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China Issues Detailed Rules on Deductions for Asset Losses --
New Incentives for Technology Companies

By Yongjun Peter Ni, Linda Ng, Jiang Bian and Angel Wu (White Case, China)

Detailed Rules on Deduction of Asset Losses Issued

Under the new Enterprise Income Tax Law, the taxable income is defined as an enterprise's total income minus the sum of non-taxable income, tax-exempt income, deductions and net operating loss carryovers. Deductions include costs, expenses, taxes, losses and other expenses. In order to provide detailed guidance on loss deduction, the Ministry of Finance and the State Administration of Taxation ("SAT") have jointly issued circular Caishui [2009] No 57, *the Notice regarding Pre-tax Deduction of Asset Losses,*

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Chinese Controlled Foreign Corporations:
Actual Management Key to Residence Treatment

By Patrice Marceau and Daniel Chan (DLA Piper, China)

Guoshuifa [2009] No. 82 issued by the SAT clarifies when Chinese-controlled foreign companies will be considered to have their 'place of actual management' in China. 'Place of actual management' is a key determinant on whether an enterprise will be treated as a 'resident enterprise' or 'non resident enterprise' which in turn arbitrates between the taxpayer being subject to tax on its worldwide income and being subject to tax only on China-sourced income. Circular 82 is retroactive to January 1, 2008.

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New Tax Rules Regarding M&A Transactions in China

By Lester Ross and Aileen Goa (Wilmer Hale, Beijing)

On May 7, 2009, China's Ministry of Finance (the "MoF") and State Administration of Taxation ("SAT") jointly issued the long-awaited Notice on Several Enterprise Income Tax Issues Relating to Enterprise Reorganization Activities, Caishui [2009] No. 59 (the "New Reorganization Tax Rules"), and the Notice on Several Enterprise Income Tax Issues Relating to Enterprise Liquidation Activities, Caishui [2009] No. 60 (the "New Liquidation Tax Rules"), both dated April 20, 2008, and effective retroactive to January 1, 2008. These rules mark a milestone in China's tax reform: for the first time, China now has a set of rules providing for so-called "tax-free" (actually tax-deferred) corporate reorganizations.

Before the promulgation of these new rules, corporate reorganizations were governed by one of two series of SAT circulars, one pertaining to domestic companies and the other to foreign-invested enterprises ("FIEs"). The series for FIEs consisted of Guoshuifa [1997] No. 71 ("Circular 71") and Guoshuifa [1997] No. 207 ("Circular 207"). Circular 71 was intended to be a comprehensive guideline on tax treatment of four types of M&A transactions: merger, division, equity restructuring, and asset transfer. Circular 207 specifically allowed a foreign investor to transfer its equity interest in an FIE to a 100% owned subsidiary at cost (thus realizing zero gain), provided that the transaction was motivated by a reasonable business purpose. Under those Circulars, many foreign investors were able to reorganize their China operations without significant tax consequences. However, the new Enterprise Income Tax Law, which unified the previously separate tax regimes for domestic enterprises and FIEs, effectively repealed those Circulars as of January 1, 2008.

A remarkable difference between the New Reorganization Tax Rules and the previous patchwork of SAT circulars is that the new rules are based on the same fundamental principles as the U.S. tax rules regarding corporate reorganizations. They also recognize a broader range of M&A and debt-restructuring transactions already common outside of China. The New Reorganization Tax Rules are also designed to address all tax issues involved in corporate reorganizations—there are provisions on the treatment of tax attributes, several provisions are introduced to guard the new freedom against abuse, and certain loopholes are closed. The only major issues related to reorganizations that are not addressed in the New Reorganization Tax Rules are those that are technically post-reorganization issues in taxable acquisitions, and they are covered by the New Liquidation Tax Rules.

For the first time, China now has a set of rules providing for so-called "tax-free" (actually tax-deferred) corporate reorganizations.

Summary and Analysis

The New Reorganization Tax Rules address six types of reorganizations and prescribe two types of tax treatment for them. The six transaction types include four types of M&A transactions—equity acquisition, asset acquisition, merger, and division—along with change of legal form and debt restructuring. A reorganization of each of these types is a taxable transaction unless it meets the requirements for a taxfree transaction. This report focuses on M&A transactions.

Taxable Transactions

In a taxable M&A transaction, the target must recognize gain or loss from the transfer of assets or the target shareholders must recognize gain or loss from the transfer of their shares, and the purchaser takes the fair market value (in most cases the purchase price) as its tax basis in the equity or assets. Net operating losses ("NOLs") may not be carried over to the purchaser (to offset its own tax liability). Surviving parties can continue to enjoy their pre-existing tax holidays (subject to proportional reduction in the case of a division), provided that they separately meet the qualification criteria.

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Tax-Free Reorganizations

When a transaction qualifies as a tax-free transaction, recognition of gain or loss from the transaction (other than gain allocable to "boot") is deferred until a future recognition event. The deferral (rather than permanent exemption) is preserved through the concept of "substituted basis." For example, in a stock-for-stock deal (a tax-free equity acquisition), the basis in the purchaser's stock which the target's shareholders receive is the same as their basis in the target's stock transferred; this type of substituted basis is called "exchanged basis." At the same time, the purchaser's basis in the target's stock acquired is the same as the stock's basis in the hands of the target's shareholders; this type of substituted basis is called "transferred basis." Similarly, in a stock-for-assets deal (a tax-free asset acquisition), the target takes an exchanged basis in the purchaser's stock which it receives, and the purchaser takes a transferred basis in the target's assets received. Tax-free mergers and divisions are treated the same way. By imposing substituted bases, the rules make sure that the built-in gain in the equity and assets will be taxed when the new owners make a taxable disposition in the future. It is in this sense that the commonly used term "tax-free" is inaccurate. Finally, the last benefit of tax-free treatment in tax-free mergers and divisions is that NOLs can be carried over to the new owner, subject to certain limitations. Treatment of tax holidays is subject to the same rules as govern taxable reorganizations.

The new rules are based on the same fundamental principles as the U.S. tax rules regarding corporate reorganizations.

Criteria for Tax-Free Reorganizations

The criteria for tax-free treatment are essentially the same as the combined criteria contained in the Internal Revenue Code and case law of the U.S., such as business purpose, continuity of business enterprise ("COBE"), continuity of shareholder interests, the "all or substantially all" requirement, and limitation on boot. Specifically, the transaction must have a bona fide business purpose, 75% or more of the target's total equity or assets must be transferred, the original core operations of the transferred assets must continue for at least 12 months after the transfer, any nonequity payment (defined to include cash, bank deposits, accounts receivable, marketable securities, inventory, fixed assets, other assets, assumption of liabilities, etc., together commonly referred to as "boot") must be less than 15% of the total purchase price, and target shareholders may not transfer purchaser's equity which they receive until 12 months after the transfer. The principle under lying these requirements is, according to Assistant Professor Jiguang Zhai of China University of Political Science and Law, one of the drafters of the New Reorganization Tax Rules, that a corporate reorganization should not trigger tax liability to the parties as long as they have not cashed out their stakes in the business operations. Finally, to qualify for tax-free treatment, parties to reorganizations must report the transactions when filing their annual tax returns for the year in which the transactions are completed.

Cross-Border Reorganizations

Cross-border transactions are subject to additional restrictions or adjusted tax-deferred treatment. The New Reorganization Tax Rules enumerate three types of crossborder equity or asset acquisitions that are eligible for tax-free treatment: transfer of equity interest in a resident enterprise by a non-resident enterprise to its 100% non-resident enterprise subsidiary ("foreign Co-to-foreign Sub"), transfer of equity interest in a resident enterprise by a non-resident enterprise to its 100% resident enterprise subsidiary ("foreign Co-to-domestic Sub"), and transfer of equity or assets by a resident enterprise to its 100% non-resident enterprise subsidiary ("domestic Co-to-foreign Sub"). Other types of cross-border transactions are not eligible for tax-free treatment unless otherwise approved by the MoF or SAT. For domestic Co-to-foreign sub transactions, the favorable tax treatment is a 10-year concession rather than an open-ended deferral: gain realized must be recognized over a 10-year period using a straight-line method. For foreign Co-to-foreign Sub transactions, two additional requirements must be met: (1) the Chinese capital gains withholding rates applicable to the transferee and the transferor must be the same (which will depend on the terms of any applicable income tax treaties), and (2) the transferor must undertake in writing to the governing tax bureau that it will not transfer its interest in the transferee for three years after the transfer. Presumably, these addi-

tional requirements are designed to discourage treaty shopping.

Initial Reactions

Although business and tax professionals generally welcome these new rules, some are already concerned about the potential impact of certain provisions that are less favorable than previous rules. During the period from January 1, 2008 to May 7, 2009, many overseas holding companies transferred their interests in PRC operating companies to Hong Kong intermediate holding companies with the goal of taking advantage of the lower dividend withholding rate under the PRC-Hong Kong tax arrangement. Many such transactions were entered into on the assumption that Circular 207 remained in effect until it was officially repealed. As the New Reorganization Tax Rules are effective retroactive to January 1, 2008, those companies now must prove that their transactions qualify for tax-free treatment under the above requirements. This may be a challenge if the Hong Kong company does not perform substantive functions or its functions are not supported by adequate documentation.

Another point of concern is the rigidity of the additional restrictions for cross-border transactions. The policy underlying the additional restrictions presumably is to prevent tax leakage through sham outbound transactions, but these restrictions can also impose additional barriers and costs on legitimate intra-group consolidations. For example, suppose a multinational corporation wants to consolidate two of its PRC operating companies, one held through a Hong Kong holding company and the other through a Cayman holding company, by having the Cayman company transfer its equity interest in its WFOE to the Hong Kong company in exchange for the Hong Kong company's stock. Even if this transaction is motivated by legitimate business reasons, it will not qualify for tax-free treatment because it does not fit under any of the three enumerated forms. To achieve its business goal on a tax-free basis, the multinational must take the additional step of first transferring its equity interest in the Hong Kong company to the Cayman company, so that the Hong Kong company becomes a 100% subsidiary of the Cayman company. Then, when the Cayman company transfers its WFOE to the Hong Kong company, the transaction can be eligible for tax-free treatment. In contrast, Circular 207 would have allowed one-step restructuring, as it allowed tax-free equity transfers not only to 100% subsidiaries, but also to sister companies under 100% common control.

Conclusion

The new rules reflect the Chinese government's growing sophistication and familiarity with international tax and corporate practices. In the past, the bulk of tax planning techniques used by parties to enhance deal value were useless in China. These new rules will change that and, as the government has intended, facilitate bona fide M&A activity.

The new rules will also present new challenges to both the government and taxpayers. Given the brevity of these rules and the broad range of transactions governed by them, they are vulnerable to abuse. The New Reorganization Tax Rules introduce the step-transaction doctrine, which authorizes tax bureaus to treat multiple transactions taking place within a 12-month period as a single transaction based on the substance-over-form principle. Together with the business-purpose requirement, this rule will prove to be a powerful anti-avoidance device. However, sophisticated techniques could be used to plan not only direct tax consequences but also tax attributes, and we have yet to see if the existing anti-avoidance rules will be sufficient.

The new rules will also present new challenges to both the government and taxpayers. Given the brevity of these rules and the broad range of transactions governed by them, they are vulnerable to abuse.

From the taxpayer's perspective, many key issues, such as the criteria for reasonable business purpose, the determination of fair market value, and the specifics of COBE, remain vague. Much of the vagueness is probably intentional, since certain issues—such as the step-transaction doctrine and the reasonable business purpose requirement—are by their nature much better addressed by a "facts and circumstances" approach than by a set of codified criteria. As a result, we are likely to see communications between tax bureaus and taxpayers becoming a more impor-

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tant part of tax practice. Although currently there are no formal procedures for obtaining rulings from the Chinese tax authorities, some national tax bureaus at provincial or municipal levels are prepared to provide verbal guidance upon request. Some issues, however, can be clarified by administrative guidance. For example, what are the details of the COBE requirement—does a purchaser have to continue the historical business of the target, or can the purchaser use the acquired assets to operate a similar business? These questions can determine the feasibility of a deal, and companies will welcome guidance when contemplating M&A transactions.

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Business in China: Misconceptions on Contract Enforcement and Chinese Debt Collection Practices

By Dan Harris (Harris & Moure, PLLC, Seattle, Washington)

Enforcing Contracts In China. Way, Way Better Than You Think

At a recent meeting of foreign businesspersons in Qingdao, I sat next to a very unhappy man who loudly stated: "Chinese contracts are not worth the paper they are written on." I told him: "Your statement is not true. As a matter of fact, the Chinese courts do very well at enforcing clear written contracts." As usual, I was greeted with disbelief. The problem with this person's statement is that it becomes a self-fulfilling prophecy. People who think China will not enforce contracts tend to ignore the issue. They either enter into no contract at all or they enter into a poorly drafted contract or they enter into a contract that is not enforceable in China. This is the actual story for this particular individual. As he now knows, this attitude about Chinese contract enforcement is a mistake.

My view of the Chinese contract enforcement process is based on over 30 years of experience in China. However, I am clearly not the only person who has come to this conclusion. Every year the World Bank publishes its Doing Business rankings. This report ranks 181 countries by ease of doing business. As might be expected, China ranks about in the middle of this list. It is ranked number 83 on the list. Not the worst, but still a challenging place to do business. China gets low scores in areas that are quite familiar to me in my daily practice: Starting a Business 151, Employing Workers 111, Paying Taxes 132.

However, in the category of Enforcing Contracts, China is rated as number 18. This means that China has one of the best systems in the world for enforcement of contracts. Compare that with India, which is rated 180 out of 181 countries, or Brazil, which is rated at 100. The China rating is actually better than the United Kingdom, which comes in at 23, and better than Japan, which comes in at 21. It is therefore a serious mistake to place China in the same category as some of its developing country competitors.

Given the facts, why do people continue to say that Chinese contracts are not worth the paper on which they are written? This appears to be based on the following three basic reasons:

- Chinese companies have an unfortunate tendency to ignore contract terms in dealing with foreigners. They do this not so much because they believe they can prevail in any eventual lawsuit, but rather, because they assume (too often rightfully) that the foreigner will not sue. This leads them to

believe they can violate contract terms with little risk.

- Many contracts entered into by foreigners are simply unenforceable in China. A typical unenforceable contract is not written in Chinese, not subject to Chinese law and provides for enforcement outside of China. Such contracts are truly usually not worth the paper on which they are written, but this is **not** due to a defect in China's legal system.
- Many contracts are too vague to allow for effective action by the courts. The Chinese courts are good at enforcing simple, clear contracts where the standards for default are objective and where the penalty requires little analysis. The Chinese courts are not good at making a contract for the parties, as is common in the U.S. and English legal systems. It is therefore essential to use contracts in a way that will produce a good result in court. I see many foreign parties who want to base a claim on a complex set of emails, oral communications and practice over time. This does not typically work in China. An aggressive lawsuit based on a clear written contract does work.

The Chinese court system is one of the gifts the Chinese system gives to foreign investors. Given the other obstacles and difficulties the Chinese system poses for foreign investors, it is really a big mistake not to take advantage of the Chinese court system for enforcement of contracts.

Owe Money To A Chinese Company? No Need to Pay

If you owe money to a Chinese company for product and you cannot pay all of your creditors, skip out on the Chinese company. Near as I can tell, there is nearly a 100% chance they will never sue you to recover.

I am NOT advocating not paying your debt, but I am saying that if you have to choose among your creditors on who to pay, the Chinese company should be your choice. I am saying this based on the following:

1. About a year ago, a client had come to me for a consultation regarding a dispute it was having with its Chinese OEM supplier. The Chinese company was threatening to sue my client for about $350,000, per its invoices. My client was refusing to pay the Chinese company due to a spate of bad product. My client was seeking a $150,000 credit for the bad product and the Chinese company was refusing and threatening to sue. I advised my client not to pay anything, based on two legal maxims. One, possession is nine-tenths of the law, and two, never fund someone who is threatening to sue you.

So I met with this US client last week on something completely unrelated and I asked him "whatever happened with that Chinese supplier that had been threatening to sue you?" His response was that absolutely nothing has changed. Every few weeks, the Chinese company emails seeking its $350,000 and threatening to sue. My client responds by offering $200,000 in full settlement and the Chinese company refuses. We laughed and moved on.

The China rating in contract enforcement is actually better than the United Kingdom, which comes in at 23, and better than Japan, which comes in at 21.

2. Many years ago, my firm was retained by a Chinese company to collect on approximately $500,000 owed the Chinese company by a US company. My firm mapped out our litigation strategy, which involved suing an Alabama based company in Washington Federal Court. We spent an inordinately long time discussing with the client the costs involved in such litigation and the strategies we would employ. The Chinese company hired us and sent us a decent sized retainer.

We emailed the Chinese company to say the retainer had arrived and they emailed me back with a laundry list of things we should do on the case. Nothing on that list corresponded to what we had told them we needed to do and one of the things on the list was flat out ridiculous. We had a few weeks earlier told the Alabama company that if they did not pay by such and such a date, we would sue them. Amazingly enough, item #1 on the list from the Chinese client was that I fly down to Alabama to try to talk settlement. We wrote the Chinese company and explained that they had hired us because we were US attorneys and, as such, we know what we are doing in terms of dealing with US companies on what had now essentially become a US case. We told the Chinese company that the absolute worst

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thing we could do would be to fly to Alabama to talk settlement and that doing so would be tantamount to our saying that we were not really serious about suing. The Chinese company then confessed that they were not really serious about suing and that they just wanted us to settle the case. I then gave them the maxim about how you have to be prepared to try a case to settle a case and they told me they had decided not to go forward with the matter and asked us to return the retainer, which we did.

I emailed them the other day just out of curiosity to ask how their case was going and they asked us to take their case on again. We vehemently declined and noted how they needed to retain an attorney immediately because they were now facing serious potential statute of limitation problems.

3. We were once contacted by a Chinese company owed around $300,000 by an American company. We asked him all sorts of questions about the debt and he gave good answers so we asked him to send us the documents. Turns out his debt was about ten years old and way past the time we could sue. We asked him why they had waited so long and the explanation was that they had been trying to work it out. I am not kidding.

The Chinese courts are good at enforcing simple, clear contracts where the standards for default are objective and where the penalty requires little analysis.

My firm has been handling cases like these for Korean and Japanese and Russian and German and companies from other countries for years. China is different. Sorry.

This is not to say, however, that foreign companies that do not pay may not face repercussions other than a law suit. For example, if you are a foreign company with a real presence in China, not paying a Chinese company might end up causing you real problems in China and you must consider this before choosing not to pay. Just by way of example, we represent a large Chinese manufacturer in an industry where there are only around five companies capable of manufacturing this particular product. Our Chinese client is owed millions by a US company and that US company figured it would not need to pay. What this US company did not figure was that our client would alert the other manufacturers of the non-payment and now none of those manufacturers will make product for this US company either. Once the US company started running out of product, it started paying our client again. On the other hand, if you have but a small presence in China and you can switch your manufacturing over to some other country....

Trademark Protection In China – Is your Trademark Registered?

Over the last six months or so, my firm's work for Chinese companies going international has zoomed, and with that, my knowledge of how Chinese companies "handle" foreign companies has zoomed as well. One of the things I have learned is that Chinese companies understand the value of trademarks -- YOUR trademark. Let me explain.

I am going to have to be very vague here so as to avoid revealing any confidential information, but I can be specific enough so you can get the gist. Two stories:

1. Chinese company manufactures product for US company. Product ships from China with US company name on it and US company distributes it throughout North America. China company also sells its product in North America under its own brand name. US company is trying to get Chinese company to lower its prices and Chinese company is balking. US company is talking of finding another manufacturer. Chinese company tells me that people in China "very friendly" to them registered the US company's name in China for this product years ago and so if anyone else tries to manufacture this product in US company's name, Chinese company will be able to stop them based on trademark violation.

China company is very smart. It knew that it could not register the trademark itself because China trademark law prohibits an agent to register the trademark of the company for whom it is acting as agent, so Chinese company did not register the trademark itself. US company is going to be in for a very rude awakening if it ceases to use this Chinese company for its manufacturing. Now here's the part that ought to really scare you. I asked my Chinese client how they knew to secure the trademark and the response was "everybody in China knows about this."

2. US Company A is in a very contentious battle with US Company B. US Company A had for many years been working with US Company B, with US Company A assisting US Company B in China. But when things started going bad, US Company A had a Chinese company secure a China trademark for a name that is absolutely essential for US Company B. US Company B does not know this yet as US Company A plans not to tell them unless and until things get really bad, along the lines of a loss at trial, if things ever get that far without resolution.

Because US Company A is a US company, I was a bit concerned that its having orchestrated the registering of a China trademark of a name that is absolutely critical for Company B might somehow subject Company A to legal liability in the US. However, I have discussed this with many US lawyers expert in this sort of thing and all of them are of the view that this is not going to be the case because Company A's actions were completely legal in China. Amazingly enough, US Company A has a paper trail showing that it strongly advised US Company B of the need for US Company B to register its trademark in China.

Vacuums get filled and if you are having product made in China with your name on it, you had better register your trademark in China, even if (especially if?) your China presence is through a third party.

On the flip side of this, if you are a company that gets paid to handle China outsourcing for Western companies, you would be well advised to put something in writing somewhere (perhaps in your contract with the Western company) making clear that you are of the view that your client should be registering its trademark and that you will not be doing that for them. Such a provision will help protect you from a negligence or breach of contract lawsuit should what I described above happen to your Western client.

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Hong Kong and Transfer Pricing: DIPN 45 Provides Additional Guidance

By Patrice Marceau And Daniel Chan (DLA Piper, China)

The Hong Kong IRD has long promised a Practice Note[1] on transfer pricing even though the *Inland Revenue Ordinance* does not really have a particularly robust framework for transfer pricing. In the past, transfer pricing was not an issue detrimental to Hong Kong since groups of companies usually diverted profits to Hong Kong rather than out of Hong Kong. In recent years however, we have seen more and more tax planning structures involving companies located in tax haven jurisdictions such as the British Virgin Islands and the Cayman Islands and, as a result, the authorities have become more aware of the issue.

Generally, the Hong Kong tax authorities can achieve transfer pricing adjustment by various means such as:

Section 20(1) of the Inland Revenue Ordinance

This is the only transfer pricing-like provision of the *Inland Revenue Ordinance*. The section applies where a Hong Kong resident deals with a closely connected non resident and the…*business is so arranged that it produces to the resident person either no profits…or less than the ordinary profits which might be expected to arise in or derive from Hong Kong.* In such case, the…*business done by the non-resident person…shall be deemed to be carried on in Hong Kong, and such non-resident person shall be assessable and chargeable with tax in respect of his profits from such business in the name of the resident person as if the resident person were his agent.* Because the wording of the section is somewhat convoluted, in practice, the provision is rarely invoked by the tax authorities.

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Section 16 of the Inland Revenue Ordinance

This is the general provision confirming the right of taxpayers to deduct expenses…*to the extent that they are incurred…in the production of profits …chargeable to tax*. The words 'to the extent that' provide the tax authorities the flexibility to deny this or that deduction if they are of the view that the profits assessable in Hong Kong within a related group are insufficient. By simply questioning the validity of a deduction, the authorities can effectively adjust the transfer price of the goods and services transacted between the Hong Kong company and the other entities of the group.

Section 61A of the Inland Revenue Ordinance

Section 61A is the general anti-avoidance provision of the *Inland Revenue Ordinance* and it provides wide authority to the Commissioner to review transactions and adjust their tax results where it is found that the taxpayers did not abide by appropriate commercial principles.

In the past, transfer pricing was not an issue detrimental to Hong Kong since groups of companies usually diverted profits to Hong Kong rather than out of Hong Kong.

DIPN 45[2] is unfortunately not yet the long awaited official view on the topic of transfer pricing and it deals only with adjustment to transfer pricing in the context of transactions involving Hong Kong and a jurisdiction with which Hong Kong has a tax treaty. Given that right now Hong Kong has tax treaties only with Thailand, Luxembourg, Belgium and Vietnam (not yet in force), as well as a tax treaty like arrangement with the Mainland of China, the new DIPN will have limited impact for the time being. However, given the firm intent of the government to expand the tax treaty network, and the steps it is undertaking to make itself attractive to treaty partners19, the expectations are that the treaty network will expand in the next few years.

The DIPN distinguishes two types of double taxation which can arise as a result of transfer pricing adjustments. The first is what it calls economic double taxation and refers to double taxation arising as a result of the same profits being taxed in the hands of two entities located in different jurisdictions. Economic double taxation would occur if a payment from a Hong Kong entity to a foreign entity is considered income for the recipient but is denied as a deduction for the payor. The other is what is called juridical double taxation where the same entity is taxed in two jurisdictions on the same profits. For instance, juridical double taxation can occur where a Hong Kong company with a branch in another jurisdiction is taxed in both Hong Kong and the other jurisdiction on the same income.

The DIPN details the conditions, procedures to follow and methods of adjustments when a Hong Kong resident is caught in either juridical or economic double taxation. While of limited use for now, we suspect that it will become ever more relevant as the next few years, particularly given the attention given to transfer pricing around the world in recent times.

1. The official name of the relevant publication is Departmental Interpretation and Practice Notes. These are guidance produced by the tax authorities to set out their position on particular matters.
2. Paragraph 13 of DIPN 45 says that [t]*he basis on which transfer pricing adjustment are to be made is explained in another Departmental Interpretation and practice Note*. As we are not aware of a DIPN yet on transfer pricing, perhaps the author of DIPN 45 was jumping the gun and one will be issued very soon.

Mr. Marceau is a Canadian living in Hong Kong since 1996. He is partner in the Corporate group of DLA Piper Hong Kong specializing in Hong Kong and regional taxation. Mr. Marceau has extensive experience advising corporations and high net worth individuals on tax planning and litigation matters. His practice focuses on tax planning for individuals, including estate planning, establishing and advising on the use of trusts for tax planning purposes (particularly from a Canadian angle) as well as local, regional and international tax issues for corporations and other business entities. Mr. Marceau may be reached by phone at +852 2103 0554 or via e-mail at patrice.marceau@dlapiper.com. Mr. Chan's practice focuses on providing advice to multinational clients and Hong Kong-based clients on investment and taxation in the People's Republic of China (PRC). Recently he has focused on supply chain management, distribution and retail sectors in China. He has undertaken numerous transactions relating to direct investment, acquisitions, reorganizations, tax, customs and employment in the PRC. He may be reached by phone at +852 2103 0821 or via e-mail at daniel.chan@dlapiper.com

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followed by circular Guoshuifa [2009] No 88, *the Administrative Measures of Pre-tax Deduction of Asset Losses.* The latter lays out the detailed implementation rules on deduction of asset losses. Both circulars take retroactive effect back to January 1, 2008. We have summarized the salient points of the two circulars as follows.

Scope of Asset Losses

Under the two circulars, asset losses that can be deducted are divided into three categories, based on the nature of the asset:

- Losses related to monetary assets such as cash, bank deposits, accounts receivable and advance payments;
- Losses related to non-monetary assets such as inventory, fixed assets, constructions in progress, and biological assets; and
- Losses related to debts and equity investments such as loans, guarantees, letters of credit, overdrafts, students loans, asset managements and equity investments.

For this purpose, losses resulting from bad loans made by enterprises, the business licenses of which do not allow for making loans, cannot be deducted. However, this doesn't include entrustment loans, i.e. an enterprise makes a loan to another enterprise through a bank under an entrustment arrangement. Losses resulting from such entrustment loans can still be deducted.

Also, since capital gains are taxed in the same manner as ordinary income in China, capital losses from equity investment can generally be deducted against ordinary income.

Timing for Claiming Asset Losses

As a general rule, an enterprise can claim asset loss deductions only in the year when the losses are recognized or actually incurred. If for any reasons an enterprise cannot claim deductions in that year, upon the approval of the tax authorities, it can make retroactive deductions in a later year and apply for a tax refund accordingly.

Conditions for Claiming Asset Losses

The two circulars set out detailed conditions for claiming each type of asset loss.

Cash

Cash shortages can be claimed as losses after offset against compensations from responsible parties.

Bank Deposits

Cash deposited in the financial institutions with valid deposit licenses and lost due to their bankruptcies, liquidations, creasing operations or closures can be claimed as losses.

Accounts Receivable and Advance Payments

Bad debts regarding accounts receivable and advance payments due to one of the following reasons can be claimed as losses:

In order to encourage technologically-advanced service enterprises, the Ministry of Finance, the SAT, the Ministry of Science and Technology and the Ministry of Commerce have jointly issued circular Caishui (2009) No 63 that provides a number of tax incentives to qualified technologically-advanced service enterprises.

- Losses due to the bankruptcy, closure, dissolution, disappearance or death of the debtor;
- Losses resulting from debt restructuring or force majeure; and
- Losses resulting from being more than 3 years overdue, with solid evidence of insolvency.

Inventory, Fixed Assets and Other Non-Monetary Assets

Losses due to shortage, damage, scrap, theft or force majeure such as a natural disaster can be deduced after offset against insurance claims and compensations from responsible parties. For this purpose, the input VAT paid on the inventory in question should be transferred out for VAT credit purposes and deducted together with inventory losses.

Loans

Bad debts regarding loans falling into one of the following situations can be claimed as losses

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Asset Losses, from page 11

after completing all the possible recovery measures and necessary legal procedures:

- Losses due to the bankruptcy, closure, dissolution, disappearance or death of the borrower or guarantor;
- Losses due to the severe natural disaster or accident without sufficient insurance compensations;
- Losses due to the legal penalties on the borrower for violations of laws (e.g. death penalty) whose assets are insufficient for repaying the loan;
- Losses resulting from debt restructuring;
- Losses resulting from foreclosure; and
- Losses specifically approved by the State Council.

As a prerequisite, qualified enterprise have to be certified as technologically-advanced service enterprises by the province level authorities in charge of science and technology, commerce, finance, tax, and development and reform, respectively.

Equity Investments

Losses from equity investments falling into one of the following situations can be claimed as losses after offset against insurance claims, compensations from responsible parties and deemed recoverable value (5% of the book value of the investment):

- Losses due to the bankruptcy, closure or dissolution of the investee;
- Losses due to the severe insolvency of the investee that has ceased operations for more than 3 years and doesn't have a restructuring plan;
- Losses on minority investment the term of which has either become due or run for more than 10 years, due to the insolvency of the investee that has been making losses for three years;
- Losses due to the severe insolvency of the investee that has been liquidated or has been in liquidation process for more than 3 years; and
- Other situations specified by the finance or tax authorities.

Approval Requirement

Based on the two circulars, except for 6 types of asset loss such as losses due to inventory shortage, fixed asset scrap, and trading of stock, bonds, mutual funds, etc through public securities markets, asset losses shall be approved before they can be deducted.

Evidence

In order to support asset loss deductions, enterprises shall prepare sufficient evidence including external evidence and internal evidence. External evidence includes court decisions, police reports, certifications from professional organizations, etc. Internal evidence includes contracts, internal memos, internal approvals, etc.

Other notable points

Other notable points include the following:

- Losses due to illegal operations are not deducible.
- Losses recovered in later years shall be included in the taxable income of those years.
- Losses from operations outside China cannot be deducted against the income from operations within China.

New Tax Incentives for Technologically-Advanced Service Enterprises

In order to encourage technologically-advanced service enterprises, the Ministry of Finance, the SAT, the Ministry of Science and Technology and the Ministry of Commerce have jointly issued circular Caishui (2009) No 63 that provides a number of tax incentives to qualified technologically-advanced service enterprises.

Qualified Cities

The new incentives are available to the qualified enterprises located in the following 20 cities that have been designated as China's Outsourcing Model Cities. The 20 cities are:

- Beijing
- Tianjin
- Shanghai
- Chongqing
- Dalian
- Shenzhen
- Guangzhou
- Wuhan
- Haerbin
- Chengdu
- Nanjing
- Xi'an

- Jinan
- Hangzhou
- Hefei
- Nanchang
- Changsha
- Daqing
- Suzhou
- Wuxi

Incentives

Qualified enterprises are eligible for the following new tax incentives:

- A 15% reduced enterprise income tax rate;
- Deduction of staff education expenses up to 8% of total wage expenses with the excess being carried over to later years; and
- Business tax exemption for the income from offshore service outsourcing.

The above incentives are valid from January 1, 2009 to December 31, 2013.

Scope of Technologically-Advanced Services

The qualified services are dividend into three categories:

- Information technology outsourcing ("ITO"), including software development, information technology R&D, information system maintenance, etc.
- Business process outsourcing ("BPO"), including business process design, back office function, internal control, supply chain management, etc.
- Knowledge process outsourcing ("KPO"), including IP research, data mining, pharmaceutical R&D, etc.

There is a detailed catalog of qualified services that comes with the circular. Interested companies can check the catalog to see if their businesses are considered qualified services.

Conditions for Enjoying the Incentives

An enterprise can enjoy those incentives if all the conditions listed below are met:

- The enterprise is engaged in one or multiple qualified services;
- Both the registration place and the operation place of the enterprise are in those cities;
- The enterprise has a legal person status and hasn't violated laws in the areas of import and export, finance, taxation, foreign exchange, customs, etc. during the past 2 years;
- The enterprise has strong R&D ability and more than 50% of its total staff have colleague or junior colleague degrees;
- The income from qualified services is more than 70% of annual income; and
- The enterprise has the relevant international industry certifications and the offshore outsourcing income received from foreign customers is more than 50% of annual income.

Certification Process

As a prerequisite, qualified enterprise have to be certified as technologically-advanced service enterprises by the province level authorities in charge of science and technology, commerce, finance, tax, and development and reform, respectively.

Calculation of Non-deductible Interest Expenses Due to Failure to Contribute Registered Capital Timely Clarified

The SAT has recently issued circular Guoshuihan [2009] No 312 to clarify the interest deduction issue regarding an enterprise the investors of which have failed to make a timely capital contribution. Specifically, if the registered capital of an enterprise is not contributed within the prescribed time limit, the interest incurred on its loans cannot be deducted to the extent of the difference between the committed capital and the actually contributed capital.

Under the two circulars, asset losses that can be deducted are divided into three categories, based on the nature of the asset.

The formula used to calculate such non-deductible interest expenses is as follows:

Non-deductible interest expense in a period = Total loan interest in that period × (Capital contribution shortage in that period ÷ Total loan amount in that period)

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Hong Kong Inland Revenue (Amendment) (No. 2) Bill 2009

The Hong Kong government published Inland Revenue (Amendment) (No. 2) Bill 2009 (the "Bill") in the government gazette on June 12, 2009. The Bill proposes to make the following amendments to the Inland Revenue Ordinance (the "IRO") to improve the administration of the IRO:

- Section 16(2)(*e*) will be amended to allow the deduction, from assessable profits, of interest payable on capital expenditure incurred on the provision of machinery or plant for research and development, prescribed fixed assets, and environmental protection machinery. For this purpose, prescribed fixed assets include specified machinery or plant that is used specifically and directly for any manufacturing process; computer hardware, other than that which is an integral part of any machinery or plant; and computer software and computer systems.
- Section 26E will be amended to empower an assessor to make an additional assessment of the tax payable due to a taxpayer's revocation of a claim for deduction of home loan interest after the statutory period of 6 years provided under section 60(1) of the IRO. The assessor may exercise the power within 2 years of the revocation of the claim.
- Section 71(7)(*d*) will be amended to empower the Commissioner of Inland Revenue to refund to holders of tax reserve certificates the principal value of the certificate together with interest without requiring the holders to return the certificate to the Commissioner where the certificate has not been accepted as a tax payment.
- Section 81 will be amended to extend the period within which prosecution of an offense in respect of breach of secrecy may be brought from 6 months to 6 years.

As a general rule, an enterprise can claim asset loss deductions only in the year when the losses are recognized or actually incurred.

Other proposed amendments to the IRO include the following changes to improve the operation of the Board of Review:

- Section 65(4) will be amended to empower the chairman of the Board of Review (instead of the Chief Secretary for Administration) to nominate members to attend meetings of the Board at which appeals are to be held.
- Section 65(7) will be amended to empower a person who ceases to be the chairman, a deputy chairman or a member of the panel to continue to perform certain functions relating to an appeal in which the person was involved before.
- A new section 68A will be added to empower the Board of Review to correct clerical mistakes or other errors (arising from any accidental slip or omission) in the decisions of the Board.

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Foreign Corporations, from page 1

According to Circular 82, an overseas company controlled by one or several PRC enterprise(s) will be considered a 'resident enterprise' due to its 'place of actual management' being in China where all of the following conditions apply:

- senior management responsible for day-to-day production and operation of the company is located primarily inside China and their management duties are performed primarily inside China;
- the company's financial decisions (e.g. borrowing, lending, raising capital, financial risk control, etc) and decisions on employment (e.g. appointment, dismissal, wage and compensation, etc) are made or approved in China;
- significant assets, financial and accounting books, company chops, minutes of meetings of board of directors and meetings of shareholders are maintained or stored inside China; and
- at least half of the directors of the company reside in China.

Once again, the authorities will follow substance over form when assessing the circumstances. Circular 82 provides the following guidance on the legal and tax treatment of a company considered a resident enterprise because of its place of actual management.

- The company is eligible to the PRC tax exemption treatment on dividends, interests and other equity investment proceeds received from other Chinese resident enterprises[1];
- Investor(s) of the company are taxed on dividends, interests and other equity investment proceeds on the basis that such returns originate from China for purposes of the new EIT Law (including any available exemption therein).
- For the Chinese investors, the company is not considered a Controlled Foreign Corporation pursuant to Article 45 of the new EIT Law. However, foreign entities controlled by the Company could be considered CFCs of the Chinese investors.
- A company may apply for registration as a resident enterprise at the tax bureau in

An overseas company controlled by one or several PRC enterprises will be considered a 'resident enterprise' due to its 'place of actual management' being in China if certain conditional all are applicable.

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charge of the region of either its place of actual management or the location of the Chinese domestic enterprise investor, subject to the verification by the tax bureau and the final approval by the SAT. Failure to apply will authorize the tax bureau to make its own preliminary determination on the tax resident status, subject to confirmation by the SAT.

- Where a company is also considered a resident of another jurisdiction, the rules of any applicable tax treaty (or arrangement) would apply to resolve any double taxation issues.
- Interestingly, an enterprise established in China by the overseas company will be considered as established by a foreign enterprise and thus be able to maintain its status as an foreign investment enterprise under PRC law.

Furthermore, the guidelines set out in Circular 82 can easily extend more generally to when a foreign company can be considered a resident on the basis of place of actual management. Take for instance a Hong Kong company whose senior staff are expatriates who are all located in the PRC working for an affiliate of the Hong Kong company.

It is clear that the principles developed in Circular 82 could extend to their circumstances to deem the Hong Kong company to be a resident enterprise for EIT Law purposes.

1. Article 26 of the new EIT Law and Article 83 of the Implementation Rules

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