Legal Update

September 2023

China: Tax Update | September 2023

In brief

In this issue of China Tax Update, we will discuss the major China tax developments from May to August 2023, including the following:

1. Modification to the issuance of tax residency certificates in Hong Kong
2. Extension of particular preferential individual income tax policies
3. Elevated IIT special additional deduction standards for nursing expenses, children's education and elderly support
4. Extension of preferential tax policies in support of capital market
5. Optimization of EIT prepayment filing for the super deduction of R&D expenses
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1. Modification to the issuance of tax residency certificates in Hong Kong

In brief

Hong Kong Internal Revenue Department (HK IRD) recently modified its approach to the issuance of Certificate of Resident Status (CoR) and revised the relevant application forms in the context of strengthened international tax cooperation and changing business environment. Under the updated regime, HK IRD will decide on the issuance of CoR solely based on the plain definition of "resident of the Hong Kong SAR" in relevant tax treaties/arrangements (DTAs), without assessing the applicant's economic substance in Hong Kong anymore. A more detailed description of key changes adopted by the HK IRD is included in the section below.

In detail

For the purposes of claiming tax benefits under applicable DTAs, Hong Kong tax resident generally needs to apply for a CoR to certify its tax residency status. Historically, in deciding whether a CoR can be issued, HK IRD would consider not only if the applicant is a "HK resident" but also if it is "entitled to tax benefits" under the applicable DTA. In practice, HK IRD only issued CoRs to residents who have sufficient economic substance in Hong Kong, even though such requirement is devoid of statutory basis in both domestic laws and applicable DTAs. The stricter scrutiny intentionally adopted by HK IRD on applicants' qualification for CoR had intermittently put HK IRD into disputes and even lawsuits with taxpayers.[1]

[1] In 2022, a company incorporated in Hong Kong brought judicial review proceedings against the Commissioner of HK IRD for declining to issue it with a CoR for the calendar year 2021 because the HK IRD deemed that the company had insufficient economic substance in Hong Kong, notwithstanding that the company was, as a matter of law, a tax resident in Hong Kong in that year by virtue of being incorporated in Hong Kong. That case was finally settled prior to the scheduled court hearings. The company finally received the CoR for 2021 and dropped the judicial review proceedings.

Perhaps motivated by the awareness of the lack of legitimate ground for its historical practice, i.e., denial of CoR issuance purely on the grounds of limited economic substance, HK IRD officially revamped the approach to the issuance of CoRs for non-individual applicants (i.e., company, partnership, trust, and any other body of persons), effective from 12 June 2023. With the modified approach, HK IRD will thereafter issue CoRs to applicants merely based on the plain definition of tax residency as stipulated in applicable DTAs. This effectively means that under most DTAs, applicants that are incorporated/established in Hong Kong should be able to easily obtain a HK CoR without being assessed on the sufficiency of economic substance they have in Hong Kong.[2]

HK IRD is legally required to issue the requested CoR to the qualified applicant within 21 working days after receipt of a properly completed application. Whereas we observed that such processing time has been significantly shortened by HK IRD after the modified approach became effective. It is not uncommon among recent applicants to receive CoRs within around one week. The market feedback evidence that HK IRD has indeed foregone the assessment of applicants' economic substance when deciding on the issuance of CoRs.

Our observation

Modification to the prior practice removes the additional and disputable barrier imposed by HK IRD itself and should be conducive to cross-border tax planning with the increase of tax certainty. Meanwhile, it is important to note that the receipt of a CoR will not guarantee the applicant's success in getting the treaty benefits under applicable DTAs, which is ultimately a decision to be made by the treaty partner jurisdiction. It will be up to the treaty partner to determine whether all relevant criteria are satisfied and whether the applicable treaty benefits should be granted.

For example, in the cases where a HK tax resident pursues the treaty benefit under the tax arrangement concluded by Mainland with Hong Kong, the applicant should be a qualified beneficial owner of the income in concern and the principal purpose of the relevant arrangement should not be to obtain tax benefits under the tax arrangement. Any adverse conclusion could result in the denial of tax treaty benefits. In that sense, Hong Kong applicants would generally still need to have sufficient economic substance in Hong Kong to withstand any potential challenges on treaty abuse raised by in-charge tax authorities of the jurisdiction from which a treaty benefit is sought.

Moreover, according to the administrative arrangement agreed in the notes exchanged between the Mainland and Hong Kong on 16 March 2016 and 15 April 2016, a CoR issued to an applicant for a particular calendar year could serve as proof of its Hong Kong residency status for that calendar year and the two succeeding calendar years. With the simplification of CoRs issuance, it remains uncertain now whether the authorities will shorten the valid period of CoRs accordingly and taxpayers should not be surprised if they finally adopted to do so.

2. Extension of particular preferential individual income tax policies

In brief

On 18 August 2023, the Ministry of Finance (MOF) and State Taxation Administration (STA) released three bulletins to extend the preferential individual income tax ("**IIT**") policies for equity incentive, annual bonus and expatriates' allowance to 31 December 2027.

Also on the same date, MOF and STA jointly issued Cai Shui [2023] No. 34 ("**Circular 34**") to extend the existing preferential IIT policy in Greater Bay Area (GBA) for another four years to the end of 2027.[3]

In detail

Those extended preferential IIT policies have all been implemented in China for a long time and were originally set to expire on 31 December 2023. The key points of them are summarized as follows.

[2] Most of DTAs concluded by Hong Kong simply define a company, partnership, trust or body of persons as a "HK resident" if it is incorporated or constituted under the laws of Hong Kong. As a rare exception, under the DTA concluded by Hong Kong with Japan, a company would qualify as a "resident of Hong Kong" if it has a primary place of management and control in Hong Kong.

[3] The Notice of MOF and STA Relating to the Extension of the Preferential IIT Policies in Greater Bay Area, Cai Shui [2023] No. 34, dated 18 August 2023 and effective until 31 December 2017.

1. Extension of preferential tax treatment for equity incentives

Under Cai Shui [2018] No. 164, PRC resident individuals receiving qualified equity incentives, which may take the form of stock options, stock appreciation rights, restricted shares or equity rewards, are eligible to separate such equity incentive income from the annual comprehensive income for the purpose of IIT calculation.[4] Following two short-term extensions over the past few years, MOF and STA Bulletin [2023] No. 25 further extends the policy until 31 December 2027.[5]

2. Extension of preferential tax treatment for annual bonuses

Similar to the above policy regarding equity incentives, Cai Shui [2018] No. 164 also provided an IIT policy to tax the annual bonuses derived by resident taxpayers separately from their comprehensive income. MOF and STA Bulletin [2023] No. 30 further extends such preferential policy to 31 December 2027.[6]

3. Extension of tax exemption policy for expatriates' subsidies and allowances

The IIT exemption policy originally provided under Cai Shui [2018] No. 164 for certain qualified subsidies and allowances derived by expatriate employees (e.g., housing subsidy, language training fee and children's education fee, etc.) is also extended to 31 December 2027.[7]

Under the effective rules, an expatriate who is a Chinese tax resident is allowed to either claim special additional deductions for IIT following the applicable standards, or to enjoy the aforementioned tax exemption for received allowances, but not both. Once decided, the choice cannot be changed within a tax year. In practice, the tax exemption incentive may be more favorable to foreign individuals in comparison with the special additional deduction, of which the standard deductible amount is relatively low.

4. Extension of preferential IIT policy in GBA

Since 2019, local governments of the nine cities in GBA have been providing tax-exempt financial subsidies to overseas high-end and urgently needed talents working in GBA, which are set to cover the portion of IIT exceeding 15% of the subsidy recipients' taxable income.[8] This policy was supposed to expire by the end of 2023, while the issuance of Circular 34 granted a generous four-year extension.

Of note, prior to the issuance of Circular 34, Guangdong province had imposed a cap to the said subsidy at RMB 5 million for each person per tax year.[9]

Our Observation

Extension and optimization of prevailing tax and fee incentives is one of the key topics for 2023 macroeconomic work as set forth by the 14th National People's Congress. As discussed in other sections in this tax newsletter, relevant governmental departments have announced the renewal and upgrading of a wide range of existing policies. Though it is a common practice of STA to grant extensions to some tax incentive policies from time to time, the recent move to one-off extend such massive policies is still beyond market expectation. Specifically, it reflects the Chinese government's continuous efforts to establish a stable policy environment and to boost market participants' confidence in face of the slowing economy momentum.

Meanwhile, it is important to note that Chinese tax authorities have also been strengthening tax compliance supervision to extend tax base and increase tax collection, so as to ease fiscal pressures on local governments. Therefore taxpayers should

4 The Notice of MOF and STA on the Transition of Relevant Preferential Tax Policies after the Amendment of the IIT Law, Cai Shui [2018] No. 164, dated 27 December 2018 and effective as of 1 January 2019.

5 The Notice of MOF and STA Relating to the Extension of the IIT Policies on Equity Incentives by Listed Companies, Bulletin [2023] No. 25, dated 18 August 2023 and effective from the same date.

6 The Notice of MOF and STA Relating to the Extension of the IIT Policies on Annual Bonus, Bulletin [2023] No. 30, dated 18 August 2023 and effective from the same date.

7 The Notice of MOF and STA Relating to the Extension of the IIT Policies on Expatriates' Subsidies and Allowances, Bulletin [2023] No. 29, dated 18 August 2023 and effective from the same date.

8 The Notice of MOF and STA on the Preferential IIT Policy in GBA, Cai Shui [2019] No. 31, dated 14 March 2019 and effective from 1 January 2019 to 31 December 2023.

9 The Notice of Four Departments of Guangdong Province on Further Implementing Preferential IIT Policy in GBA, Yue Cai Shui [2023] No. 21, dated 2 June 2023 and effective from the same date.

be mindful of applicable administrative requirements relating to the above-mentioned tax policies. For example, enterprises granting equity incentives to employees should timely fulfill the reporting obligations under Shui Zong Zheng Ke Fa [2021] No. 69 upon deciding to implement equity incentives, in addition to the granting and/or vesting filings in accordance with Cai Shui [2005] No. 35.

With respect to the extended subsidy policy in GBA, though the RMB 5 million upper limit imposed earlier this year may undermine the potential tax benefits that could have been obtained by some qualified high-income individuals, the extension of such policy is still welcome news for foreign individuals and the ones from Hong Kong, Macau and Taiwan regions working in GBA and provides them with a clear expectation for the government's future policy support in GBA. Specific qualification criteria and application procedure for the subsidy are to be provided by in-charge local governments. Any interested applicants are therefore advised to keep close attention to relevant local measures to enjoy the financial subsidy.

3. Elevated IIT special additional deduction standards for nursing expenses, children's education and elderly support

In brief

On 28 August 2023, the State Council issued Guo Fa [2023] No. 13 ("**Circular 13**") to increase the quotas of special additional deduction for taking care of children under age three, children's education expenses and elderly support for IIT purposes by RMB 1,000 per month individually.[10]

In detail

According to Circular 13:

- The special additional deduction standard for nursing expenses for children under age three is raised from RMB 1,000 per child per month to RMB 2,000 per child per month. Parents (guardians) can equally divide the RMB 2,000 standard deduction for each child on their respective income tax return or have one of them taking the full deduction.[11] Taxpayers can take advantage of such deduction from the month the baby is born until the month before the baby becomes three years old.
- The special additional deduction standard for children's education is raised from RMB 1,000 per child per month to RMB 2,000 per child per month. Such deduction covers from pre-school education all the way to doctoral education, including technical education.[12]
- The special additional deduction standard for supporting the elderly is raised from RMB 2,000 to RMB 3,000 per month. Single-child of the dependent(s) could fully deduct RMB 3,000 from his/her taxable income per month, while non-single children should share the fixed-amount deduction quota with their siblings and the amount shared by each person cannot exceed RMB 1,500 per month.[13] Eligible dependents should be the taxpayer's parents (or grandparents) aged 60 or above.[14]

The new deduction standards have retrospective effect from 1 January 2023, meaning that qualified taxpayers can also claim the tax benefits for the already passed nine-months period when conducting annual IIT settlement for the year 2023.

Our observation

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[10] The Circular of State Council on Increasing IIT Additional Special Deduction Quota, Guo Fa [2023] No. 13, dated 28 August 2023 and retroactively effective from 1 January 2023.

[11] The Bulletin of STA on Implementing the Increased IIT Additional Special Deduction Quota, Bulletin [2023] No. 14, dated 30 August 2023 and retroactively effective from 1 January 2023 ("**STA Bulletin [2023] No. 14**").

[12] The Bulletin of STA on Revising and Issuing the Operational Measures for Special Additional Deductions for Individual Income Tax, STA Bulletin [2022] No. 7, dated 25 March 2022 and effective from 1 January 2022.

[13] STA Bulletin [2023] No. 14.

[14] The Circular of State Council on Issuing the Interim Measures for IIT Special Additional Deductions, Guo Fa [2018] No. 41, dated 13 December 2018 and effective from 1 January 2019.

In light of the decline in birth rates, China's government has made continuous efforts to encourage larger families and address the urgent population aging issue.[15] From a tax compliance perspective, human resources department of MNCs should be mindful of the applicable administrative requirements when withholding IIT for their employees.

4. Extension of preferential tax policies in support of capital market

In brief

In August, MOF and STA issued a series of circulars to extend multiple existing preferential tax policies in support of the development of capital market, which could benefit both individual and institutional investors in domestic market.

In detail

Highlights of these newly released or extended tax policies are set forth as follows.

1. Half-reduction of stamp duty on trading securities

Effective from 28 August 2023, the stamp duty on trading securities is reduced by 50%, i.e., the effective tax rate is reduced from 1‰ to 0.5‰.[16]

2. Extension of IIT exemption policy for the Shanghai-Hong Kong/Shenzhen-Hong Kong stock connect mechanisms and the mutual recognition of funds between the Mainland and Hong Kong

The IIT exemption policy for the Shanghai-Hong Kong/Shenzhen-Hong Kong stock connect mechanisms and the mutual recognition of funds between the Mainland and Hong Kong, which was originally set to expire on 31 December 2023, is now extended to 31 December 2027.[17] Under the effective policy, IIT shall remain temporarily exempted for the capital gains derived by Mainland individual investors from trading the stocks listed on the Hong Kong Stock Exchange through the Shanghai-Hong Kong Stock Connect or Shenzhen-Hong Kong Stock Connect, as well as from trading Hong Kong fund shares under the mutual recognition of funds between the Mainland and Hong Kong.

3. Extension of the tax policies on domestic offering of CDR

In 2019, MOF, STA and CSRC issued the tax policies applicable to domestic offerings of Chinese Depository Receipt (CDR) by innovative enterprises during the pilot program, which covered tax treatments in terms of income tax, value-added tax (VAT) and stamp duty.[18] In August 2023, the same in-charge authorities further extended the same policies to the end of 2025.[19]

4. Extension of IIT policies for individual partners of venture capital enterprises

Cai Shui [2019] No. 8 provided special rules for individual partners in the venture capital enterprise taking the form of a limited liability partnership,[20] under which the partnership could choose between one of two accounting methods for their individual partners to determine their IIT liabilities: (i) accounting based on a single investment fund (the individual partners will be subject

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[15] For example, in 2022, the State Council added nursing expense for infants and toddlers to the existing list of additional special deduction items, and established the private pension mechanism. See the tax newsletter issued in April 2022 for further details, available at https://insightplus.bakermckenzie.com/bm/tax/china-tax-update-2022.

[16] The Notice of MOF and STA on Half-reduction of the Stamp Duty on Trading Securities, Bulletin [2023] No. 39, dated 27 August 2023 and effective from 28 August 2023.

[17] The Notice of MOF, STA and China Securities Regulatory Commission (CSRC) on Extension of IIT Policies Relating to Shanghai-Hong Kong / Shenzhen-Hong Kong stock connect and the mutual recognition of funds between the Mainland and Hong Kong, Bulletin [2023] No. 23, dated 21 August 2023 and effective until 31 December 2027.

[18] The Notice of MOF, STA and CSRC on Relevant Tax Policies Applicable during the Pilot Program of Domestic Offering of Depository Receipts by Innovative Enterprises, Bulletin [2019] No. 52, dated 3 April 2019.

[19] The Notice of MOF, STA and CSRC on Extension of the Tax Policies Applicable during the Pilot Program of Domestic Offering of Depository Receipts by Innovative Enterprises, Bulletin [2023] No. 22, dated 21 August 2023.

[20] The Notice on the IIT Policies for Individual Partners of Venture Capital Enterprises, Cai Shui [2019] No. 8, dated 10 January 2019 and effective from 1 January 2019 to 31 December 2023. See the China Tax Update in 2022 February for further details on the policy, available at https://insightplus.bakermckenzie.com/bm/tax/china-tax-update_1.

to IIT at 20% rate while the losses cannot be carried forward) or (ii) accounting based on the partnership's annual income (the individual partners will be subject to the progressive IIT rate ranging from 5% to 35% while the losses can be carried forward). Recently, the same policy is further extended until the end of 2027.[21]

Our observation

The above-mentioned tax policy package is an integral part of the central government's recent efforts to support healthy development of capital market and boost investors' confidence. From a tax compliance perspective, eligible investors and their withholding agents (if any) should be mindful of the applicable criteria and ensure their fulfilling compliance obligations.

5. Optimization of EIT prepayment filing for the super deduction of R&D expenses

In brief

Following the up-scale of super deduction ratio for R&D expenses of all eligible industry enterprises from 75% to 100%,[22] MOF and STA jointly issued Bulletin [2023] No. 11 ("**Bulletin 11**"), which optimizes the enterprise income tax (EIT) prepayment filing by allowing enterprises to claim the benefit earlier in the July filing period.[23]

In detail

Prior to the issuance of Bulletin 11, enterprise taxpayers could take the R&D super deduction during October filing period or in annual settlement by self-evaluating if they are qualified for the preferential policy. To further enable eligible enterprises to leverage the EIT benefits timely, Bulletin 11 optimizes the tax filing requirements and provides three options that taxpayers could choose to:

1) Claim super deduction for R&D expenses incurred in the first half of the year in the monthly/quarterly EIT prepayment filing in July.
2) Claim super deduction for R&D expenses incurred in the first three quarters of the year in the monthly/quarterly EIT prepayment filing in October.
3) Claim super deduction for R&D expenses incurred in the whole year when conducting the EIT annual settlement.

Our observation

Bulletin 11 provides taxpayers with greater autonomy in determining when to claim the R&D expenses super deduction based on their own business operation status. Earlier filing period could be good news for enterprises that have incurred significant R&D expenses in the first half of the year. Meanwhile, other enterprises could still choose to enjoy the policy later if they have sales revenue fluctuating over the year, or would need some time to accurately aggregate and account for the R&D expenses.

6. Amendment to the Administrative Measures for Invoices

In brief

On 20 July 2023, the State Council issued amendments to the Administrative Measures for Invoices, which revised certain outdated provisions to accommodate the promotion of digital invoices and other recent trends of invoice administration.

In detail

The pilot program of fully digitalized electronic invoices kicked off on 1 December 2021 for the selected taxpayers in Shanghai, Guangdong and Inner Mongolia regions. Since then, such pilot program has been gradually expanded, with a broader scope of

[21] The Notice on the Extension of Income Policies for Individual Partners in Venture Capital Enterprises, Bulletin [2023] No. 24, dated 21 August 2023.

[22] See the China Tax Update issued in May 2023, available at https://insightplus.bakermckenzie.com/bm/tax/china-tax-update-may-2023.

[23] The Notice of MOF and STA on Matters Regrading Optimizing Prepayment Filing for R&D Super Deduction Policy, Bulletin [2023] No. 11, dated 21 June 2023 and retrospectively effective from 1 January 2023.

taxpayers being able to issue and accept fully digitalized electronic invoices, which provided much convenience to taxpayers. The administration of fully digitalized electronic invoices differs from the prevailing paper-based invoice regime in that taxpayers no longer need to use a tax control device, apply for invoice category identification and collect blank invoices before starting to issue invoices. Being relieved from those burdens, taxpayers are able to issue fully digitalized electronic invoices from their first day upon business commencement. Besides, the fully digitalized electronic invoice regime sets a total invoicing amount quota for issuers only, and no longer restricts the invoice's face value quota as under the traditional paper-based invoice regime.

It is expected that the scope of pilot program will be further expanded in the future. Under such background, the Administrative Measures for Invoices is amended to collate the rules on digital invoices scattered in various policies and to adapt to the increasingly comprehensive application of digital invoices.

Specifically, the amended Administrative Measures for Invoices confirm that electronic invoices and paper-based invoices have the same legal effect. It was also formalized that paper-based invoices can be only issued within the province where the issuer is located, whereas the same restriction does not apply to electronic invoices.

Other amendments were made as well to reflect the prevailing practical measures in connection with the administration of invoices in China. For example, the legislators abolished the outdated requirements regarding security deposits for applying for invoices, the invoice purchase book and so on, which were already not applicable in practice prior to this amendment of the Administrative Measures for Invoices.

Our observation

The amendment to Administrative Measures for Invoices this year does not make significant changes to the current invoice administration regime except some minor revisions to reflect established invoice management practices. Whereas the focus on digital invoice demonstrates that Chinese government will continue to expand the application of digital invoices and push forward the tax collection and administration reform.

It is also important to note that PRC tax authority has been strengthening the invoice compliance administration. Detection and punishment on falsified invoices have always been the core tasks of local tax authorities. The widespread promotion of fully digitalized invoices will provide tax authorities with better insights into taxpayers' invoice chain and overall business operation, thus enabling tax authorities to discover tax risks in a more timely manner with higher accuracy.

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