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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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1. China Issues New Individual Income Tax Rules on Equity Incentives

On 20 September 2016, the State Administration of Taxation (SAT) and the Ministry of Finance jointly issued new rules on the individual income tax (IIT) treatment of equity incentives, i.e., Notice 101[1]. On 28 September 2016, the SAT issued Bulletin 62[2] to clarify the implementation of Notice 101.

Notice 35[3] treatment extended to unlisted companies

Under Notice 101, an employee receiving shares and share rights from the employer at a price lower than the fair market price is liable to pay tax on the difference between the actual price and fair market price. The price difference should be treated as salary and the tax is payable when the employee receives the shares. The tax should be calculated in accordance with Notice 35 if tax deferral treatment (discussed below) is not available.

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1 *Announcement of the State Administration of Taxation and Ministry of Finance on Improving Certain Income Tax Policies Concerning Equity Incentive and Equity Contribution through A Technology Transfer*, Cai Shui [2016] No. 101, dated 20 September 2016, retroactively effective from 1 September 2016.

2 *State Administration of Taxation's Bulletin on Issues relating to the Collection and Administration of Income Tax on Equity Incentive and Equity Contribution through A Technology Transfer*, SAT Bulletin [2016] No. 62, dated 28 September 2016, retroactively effective from 1 September 2016.

3 *Announcement of the State Administration of Taxation and Ministry of Finance Concerning the Collection of Individual Income Tax on Individuals Deriving Stock Option Income*, Cai Shui [2005] No. 35, dated 28 March 2005, effective from 1 July 2005.

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Bulletin 62 further provides that the fair market price for the unlisted shares should be determined based on the net asset value method, analogous method or other reasonable methods applied in sequence. Under the net asset value method, the company's net asset value of the previous year-end should be used.

Previously, equity incentive income derived by an employee under an unlisted company's equity incentive plan would normally receive less preferential IIT treatment as compared to the income derived under a qualified listed company's plan. Notice 35 created this disparity by allowing income derived by an employee under a qualified listed company's equity incentive plan to be taxed as a separate month's salary using a preferential calculation method. This method averages the equity incentive income over the employee's working months in China (capped at 12 months) to determine the applicable tax rate[4]. Whereas, income derived by an employee under an unlisted company's equity incentive plan was simply added to the employee's salary in the month of receipt and subject to tax at a rate determined by the employee's overall salary in that month.[5]

Tax deferral for equity incentives from unlisted companies

Notice 101 provides that an employee may, subject to a recordal with the in-charge tax authority, defer the tax liability on stock options, restricted stocks and share awards (collectively as "**Equity Incentive**") granted by an unlisted employer until the transfer of the relevant shares if the following conditions are met:

- The Equity Incentive is implemented by a PRC unlisted enterprise ("**Issuer**");
- The Equity Incentive plan is approved by meetings of the Issuer's Board and shareholders;
- The Equity Incentive is paid in the Issuer's shares (for share awards, the Equity Incentive can also be paid in another PRC resident enterprise's shares if those shares were received by the Issuer as consideration for an equity contribution through a technology transfer);
- The Equity Incentive should be granted only to senior managers and core technical staff as decided by the Board or shareholders' meeting, and the total number of employees that receive grant of Equity Incentives should not exceed 30 percent of the Issuer's average workforce during the last six months;

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4 Salary is taxed in China at a progressive tax rate of up to 45 percent.

5 An exception is that the Hainan Provincial Local Tax Bureau allows stock options granted by unlisted companies to be taxed using the Notice 35 preferential calculation method. Please see the Hainan Provincial Local Tax Bureau reply to the Haikou Municipal Local Tax Bureau (Qiong Di Shui Han [2015] No. 1151) for details.

- The employee should hold the shares for at least three years from the grant date (for stock options and restricted stocks, the employee should also hold the shares for at least one year from the vesting date);
- For stock options, the period between the grant and vesting should not exceed 10 years; and
- The business of the Issuer and the company whose shares are granted under the Equity Incentive does not fall within the restricted industry catalogue as prescribed under Notice 101.

Under this tax deferral mechanism, gains from a share transfer will be taxed as capital gains, which are subject to IIT at a flat rate of 20 percent, rather than salary, which is subject to IIT at a progressive rate of up to 45 percent.

Extended tax payment period for listed company equity incentives

Under Notice 101, the tax calculation methods for an equity incentive derived by an employee from a listed company remain unchanged. However, an extended tax payment period is now available for certain equity incentives from PRC listed companies. Previously, subject to tax authority approval, a listed company's senior manager was allowed to pay taxes on stock option income in several batches within six months from the vesting date of the stock option. Notice 101 now allows the employee, subject to a recordal with its in-charge tax authority, to defer the tax payment on stock options, restricted stocks or share awards granted by a PRC company listed on the Shanghai and Shenzhen stock exchange, for a period up to 12 months from the vesting date.

Observations

Under Notice 101, the tax deferral treatment is limited to equity incentives granted by a PRC unlisted company. Similarly, the treatment of 12-month tax payment period is only available to equity incentives granted by a PRC company listed on the Shanghai and Shenzhen stock exchange. Thus, equity incentives granted by foreign multinational companies (MNCs) will unlikely benefit from these two preferential treatments.

What may be of relevance to foreign MNCs is the possible extension of Notice 35 treatment to cover unlisted companies' equity incentives as well as extension of such treatment to employee stock purchase plans. From a literal reading, neither Notice 101 nor Bulletin 62 limits the extension of Notice 35 treatment to PRC companies. Thus, from a purely literal reading, it is possible to interpret that Notice 101 extends Notice 35 treatment to equity incentives (including employee stock purchase plan) granted by a foreign listed or unlisted companies.

However, it seems the policy rationale of Notice 101 is to encourage domestic start-up or innovation companies. Thus, it is unclear whether PRC tax authorities would agree to grant Notice 35 treatment to equity

incentives granted by foreign unlisted companies as well as an extension to employee stock purchase plans. Without further clarification, Notice 101 implementation may depend heavily on the varying local practices of the PRC tax authorities.

2. The SAT Clarifies the VAT Treatment of Prepaid Cards

On 18 August 2016, the SAT issued Bulletin 53[6] to address certain issues relating to the value-added tax (VAT) pilot program. Among those issues, Bulletin 53 clarifies the VAT treatment on transactions involving prepaid cards.

According to Bulletin 53, prepayments received by a card seller for the sale of pre-paid cards are not subject to VAT. At this prepayment stage, the card seller can only issue a normal VAT invoice rather than a special VAT invoice to the buyer. When the buyer purchases goods or services with the pre-paid card, the supplier of the services or goods is liable to pay VAT, but the supplier cannot issue a VAT invoice (normal or special) to the buyer. If the card seller and the supplier of the services or goods are not the same party, the supplier should issue a normal VAT invoice rather than a special VAT invoice to the card seller upon receipt of payment.

Observations

Taxpayers commonly conduct transactions using pre-paid cards. Before Bulletin 53, every taxpayer was forced to decide independently how to invoice these transactions. The result was a wide range of disparate invoicing practices among taxpayers. Now, Bulletin 53 will establish a consistent invoicing practice, and taxpayers will need to change invoicing practices that are inconsistent with the new requirements under Bulletin 53.

According to Bulletin 53, neither the card seller nor the supplier of the services or goods can issue a special VAT invoice to the buyer. We do not think this is a substantial change because goods or services purchased using a pre-paid card are normally used for final consumption and it is established rule that no special VAT invoice can be issued on goods or services used for final consumption purposes.

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6 *Announcement of the State Administration of Taxation on Certain Issues Concerning the VAT Pilot Program*, SAT Bulletin [2016] No. 53, dated 18 August 2016, effective as of 1 September 2016.

3. Jiangsu State Tax Bureau Proposes A New Transfer Pricing Method

As reported in our client alert in July 2016, Bulletin 42[7] requires taxpayers to include value chain analysis into the transfer pricing documentation. As a result, Bulletin 42 raises questions about how the value chain analysis will affect the PRC tax authorities' attitudes toward transfer pricing methods. We initially expected that the tax authorities might be more inclined to accept two-sided methods, e.g., the profit split method.

On 9 August 2016, the Jiangsu State Tax Bureau issued its 2016-2018 Administration Plan for International Tax Compliance, i.e., Su Guo Shui Fa [2016] No. 125 ("**Circular 125**"). By recommending MNCs use a new transfer pricing method based on value chain analysis, Circular 125 introduces another possibility of how the PRC tax authority will view the value train analysis. According to Circular 125, this new method involves a three-step approach:

(1) collect sufficient information to understand the value chain, including the group's master file, country-by-country report, data from commercial databases and internal financial data, etc., and fully understand the substance of such information;

(2) analyse the group's value chain to identify each function performed by a participant in the value chain and to identify all the key value contributors (e.g., intangibles, fixed assets, number of employees, and markets);

(3) allocate profits to participants based on a set of core indicators (such as assets, sales, expenses and costs, etc.) to ensure that the profit allocation matches each participant's functions and risks.

Notably, Circular 125 states that the application of this new method should be based on the arm's length principle. The tax authority should avoid simply applying the global formula allocation method.

Observations

Under the new transfer pricing method, there is a concern that the tax authorities may allocate MNCs' profits simply based on some "core indicators". Where intangible asset is given no or limited consideration when selecting the allocation indictor(s), this method would be a concern for any MNC that derives value from intangible assets such as IP and branding rather than tangible assets.

That being said, Circular 125 provides guidance rather than the mandatory effect of legislation; therefore, taxpayers and tax bureaus (even the Jiangsu tax bureaus) will not be bound by its recommendations. As

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7 *State Administration of Taxation's Bulletin on Issues Relating to the Enhancement of the Declaration of Related Party Transactions and Administration of Contemporaneous Documentation*, SAT Bulletin [2016] No. 42, dated 29 June 2016, retroactively effective from 1 January 2016.

pointed out by the OECD, the value chain analysis is simply a tool to assist in accurately delineating the transaction, and it does not, of itself, indicate that the transactional profit split is the most appropriate method.[8] That is to say the value chain analysis itself is not sufficient to justify the profit split method, let alone the new transfer pricing method proposed by Circular 125. More importantly, China's transfer pricing rules still follow the arm's length principle. Therefore, taxpayers should remain confident in being able to defend their related party transactions before the tax authorities as long as their positions are based on a sound application of the arm's length principle and are supported by high-quality comparable data.

4. New China-Russia Tax Treaty Enters into Force

The new China-Russia Double Tax Treaty and its protocol (collectively "**New Russia Treaty**") entered into force on 9 April 2016 and will apply to income derived on or after 1 January 2017. The New Russia Treaty contains some notable changes.

Zero withholding tax on interest

Unlike the current treaty, which provides a 10 percent withholding tax rate on interest, the New Russia Treaty allocates the exclusive right to tax interest to the resident state. That is to say, interest derived by a Russian tax resident will be no longer subject to enterprise income tax (EIT) in China, or vice versa. This provision is quite unusual and is rarely found in China's tax treaties.

Reduced withholding tax on dividends and royalties

The New Russia Treaty reduces the withholding tax on dividends to 5 percent if: (i) the beneficial owner is a company directly holding at least 25 percent of the capital of the company paying the dividends; and (ii) this holding equals at least EUR80,000. For all other situations, the applicable tax rate continues to be 10 percent.

In addition, the New Russia Treaty lowers the withholding tax rate on royalties from the current 10 percent to 6 percent.

Expanded exemption for gains from share transfers

The New Russia Treaty removes the 25 percent shareholding threshold. It provides that capital gains derived from transfer of shares in a company other than a land-rich company are taxable only in the resident state. This means Russia will join the few jurisdictions, such as Ireland, Korea and Estonia, with tax treaties with China that provide a broad tax exemption for gains from share transfers without a shareholding percentage requirement.

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8 OECD: *BEPS Actions 8-10 Revised Guidance on Profit Splits* (public discussion draft, 4 July 2016), Para. 27.

Anti-treaty abuse

Consistent with the majority of China's recent tax treaties, the New Russia Treaty contains additional provisions denying treaty benefits on dividends, royalties, interest and other income if the main purpose or one of the main purposes of creating or assigning the rights for which the payments are made is to take advantage of the treaty benefits.

More importantly, the New Russia Treaty introduces a limitation on benefits (LOB) clause to ensure a sufficient link between the entity claiming the treaty benefit and its state of residence. In order to enjoy the treaty benefit, the LOB clause requires the non-tax resident to be a "qualified person"[9] or to have located in the resident state active business activities that are substantially related to the generation of the relevant income item. We expect this LOB clause to create difficulties for companies without sufficient economic substance when trying to claim treaty benefits under the New Russia Treaty.

5. Zhejiang Case: Tax Bureau Applies Beneficial Ownership Test to Treaty Benefits for Capital Gains

On 2 September 2016, China Taxation News reported that the Huzhou State Tax Bureau of Zhejiang Province denied a Hong Kong company's treaty benefit claim for capital gains from share transfer and that it collected RMB77.79 million in EIT from the Hong Kong company.[10]

Facts

In April 2016, a PRC listed company announced that one of its shareholders, a Hong Kong company, planned to reduce its shareholding in the PRC company. After obtaining this information, the tax bureau approached the PRC company and the Hong Kong company, requiring the Hong Kong company to pay tax once the planned share transfer was completed.

Faced with this requirement, the Hong Kong company argued that it should be exempt from EIT in China according to the China-Hong Kong Double Taxation Arrangement ("**China-HK Arrangement**") because it only held 24.77 percent of the PRC company.[11]

The tax bureau rejected this treaty benefit argument because the Hong Kong company was not the beneficial owner. According to the tax bureau, a non-resident should be the beneficial owner in order to enjoy the treaty

9 According to the New Russia Treaty, an individual will automatically be considered a "qualified person" whereas a company must pass a complicated analysis to be considered a "qualified person".

10 See http://www.ctaxnews.net.cn/html/2016-09/02/nw.D340100zgswb_20160902_1-10.htm?div=-1.

11 Under the China-HK Arrangement, income from a share transfer in a company other than a land rich company is taxable only in the resident jurisdiction if the transferor holds less than 25 percent of the capita of the target company.

exemption on capital gains. Whereas, the Hong Kong company could not provide evidence that it had substantial business activities. Thus, the tax bureau decided that the Hong Kong company was not the beneficial owner and was not entitled to the treaty exemption. The Hong Kong company finally accepted the tax bureau's decision and agreed to pay the tax.

Observations

As none of the capital gains provisions under the China-HK Arrangement or China's other tax treaties have a "beneficial ownership" requirement for capital gains tax exemption, it is technically incorrect to apply the beneficial ownership analysis to treaty benefits on capital gains. However, even before the Zhejiang Case, several published cases had mentioned the Chinese tax authorities mistakenly applying "beneficial ownership" analysis to deny treaty benefits on capital gains. These cases mainly involved taxpayers from traditional tax havens, such as Barbados. However, the Zhejiang Case indicates the tax authority's scrutiny of capital gains treaty benefits may expand to other jurisdictions even though the tax authorities are using a technically questionable method.

6. PRC Tax Authorities Increase Scrutiny on Service PEs

Recently, an increasing number of cases are being published in which the PRC tax authorities are reported to have deemed a non-resident enterprise to have a permanent establishment (PE) due to its services performed in China.

Jiangsu Case

According to a news report published on the Hainan Local Tax Bureau's website, the Nanjing State and Local Tax Bureaus in Jiangsu cooperated in an investigation to collect RMB5.89 million in EIT and RMB31 million in IIT.[12]

The local tax bureau started the investigation when it learned that a Chinese company had paid large service fee amounts to an offshore company. As the services were rendered over a long period, the local tax bureau decided to look into whether the offshore company had created a PE in China. The local tax bureau contacted the state tax bureau and asked to review the service contract submitted by the PRC company to the state tax bureau for recordal purposes.

After reviewing the service obligations in the service contract, the two tax bureaus suspected that the offshore company would need employees in China to perform the obligations. After questioning the PRC company's employees and conducting an on-site investigation, the tax bureaus found that the offshore company did have technical staff in China. After further investigation, the tax bureaus confirmed that these technical staff had stayed in China long enough to establish a PE. Therefore, the offshore

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12 See http://www.tax.haina n.gov.cn/hnportal/yasf/869245.jhtml.

company was liable to pay EIT and withhold IIT for its technical staff working in China.

In order to determine the EIT payable, the state tax bureau allocated RMB157.12 million from the total service fees (i.e., RMB368.31 million) to the PE and taxed the PE using the deemed profit method.

Zhejiang Case

On 12 August 2016, China Taxation News reported that the Ningbo State Tax Bureau in Zhejiang collected RMB10.88 million in EIT from a UK university on service fees received from a Chinese university ("**Payer**").[13]

The Payer was a Sino-foreign cooperative university jointly owned by the UK university and a Chinese university. The UK university and the Payer entered into a service agreement, according to which the former provided education services to the latter. These education services included seconding experienced teaching and management staff to China.

The tax bureau decided to investigate because the UK university had been receiving increasing service fees in recent years but had never paid EIT in China. A key issue under investigation was whether the seconded staff created a PE for the UK university. The UK university argued that no PE was created because the seconded staff signed labor contracts with the Payer and therefore were the Payer's employees. The tax bureau rejected this argument because the investigation showed that the seconded staff were hired and paid by the UK university. On this basis, the tax bureau decided the UK university had a PE in China and was liable for tax on income attributable to the PE.

In order to determine the EIT payable, the tax bureau allocated 47 percent of the total service fees to the PE and taxed the PE using the deemed profit method.

Observations

Due to the tax recordal mechanism for outbound remittances,[14] the PRC tax authorities can examine outbound payments to determine whether a PE is created. The Jiangsu and Zhejiang Cases indicate the PRC tax authorities are being especially rigorous in searching for service PEs. We expect this trend to continue.

If a service PE is created, the offshore service provider's EIT burden depends largely on how much income is attributable to the PE. As such, every offshore service provider should maintain sufficient documentation on the income allocation between services performed inside and outside of China to prevent the PRC tax authorities from arbitrarily allocating income to the PRC PE.

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13 See http://www.ctaxnews.net.cn/html/2016-08/12/nw.D340100zgswb_20160812_1-10.htm?div=-1.

14 Under PRC law, a PRC taxpayer must make a tax recordal for each non-trade outbound remittance in excess of USD50,000.

7. China Strengthens Tax Collection on Entertainers' Income

On 26 August 2016, China Taxation News reported that a state tax bureau in Zhejiang assessed RMB2.06 million in EIT on a Korean company.[15] The Korean company derived RMB16.5 million in service fees from a PRC company for sending actors and actresses to perform in the PRC company's TV dramas. The tax bureau decided the Korean company was liable to pay EIT in China because income from entertainers' activities was not entitled to PE protection. As the Korean company refused to disclose information on payments to its actors and actresses, the tax bureau was unable to verify the Korean company's actual taxable profit. Thus, the tax bureau deemed 50 percent of the gross service fees to be the Korean company's taxable profit after considering the overall tax burden (including EIT and IIT).

In another case reported by the China Taxation News on 9 March 2016, a local tax bureau in Beijing collected RMB18 million in IIT and late payment surcharges from a US movie star.[16] The compensation for the movie star's performance in a film shot in Beijing was paid to a US one-person company owned by the movie star. The tax bureau borrowed the "substance over form principle" from the *Enterprise Income Tax Law* to look-through the one-person company and taxed the movie star accordingly.

Observations

Normally, income should be subject to tax at the hand of the income recipient. However, due to lack of information on income derived by the actors and actresses, the tax bureau in Zhejiang was unable to collect IIT at the hands of the actors and actresses. As a result, the tax bureau decided to use a profit rate of 50 percent for EIT collection purposes so that the uncollected IIT can be reflected in the EIT. The tax bureau in Beijing allocated the income to the movie star despite there being no anti-avoidance rule under IIT law. These two cases demonstrate heightened scrutiny of entertainers' income in the PRC.

15 See http://www.ctaxnews.net.cn/html/2016-08/26/nw.D340100zgswb_20160826_1-10.htm?div=-1.

16 See http://www.ctaxnews.net.cn/html/2016-03/09/nw.D340100zgswb_20160309_4-01.htm?div=-1.

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