

PEOPLE'S REPUBLIC OF CHINA ¹

DECEMBER 2011

MONEY GRAB

On 1 July 2011, the National People's Congress of the People's Republic of China enacted the *Social Security Law*. The new law is a consolidation of various medical and social insurance programs that were applicable here and there in the PRC. At that time, what was left unaddressed was how the new law would apply to expatriates and there were hopes that, perhaps, they and their employers would be spared from contributing to the various insurance funds promoted in the new law. Such hopes were dashed on 8 September 2011 when the Ministry of Human Resources and Social Security released *Provisional Measures for the Participation of Foreigners Employed in China in Social Insurance* which, amongst others, make it clear that expatriates are equally (with local workers) required to participate to the various funds of the social net. The new rules have become effective since 15 October 2011.

While the efforts of the PRC government to provide a safety net for workers are no doubt laudable, for most expatriates and their employers, the reality is that the revamped scheme will be no more than an additional tax.

Who is an expatriate?

For the purposes of the new law, an expatriate is defined as a non-Chinese national requiring any of the following to reside and work in China.

- A work permit
- A foreign expert certificate
- A foreign journalist card
- A permanent residence card.

Contributions

According to the Provisional Measures, the employer of an expatriate must apply for social insurance registration on his/her behalf within 30 days after issuance of the immigration authorization (work permit, expert certification, etc.). Thereafter, the employee and his/her employer will be required to contribute to the following funds at rates to be determined locally (we set out below the rates applicable in Beijing, Shanghai and Guangzhou).

¹ As usual, we have to caution that, under current Chinese regulations, foreign lawyers such as DLA Piper are not formally admitted to practise 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 translation of the *Enterprise Income Tax* law, the Implementing Rules or the notices and 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.

Fund types	Shanghai		Beijing		Guangzhou	
	Employee	Employer	Employee	Employer	Employee	Employer
Pension	8%	22%	8%	20%	8%	12%
Medical	2%	12%	2%	10%	2%	8%
Unemployment	1%	1.7%	0.2%	1%	1%	2%
Maternity	0%	0.8%	0%	0.8%	0%	0.85%
Worker compensation	0%	0.5%	0%	0.3% - 1%	0%	0.5% - 1.5%
Total	11%	37%	10.2%	32.1% - 32.8%	11%	23.4% - 24.4%
Max assessable amount	¥11,688		¥12,603		¥13,623	
Max monthly cont.	¥1,286	¥4,325	¥1,289	¥4,046 - ¥4,134	¥1,499	¥3,181 - ¥3,317

Employers are liable not only to pay their contributions but also to withhold and remit the contributions of their employees. Failure to do so would engage personal liability of the employer as well as potential penalties.

An expatriate who is a national of a jurisdiction with which the PRC has concluded some form of social insurance agreement will not be required to participate in the new scheme. Currently, the PRC has only two such agreements: one with South Korea covering pension contributions; the other with Germany covering both pension and unemployment. To that extent, German and South Korean nationals will be exempt from the relevant contributions.

It is also noted that many application details of the new law are to be completed and administered locally so it is likely that employees and employers will face subtle or not so subtle differences from one jurisdiction to the next on the extent of their liability or the procedures of application for the various schemes.

Benefits

Different rules apply for different funds.

- **Pension benefits**

An expatriate who has made pension contributions for an accumulated period of 15 years will be entitled to full pension benefits under the law when reaching the statutory retirement age.² Where the expatriate leaves the PRC before reaching retirement age, his/her account would be either preserved until such time as he/she returns to the PRC or paid back to him/her in the event of permanent departure from the PRC.

The scheme looks appropriate but there are still too many unknowns to fully assess it. For instance, the new law does not provide for the procedure for recovery of an expatriate's contributions and there are no provisions for payment of related investment returns but, perhaps most importantly, there are no provisions for what happens to an employer's contributions in such circumstances. These questions and more will need clarifications before we can pass judgement on the fairness and effectiveness of the scheme from an expatriate's perspective. We are not hopeful that all of the issues will be resolved favourably.

- **Medical benefits**

An expatriate's contribution will open access to outpatient and inpatient treatments offered by the local government of his/her work location. Upon reaching retirement age, provided medical insurance premiums have been made for a sufficient period³, the expatriate will thereafter enjoy free medical benefits.

² 60 for men and 55 for women.

³ For instance, 15 years in Shanghai; 20 years in Beijing.

Many expatriates would already be enrolled to medical coverage plans through their employers so it is unclear how the public system will impact on the quality of the coverage they currently receive. But then again, anything that may improve access to medical care (particularly for emergencies) has to be welcome.

- **Unemployment benefits**

The new law proposes a typical plan for unemployment where a contributing employee is entitled to certain benefits if employment is lost for causes beyond the control of the employee (such as redundancy or lay-offs). Level of benefits is determined locally.

For expatriates, the difficulty in collecting benefits arises from the fact that a claim can only be made if the applicant is a resident of the PRC. The vast majority of expatriates will (often, have to) leave the PRC in the event of job loss and, as a result, would become ineligible for benefits. It follows that, as it pertains to the unemployment fund, employer and employee are effectively made to contribute into a plan out of which the employee is unlikely to ever collect benefits.

- **Work-related injury benefits**

The coverage includes medical and rehabilitation expenses, costs of assisting devices for the disabled, nursing fees (when self-care has become impossible) and disability/death subsidies. However, the exact scope of benefits and whether or not an injury is work-related would be subject to review and assessment from local social security authorities and the Working Ability Assessment Commission.

The scheme is certainly welcome but it is unclear how many expatriates would choose to remain in the PRC to recover from a significant or debilitating illness or injury.

- **Maternity benefits**

Maternity benefits cover the cost of medical expenses for birth and family-planning as well as payment of subsidies for the duration of the leave to attend to such medical needs. The subsidies are as paid out of a maternity insurance fund every month in the amount of the average monthly salary for all employees of the employer in the previous year (but usually capped at 300% of the average monthly salary of all employees in the local area in the previous year).

Non Compliance

Employers who do not register their expatriates can be subject to a penalty of up to three times the amount due (up to a maximum of RMB 3,000) and an interest charge (0.05% per day) for any late payments.

Impact on Taiwan, Hong Kong and Macau (THKM) residents?

Prior to the new law, pursuant to *Labour and Social Security Bureau Order [2005] No. 26*⁴, THKM residents were required to contribute to PRC social security schemes whenever they were employed by a PRC company in a location with an active plan in place. Nothing has changed and they will continue to have to participate to the extent that neither the new law nor the Provisional Measures introduce any particular exemption for THKM residents.

⁴ Titled "Administrative Measures for Employment of Residents of Taiwan, Hong Kong and Macau in China"

Amid increasing income and wealth disparity in the PRC, one can understand the impetus for the PRC government to provide protection to workers in the form of insurance plan. However, to the extent that 2012 promises to be a challenging year throughout the world, the general feeling is that the timing could have been better for introducing a system which will increase, often significantly, the cost of doing business in China (but then again perhaps there is never a good time to introduce such measures). In any event, for expatriates and their employers, the new law is unlikely to bring much benefit and will be seen as no more than an additional form of tax. Time will tell if this eventually causes foreign enterprises to change their hiring patterns for expatriates for the PRC.

REACHING OUT

China is going to deploy production factors all over the world and that is the background for China's CFC (controlled foreign corporations) rules.

Our aim is to build a tax regime that supports Chinese economic development while respecting a fair share of revenue and protection of the tax base.

So said Mr. Liao Tizhong, Deputy Director General of International Taxation of the State Administration of Taxation on 17 October 2011 when he spoke at a conference on international taxation and competitiveness sponsored by the American Tax Policy Institute. Mr. Liao was then confirming the intent of the PRC tax authorities to continue the development of CFC rules with a view to expand the reach of PRC taxation to foreign entities established by PRC individuals and enterprises for tax avoidance purposes.

The CFC rules in their current form were introduced in 2008 as part of the rewrite of the *Enterprise Income Tax Law (EIT Law)*. They were then further elaborated in the *EIT Implementation Rules* and the *Implementation Regulations for Special Tax Adjustments (TP Measures)*.⁵

Pursuant to Article 45 of the *EIT Law*, where a taxpayer controls a CFC which is either

- Located in a jurisdiction with an effective tax rate of lower than 12.5% (Article 118 of the *EIT Implementation Rules*); or
- Without a legitimate business purpose,

the taxpayer may be taxed⁶ on its proportionate share of the undistributed profits of the CFC.

Article 117 of the *EIT Implementation Rules* have also clarified that for the purpose of applying Article 45, CFCs include the following

- A PRC enterprise or individual each directly or indirectly⁷ owns 10% or more of the CFC's voting shares, and jointly owns more than 50% of the CFC's total shares (Article 117(1)); or

⁵ Guoshuifa [2009] No. 2. Interested readers may refer to our previous article in January 2009 titled "China Transfer Pricing Implementing Measures - Beyond the Compliance Requirements".

⁶ In determining the CFC's profits, all income (including passive income) that is attributable to the onshore tax resident will be taken into account and taxed at the standard PRC EIT rate of 25%. Income attributable to a Chinese individual shareholder will be taxed at the standard PRC IIT rate of 20%.

⁷ The TP Measures provide that when determining a tax resident's shareholding percentage of an indirectly owned offshore subsidiary, the general rule is to multiply its shareholding percentage of the intermediate holding company by the holding company's shareholding percentage of that offshore subsidiary. However, if the intermediate holding company owns more than 50% of that offshore subsidiary, it would be treated as owning that offshore subsidiary 100% for CFC purposes.

- The PRC enterprise or individual is able to exert substantial control over the CFC by virtue of shares, capital, business operations, purchases and sales, etc. (Article 117(2)).

A taxpayer is required to report for tax purposes the following income in respect of each CFC it may have during a taxation year:

$$\text{Deemed income} = \text{Undistributed Income of CFC} \times \frac{\text{Number of CFC days}}{\text{Number of days in tax year}} \times \text{Shareholding interest}$$

Income taxed under the CFC rules is creditable against EIT/individual income tax otherwise payable and, of course, future repatriations of previously taxed income will be exempt from further tax. In addition, the PRC allows foreign tax credits (whether direct or indirect) for foreign taxes attributable to the amounts subject to PRC taxation.

As is common for CFC regimes around the world, the TP Measures clarify that the CFC rules do not apply where the foreign entity

- Earns active business income
- Has profits of less than RMB5 million; or
- Is established in a jurisdiction with a sufficiently high taxation rate as determined by the SAT.⁸

The CFC regime is still in its infancy but given how quickly the PRC authorities have caught up in matters of anti avoidance, we expect that it will not be long before the SAT operates an effective and wide reaching CFC system.

VAT IS HAPPENING

Businesses in China have long had to grapple with the complexity of multiple forms of transaction taxes. With different regimes applying to different types of supplies (business tax on services and value added tax (VAT) on goods), the system was widely considered overly complex and inefficient.

Thankfully, reforming the system has now become a major priority of the PRC government having received specific mention in the *12th Five-year Plan (2011-2015)*⁹.

On 26 October 2011, the State Council took the first tangible steps towards reform by proposing to fold the business tax (BT) regime into the VAT system. This was followed in November with the joint issuance by the Ministry of Finance and the SAT of Circulars 110, 111 and 131¹⁰ to outline a pilot program applicable to the transportation sector and

⁸ The list is found at Guo Shui Han [2009] No. 37 titled The White List of Controlled Foreign Corporations and includes Australia, Canada, France, Germany, India, Italy, Japan, New Zealand, Norway, South Africa, the UK and the US.

⁹ China's Five-year Plans are blueprints which outline key national economic and development targets for the next five-year period. In March 2011, the National People's Congress approved the 12th Five-Year Plan highlights of which include population to be controlled.

¹⁰ Cai Shui [2011] No. 110 titled Pilot Program to Replace Business Tax with Value-added Tax, Cai Shui [2011] No. 111 titled Notice for Converting from BT to VAT in the Transportation Industry and Certain Modern Service Sectors in Shanghai and Cai Shui [2011] No. 131 titled Notice for Taxable Services that are eligible for VAT Zero-rating and VAT Exemption

(so-called) modern services sector (see below) to be implemented in Shanghai¹¹. Under the pilot program, as to 1 January 2012, Pilot Businesses would convert to a full VAT system and thus would cease to pay BT on targeted services.

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|---------|---|
| Phase 1 | An initial trial to be applicable in Shanghai only to the transportation and modern services sectors (Pilot Businesses) |
| Phase 2 | The pilot program to be expanded to Pilot Businesses in other regions, and eventually nationwide (timing would depend on how successful Phase 1 will be but the expectation is that at least a firm announcement of an implementation date is expected in 2012) |
| Phase 3 | Full VAT reform to be expanded nationwide and to all service industries (no timeline announced yet) |

The pilot program proposes implementation in three phases:

Pilot Businesses

The Circulars do not provide for a precise definition of what is included in the transportation and modern services sectors. However, Circular 131 specifies service providers eligible for VAT zero-rating (as we set out below) from which we can somewhat draw the scope of the two sectors:

- Qualified international transportation services (operating permits must be obtained)
- R&D services to overseas service recipient(s)
- Design services to overseas service recipient(s) (except for design services in relation to immovable properties located in China)

In addition, the following service providers are VAT exempted pursuant to Circular 131:

- Engineering and exploration services (related project or mineral resources must be located outside China)
- Overseas conferencing and exhibition services
- Overseas storage services
- Movable property leasing services (the object of leasing must be located outside China)
- Engineering and exploration services (related project or mineral resources must be located outside China)
- Overseas conferencing and exhibition services
- Overseas storage services

¹¹ Indeed, the MOF and the SAT have issued a series of follow up notices in respect of implementing the pilot program including Cai Shui [2011] No. 133 (Issues regarding the sale of used fixed assets, cross-year transactions, calculation of sales revenue, etc.), SAT Bulletin [2011] No. 65 (Issues regarding the certification of VAT general taxpayers in the trial industries of Shanghai) and SAT Bulletin [2011] No. 77 (Issues regarding the issuance of VAT invoices by enterprises in the trial industries in Shanghai). We will update you on the significant developments in future TQNs.

- Unlicensed international transportation services which do not qualify for VAT zero-rating
- Overseas advertising services
- The following services to overseas service recipient(s)
 - Technology transfer(s)
 - Technology consulting
 - Contract energy management (except where the project is located in China)
 - Software
 - Circuit design and testing
 - Information system(s)
 - Operation process management
 - Trademark and copyright transfer(s)
 - Intellectual property
 - Logistics auxiliary services (except storage services)
 - Verification services (except for goods/immovable property located in China)
 - Authentication services (except for goods/immovable property located in China)
 - Consulting services (except for goods/immovable property located in China)

VAT Payers

The Pilot Businesses would form two classes of VAT payers:

- General VAT payers - Shanghai businesses engaged in the Pilot Sectors with annual turnover of RMB5 million or above¹².
- Small-scale VAT payers - Shanghai businesses engaged in the Pilot Sectors with annual turnover of less than RMB5 million¹³.

¹² As compared to RMB800,000/RMB500,000 for manufacturing/trading companies under the current VAT regimes, the General VAT payer registration threshold is raised to RMB5 million of annual turnover under the pilot program.

¹³ Small-scale VAT payers may also apply for General VAT payer status if they meet certain conditions.

VAT Rates

There are two new VAT rates: 11% for the transportation sector and 6% for the modern services sector (previous BT rates on most services were 3% or 5%, with a maximum 20% rate applying to the entertainment industry). These rates apply in conjunction with the current general VAT rates of 17% and 13% (concession offered to certain goods such as agricultural machinery, books and utilities).

Under the pilot program, the Pilot Businesses' input VAT incurred is generally creditable in full against their output VAT so as to eliminate the effect of VAT to their businesses (except from a cash flow perspective).

Classes of taxpayers	Type of Services	VAT Rate
General VAT payers	Leasing of movable property	17%
	Transportation services	11%
	R & D and technology services	6%
	IT services	
	Cultural and creative services	
	Logistics auxiliary services	
	Authentication & consulting services	
Small scale VAT payers	All services in the Pilot Sectors	3%

VAT Calculation

General VAT payers

The calculation methodology is consistent with the prevailing VAT regime. Output VAT is based on the service income at the relevant VAT rates, whilst input VAT paid for the purchases of goods and services is now creditable¹⁴.

$$\text{VAT payable} = \text{Output VAT} - \text{Input VAT}$$

$$\text{Output VAT} = \text{Sales revenue} * \text{Applicable VAT rate}$$

Small-scale VAT payers

$$\text{Output VAT} = \text{Sales revenue (VAT inclusive)} / (1 + \text{Applicable VAT rate})^{15}$$

¹⁴ Deductible/creditable input VAT includes:

- Input VAT shown on the special VAT invoices
- Import VAT shown on the Import VAT Payment Certificate issued by PRC Customs
- 13% of the purchase amount shown on the "agricultural products sales invoice"
- The recipient of transportation services can deduct input VAT based on the special VAT invoice obtained from transportation services provides

If services are provided by entities or individual overseas and received in China, the VAT withheld by the recipient in Shanghai can be deducted if Tax Clearance Certificates are obtained from the tax bureau (written contracts, payment certificates and debit notes, or invoices issued by the overseas entities must be provided the support the position).

¹⁵ Similar to small-scale VAT payers under the current VAT regime, no input credit is allowed for them under the pilot program.

Where a Pilot Business performs services to a non-Shanghai company¹⁶, it should issue special VAT invoices to the non-Shanghai company. If the non-Shanghai company is a General VAT payer, its input VAT could be deducted. If it is a BT payer, it would suffer from additional VAT dollars charged by the Pilot Business as it would have to treat the VAT paid as part of its procurement costs.

Conversely, where a Pilot Business receives services from a non-Shanghai company, the non-Shanghai company's revenue from such services would be BT-able, and would not be deducted from the Pilot Business' VAT liability.

At this stage, it appears that the pilot program will be beneficial to Pilot Businesses

- Providing services to other Pilot Businesses (ie B2B transactions), as the service recipient is now be eligible to claim input VAT on the purchases of these services
- Having significant service inputs to their business, irrespective of whether they are in the goods or services sector, because those service inputs no longer have embedded BT costs
- Having substantial fixed assets as they are eligible for input VAT credits.

In contrast, end-consumer service businesses with relatively few inputs eligible for input VAT credits may suffer and be eventually forced to raise their prices.

Pilot Businesses may want to evaluate their accounting and invoicing systems and simulate their tax burden under the new rules so as to capture potential pricing opportunities. They may also want to consider whether it is preferable to acquire services from other Pilot Businesses (for which an input VAT credit may apply) in preference to suppliers outside Shanghai (for which irrevocable BT will have to be paid - this preference should be temporary once Phases 2 and 3 kick in).

Anyone carrying on business in the PRC should take heed of the developments in Shanghai because the future is clear: VAT is happening!

TIDBITS

Tax is a riot

A dispute between a children's clothing store owner and tax collectors in Zhili (a small town in the city of Huzhou) in eastern China's Zhejiang province recently erupted into a two-day riot.

On 26 October 2011, a migrant business owner, recently relocated to Zhejiang from adjacent Anhui (a poor region from where millions of migrant workers originate) became involved in an argument with tax collectors when he refused to pay taxes which he claimed were discriminatory. As it happens, taxes on migrant businesses were indeed higher (reportedly 200%!) than those applicable to local businesses and were apparently scheduled to increase even more in the coming year. When the altercation escalated and turned physical, somewhat to the dismay of the shop owner, chaos ensued and was not brought under control for two days, following police intervention and the arrest of 28 people.

¹⁶ Readers may note that if the head office of a group company and its branch offices are registered in different locations, its registered location would dictate whether they should pay VAT or BT.

For the business owner and his fellow merchants, all was not for naught: it has now been reported that the Zhili township government has decided to suspend tax collection on clothing assembly workers and has dismissed the tax collectors involved in the incident. One would hope that such disputes can be resolved more peacefully in the future.

The art of tax

All war is deception

Sun Tzu

Mr. Ai Weiwei (pronounced eye-way-way), 54, a Chinese artist-activist, was recently detained for 81 days without apparent reason. However, soon after his release in June, the Xinhua news agency implied that the arrest was linked not to political activities but rather for his involvement in a firm accused of tax evasion. Xinhua reported that the police insinuated that "huge amount" of taxes were unpaid by Fake Cultural Development, a firm promoting Mr. Ai's work. The police also alleged the destruction of key accounting records controlled by Mr. Ai. To no one's surprise, soon after Mr. Ai's release from detention, the Beijing tax bureau issued various tax demands against Fake Cultural Development adding up to RMB12 million (including a hefty RMB7 million in penalty!). In early November, the tax bill was increased to RMB15 million: the penalty had by then been reduced to RMB6.8 million but a RMB3 million amount had been added as late payments charges. Mr. Ai was given 15 days to pay or provide a guarantee of at least RMB8.45 million. Mr. Ai eventually paid with, he says, funds from donations of supporters.

Mr. Ai and his lawyer subsequently questioned the legality of the penalty and the process by which it was imposed in a 9000-word request for administrative review. On 4 January 2012, the Beijing tax bureau agreed to consider the request for administrative review so that, in accordance with PRC laws, the Beijing tax bureau now has two months to decide whether the penalty was properly imposed. In parallel, Fake Cultural Development has filed an appeal against the RMB5.3 million back taxes.

We will see in the next few months how all of this gets sorted out but, meanwhile, it is ominous to note how the PRC government used the tax system to achieve political objectives. It used to be that the PRC government would stifle activism without feeling compelled to give their action the veneer of legality. But with its growing influence around the world, the PRC government has become more conscious of acting in ways and reasons that withstand international attention. In such context, the tax system can be a particularly effective tool in its relentless quest to stifle activism. We do not think that this is a particularly welcome development.

New tax treaties

The China-Malta tax treaty was first signed in February 1993. It was replaced by a new treaty in October 2010. Significantly, the new treaty halves the China withholding tax rate for outbound dividends from the previous 10% to 5% (as long as the taxpayer owns at least 25% of the company paying the dividends). It also fixes a maximum China withholding rate of 7% for outbound royalties paid by way of consideration for the use of (or the right to use) industrial, commercial or scientific equipment (maximum withholding rates otherwise remain unchanged at 10%). It is also updated to meet current OECD guidelines in respect of exchange of information and introduces means for mutual assistance in tax collection. However, it does not provide for tax sparing and therefore the mechanism provided in the earlier treaty is no longer available. It applies to income obtained on or after 1 January 2012.

The SAT also announced that the China-Syria tax treaty and the No. 2 Memorandum on the China-Macau tax treaty have come into effect. They apply to income obtained on or after 1 January 2012.

HONG KONG

ON WITH IT!

Readers interested in judicial tax matters will recall the scolding the Court of First Instance (CFI) gave to the Board of the Review in the *Li & Fung*¹⁷ decision. The CFI was very troubled, even dismayed, that the Board had taken 3.5 years to hand down its decision in the matter. The Court suggested that a decision in the vast majority of cases should be handed down within six months of the hearing.

The admonition of the Court to speed up the administration of the tax system is not new and can be found at other levels of the objection and appeal system. In fact, not only is the Board being put to task to deal swiftly with matters in front of it, the Commissioner is also receiving his due share of the criticism. The decision in *Kong Tai Shoes Manufacturing Company Limited v Commissioner of Inland Revenue*¹⁸ is another example of the Court compelling the Commissioner to get on with deciding taxpayers' objections within a reasonable time.

Facts

During the years of assessment under review, the taxpayer was part of a Hong Kong listed group by the name of KTP Holdings Ltd. The taxpayer manufactured athletic footwear through factories in Shenzhen and Dongguan in PRC. The Shenzhen factory was operated under a contract processing agreement with a mainland partner while the Dongguan factory was owned and operated by an affiliated company, Dongguan Hung Yip Shoes Manufacturing Co. Ltd. (DHY).

The taxpayer claimed that none of its profits were taxable in Hong Kong on the basis that all key aspects of its business were performed in the mainland and that only support services such as investor relations, listing rules compliance and financial reporting were provided in Hong Kong. In source of profits lingo: the services in Hong Kong were merely antecedent or incidental to the profit making activities.

The Commissioner disagreed and issued estimated profits tax assessments on a 50-50 apportionment basis and, by the time of the Court application, more than 12 years (!) of assessment were under review and pending. From the perspective of the taxpayer, the situation was particularly unsatisfactory to the extent that, every year, in accordance with rules related to recovery of tax, the Commissioner was insisting on purchases of tax reserve certificates (effectively a form of certificates of deposits held by the tax authorities) to protect for the amount of the assessment.

When assessment time for 2010/11 came along and the Commissioner came around to make an additional request for tax reserve certificates, the taxpayer had had enough and, on 24 May 2011, it was granted leave to apply for judicial review of the Commissioner's decision to assess taxpayer and his refusal to grant an unconditional holdover of tax. The taxpayer also claimed that all of the assessments against it were *ultra vires* and should be quashed for a variety of reasons.

The decision of the Court is interesting as Judge Reyes provides for a good summary of the state of the law on scope and limitations of judicial review applications. We note in particular:

¹⁷ [2011] HKCFI 260. Readers may refer to the articles in TQN June 2009 entitled "Justice Delayed is...Well, not all that bad sometimes" and TQN June 2011 entitled "Elementary".

¹⁸ [2011] HCAL 34/2011

- **Judicial review is not the occasion to review the merits of the assessments**

The taxpayer claimed that the Commissioner assessed tax on its profits without merit and capriciously and that it was uncontroversial that the disputed profits were sourced outside Hong Kong. Judge Reyes confirmed that, in a judicial review, there is no authority for him to decide on the substantive issues raised by an assessment. He noted succinctly:

*In a judicial review, it would be wrong for me to determine the source of Kong Tai's profits summarily. I should not usurp the functions expressly reserved to the Commissioner and the Board of Review by the IRO.*¹⁹

- **'Protective' or 'estimated' assessments are valid assessments**

The taxpayer claimed that, because the assessments were in the form of 'protective' or 'estimated' assessments, the Commissioner had in fact failed to properly exercise his authority to assess tax. This was particularly so by his failure to issue revised assessments after the taxpayer had provided sufficient information for the Commissioner to complete the process.

Judge Reyes explained that, while estimated assessments pursuant to section 59(2)²⁰ may sometimes be characterized in everyday parlance as 'protective assessments', they are no less 'real' or 'genuine' and binding on taxpayers unless and until the taxpayer's objection to the assessment is upheld in subsequent determinations by the Commissioner or the Board of Review.

- **Allegation of profit shifting does not amount to assessing pursuant to anti-avoidance**

The taxpayer then alleged that statements made by the assessors to the effect that they believed that the taxpayer had engaged in profit shifting activities by making excessive subcontracting payments to related companies were evidence that the Commissioner had assessed the taxpayer on the basis of anti avoidance and section 61A. If so, to the extent that assessments issued pursuant to section 61A are subject to a prescribed procedure, the assessments in dispute would be null and void for having failed to follow such procedure.

Counsel for the IRD explained that all of the assessments were issued pursuant to section 59(2) (the general authority to issue revised assessments) and not on the basis of section 61A. In referring to profit shifting, the assessors were in fact referring to excessive deductions the disallowance of which did not have to rely on section 61A.

Judge Reyes agreed with this submission and held that, irrespective of any comment made on profit shifting, he could not infer from the impugned comments that the assessments were issued pursuant to section 61A.

¹⁹ Paragraph 22 of the decision

²⁰ Section 59(2) IRO provides that, where a person has furnished a return in accordance with the provisions of section 51 the assessor may either-

- a) accept the return and make an assessment accordingly; or
- b) if he does not accept the return, estimate the sum in respect of which such person is chargeable to tax and make an assessment accordingly.

With reference to the above, section 59(1) provides that every person who is in the opinion of an assessor chargeable with tax under the IRO shall be assessed by him as soon as the time stated in the notice requiring him to furnish a return within a reasonable time has expired. Judge Reyes held that the assessor of KTS is in compliance with this exactly by issuing estimated assessments under section 59(2).

Reasonable time?

On the issue of time for the review by the Commissioner, the taxpayer sought an order of mandamus to require the Commissioner to determine all outstanding objections within one month.

The Commissioner responded that there was no undue delay for most of the years under review since the assessments had been issued recently (all assessment for the years of assessment 2003/04 to 2008/09 were issued in 2010). In addition, the Commissioner contended that the IRD needed more time for further investigation because the taxpayer changed its operations in 2004, and it had yet to fully satisfy requests for more information and documentation.

Judge Reyes would have none of it and he commented dryly that

One can always ask for more information. But at some point, one cannot just keep asking for more. One has to decide. That would be in keeping with the duty to act within a reasonable time.

Judge Reyes held that the time taken by Commissioner to resolve the matter was simply unacceptable and ordered the Commissioner to rule on the taxpayer's objections before 31 March 2012. Surely this must be right: a taxpayer is entitled to certainty and the Commissioner cannot simply shirk his responsibilities to assess the taxpayer.

There is another interesting twist to the decision. The taxpayer also argued that the delay in the matter was a systemic, deliberate attempt by the IRD to subdue the taxpayer so as to force a settlement of the tax dispute at terms unfavourable to the taxpayer. According to the taxpayer, this was achieved by a system whereby the Commissioner was purposely delaying the resolution of its objection while, at the same time, draining its resources by forcing the purchase of increasingly large amounts of tax reserve certificates. The taxpayer referred to *Yue Yuen Marketing*²¹ to make the case that the approach was systemic and deliberate.

Judge Reyes was not impressed by the argument and considered that one must tread carefully in making allegations implying bad faith. Judge Reyes acted on his displeasure with the taxpayer for its gratuitous accusations in his order on costs.

There will be an Order Nisi that the Commissioner bears 75% of Kong Tai's costs. In so ordering, I follow my decision in Yue Yuen Marketing to deprive an Applicant of some costs where the Applicant has made unwarranted allegations of bad faith. In my view, the Applicant's allegation of a system and deliberate culture of delay on the part of Revenue constituted such an unjustified allegation. There was no real evidence to warrant the making of the allegation and it should not have been made.

Perhaps the taxpayer did go too far in its allegations but one can understand a taxpayer being frustrated by years of delay to resolve a matter. When faced with countless requests for information and seemingly systematic refusal to turn to the merits of a matter, at some point, one can legitimately think that the delay is dilatory and systemic.

Appeals have been filed in the matter. We will keep you posted.

²¹ *Yue Yuen Marketing Company Limited et al v Commissioner of Inland Revenue* [2009] HCAL 49/2009. Readers may refer to the articles in TQN June 2009 entitled "Waiting for the Other Shoe to Drop...Not!" and TQN March 2010 entitled "Now we know".

CERTAINTY

Under an advance ruling system in place since 1 April 1998, a taxpayer may seek a ruling from the Commissioner on how any provision of the IRO applies to him for any arrangement specified in the application. According to the IRD, the main objectives of this service are three folds.

- Provide taxpayers with a degree of certainty about the tax treatments basing on the current tax laws for seriously contemplated arrangements
- Promote consistency in the application of the IRO
- Minimize disputes between the IRD and taxpayers.

Schedule 10 of the IRO details how the advance ruling system is expected to operate. Furthermore, to explain how the Commissioner intends to administer the ruling system, the IRD has issued Departmental Interpretation and Practice Notes No. 31 (DIPN 31) titled *Advance Rulings*.

An advance ruling application to the IRD must be made before the relevant tax return becomes due.²² The application form, Form IR1297, can be downloaded from the IRD website or requested in writing to the IRD. On the application form, the applicant is asked to explain the issue(s), provide a full description of the relevant facts, state the laws in respect of which a ruling is sought for, etc.²³

Ruling applications are normally dealt on a first come, first serve basis and the IRD is committed to respond within 6 weeks of the date of receipt of the ruling application (provided all relevant information is furnished and further consultation with the applicant is unnecessary). In its processing, the IRD may request further relevant information and documents or an on-site inspection.

The Commissioner's ruling is final (whether favorable or not). No further correspondence will be entertained and the ruling will not be subject to objection or appeal. The IRD has however made it clear that neither the objection nor appeal rights of a taxpayer are affected by an unsuccessful ruling.

An advance ruling is not free. The IRD charges (i) an application fee of HKD30,000 for a ruling on whether profits are chargeable to profits tax under section 14 of the IRO as arising or derived from Hong Kong, (ii) HKD10,000 for a ruling on whether remuneration is chargeable to salaries tax under section 9A of the IRO and (iii) HKD10,000 for any other ruling.²⁴ The application fees are exclusive of reimbursements in relation to external advice and any costs and reasonable disbursements incurred.

The IRD has recently revised DIPN 31 to cover issues such as (i) discretion, (ii) extent of disclosure, (iii) quality and completeness of information, (iv) class rulings and (v) incorrect information or false answer. Certain issues, for example, processing of ruling requests and publication of rulings, are also elaborated in greater detail. We summarize as follows.

²²This is opposite to the case an objection. An objection to tax can only be lodged after the tax return has been submitted and a relevant tax assessment has been received.

²³Interested readers may want to refer to Appendix 1 of DIPN 31 (http://www.ird.gov.hk/eng/pdf/e_dipn31.pdf) containing a checklist for a ruling request. Paragraph 19 of DIPN 31 also provides a list of information and documents to be provided with a ruling request.

²⁴Indeed, the IRD has laid out in Appendix 7 of DIPN 31 that where the time spent on a particular advance ruling application in the nature of (i) exceeds 23 hours, (ii) exceeds 11 hours or (iii) exceeds 7 hours, an applicant is to pay an additional fee calculated on the basis of each hour or part hour spent by

(a) a Deputy Commissioner ----- HKD 1,330

(b) an Assistant Commissioner ----- HKD 1,260

(c) any other person appointed under the IRO -- HKD 1,000

- **Discretion**

In relation to provisions of the IRO allowing the Commissioner to exercise his discretion, applicants who wish to seek the exercise of that discretionary power should apply directly for the actual exercise rather than an advance ruling on how it may be exercised. DIPN 31 states that the Commissioner may decline to rule on a matter relating to the exercise of a discretion if it would be more appropriate to exercise the discretionary power under that provision (or to inform the applicant that the discretionary power would not be exercised).

- **Extent of disclosure**

When seeking a ruling, an applicant must *put all his cards face upwards on the table*.²⁵ The applicant is expected to ensure that the information provided is correct, accurate and complete. Indeed, it is not enough to merely disclose sufficient information so that inferences could be drawn. The applicant is expected to draw the Commissioner's attention to all the crucial issues and questions of the proposed arrangement and make him aware of all relevant materials, matters or sources of information so as to ensure access to all the pertinent facts and law.

- **Quality and completeness of information**

In addition to hard copies, the applicant can provide diskettes or CD-ROMs containing copies of the proposed draft ruling and, if available, other relevant documents, including all draft contracts and the draft public offer document.

In respect of completeness of information, the Commissioner would not begin considering the case until what is missing has been provided. If the applicant cannot provide all the required information, he/she may apply to the Commissioner for waivers (but he/she must provide explanations together with supporting evidence as to why such information is unavailable).

- **Class rulings**

In order to avoid individual applicants seeking rulings on the same issue, the Commissioner may, where appropriate, issue a class ruling about the application of an IRO provision to a specific class of persons in relation to a particular arrangement. Examples include situations where an employer seeks ruling about the tax consequences of redundancy plans and share acquisition plan for its employees or a company seeks ruling about the tax consequences for its shareholders arising from a corporate restructuring or a split/consolidation of its shares.

- **Incorrect information or false answer**

An applicant must also pay attention not to give any incorrect information in relation to any matter or thing affecting his or any other person's tax liability and not to give any false answer (whether verbally or in writing) to any question or request for information. The Commissioner may take penal actions (for example, fines) for such actions under Part XIV of the IRO.²⁶

²⁵ *R v IRC ex parte MFK Underwriting Agencies Ltd & Others* 62 TC 607

²⁶ An applicant is reminded to make an immediate disclosure to the IRD if an arrangement has been carried out on the basis that it conforms with a ruling but it is indeed implemented in a manner materially different to that explained in the relevant ruling.

²⁷ For a list of the 47 IRD's advance rulings previously made, please visit <http://www.ird.gov.hk/eng/ppr/arc.htm>.

Advance rulings may also serve as yardsticks to taxpayers other than the ruling applicants. The IRD has posted its 47 previous advance rulings on its website²⁷, but readers should be reminded that caution should be exercised in relying upon those rulings. Taxpayers may only make reference to a ruling if the facts of their proposed arrangements are identical (but similar transactions often have different facts). Also, a ruling may no longer be appropriate if an administrative practice outlined therein turns out to be used as a tax avoidance vehicle.

A FORGIVING RULING

In the context of the liquidation of a company, a frequent issue is how to deal with amounts owing by the company to related entities. Often times, the best and easiest option would be to simply forgive the debt but advisors in Hong Kong have always been wary as to how section 15(1)(c) of the IRO may apply to such transaction.

Pursuant to section 15(1)(c), amounts received by a company as grant, subsidy or similar financial assistance in connection with the carrying on of a trade, profession or business in Hong Kong are chargeable to profits tax. While it is generally considered that 'grant' and 'subsidy' are forms of financial assistance provided for specific purposes usually by governmental or semi governmental entities, the more generic reference to 'financial assistance' was ambiguous enough to raise doubts as to where the line is drawn.

To avoid the issue, many taxpayers felt the need to maneuver cash around so as to ensure the debt would not be forgiven. This may now no longer be necessary in most circumstances. In Advance Ruling No. 47, the IRD confirms that the forgiveness of non trade debts will not trigger assessable income.

In the ruling, a subsidiary had obtained funding from its parent in order to finance an investment in infrastructure. The parent subsequently waived a portion of the loan for the purpose of improving the capital structure and the negative equity status of the subsidiary. The Commissioner ruled that the subsidiary would not be chargeable to profits tax on the forgiven loans and advances under section 15(1)(c) since the parent's waiver was not done in connection with the carrying on of the subsidiary's business.

This ruling provides comfort to taxpayers by confirming that there would be a low risk of adverse tax consequences by way of forgiving intercompany loans that are non-tradable. Of course, taxpayers should make certain the capital or working capital purposes for which they grant loans to their group companies. For example, if the amount forgiven relates to a trade payable owing by the liquidating company, and the payable amount was previously deducted as cost of goods sold, then the amount forgiven would be subject to profits tax.

BACK AT IT

Readers must remember Dr Lam Tai-fai's countless questions²⁸. In the Legislative Council's meeting on 23 November 2011 (the members finally resumed their meetings after a long summer break), Dr Lam was at it again with his new rounds of questions. Surprisingly, his attention turned away from import/contract processing (he finally run out of questions?) to the tax treaty between mainland China and Hong Kong, particularly, the arrangement that mainland Chinese and Hong Kong residents are only taxed on their employment income derived from the other side if they are present in the other side for more than 183 days in any 12 month period commencing or ending in the taxable period concerned. Dr Lam asked for clarifications on the following aspects of the arrangement.

²⁸ Readers may refer to our previous TQN articles titled "Section 39E: An(other) Update" (December 2010), "Section 39E: A continuing Sage" (March 2011) and "When No is not an Answer" (June 2011),

- Whether only actual working periods are counted for the purposes of the '183-day' threshold, in particular, why weekends and holidays are counted
- The approach to tax Hong Kong residents who live in Shenzhen and are employed by Hong Kong companies, but who may need to work in the mainland for some of their time
- Whether there are proposals to request the mainland authorities to relax the '183-day' threshold as the number of cross-boundary workers is expected to continue to increase or introduce tax rules for cross-boundary workers.

In his reply, Professor K C Chan, the Secretary for Financial Services and the Treasury, confirmed the general expectation that the Hong Kong and mainland authorities count the 'days of stay' or 'days of physical presence' (as opposed to actual working days) to determine a taxpayer's liability in the other side. According to the Secretary, the '183-day' threshold is consistent with the international standard which has been effectively applied and has taken into account and balanced the tax interests of the resident and source jurisdictions, and therefore, there is no plan to change. In addition, a day during any part of which (however brief) a taxpayer is present in a tax jurisdiction (such as same-day trips) still counts as a day of physical presence for tax purposes.

As to the tax treatment for Hong Kong taxpayers living in Shenzhen, the Secretary replied that their entire income derived from Hong Kong employment is taxable in Hong Kong. If any part of the taxpayer's income is derived from the mainland and he/she has been taxed accordingly in the mainland, that part of his/her income may be exempted under section 8(1A)(c) of the IRO²⁹.

Finally, the Secretary was not keen on Dr Lam's initiative to introduce tax rules for cross-boundary workers. He pointed out that Hong Kong's tax system is based on the territorial principle and the introduction of special provisions for frontier workers could lead to double non-taxation of the income. Besides, as a practical matter, defining the term 'cross-boundary workers' on an objective basis and crafting the scope of exemption would be difficult. Hence, it can be inferred that the proposal for such new tax rules requires careful deliberations.

TIDBITS

Updates on tax treaties

The Global Forum on Transparency and Exchange of Information for Tax Purposes (tasked to monitor and review the implementation of the OECD Model Agreement) issued its Phase I peer review report on Hong Kong in October. The Phase I review is intended to evaluate the quality of Hong Kong's legal and regulatory framework. The Phase II review is scheduled to be released in the second half of 2012 and will discuss the practical implementation of that framework.

The Global Forum is generally satisfied with Hong Kong's progress on the implementation of international standards. It noted that Hong Kong can benefit from stand-alone tax information exchange agreements (TIEAs) (the Hong Kong government later acknowledged and said it would recommend Legco to work on legislative measures to enable Hong Kong to conclude TIEAs with other jurisdictions) and fewer restrictions on information exchange under its tax treaties (the Global Forum gave as an example that the Hong Kong tax treaties with Belgium, Vietnam and Thailand still contain domestic interest conditions as a requirement for exchange of information to take place).

²⁹ Section 8(1A)(c) provides that taxable income arising in or derived from Hong Kong from any employment excludes income derived by a person from services rendered by him in any territory outside Hong Kong where

- By the laws of that territory, the income is chargeable to tax of substantially the same nature as salaries tax under the IRO; and
- The Commissioner is satisfied that that person has, by deduction or otherwise, paid tax of that nature in that territory re the income.

The Global Forum also found that Hong Kong can improve on ensuring accurate, adequate and reasonably current information where nominees, share warrants to bearer and foreign/private express trusts are involved in relation to legal ownership and control of companies.

On the other hand, the Hong Kong government has followed suit (the China-Malta tax treaty took effect recently, please refer to PRC Tidbits above) and entered into a tax treaty with Malta. Tax treaties previously signed with the following countries have also come into force:

Country	Signing date of tax treaty	Effective date of tax treaty
Netherlands	22 March 2010	24 October 2011
New Zealand	1 December 2010	9 November 2011
France	21 October 2010	1 December 2011

Annual Meeting

The IRD and the Hong Kong Institute of Certified Public Accountants meet once every year to discuss the tax aspects of accounting-related issues of interest. The purpose of these meetings is to clarify the interpretation of Hong Kong tax laws and exchange views on policy matters. In 2011, the meeting was held in February and the minutes were published in October.

The Institute raised discussion items covering profits tax, salaries tax, double tax treaties and IRD policies. The IRD also shared discrepancies it detected in corporations with tax audits completed during the year ended 31 December 2010. The field audit teams uncovered discrepancies in 272 corporate cases (235 carried clean auditors' reports). A total tax of HKD980 million was recovered from these cases. The IRD specified that there was a significant increase in discrepancies detected in relation to offshore income/profits disallowed. Other discrepancy drivers include gross profits understated, expenses over-claimed and sales omitted.

The next meeting date will be agreed by the IRD and the Institute in due course.

New tax deduction for IP rights

The *Inland Revenue (Amendment) (No. 3) Ordinance 2011* was published in the Gazette on 16 December 2011 to implement the 2010-11 Budget initiative. The Amendment Ordinance will apply for any year of assessment commencing on or after 1 April 2011. New tax deduction is available to certain intellectual property (IP) rights including patents, rights to any know-how, copyrights, registered designs and registered trademarks. All of the following conditions must be satisfied to qualify for tax deduction:

- Deduction is only allowable for "registered designs" or "registered trademarks" (ie these two types of relevant intellectual property rights must have been registered (either in Hong Kong or overseas) on the date of acquisition)
- Taxpayers must have acquired the proprietary interest (ie legal and economic ownership of the relevant IP rights)
- The relevant IP rights are in use for the production of chargeable profits
- Where a relevant IP right is used partly in the production of chargeable profits, deduction is only allowed for the portion of capital expenditure that is relevant to the production of such chargeable profits



- Where a relevant IP right is owned by more than one taxpayer, tax deduction for each taxpayer is granted for the amount of capital expenditure that is proportional to his/her share in the relevant IP right.

The IRD will issue a relevant practice note. We will keep you posted.

And, on this note, allow us to wish you a happy 2012!

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