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INSIGHTS AND IDEAS

LEGAL UPDATES

INSIGHTS AND IDEAS

Practice and Administration of Tax Treaty Treatment for Nonresidents (Author: Qiushuang ZOU)

Since the implementation of the *Enterprise Income Tax Law of the People's Republic of China* (the "**EIT**") and *its Implementation Rules* (the "**EIT Implementation Rules"**) on January 1, 2008, the State Administration of Taxation ("**SAT**") has placed great emphasis on the tax payment issues of nonresidents, especially nonresident enterprises, and has promulgated several regulations[1]aimed at regulating the tax obligations of nonresident enterprises under different circumstances. On August 24, 2009, the SAT issued the *Measures on the Administration of Tax Treaty Treatment for Nonresidents (Trial Implementation)* (Guo Shui Fa [2009] No.124, or the "**Measures**"), which will be effective on October 1, 2009.

The Measures only apply to nonresidents that are subject to Chinese tax wishing to obtain benefits under China's tax treaties. Under the Measures, nonresidents refer to taxpayers that are not Chinese tax residents under either China's domestic tax laws or tax treaties, including nonresident enterprises and nonresident individuals. Hence, the application of the Measures depends on whether an enterprise or individual claiming for benefits under China's tax treaties is a nonresident as defined under the Measures. In many cross-border transactions, we may often need to determine whether an overseas enterprise in a transaction structure is a nonresident enterprise and thus can enjoy the relevant tax preferential treatment(s). This article will mainly focus on tax treaty treatment for nonresident enterprises.

Section 2 of the EIT provides that, enterprises are categorized as resident enterprises and nonresident enterprises. Resident enterprises are those which are duly incorporated within China, or which are incorporated under the laws of foreign countries (or regions) but with their actual management institutions located in China; nonresident enterprises are those which are incorporated under the laws of foreign countries (or regions) and have no actual management institution in China, but may set up institutions and facilities in China, or receive incomes from within China even if they have not set up any institutions or facilities in China. The EIT Implementation Rules further provides that, the "actual management institution" mentioned in Section 2 of the EIT is such institution that imposes substantial overall management and control over the enterprise's production and operation, personnel, accounting and assets etc.; "institutions and facilities" mean the institutions and facilities that engage in production and operation in China.

Thus, besides the place of registration principle, the EIT and its Implementation Rules mainly adopt the commonly used rule for the coordination of jurisdictions of the residence country and income source country in the international tax treaties and international taxation law practice, namely, the permanent establishment principle, to realize the taxation jurisdiction of the income source country through the taxation on the operation profits of the domestic permanent establishment of nonresident enterprises.

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[1]including the *Provisional Measures on the Administration of Withholding of Enterprise Income Tax for Nonresident Enterprises* (Guo Shuo Fa [2009] No.3), the *SAT Notice on Issues Relevant to the Implementation of the Dividend Article under Tax Treaties* (Guo Shui Han [2009] No.81), and the *SAT Notice on Issues Relevant to the Recognition of Sino-controlled Enterprises Registered Overseas as Resident Enterprises in Accordance with the Actual Management Institution Standard* (Guo Shui Fa [2009] No.82)

However, in practice, due to the lack of quantifiable standards for determining actual management institutions, it is very easy to lead to disputes in deciding whether the institutions and facilities set up by a foreign enterprise in China constitutes actual management institutions in China.

The *SAT Notice on Issues Relevant to the Recognition of Sino-Controlled Enterprises Registered Overseas as Resident Enterprises in Accordance with the Actual Management Institution Standard* (Guo Shui Fa [2009] No.82, "**Circular 82**") may provide some guidance for the determination of Chinese tax resident enterprise status: (1) the places where the senior management personnel and department in charge of the enterprise's daily production and operation perform their duties are mainly located in China; (2) the financial decisions (such as borrowing, lending, financing, financial risk management) or personnel decisions (such as appointment, firing and salaries) of the enterprise are made by institutions or persons in China, or need to be approved by institutions or persons in China; (3) the main properties, accounting records, corporate seals, minutes of board of directors meetings and shareholders' meetings are located or kept in China; (4) 1/2 or more of the directors or senior management who have voting rights of the enterprise often reside in China. According to Circular 82, the above criteria need to be satisfied simultaneously in order to qualify as Chinese tax resident enterprise. Meanwhile, the principle of "substance over form" should be applied in determining whether the above four criteria are met. In practice, there are still uncertainties in determining whether a foreign company is a non Chinese tax resident.

According to the Measures, if an enterprise incorporated under the laws of a foreign country (or region) is regarded as a nonresident enterprise and wishes to enjoy tax treaty treatment as provided in tax treaties, it shall submit an application to the competent taxation authority for approval, and fill and submit a series of documents as required by the Measures. Approval obtained from the competent tax authorities is valid for three years (including the year in which the initial application is submitted) in respect of recurring items of income that is of the same type and subject to the same tax treatment under the treaty. Where a nonresident wishes to enjoy tax treaty treatment as provided in tax treaties, before incurring the tax obligations or declaring relevant tax obligations, the tax payer or the withholding agent shall file with the competent taxation authority.

The Measures also provides for continuing regulation. It states that after an nonresident completes the filing or approving procedures in accordance with the Measures, and has actually received tax treaty treatments, the tax payer, the withholding agent and the taxation authority shall continue later regulation in accordance with the Measures. If information reported by the tax payer or withholding agent under the Measures changes, the following measures shall be taken: if the changes do not affect the tax benefits enjoyed by an nonresident, the nonresident can continue to enjoy these benefits; if the changes result in any modifications in treaty benefits previously enjoyed by the nonresident, the nonresident shall re-conduct the filing or approving procedures in accordance with the Measures; if the changes cause the nonresident non-qualified to enjoy any treaty benefits, such benefits shall be suspended on the date when such changes occur, and the nonresident shall declare taxes or perform withholding obligations in accordance with domestic tax laws. According to the Measures, as part of their risk management process in implement a tax treaty, the tax authority may annually, on a regular or irregular basis, randomly select and inspect nonresidents that have enjoyed treaty benefits.

Additionally, an nonresident is allowed to request a refund of overpaid tax when treaty benefits were not previously claimed by submitting to the competent tax authority an application for retroactively

enjoyment of tax treaty treatment within 3 years from the date when the taxes are paid, and make up the filing or approving procedures in accordance with the Measures; applications beyond the prescribed period will not be accepted by the tax authority.

The term “tax treaty treatment or treaty benefits” as provided in the Measures refers to tax obligations that should be performed under domestic tax laws but can be alleviated or waived under the tax treaties. Although nonresidents may enjoy tax treaty treatment in accordance with relevant tax treaties, the domestic legal system has always lacked clear rules and practice guidelines in this regard. Hence, the issuance of the Measures is in no doubt good news to the nonresidents. At the same time, although the continuing regulation provided in the Measures may not be effectively enforced, at least a new channel is available for the tax authority to intensify its administration and control on nonresidents as compared to before.

LEGAL UPDATES

1. Notice on Individual Income Tax Issues Concerning Stock Incentives (Author: Hong JIANG)

On August 24, 2009, the State Administration of Taxation (the "**SAT**") issued the *Notice on Individual Income Tax Issues Concerning Stock Incentives*, Guo Shui Han [2009] No. 461 (the "**Notice**"). The Ministry of Finance and the SAT have previously issued several tax circulars, including Cai Shui [2005] No. 35, Guo Shui Han [2006] No. 902, and Cai Shui [2009] No. 5, with respect to the individual income tax treatment of stock options, stock appreciation rights("**SAR**"), and restricted stock. In comparison with the previous tax circulars, the new Notice further clarifies the following issues:

(1) Determination of taxable income and timing of taxable events

(a) Stock Appreciation Rights

A taxable event arises on the date on which an individual exercises the rights awarded under an SAR plan.

Taxable income = (stock price on the date of exercise – stock price on grant date) x number of stocks exercised

(b) Restricted Stock

A taxable event arises on the date on which any of the stock awards become fully vested, i.e. when the restrictions are lifted.

Taxable income = (closing price of the stock on the date the stocks are registered + closing price of the stock on date of vesting) / 2 x number of stocks vested – total acquisition cost paid by the individual x (number of stocks vested / total number of stocks awarded)

(2) Filing requirements

Companies listed in mainland China that implement a stock incentive plan/SAR plan should file the plan and various other documents with the competent tax authority.

Companies listed in mainland China that implement a Restricted Stock plan should register the stocks awarded under the plan with the China Securities Depository and Clearing Corporation, and file the relevant plan documents and implementation rules with the competent tax authority within 15 days of publicly disclosing the implementation of the plan.

If a company is listed on the stock exchange of a foreign jurisdiction, its entity within China should file the incentive plan (Chinese/English versions) of the publicly listed company with the competent tax authority.

A withholding agent or an individual taxpayer should report to the tax authority details such as type, number, exercise price, market price, and transfer price of the underlying stock, list of grantees, taxable income, and tax payable.

(3) Preferential tax treatments application

The preferential tax treatments prescribed under Cai Shui [2005] No. 35 and Guo Shui Han [2006] No. 902 will apply to the following situations:

(a) The stock incentive plan must be implemented by a publicly listed company, whereas plans implemented prior to listing and income crystallising after listing are specifically excluded;

(b) The publicly listed company must hold at least 30 percent direct or indirect interest in shares of the individual's employer; and

(c) The stock incentive plan must meet all necessary reporting and documentation requirements under the Notice.

2. Interim Measures Regarding Customs Conservatory Measures and Enforcement Measures (Author: Haoying ZHANG, Xi LIAN)

On August 19, 2009, the PRC General Administration of Customs issued the *Interim Measures Regarding Customs Conservatory Measures and Enforcement Measures* (the "**Interim Measures**"), which came into force as of September 1, 2009. We hereby set forth below a brief summary of the Interim Measures:

(1) Tariff Guarantee

The Interim Measures provides that, if there are indications that a taxpayer may attempt to transfer or conceal its taxable goods and other properties, the Customs authority may order the taxpayer to provide collateral. Pursuant to the *Regulations on Import and Export Tariff*, the consignee of import goods, the consignor of export goods and the owner of inward articles shall be the obligatory taxpayer.

(2) Conservatory measures

The Interim Measures further provides that, if the taxpayer is unable to provide collateral, the Customs authority may, upon approval of the director of he provincial Customs, or, upon the provincial Customs' authorization, the director of its subordinate Customs, take conservatory measures by notifying in writing the banks or other financial institutions (the "**Financial Institutions**") with which the taxpayer has opened an account to suspend payment to the taxpayer of an amount equivalent to the duties due.

If the Customs authority is not able to identify the bank account of the taxpayer or the amount of deposits, the Customs authority may detain the taxpayer's taxable goods or other properties of a value equivalent to the duties due. If the taxpayer's taxable goods or other properties is inseparable and there is no other goods or properties available, the Customs authority may detain the taxpayer's taxable commodities, goods or other properties of a value exceeding the duties due.

(3) Enforcement measures

If the taxpayer fails to make the tariff payment within three months of the due date, the Customs authority may, upon approval of the director of he provincial Customs, or, upon the provincial Customs' authorization, the director of its subordinate Customs, take enforcement measures in the following sequence: (i) notifying in writing the bank or other financial institution with which the taxpayer has opened an account to deduct the amount of duties due from the taxpayer's deposits, (ii) selling off the taxable goods to offset the duties due, or (iii) selling off in accordance with law the detained goods to offset the duties due. If the proceeds are not sufficient to offset the duties due, the Customs authority shall take further enforcement measures to make up the difference. If the proceeds, after subtracting all applicable fees, exceed the amount of duties due, the Customs authority shall return the balance to the taxpayer or the collateral provider.

(4) Court enforcement

The Interim Measures further states that if the Customs authority is not able to collect full amount of tariff under conservatory or enforcement measures, it is entitled to apply for court enforcement.

(5) Remedies and legal liabilities

The Interim Measures expressly provides that, if a taxpayer or collateral provider objects to a conservatory measure or enforcement measure undertaken by the Customs authority, it may apply for an administrative review in accordance with law or lodge an administrative suit in the people's court. Except for the foregoing remedies, according to the Interim Measures, if the Customs authority has taken any conservatory measures or enforcement measures in an improper manner, and injured the lawful rights of the taxpayer, the Customs authority shall be liable for it. If the taxpayer refuses or obstructs the Customs authority from legally performing the conservatory or enforcement measures, such acts shall be submitted to the public securities bureau for disposition. If such acts constitute an offence, criminal liabilities shall be imposed in accordance with law.

3. Circular of the Ministry of Culture to Strengthen and Improve the Censorship over the Content of Online Music (Author: Najuan MA, Kuinan WEI)

The Chinese Ministry of Culture promulgated the *Circular of the Ministry of Culture to Strengthen and Improve the Censorship over the Content of Online Music* on August 18, 2009 (the "**Circular"**). According to the Circular, the Ministry of Culture (the "**MOC**") will strengthen its administration over the content of internet-based music. Specifically, the Circular states that the content of imported online music is subject to censorship of the Ministry of Culture, whereas domestic online music is required to be filed with the MOC. Meanwhile, the MOC requires internet operators to conduct self-checking on the content of online music, in particular, on those that are not subject to the MOC's scrutiny. We hereby set forth below a brief summary of the key points of the Circular.

(1) Scope of the Circular

The Circular defined "Online Music" as any digitalized music product that are transmitted via internet, mobile communication network, fixed communication network and other communication networks, in the forms of on-line play back or a download link or any other forms, including but not limited to songs, music and MV. Entities that engage in the business of production, publication, dissemination (including providing download links) and importation of online music products, must be commercial internet operators (the "**Operating Entity**") as approved by the MOC.

(2) Censorship over the content of imported online music

According to the Circular, online music products whose original copyrights are owned by foreign individuals, entities and other organizations are imported online music products, and are subject to content censorship of the MOC. Music Products imported from Hong Kong, Macau and Taiwan are subject to the same scrutiny.

The Circular also specify the entities that are responsible for submitting the application with the MOC. According to the Circular, only entities that have acquired the exclusive and full right to disseminate the products on communication networks in mainland China or to act as an agent of the same (the "**Importing entity**"), are qualified to make the submissions. In addition, the Circular imposes stringent

requirements on the online music importation agreements entered into between the importing entity and the foreign copyright owner. It states that these importation agreements shall have a term of no less than one year and the subject of these agreements and shall be the right of dissemination via communication network. These agreements must state that the agreements' validity and enforceability are subject to the approval by the MOC.

In addition, the Circular has set forth a detailed roadmap of the application procedures. According to the Circular, the electronic version of the application materials may be submitted through MOC's "Online Music Filing Software" (Download address: www.ccnt.gov.cn). The importing entity shall fill out the information as required by the software, and upload the same to MOC's Online Music Censorship System. Hardcopies and CDs shall be mailed to the MOC via registered mail. MOC shall render a decision within 20 working days (exclusive of the time of panel review).

Under circumstances where the examination process should be expedited for some reason, e.g., by reason of simultaneous publication arrangements, the importing entity may use the "green-pass" function of the "Filing Software", through which the timeline will be shortened to 3 working days. For imported music products that have gone through the content-checking process of other relevant authorities and have already been officially publicized and distributed, their examination process can be simplified.

It should be noted that online music products that have been imported before the promulgation of the Circular are also subject to the censorship of the MOC. Missing applications must be completed prior to December 31, 2009.

(3) Filing of domestic online music

The Circular requires that entities that operate online music business shall file its domestic online music products with the MOC within 30 days of its operation.

Filings could also be conducted through the "Online Music Filing Software" or via registered mail (see Section 2 for more details in this regard). Compared to the censorship process of imported music, the timeline of the filing process of domestic online music is shorter. It normally takes 10 working days if the application package is complete. The Circular provides that the filing process of domestic music products that have been officially published and circulated can be simplified where a serial number is provided.

(4) Self-checking responsibility of the operating entity

The Circular imposes certain self-checking responsibilities on the operating entities, requiring the operator to establish an internal self-checking system, and to set up special departments to be responsible for the scrutiny work. Music composed, performed and uploaded by internet users is not subject to the censorship of the MOC, however, operators that provide uploading services to the same are obligated to carry out scrutiny over, and ensure the legality of, the content of the music.

4. Circular on Strict Administration of Construction Land and Promoting the Use of the Approved but Unused Land(Author: Xuwu WANG, Qing GUO)

On August 11, 2009, the Ministry of Land and Resources ("**MOLR**") issued the *Circular on Strict*

Administration of Construction Land and Promoting the Use of the Approved but Unused Land (the "**Circular**"). The Circular addresses the following five major issues concerning the current status of land administration:

(1) The Circular requires accelerating the approval of urban construction land and the implementation of land expropriation. According to the Circular, the approval of conversion of agricultural land will be invalid if the expropriation is not actually conducted within two years of the approval by the provincial government.

(2) The Circular permits the appropriate adjustment of the location of the construction land, provided that the adjustment is (a) in compliance with the comprehensive land use planning and the urban planning; (b) not exceeding the scale of the total urban land and increased construction land as approved by the State Council; (c) not reducing the area of "Three Categories of Housing" and other civil use land. Such adjustment shall be approved by the provincial government and filed with the MOLR, with a copy to the local accredited national land supervisory department.

(3) The Circular strengthens the administration of construction land from the following three respects: (a) regulating the procedures of supply of the land for urban infrastructure; (b) improving the filing system of industrial land; (c) promoting the effective use of the construction land.

(4) The Circular imposes serious inspection and punishment requirements on the construction of buildings with minor property rights and golf course in violation of applicable laws and regulations.

(5) The Circular requires the establishment of a dynamic supervision system to strengthen post-approval supervisions over the construction land.

5. The Rules on Issues Regarding Trademark Transfer Applications, Issued by the Trademark Office of the State Administration for Industry and Commerce (effective on August 10, 2009) (Author: Yanlin LIU)

During the past few years, more and more illegal transfers of registered trademarks emerged in China, which led to a lot of civil litigations or even administrative litigations. To resolve the problem, the Trademark Office of the State Administration for Industry and Commerce has been improving its examination system for trademark transfer applications, and recently promulgated the *Rules on Issues Regarding Trademark Transfer Applications* (the "**Rules**"). The Rules has become effective on August 10, 2009. We hereby summarized the Rules as follows:

(1) Examination on the authenticity of trademark transfer applications

Section 25 of the *Regulations for the Implementation of the PRC Trademark Law* provides that the trademark transfer application shall be filed by the transferee. This provision created a procedural loophole for some outlaws, who forged the seal or signature of trademark owners and then applied for trademark transfers. Aimed at stopping such phenomena, the Rules add some provisions to examine the authenticity of trademark transfer applications, which include:

(a) Among the materials to be submitted for a trademark transfer application, the Rules require the applicant to provide copies of valid certificates that can prove the qualifications of the transferor and transferee, which shall bear the official seals of the transferor and transferee; if the Trademark

Office has doubts regarding the authenticity and validity of such certificates, it can require relevant evidentiary documents or certified copies of the certificates;

(b) For application documents in foreign languages, the applicant shall provide Chinese translations, which shall be confirmed by the applicant or its agent by signature or seal;

(c) After the Trademark Office accepts a transfer application, the Notice of Acceptance of Transfer Application will be delivered to domestic transferors as well at the same time (not including transferors in Hong Kong, Macao and Taiwan). (Please be noted that the Trademark Office had began such practice since 2006.)

(2) Remedies for the trademark owners

According to the Rules, if a trademark owner finds out that his/her/its trademark is applied to be transferred without his/her/its consent, the trademark owner may enjoy the following remedies in accordance with the status of the transfer application:

(a) If the transfer application is found by the trademark owner after it is submitted, the trademark owner may make a written complain to the Trademark Office, or if the Trademark Office itself has doubts concerning the authenticity of the transfer, then the Trademark Office can send a notice for supplementary materials to the applicant, requiring the applicant to explain in writing or provide certified transfer agreement or certified consent of the transferor, or other evidentiary documents;

(b) While the transfer application is pending, the dissenting trademark owner or the interested party may make a written application to the Trademark Office to suspend the examination process, and provide relevant proof of case acception from judicial authorities or other evidentiary document. Based on such an application, the Trademark Office may suspend the examination process of the trademark transfer application;

(c) If a (illegal) trademark transfer is found by the trademark owner after the transfer has been completed, the owner may bring a civil litigation before the people's court, and the Trademark Office will make a decision on the transfer based on the judgment of the litigation.

(3) Time restrictions for re-transfer applications

To prevent illegal transfers of registered trademarks or trademark applications, the Rules provides some restrictions on the timing for the re-transfers of trademarks or trademark applications:

(a) For transfer of a registered trademark, the transferee obtains the right in the trademark from the date of publication. As such it can only apply for re-transferring the trademark after that date;

(b) For transfer of a trademark application, the transferee can only apply for re-transferring the application after the transferee receives the notice of approval for the first transfer.

If you have any questions regarding the above contents, please feel free to contact us. Thank you!

6. The Provisional Measures on the Administration of Special Funds for Financial Guarantees of Small and Medium Foreign-Trade Enterprises (promulgated on August 7, 2009) (Author: Ruijie LIU)

To implement the State Council's policy of further stabilizing foreign needs, support guarantee institutions to enlarge the financial guarantee business for small and medium foreign-trade enterprises, and relieve the difficulty of such enterprises in financing, on August 7, 2009, the Ministry of Finance and

the Ministry of Commerce jointly promulgated the *Provisional Measures on the Administration of Special Funds for Financial Guarantees of Small and Medium Foreign-Trade Enterprises* (the "**Measures**"), which came into effect on the date of its issuance. The main contents of the Measures are as follows:

(1) Objects of the supports

The Measures expressly provides that the special funds can only be used for encouraging guarantee institutions to operate financial guarantee business targeted at small and medium foreign-trade enterprises, which must be those who had made actual achievements in export business in the preceding or the current year. Additionally, the Measures require the guarantee institutions who apply for the special funds to meet the following qualifications: the institution must be duly incorporated and qualify as an independent legal person; the institution must have sound accounting systems, and have drawn, managed and used various preparation funds; the institution must have good accounting, taxes and banking credits.

(2) Methods of the supports

The Measures allow the following three methods of supports:

(a) Guarantee institutions are encouraged to provide financial guarantee services to small and medium foreign-trade enterprises, for which up to 2% of the guaranteed amount will be funded, and the special funds received by the guarantee institutions will be used for directly compensating the guarantor's losses in fulfilling the guarantee's debts;

(b) Guarantee institutions are encouraged to provide low-rate guarantee services. Provided that other fee rates are not raised, rewards will be given to the small and medium foreign-trade enterprise financial guarantee business whose guarantee fee rate is lower than 50% of the then current bank loans' interest rate. The rewards will not exceed the difference between 50% of the then current bank loans' interest rate and the actual fee rate of the guarantee, and the special funds received by the guarantee institutions will be used for directly compensating the guarantor's losses in fulfilling the guarantee's debts;

(c) The local governments where credit guarantee business is less developed are supported to establish and fund guarantee institutions and operate small and medium foreign-trade enterprise financial guarantee business, and the support can be up to 30% of the government's contribution. The support used for the contribution in guarantee institutions shall not exceed 30% of the special funds allocated to the local district by the central government, and the special funds will be directly contributed to the guarantee institutions as national capital.

(3) Authorities for the approval and allocation of funds

The Measures require the Ministry of Finance and the Ministry of Commerce to allocate the special funds to provincial finance authorities, issue the funds budget quota and appropriate the funds at one time, in consideration of the foreign exports, numbers of small and medium foreign-trade enterprises and operation of guarantee business of various districts.

After the Ministry of Finance and the Ministry of Commerce issue the funds budget quota and appropriate the funds to the provinces, the provincial finance and commerce authorities are responsible to frame the funds usage plans and detailed implementing measures based on the reality of the local district, and shall file such plans and measures with the Ministry of Finance and Ministry of Commerce within 1 month after the issuance of the Measures.

Based on the territorial principle, the provincial commerce authorities shall, together with the provincial finance authorities, organize the project application and the examination and approval for the special funds, and propose funds usage plans on a quarterly schedule. The provincial finance authorities are responsible for the budget arrangement of the special funds, examination of the funds usage plans proposed by the provincial commerce authorities, and appropriation of the special funds on a quarterly schedule. The funds shall be appropriated to the guarantee institutions within 1 month after the end of each quarter. The appropriation documents shall be copied to the Ministry of Finance and the Ministry of Commerce at the same time.

(4) Penalties

The Measures expressly provide that the special funds shall only be used for specified purposes. No entities or individuals are allowed to detain, intercept, occupy or embezzle special funds. If any of the aforementioned acts are discovered and confirmed, the Ministry of Finance will retake the already arranged special funds, and impose sanctions in accordance with applicable provisions in the *Rules on the Punishments and Sanctions for Illegal Financial Acts* (State Council Order No.427).

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