguards in respect of the privacy and confidentiality of information of taxpayers under a TIEA would be the same as those afforded under CDTA. The salient features are set out below:-

(a) Hong Kong will only exchange information upon receipt of requests and no information will be exchanged on an automatic or spontaneous basis;

(b) The information sought should be foreseeably relevant, i.e. no fishing expeditions;

(c) Information received by the treaty partners should be treated as confidential;

(d) Information would only be disclosed to the tax authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of and the determination of appeals in relation to taxes falling within the scope of EoI but not for release to their oversight bodies unless there are legitimate reasons given by the treaty partners;

(e) Information requested should not be disclosed to a third jurisdiction;

(f) There is no obligation to supply information under certain circumstances, for example, where the information would disclose any trade, business industrial, commercial or professional secret or trade process or which would be covered by legal professional privilege, etc; and

(g) Hong Kong will not accede to any requests from its treaty partners for tax examination abroad and assistance in collection of taxes.

The Hong Kong government has undertaken to strive to include these safeguards in the texts of future CDTAs/TIEAs. Further, similar to the existing CDTAs, the Rules will be in place to serve as domestic statutory safeguards[17]. The Rules will stipulate the particulars to be contained in an EoI request made by our treaty partner to demonstrate that the requested information is "foreseeably relevant". It also provides for a notification and review system in handling EoI requests and related appeals.

COMMENTARY

Naturally, with the rising competition by other cities in Asia, Hong Kong cannot afford to be named a uncooperative jurisdiction by the Global Forum and also for other jurisdictions to impose unilateral sanctions on us. Hong Kong's international reputation and position and competitiveness as an international business and financial centre is to be maintained. The passage of the Bill is therefore undoubtedly welcome.

Further, we note that Hong Kong did not introduce legislative amendments to the IRO for the adoption of the OECD's 2004 version of the EoI article in its DTAs until 2009. The model TIEA was released by the OECD in April 2002 and we are only now adopting this international standard after 11 years. Meanwhile, the OECD has recently introduced its latest global model of automatic exchange of information. This lag in pace has allowed Hong Kong to consider the different creatures of EoI proposed by the OECD carefully and incorporate them appropriately for the full benefit of Hong Kong.

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[17] Departmental Interpretation and Practice Notes No. 47 – "Exchange of Information under Comprehensive Double Taxation Agreements" also sets out the practice of the Inland Revenue Department on the processing and EoI upon requests received from treaty partners.

MIXED MESSAGES

"Is the IRD's scrutiny of offshore fund managers undermining Hong Kong's attractiveness to the fund industry?"

In our first Newsletter of the year[18], we discussed a new initiative to extend an existing profits tax exemption available to offshore funds that cover transactions involving private non-Hong Kong companies that do not hold any real property nor conduct business in Hong Kong. The Government policy behind the initiative was put forth in the 2013/2014 Budget Speech, in which Financial Secretary John Tsang pledged to "attract more private equity funds to domicile in Hong Kong".

Notwithstanding this pledge, the Inland Revenue Department (IRD) has recently conducted over 25 audits targeting offshore funds with Hong Kong-based investment advisors. The targeted funds utilise a structure featuring an offshore fund manager (usually an offshore company) that, pursuant to a services agreement with the fund, provides investment management and advisory services to the fund in return for a fee. The offshore fund manager, in turn, contracts with a Hong Kong-based investment advisor (often a related party entity) to provide it with trade execution, market research, and other more localised services.

The IRD is giving more scrutiny to such structures in an effort to determine where the fund management functions are actually being performed. Pursuant to this, the audits have largely focused on:-

(i) whether the Hong Kong-based investment manager, who is customarily remunerated on a cost-plus basis, should be attributed an appropriate allocation of the overall management fee between itself and its offshore fund manager; and

(ii) whether the offshore fund manager has any commercial substance, or is essentially acting via the Hong Kong investment manager.

So far, the IRD has not disclosed the purpose of this industry-specific audit focus. It may be that they have selected a few sample targets for audit in order to better understand their business and operational structure. Audit targets are often chosen by looking into related-party transactions with non-residents and transfer-pricing policies, as well as to verify whether payments for investment advisory services, capital-raising functions and/or support services are consistent with market rates[19].

But even if the IRD's motivation for these audits is innocuous, their broad scope and duration cannot be comforting for offshore fund managers. Many (if not most) fund managers earn the bulk of their profits from performance fees[20]. In many jurisdictions, such performance fees are treated as a capital gain for tax purposes (under the theory that the manager committed substantial capital- whether in the form of cash or "sweat equity"- into the fund), thus subjecting such fees to capital gains tax treatment. Other jurisdictions have either enacted outright tax exemptions for performance fees, or are seeking to do so. So while the IRD may take a considerable amount of time to study the assessibility of such performance fees, in the interim many offshore fund managers may simply decide to relocate their advisory functions elsewhere.

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[18] Readers may refer to the article entitled "Amber Light for Offshore Private Equity Funds" in our Tax Quarterly Newsletter Q1 2013.

[19] The IRD also relies on informants to provide potential audit targets. Another technique is to compare statements and citations by fund managers in newspapers, magazines, and financial publications with information provided in the fund's financial statements and/or tax filings.

[20] Typically, a fund manager will earn both a management fee and a performance fee. The management fee is paid on a cost-plus basis, while the performance fee is measured as a percentage of the fund's profits for a particular financial year.

This should be a worrying prospect for the Hong Kong Government. The IRD's recent audit activity, particularly their scrutiny of offshore fund managers, may very well undermine the Financial Secretary's stated policy objectives. If the funds think that the performance fees earned by their offshore managers will be assessable to profits tax, there is a real possibility that they will leave Hong Kong. As of yet, the IRD has not made any definitive pronouncements on performance fees.

Another area of concern involves transfer pricing. It seems that the old approach of paying a cost-plus 10% mark-up to a Hong Kong investment advisor with little or no justification will probably not suffice. The IRD now expects more robust support (perhaps in the form of transfer pricing analysis) to justify a particular management fee allocation. The bar has been raised.

As the Financial Secretary's proposed tax exemption is still being reviewed by various constituencies and interested parties (including the Hong Kong Venture Capital Association), the fund industry itself is facing a tricky tax environment. If the final result of the IRD audits is a significant increase in tax collection, the IRD may become emboldened to broaden its audit initiative. That would almost certainly result in louder cries of protest from the fund industry.

In the meantime, interested parties are petitioning the IRD to quickly reach a conclusion on their tax treatment of fund structures. Until they do, offshore fund managers will still concern themselves with setting up and maintaining complicated structures in order to avoid establishing a taxable presence in Hong Kong.

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UPDATES ON TAX TREATIES

KUWAIT

The Comprehensive Agreement for the Avoidance of Double Taxation (CDTA) formally signed between Hong Kong and Kuwait on 13 May 2010 has now come into force on July 24, 2013 after completion of ratification procedures on both sides. It shall apply to any year of assessment beginning on or after April 1, 2014.

JERSEY

The CDTA agreement between Hong Kong and Jersey signed in February last year has also come into force on July 3, 2013, after completion of ratification procedures on both sides. According to paragraph 2 of Article 27 of the Jersey and Hong Kong CDTA, it shall apply to any year of assessment beginning on or after April 1, 2014.

QATAR AND GUERNSEY

In addition, Hong Kong signed a CDTA with Guernsey on 22 April 2013 and another CDTA with Qatar on 13 May 2013. The CDTAs will bolster the economic and trade connections between the jurisdictions and offer added incentives for companies in Qatar and Guernsey to do business or invest in Hong Kong. The CDTAs will also bring a higher degree of certainty and clarity on taxation liabilities for investors from these two jurisdictions. Following the signing, Hong Kong has CDTAs with 29 jurisdictions (including signed CDTAs with pending ratification).

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DOING BUSINESS WITH EU CUSTOMERS

Doing Business with EU Customers:

INDIRECT TAX TRAPS FOR THE UNWARY – PART 1 SALES OF GOODS

As Chinese businesses (and other businesses outside the EU) broaden their markets and their offerings to EU customers, including online sales, they are increasingly finding that the indirect tax consequences of selling into the EU and across EU member states are a potential barrier to smooth international trade, if not dealt with in advance.

The VAT and customs duties implications of doing business in EU, and with EU customers must be appreciated. Unless advice is taken early, before contracts are signed and the goods or services provided, liabilities can be incurred which otherwise could have been avoided, or passed on to the customer. This article highlights some of the practical issues which arise in practice.

SUPPLYING GOODS TO THE EU

Different VAT rules apply depending on whether the goods arrive in the EU from an EU or a non-EU jurisdiction. Where the goods come from outside the EU, VAT is charged and payable when the goods arrive at the port, airport or other boundary point in the EU, unless the goods are placed under a customs arrangement or are temporarily imported into the EU. The following issues arise:

- Who is the importer and liable for the customs duties and VAT? Is it the supplier, or the customer? If it is the supplier, the VAT may generally be reclaimed by registering for VAT in that jurisdiction and charging VAT on the onwards sale to the customer. If the customer is the importer, the VAT will often be recoverable simply in the customer's periodic VAT return.
- Are there customs duties on the product imported? Does the contract allow the cost of the customs duties to be passed on to the customer? It should be noted that whereas VAT can be reclaimed from the tax authority if particular conditions are satisfied, customs duties are always an absolute cost.
- Are the import documents properly completed and the value fairly stated?
- Can the VAT and customs duties be deferred to delay payment? Setting up a deferment account should be seriously considered.

In short, before the goods are transported to the EU, there needs to be a strategy as to who is bearing the VAT and customs duties, whether they can be deferred, and how to ensure recovery of the import VAT. If no recovery of the import VAT is possible, the cost needs to be included in the prices charged to the customers.

SUPPLYING GOODS FROM ONE EU MEMBER STATE TO NON-BUSINESS CUSTOMERS IN ANOTHER MEMBER STATE

There are EU VAT rules called the "distance selling" rules which oblige sellers of goods, when delivering their goods from one EU jurisdiction (e.g. on a internet or mail order) to non-VAT registered customers in another EU jurisdiction, to register for VAT in each jurisdiction where the customers receive the goods: *Article 34 of the Principal VAT Directive*. The seller must register for local VAT once the threshold for sales in the particular jurisdiction exceeds Euros 35,000 or Euros 100,000 in the calendar year, depending on what the particular jurisdiction has chosen. Large online retailers are finding they are breaching the distance sales thresholds almost immediately. Registration is optional below these thresholds. The purpose of the rules is to ensure that the same rate of VAT applies to both local sales and goods bought cross-border from an EU location, to prevent distortions.

Accordingly, EU and non-EU businesses which supply goods from an EU location to multiple jurisdictions may need multiple VAT registrations and need to decide on their pricing structure, because the rate of VAT varies across EU member states. For example, let us assume that a Chinese business has set up a distribution warehouse in Italy from which it distributes its products to EU customers. The goods sold to customers in Luxembourg and Hungary will have very different VAT consequences. Where the distance selling rules apply, the goods sold to customers in Luxembourg will carry a VAT liability of 15%, whilst the goods sold to Hungarian customers would have a VAT liability of 27%. The seller has to decide whether its pricing structure should be uniform across EU member states or vary with the fluctuation of the VAT rates in different member states. There is no realistic prospect of harmonisation of VAT rates in the short or medium term.

An added problem is fraud. Non-business customers have to pay their sellers VAT on goods purchased cross-border or locally. But business customers with VAT registration numbers generally avoid paying their sellers VAT on goods acquired cross-border, because the customer accounts for VAT (instead of the seller) under its local VAT registration, under the "reverse charge" rules. Accordingly, some non-business customers represent to their sellers (falsely) that they are in business and offer up an EU VAT registration number to avoid paying VAT. Tax authorities expect businesses to make product checks as to whether VAT registration numbers are genuine or not, and will penalise sellers if such checks have not been made.

GETTING IT RIGHT

Tax authorities throughout the EU are tightening up on their compliance procedures and insisting on payment of interest and penalties, as well as unpaid tax, where liabilities are missed through inadvertence. There are many aspects to good business practice:

- Customs duties advice needs to be taken to understand the myriad of international goods flows and their impact on duty costs and compliance. As part of this, the business needs to understand the various reliefs and exemptions that may be available so that the net purchase cost of goods is minimised.
- VAT advice is crucial to ensure that sales taxes are properly accounted for in all jurisdictions; a particular challenge in the EU where multiple VAT registration and liabilities can arise even when sales are made and sourced from a single EU location. Keeping abreast of different VAT liabilities for the same products across different tax regimes is essential.
- Both customs duties and VAT are key elements in the businesses' gross margin calculations and getting them wrong can be costly.
- Corporate tax advice is needed to ensure that cross border transactions with overseas affiliates are carried out on arms' length terms and the relevant local documentation requirements complied with.

All these issues need to be understood to influence decisions and ensure that transactions are implemented in an efficient and compliant manner.

This article has only dealt with sales of goods. Different rules apply to services, such as electronic services, and in the next edition we will advise of the important EU VAT issues which arise in practice for businesses in China and outside the EU, when supplying services to EU based customers.

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