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China Tax Monthly is a monthly publication of Baker & McKenzie's China Tax Group.

In this issue of the China Tax Monthly, we will discuss the following tax developments in China:

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2. New Protocol Amends the China-Macau Double Taxation Arrangement
3. New China-Germany Double Tax Treaty Applies to Income Derived on or after 1 January 2017
4. Beijing Case: 15 Non-resident Enterprises Taxed on Indirect Transfers
5. Ningxia Case: Hong Kong Company Denied Treaty Benefits for Dividends
6. Shandong Case: Trustee Escaped Tax on Trust Income

1. The SAT Issues New Guidelines for HNTE Recognition

On 22 June 2016, the Ministry of Science and Technology, the Ministry of Finance and the State Administration of Taxation (SAT) jointly issued the revised Working Guidelines for the Recognition and Administration of High and New Technology Enterprises (HNTE) ("**Notice 195**")[1] to implement the new HNTE recognition rules issued under Notice 32[2] earlier this year.

IP requirement

Notice 195 restates the intellectual property (IP) ownership requirement under Notice 32. It requires an enterprise to own the core IP in its main products or services for the enterprise to qualify as an HNTE. When an IP is jointly owned by two or more enterprises, only one of them can use the IP to apply for HNTE status.

Notice 195 further classifies IP into two categories:

1 *Working Guidelines for the Recognition and Administration of High and New Technology Enterprises*, Guo Ke Fa Huo [2016] No. 195, dated 22 June 2016, retroactively effective from 1 January 2016.

2 *Administrative Measures on the Recognition of High and New Technology Enterprises*, Guo Ke Fa Huo [2016] No. 32, dated 29 January 2016, retroactively effective from 1 January 2016. For more details on Notice 32, please refer to the February 2016 issue of our China Tax Monthly.

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- **Type I** covers invention patents, exclusive rights over integrated circuit layout-design, new plant varieties, etc.; and
- **Type II** covers utility model and design patents and software copyright (excluding trademark).

An enterprise can only use a particular piece of Type II IP for one time when applying for HNTE status. Whereas, there is no such limitation on the Type I IP.

Main products or services

According to Notice 32, an enterprise must own the IP in its main products or services to qualify as an HNTE. However, Notice 32 does not clearly define what constitutes a "main product or service". Notice 195 closes this gap by providing a revenue threshold in its definition. According to Notice 195, a "main product or service" are high-tech products or services which generates an aggregate revenue in excess of 50 percent of the enterprise's total revenue from high-tech products or services in the current period.

Total revenue

Notice 32 requires the revenue from the high-tech products or services to account for more than 60 percent of the enterprise's total revenue without defining the term "total revenue". Notice 195 provides that total revenue equals the overall revenue less the non-taxable revenue. Both the overall revenue and non-taxable revenue should be calculated in accordance with the *PRC Enterprise Income Tax Law* and its implementing regulations.

Previously, some local authorities (e.g., in Hunan[3]) did not consider non-operating revenue when calculating the total revenue. Now under Notice 195, the total revenue calculation will also include non-operating revenue since non-operating revenue is subject to enterprise income tax. Under this expanded scope of total revenue, enterprises with large non-operating revenue may find it more difficult to reach the revenue threshold for HNTE qualification.

Observations

Taking effect retroactively on 1 January 2016, Notice 195 may significantly affect an enterprise's HNTE qualification. Every enterprise that intends to apply for or renew HNTE qualification should assess its qualification against the requirements under Notice 32 and Notice 195, and make necessary adjustments, if possible, to increase the likelihood of successfully applying for an HNTE.

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3 See http://www.hyinfo.gov.cn/Article/ShowInfo.asp?ID=7029.

2. New Protocol Amends the China-Macau Double Taxation Arrangement

On 19 July 2016, Mainland China and Macau signed the third protocol to amend the China-Macau Double Taxation Arrangement. One major change under the protocol is that the withholding rate on payments for leasing of airplanes and ships will be reduced from 7 percent to 5 percent. In addition, the protocol introduces an anti-abuse clause to deny treaty benefits for dividends, royalties, interest and capital gains where the main purpose of creating or assigning the rights for which the payments are made is to take advantage of the treaty benefits.

Although the third protocol is pending ratification, the ratification process is a formality that will eventually be concluded. Therefore, in response to the anti-abuse clause under the protocol, every multinational company (MNC) that conducts business in China via Macau should now start structuring new transactions to satisfy the main purpose test so that treaty benefits will not be denied.

3. New China-Germany Double Tax Treaty Applies to Income Derived on or after 1 January 2017

Following its ratification by China and Germany, the new China-Germany Double Tax Treaty entered into force on 6 April 2016 and will be applicable to income derived on or after 1 January 2017.

Key changes introduced under the China-Germany Double Tax Treaty include:

- reducing withholding taxes on dividends paid by a Chinese company to a direct German parent company or vice versa from 10 percent to 5 percent;
- reducing withholding taxes on royalties paid for the use of industrial, commercial or scientific equipment from 7 percent to 6 percent; and
- allocating the exclusive right to tax "other income" to the resident state.

For more details on the new China-Germany Double Tax Treaty, please refer to the March 2014 issue of China Tax Monthly.

4. Beijing Case: 15 Non-resident Enterprises Taxed on Indirect Transfers

On 15 July 2016, China Taxation News reported that the State Tax Bureau of Haidian District in Beijing collected RMB1.2 billion (approximately USD183 million) in enterprise income tax (EIT) from 15 non-resident enterprises on indirect share transfers.[4]

Facts

The indirect share transfers were realized through two transfers of shares in a Cayman Island company ("**Target**") that indirectly owned shares in three PRC companies (two in Beijing and the other in Tianjin). The transferors involved were 15 non-resident enterprises. The total consideration for the two share transfers was USD2.75 billion, which was paid in cash and equity. In 2015, the transferors submitted share transfer documents to the tax bureau for recordal purposes. After reviewing these documents, the tax bureau decided to further analyse whether China had the right to tax the share transfers.

The tax bureau first analysed the applicability of the Bulletin 7[5] safe harbor provisions:

- the public trading safe harbor was not applicable because the two share transfers were not public trading activities;
- the treaty safe harbor was not applicable because 12 of the transferors were from non-treaty partner jurisdictions (the remaining 3 transferors came from treaty partner jurisdictions in Luxemburg, Singapore and Mauritius);
- the internal restructuring safe harbor was not applicable because the transferors and transferees were not related parties and a part of the consideration was paid in cash.

The tax bureau then analysed the reasonable commercial purpose of the share transfers. The tax bureau decided that the share transfers should, in accordance with Article 4 of Bulletin 7, directly be deemed as lacking reasonable commercial purpose because:

- the Target and the intermediate holding enterprises had no substantial business activities;
- the main value of the Target's equity was derived from the three PRC companies;
- nearly all of the Target's revenue was sourced from China; and

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4 See http://www.ctaxnews.net.cn/html/2016-07/15/nw.D340100zgswb_20160715_1-05.htm?div=-1.

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

- none of the resident jurisdictions for the 15 transferors taxed the share transfers.

On this basis, the tax bureau concluded that the share transfers should be subject to tax in China.

To determine the amount of taxable capital gains, the tax bureau and the transferors agreed to:

- set the transfer price for the shares in the PRC enterprises as the transfer price stated in the share transfer agreement minus the intermediate holding enterprises' cash assets in proportion to the transferred shares; and
- set the cost basis for the shares in the PRC enterprises as the PRC enterprises' injected capital in proportion to the transferred shares.

According to the agreed transfer price and cost basis, the tax bureau recognized taxable capital gains of approximately USD2 billion. Further, to calculate the capital gains subject to tax in Haidian district, the tax bureau referred to the allocation method in Shui Zong Han [2013] No. 82[6] ("**Notice 82**"), i.e., the capital gains should be allocated to the three Chinese enterprises based on three factors of equal weight: the injected capital, the net asset value and the total operating income of each enterprise.

Observations

Treaty Safe Harbor

China's tax treaties with Luxemburg, Singapore and Mauritius allocate the exclusive right to tax capital gains arising from a share transfer to the resident state if: (i) the target company is not a land-rich company; and (ii) the transferor's shareholding in the target company is less than 25 percent. The news report did not contain enough information to explain why the Luxemburg, Singapore or Mauritius transferors were not entitled to the treaty safe harbor. Perhaps they each indirectly held 25 percent or more shares in each of the three PRC enterprises.

Another possibility is that the PRC tax authorities denied treaty benefits based on the beneficial ownership test for the capital gains. Although China's tax treaties do not subject treaty benefits for capital gains to the beneficial ownership requirement, there are several published cases where Chinese tax authorities mistakenly applied the "beneficial ownership" analysis to deny treaty benefits for capital gains. Despite not knowing whether the beneficial ownership test was applied in this case, MNCs should be aware that the tax authorities may apply the beneficial ownership test to deny treaty benefits for capital gains.

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6 *The State Administration of Taxation's Reply Regarding Wal-Mart's Acquisition of Shares in Trust-Mart*, Shui Zong Han [2013] No. 82, dated 21 February 2013, effective as of the same date. For more details on Notice 82, please refer to the March & April 2013 issue of our China Tax Monthly.

Yet another possibility is that the PRC tax authorities denied treaty benefits because they treated the 15 transferors' share transfers as a single transaction. The share transfers seemed to have been realized through the same share purchase agreement; therefore, the PRC tax authorities might have denied treaty benefits to all transferors because a majority of the transferors were not entitled to a treaty exemption for capital gains. In consideration of this possibility, MNCs should group transactions under a single share purchase agreement only if all the transactions have similar tax consequences. Otherwise, MNCs should use separate share purchase agreements to avoid losing the opportunity to claim the most favourable tax treatment for each transaction.

Capital Gains Allocation Method

Another issue worth noting is the application of the capital gains allocation method under Notice 82. Although Notice 82 only applies to the Wal-Mart acquisition and has no binding authority in other cases, this case shows Notice 82 has persuasive authority when the tax authorities are examining similar transactions.

5. Ningxia Case: Hong Kong Company Denied Treaty Benefits for Dividends

On 12 July 2016, the Wuzhong State Tax Bureau in Ningxia reported that it denied a Hong Kong company's treaty benefit claim for dividends and that it collected RMB7.84 million in EIT from the Hong Kong company.[7]

In June 2016, a foreign invested enterprise (FIE) declared a dividend distribution of RMB174 million. As a result, the Hong Kong company, which held 49 percent shares in the FIE, derived RMB78.39 million in dividends. The FIE made a Bulletin 60[8] recordal with the tax bureau for the Hong Kong company, claiming the reduced China-Hong Kong tax treaty rate of 5 percent withholding tax on the dividends. However, after reviewing the submitted documents, the tax bureau decided the Hong Kong company was a conduit company and could not qualify as the beneficial owner of the dividends because:

- the Hong Kong company could not provide a Hong Kong residency certificate;
- the Hong Kong company's main income was dividends;
- the Hong Kong company conducted almost no business activities and therefore incurred almost no operational expenses; and

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7 See http://www.shui5.cn/article/2f/105301.html.

8 *State Administration of Taxation's Bulletin on the Administrative Measures for the Non-resident Taxpayer to Claim Tax Treaty Benefits*, SAT Bulletin [2015] No. 60, dated 11 August 2015, effective from 1 November 2015. For more details on Bulletin 60, please refer to the August & September 2015 issue of China Tax Monthly.

- the Hong Kong company's assets, staff and operations did not match its income.

As a result, the tax bureau imposed a 10 percent withholding tax on the dividends.

Observations

Although Bulletin 60 has replaced the approval procedure with a recordal procedure for a non-resident taxpayer to claim tax treaty benefits, the Ningxia Case shows the PRC tax authorities' willingness to scrutinize the taxpayer's eligibility for the treaty benefits. According to the *PRC Tax Administration and Collection Law*, the tax authority may levy late payment surcharges (i.e., 0.05% per day) and potential penalties (in the range of 50% to 500%), in addition to any underpaid tax if the taxpayer has enjoyed but is found to be disqualified for the treaty benefit. To avoid unnecessary tax costs, every MNC should make a careful assessment before it decides to claim the treaty benefit.

6. Shandong Case: Trustee Escaped Tax on Trust Income

In the June 2016 Issue of Taxation Research, two tax officials from the Laoshan State Tax Bureau in Qingdao, Shandong Province reported a case in which a trust company successfully defended itself from tax on trust income.[9]

Facts

In June 2012, a Chinese trust company ("**Trustee**") injected RMB600 million into a real property development company in exchange for 16.02 percent shares in the real property development company. The RMB600 million that was used for the capital injection were trust assets entrusted by another Chinese company ("**Settlor**"). In May 2014, the Trustee transferred the 16.02 percent shares for RMB702 million.

The tax bureau learned about the share transfer through the real property development company. The tax bureau decided that the Trustee had realized a capital gain of RMB102 million from the share transfer and informed the Trustee to pay an additional RMB25.5 million in taxes (i.e., RMB102 million * 25 percent).

In response, the Trustee argued that it should not be taxed on the share transfer because the transferred shares were trust assets rather than its own assets. The Trustee further argued that the Settlor who was the beneficiary should pay tax on the share transfer. To support its argument, the Trustee provided the tax bureau with documents issued by the local Banking Regulatory Bureau and the local Administration of Industry and Commerce to show that the transferred shares were trust assets.

9 See Taxation Research (June 2016 Issue), pp. 76-77.

The tax bureau conceded the argument to the Trustee and shifted its focus to the Settlor. The tax bureau found that the Settlor had not recorded any income on the share transfer. The tax bureau then informed the Settlor's in-charge tax bureau to collect the unpaid tax.

Observations

Currently, China has few specific rules addressing the tax treatment of trusts other than regulations on taxation of commercial trusts with securitized assets. Under the PRC Trust Law, a trust is a pure contractual relationship.

In a report[10] issued by the SAT in 2003, the SAT proposed taxing the trustee on trust income and then taxing the beneficiary on the distribution of the trust income with credits for taxes already paid on that trust income available. In this case, the tax bureau took a different position and passed over the Trustee probably because both the Trustee and Settlor (beneficiary) were Chinese enterprises and therefore China's tax rights were not affected by who was named as the taxpayer. But where the trustee and settlor are non-residents, the tax bureau might be more inclined to follow the 2003 SAT proposal. Thus, it remains unclear how trust income will be taxed in China.

10 Trust Taxation Research Team of the State Administration of Taxation, *Report on Establishing the PRC Trust Taxation Mechanism*, dated 4 May 2003.

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