



## TECH HIGHLIGHT

Every month TechWatch provides a comprehensive briefing covering all the latest standards and regulatory announcements from the Institute and other relevant organisations in Hong Kong. The full publication is available as a PDF file on the Institute's website.



# TechWatch 36

## ▶ CPD

The Institute has issued the new Statement 1.500 "Continuing Professional Development" (August 2005), introducing new CPD requirements for all members, as stated in Handbook update 18. The new CPD requirements will become effective from 1 December 2005. All members, whether practising or non-practising, must observe the same CPD requirements.

## ▶ Financial reporting updates

As reported in September's *A Plus*, the Institute has issued a new financial reporting framework and standard for small and medium-sized entities (SMEs), as stated in Handbook update 17.

The Institute comments on IFRIC Draft Interpretations D16: Scope Of IFRS 2 and D17: IFRS 2 – Group And Treasury Share Transactions.

The Institute invites comments on the IASB proposed policy on technical corrections. The Institute's proposed changes to the definition of a subsidiary in the Companies Ordinance were finally accepted with the passage of the Companies (Amendment) Ordinance 2005, which was gazetted on 8 July 2005.

## ▶ Audit and assurance

The Institute invites comments on a proposed practice note, PN 900, which applies to the audit of financial statements prepared in accordance with the financial reporting standard for SMEs (see above).

The Institute will soon issue an Exposure Draft for a proposed practice note on "Guidance to auditors with regard to preliminary announcements of results for the full year."

## ▶ Government

The Institute has been working closely with the Financial Services and the Treasury Bureau of the government, the Stock Exchange of Hong Kong, the Securities & Futures Commission and the Companies Registry on the proposed Financial Reporting Council (FRC) Bill. Through the two proposed executive arms, the Audit Investigation Board and the Financial Reporting Review Committees, the FRC's main tasks will be to carry out investigations into suspected irregularities concerning auditors of corporations and collective investment schemes listed in Hong Kong (listed entities), and to enquire into suspected non-compliance with relevant legal and accounting requirements of the financial reports of listed entities.

## ► Corporate Finance

The SFC issued a Consultation Paper on 29 August 2005 to invite comments on possible reforms designed to modernise the regime governing the public offering of shares and debentures set out in Parts II and XII of the Companies Ordinance. The possible reform initiatives are presented as 21 proposals, the overriding purpose being to encourage capital raising and issuance of securities and investments in Hong Kong by adjusting and refining the legal framework to facilitate offers while ensuring satisfactory standards of investor protection. The consultation will end on 30 November 2005.

The SFC released the Consultation Conclusions Paper on a Review of the Codes on Takeovers and Mergers and Share Repurchases on 22 August 2005. The main revisions to the codes will take effect on 1 October 2005.

## ► Taxation

The first discussion forum of the Taxation Interest Group was held on 16 August on the topic of "Issues on the Mainland-Hong Kong Double Taxation Arrangement." The Institute has since made an initial submission and a supplementary submission to the government for its consideration in its discussions with the Mainland authorities.

At the invitation of the Bills Committee, the Institute's Taxation Committee is now considering the Revenue (Profits Tax Exemption for Offshore Funds) Bill 2005. The objective of this bill is to amend the Inland Revenue Ordinance to implement the proposal announced in the 2003/04 Budget, to exempt offshore funds from profits tax.

### Quick links

- **Institute homepage**  
[www.hkicpa.org.hk](http://www.hkicpa.org.hk)
- **Full details of Hong Kong standards and updates**  
[www.hkicpa.org.hk/ebook/main.php](http://www.hkicpa.org.hk/ebook/main.php)
- **IFRIC**  
[www.iasb.org](http://www.iasb.org)
- **Companies Ordinance**  
[www.legislation.gov.hk](http://www.legislation.gov.hk)

## PRC guidance

The indices of the "PRC Legal Pronouncements" (法規信息) and "PRC Tax Bulletin" (稅收信息) are posted on the Institute's website for the reference of members. They provide an overview on China's latest laws, regulations and notices on taxation, accounting and finance promulgated by the related PRC authorities. The full contents of the publications are available for inspection at the Institute's library.





BY ANTHONY TAM AND YOLANDA LI

PRC FEATURE

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## SAFE and sound?

### Restrictions on offshore investments by Mainland Chinese individuals



*Two recent circulars issued by China's State Administration of Foreign Exchange (SAFE) could have severe consequences for Mainland individuals investing in offshore companies or acquiring Chinese companies indirectly through offshore companies.*

Until recently, it was common for a mainland Chinese individual business owner to adopt an inversion acquisition structure, in order to list in Hong Kong or another overseas stock exchange. Under this structure, the owner would invest in an offshore company, incorporated for example, in the Cayman Islands. This entity would then acquire the Chinese assets or companies from the original owner and when the acquisition was completed the offshore company would be listed on an overseas stock exchange. This is commonly known as the "Red Chip" model.

Another common practice was to use an offshore company in a merger and acquisition transaction between a foreign investor and a mainland Chinese owner. The foreign investor would invest in a Chinese company through an offshore company and the original individual owner of the Chinese company would acquire and hold an equity interest in the offshore company. In effect this would allow the Mainland owner to retain part of his interest in the Chinese company through an interest in an offshore company. Both structures enabled the mainland Chinese individual to convert his assets or

companies into offshore assets.

To ensure such structured transactions are properly supervised and approved by the various government authorities, SAFE promulgated *Huifa* 滙發 No.11 relating to the Improvement of Foreign Exchange Administration for Merger and Acquisition with Foreign Capital; and *Huifa* 滙發 No.29 relating to Registration of Overseas Investments contributed by PRC Individuals and Registration of Merger and Acquisition with Foreign Investment (known as Circulars 11 and 29), to monitor offshore investments by mainland Chinese individuals.

Overseas investments made by Mainland individuals are now subject to approval procedures similar to those that apply to domestic companies. Outbound investments must be approved by the relevant government authorities according to the 1989 "Measures on Foreign Exchange Administration Related to Overseas Investments" (hereafter known as the 1989 Measures). Similar investments

made by Chinese individuals must now be examined by and registered with SAFE and are covered by the 1989 Measures.

As a follow-up to the 1989 Measures, Circulars 11 and 29 require that anyone investing overseas for the purpose of establishing or controlling an offshore company must be examined by and registered with SAFE.

In addition, the approach outlined in Circulars 11 and 29 restricts the foreign exchange registration of certain Foreign Invested Enterprises (FIEs). Circular 11 requires that all individuals who intend to acquire any overseas equity or other property interests in exchange for domestic equity or assets must obtain certain additional SAFE approvals and registration when such FIEs are formed.

Circular 11 requires that the related FIE should be examined by SAFE at a local level when performing foreign exchange registration application, whenever either the foreign investing company in the acquisition is formed or controlled by Mainland

Chinese individuals, or the foreign investing company has the same management as the Chinese target company.

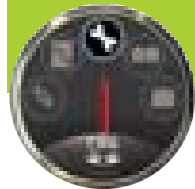
Circular 29 specifies that registration with SAFE for Foreign Exchange Registration of Overseas Investments is required for individuals who hold interest in an FIE indirectly through an overseas company after obtaining the FIE approval certificate. Certain measures are prohibited, including the distribution of dividends or funds for liquidation, share-transfers and decreasing the investment by FIE to any foreign enterprise whose shares are held by individuals who have not completed all the required registrations with SAFE. Further, except for the enterprise listed overseas, PRC individuals are required to remit the foreign currency income, received directly or indirectly from overseas companies within 30 days.

Although Circulars 11 and 29 do not have a retroactive effect, SAFE is required to identify any existing FIE that falls into the above category and to strictly monitor

its foreign exchange-related activities.

Circulars 11 and 29 are a step towards preventing the unmonitored outflow of domestic capital and extending the control on outbound investments to PRC individuals. It remains to be seen how they will be implemented as they are drafted broadly and loosely. This may cause some big discrepancies from city to city, as local authorities enforce them. In the meantime, the circulars have severely restricted flotations of domestic companies overseas by utilising an offshore entity, thus restricting the use of the "Red Chip" model to indirectly list a domestic company in an overseas stock exchange.

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## I only die once, so why double tax me?

*As we learned from Taxation 101, taxation is involuntary, confiscatory and frequently arbitrary. In 1998 the governments of mainland China and Hong Kong gave us mortals a band-aid double tax arrangement to alleviate some of the pain of double cuts. Now they may be willing to prescribe more pain-relievers.*



At the Institute's recent Taxation Interest Group discussion forum, the Inland Revenue Department reminded tax practitioners of a few realities. They noted that when we draw up our wish list of considerations on double taxation we should not overlook the roles and concerns of the oversight authorities (the Financial Services and the Treasury Bureau of Hong Kong and its Mainland counterpart) in the negotiations between the IRD and the PRC State Administration of Taxation. In particular, the profession should recognise that the Mainland government will not want to open the floodgates for other treaty countries.

This sounds like a sobering contribution to a vital debate. But rather than sinking into pessimism, it's worth taking a strategic view of what's on the table – and

### IF WE DON'T ASK, WE'LL NEVER GET IT...

Hong Kong's IRD is in the process of negotiating a new arrangement with their Mainland counterparts. We can also learn much from China's existing DTAs with other jurisdictions, about what might work best for Hong Kong.

**Capital gains:** Under the capital gains article in China's DTA with Barbados, gains derived by a Barbados company from disposal of equity interest in a PRC company are exempt from PRC withholding tax. Hong Kong needs an article to match Barbados' or we will lose out.

what else we can put there. As detailed below, many other jurisdictions have negotiated advantageous tax concessions in specific areas, such as capital gains, dividends and royalties.

### Exchange of information: A bitter pill to swallow

The IRD indicated that the Hong Kong and Mainland governments are aiming for a comprehensive double taxation agreement that includes an exchange of information article based on the 1995 version of the Organisation for Economic Cooperation and Development's (OECD) model tax convention. That is what Hong Kong has with Belgium and Thailand.

Article 25 of the Hong Kong-Belgium DTA includes the following details:

- Hong Kong and Belgium can exchange information on their residents as well as non-residents.
- Generally, only the information concerning taxes covered by the DTA can be exchanged.
- The information should only be used for the purpose of tax assessment, collection, enforcement, prosecution or determination of tax appeals.
- The authorities are not obliged to

exchange information in certain circumstances, such as where the contracting party would have to carry out administrative measures at variance with its laws, or where the information would compromise trade secrets.

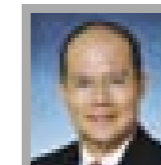
While the OECD 1995 version imposes more restrictions on the exchange of information than the OECD 2000 and 2004 versions, it would probably still not go down very well with the Hong Kong business community. Whatever the results of the negotiation may be, the IRD should take steps to educate the general public on what exchange of information clauses mean. In particular, illustrative examples could help to explain what information does and doesn't need to be exchanged.

**Let's not forget the Mainland investors** Under Hong Kong law, no withholding tax applies to dividends paid by a Hong Kong company to its foreign investors. On the other hand, Mainland investors

are subject to PRC taxes for the dividends they receive from Hong Kong. However under the current arrangement, the Mainland investors would not be entitled to a foreign tax credit for the underlying Hong Kong profits tax to which the dividends relate.

As a simple illustration, where a Hong Kong company derives a distributable pre-tax profit of HK\$100, under the current arrangement its sole Mainland shareholder would only pocket a net-of-tax dividend of HK\$55.28, i.e.  $(100 - 17.5) \times (1 - 33\%)$ .

Hong Kong would benefit from something similar to paragraph 2(b) of Article 24 of the China-Singapore DTA or paragraph 1(b) of Article 23 of the China-United Kingdom DTA. Such a provision would allow the Mainland investor to obtain a foreign tax credit for the underlying Hong Kong profits tax, ensuring Hong Kong remains an attractive investment location.



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**Interest:** If we cannot have it our way, we should at least have it Macau's way. Withholding tax rate on interest under China's DTAs with Macau and Singapore stands at seven percent, or ten percent in certain cases.

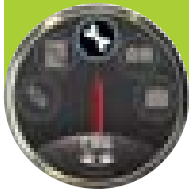
**Withholding tax on dividends:** Dividends distributed by a PRC foreign investment enterprise to its foreign investors are currently exempt from withholding tax under Mainland tax law, but there is no guarantee that this would not change in future. The dividend withholding tax rate is ten percent under the Mainland-Macau DTA. For

Singapore, the rate is generally 12 percent, but is reduced to seven percent if the Singapore recipient is a company or a partnership, which holds directly at least 25 percent of the equity interest in the Chinese company. So can we hope to match this? And if the wind really blows our way, might we have it at five percent like Mauritius?

**Royalties:** Currently, Mainland tax law imposes ten percent withholding tax on royalties for intellectual property transfers and equipment leasing. The rate was reduced to six percent under the China-Netherlands DTA. If Hong Kong

could also 'go Dutch' – or even better, gain complete exemption – it would encourage Mainland companies to use the territory as a centre for equipment leasing, research and development.

**Corresponding transfer pricing adjustments:** The current arrangement does not provide a mechanism to avoid double taxation that may arise from transfer pricing adjustments made by either the Hong Kong or Mainland tax authorities. We must have a mechanism for corresponding transfer pricing adjustments as part of a comprehensive DTA.



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## TAX FEATURE

# 轉讓定價稅收管理中 資本性 調整簡析

特約撰稿人 宋璋

隨著全球經濟一體化進程加快，特別是近幾年外商投資企業及外資企業在中國境內經營的迅速發展，關聯交易已成為企業經營過程中很正常的經濟現象。為了加強對關聯交易的管理，國家稅務總局先後對關聯交易、轉讓定價和預約定價進行了相關規定。在此基礎上，為了進一步做好轉讓定價稅收審計、預約定價簽談等反避稅工作，提高可比性分析的質量和效益，近期國家稅務總局又對轉讓定價稅收管理工作中的資本性調整問題進行了明確規定。這一政策針對目前各省市在轉讓定價稅收審計、預約定價簽談等工作中，對被調查企業與可比企業之間存在的資本性差異處理方式不統一的情況下而推出。

資本性調整是用於調整基於營運資本(包括應收賬款、應付賬款、存貨等)的利潤水平指標，用以反映被調查企業與可比企業之間由於營運資本佔用不同而對營業利潤產生的差異。因此，在比較被調查企業與可比企業的利潤水平時，當被調查企業與可比企業在營運資本(如應付賬款、應收賬款以及存貨)水平上有一定差異的時候，應調整佔用營運資本中隱含利息成本對利潤水平的影響，以取得經濟上較可靠的營業

利潤，提高可比企業利潤水平的可比性。考慮到目前我國上市公司發展還不完善，可比公司可比性資料較差的實際情況，國家稅務總局近期下發的國稅函〔2005〕745號文件明確指出：各地在對可比企業進行可比性分析過程中，以不對可比企業進行資本性調整為宜。如果可比企業選取準確，可比性較高，報經國家稅務總局批准後可以進行資本性調整。

當局進一步就轉讓定價稅收工作中的資本性調整問題進行闡釋，可有效解決目前各省市在轉讓定價和預約定價過程中，以不統一的方式處理調查企業和可比企業之間的資本性差異的問題，有利於在實施轉讓定價和預約定價過程中避免繁多的稅務審計工作，減少徵納雙方人力、物力、財力的消耗，降低徵納雙方的管理成本；有利於企業決策者據此對經營行為作出更合理的事前決策，避免資本性調整不統一對經濟活動的不正常影響。

## China transfer pricing: SAT issues rules on capital intensity adjustments

The State Administration of Taxation (SAT) recently released the "Notice of the State Administration of Taxation on the Issue of Capital Intensity Adjustments in Transfer Pricing Related Tax Administration", *Guo Shui Han* [2005] No. 745 (Circular 745), which was effective from 28 July 2005.

Circular 745 states that, "When comparing the profit levels of the company under investigation and the comparable companies, if differences exist between the company under investigation and the comparable companies in utilisation of operating capital (such as accounts receivable, accounts payable, and inventory), adjustments should be made for the impact of the utilised operating capital on the profit levels to obtain more reliable operating profits, and to enhance the comparability of the profit levels of the comparable companies." Circular 745 further instructs local tax authorities that no capital intensity adjustments should be made in transfer pricing investigations, negotiation of advance pricing arrangement, and other transfer pricing work unless certain conditions are met and the local tax authorities apply to and obtain approval from the SAT.

The conditions listed in Circular 745 include that the comparable companies are well selected and the comparability is relatively high. The Circular shows that the tax officials are growing more sophisticated very quickly along with the development of transfer pricing practices in China. In addition, it also demonstrates the SAT's increasing attention to details in transfer pricing practices.

Source: PricewaterhouseCoopers