



Further Cooperation in Tax and Economic Policies for Mainland China and Hong Kong Special Administrative Region

Recently, there are new cooperation in tax and economic policies for the Mainland China and Hong Kong Special Administrative Region ("HKSAR"). This issue of News Flash will provide an outline on these policies.

CEPA - Supplement V

The Chinese Central government and HKSAR government signed a new supplement to the Closer Economic Partnership Arrangement ("CEPA") on 29 July 2008. This is the fifth supplement ("Supplement V") since CEPA was concluded in 2003. It will become effective on 1 January 2009. Supplement V will introduce 29 further liberalisation measures covering 17 service sectors, including two new ones on mining-related services and surveying services on certain metals.

Supplement V also sets out the commitments of the two authorities in deepening the trade and investment facilitation which has been the aim of CEPA since 2003. Besides formulating new policies to cope with the e-commerce development in Hong Kong and Guangdong Province, the two governments will also set up a workforce to enhance communication and strengthen the protection on intellectual property developed by the two sides.

Among all the measures set out in Supplement V, more than half are pilot measures which focus on strengthening the cooperation between Guangdong Province and HKSAR in a bid to encourage Hong Kong companies to invest in Guangdong Province and enhance the economic growth and sustainability of Southern China.

One Step further from Supplement IV

As compared with Supplement IV, there are some particular measures which enable Hong Kong Service Suppliers ("HKSS") to enjoy even greater flexibility in carrying out business in China. The table below demonstrates the advancement which Supplement V has brought about:

	Supplement V	Supplement IV
Distribution services	The same HKSS which opens 30 retail outlets accumulatively in China can engage in distribution of commodities including pharmaceutical products, pesticides, mulching films, chemical fertilizers, vegetable oil, edible sugar and cotton of different brands through a Wholly Foreign-Owned Enterprise ("WFOE").	The same HKSS which opens 50 retail outlets accumulatively in China can be the controlling shareholder having equity up to 65% of a foreign investment enterprise for the distribution of these commodities.

	Supplement V	Supplement IV
Convention and exhibition services	WFOE or Sino-foreign Joint Venture set up by HKSS in Beijing, Tianjin, Chongqing and Zhejiang can organize overseas exhibitions on a pilot basis upon getting approval from China Council for the Promotion of International Trade.	Only Guangdong Province and Shanghai are selected as pilot places for organization of overseas exhibitions.
Air Transportation Services	The economic guarantee required for setting up air transport sales agencies in China can now be provided by any Mainland-incorporated banks, which may include foreign invested banks.	Such guarantee can only be provided by China-capital banks.

Highlights on Other Liberalisation Measures

As far as the banking sector is concerned, the banking institutions in China invested by HKSAR banks will be allowed to locate their data centre in HKSAR upon fulfilling certain requirements.

Similar to the supplements promulgated in previous years, the relaxation for market entry requirements in a number of service sectors is the key. Besides lowering the entry thresholds and allowing wholly foreign-owned investment in the service sectors which were previously restrictive, the latest measures also focus on the delegation of approval authority from State Central level to Guangdong Province level. The following is a few highlights to summarize these relevant measures:

- The delegation of approval authority to Guangdong Province is applicable to a number of sectors including outpatient clinical services, environmental pollution control services, transportation services and tourism.
- WFOEs are allowed to be established in Guangdong Province for the operation of outpatient clinics, welfare agencies for the disabled and the rendering of shipping agency services to vessel operators for routes between Guangdong Province and Hong Kong/ Macao.
- National treatment in terms of capital or investment requirements are applicable to outpatient clinics, packaging printing enterprises, printing job referral agencies and job intermediaries set up in Guangdong Province.
- There is no longer any restriction on the proportion of the total capital contributed by Chinese partners to the registered capital in construction and engineering design services joint ventures.

Supplement V has also put in place a number of measures to facilitate Hong Kong professionals such as accountants, medical practitioners, architectural engineers and tourist guides, etc. to practise in China.

Interpretation of the 2nd Protocol to the China/Hong Kong DTA

The Second Protocol to the China/Hong Kong Double Tax Arrangement ("2nd Protocol to DTA") was entered into on 30 January 2008 between the China Mainland government and HKSAR government and has taken effect since 11 June 2008. As advised in our earlier China/ HK Tax / Business News Flash issued in February 2008, the 2nd Protocol mainly addresses the change of the old "6 months" rule to the new "183 days" rule in determining if a service permanent establishment ("PE") has been established, the interpretation of "Immovable Property Holding Company", and 25% shareholding threshold for capital gains exemption purposes.

The China State Administration of Taxation ("SAT") issued a tax circular Guo Shui Han [2008] No.685 ("Circular 685") on 19 July 2008 and the Hong Kong Inland Revenue Department ("IRD") issued a revised

Departmental Interpretation & Practice Notes ("DIPN") No.44 in early August 2008 in order to provide further clarification for the transitional treatments for the determination of service PE and guidance for the implementation of the other articles in the 2nd Protocol.

Circular 685 and DIPN No. 44 (revised) now clarify the question of which rule (i.e. the "6 months" rule or the "183 days" rule) should be applied if services rendered by a resident company of One Side (say HKSAR) on a project in the Other Side (say the Mainland) commence before the effective date of the Protocol (i.e. 11 June 2008) and end after the effective date. The two Sides now agree that one has to look at the commencement date of the service project in the Mainland to decide which rule should be used. That is to say, for the service projects which have already commenced in the Mainland before 11 June 2008, the old "6 months" rule should continue to apply to the whole project period to determine if a service PE is established; whereas for projects which have not commenced in the Mainland before 11 June 2008, the new "183 days" rule will apply. DIPN No.44 (Revised) further clarifies that in counting the number of days spent by an enterprise in providing services, both Sides will take the "day of presence" approach i.e. all days of presence, including both the day of arrival and the day of departure; and whether it is a working day is not relevant.

Under the DTA and the 2nd Protocol, capital gains derived by a HKSAR investor from the alienation of shares in a Mainland company whose assets, within the three years prior to the alienation, are comprised, directly or indirectly, mainly (defined in the 1st Protocol to the DTA to mean "not less than 50%") of immovable properties situated in the Mainland would not be exempt from China corporate income tax. Now Circular 685 and DIPN No. 44 (Revised) clarify that, in determining whether the 50% threshold is exceeded, one has to look at the "year-end book value" of the assets. DIPN No.44 further interprets "year-end book value" as the net book value (i.e. historical cost reduced by the accumulated accounting depreciation and adjusted by other accounting adjustments such as revaluation) shown in the accounts that are prepared based on the prevailing accounting standards.

PwC Observation

With the signing of Supplement V, over 200 liberalization measures in 40 service sectors will be covered by CEPA. Together with the implementation of Double Taxation Arrangement concluded between Hong Kong and Mainland China, Hong Kong should become even more attractive to foreign enterprises as a springboard to enter the China market, if the prescribed conditions are fulfilled.

It is important to note in this Supplement V that Guangdong Province is designated as a pilot province in a number of new measures. Apparently the Chinese Central government would like to strengthen the economic cooperation and connection between HKSAR and Guangdong Province in order to create a win-win situation for both locations and the Southern China region as a whole.

Investors should be aware that many of the service sectors covered in CEPA are subject to the approval of relevant authorities governing the respective industries and that the approval authorities for many industries have been delegated to Guangdong Province with the implementation of Supplement V. It could be possible that the approval guidelines or implementation details for the new measures have not been well defined at the initial stage. With this in mind, investors are encouraged to conduct research and communicate with relevant authorities on the application procedures and relevant licensing requirements before implementing their holding structures in China.

In the context of this article, China refers to the People's Republic of China but excludes Hong Kong Special Administrative Region, Macao Special Administrative Region and Taiwan Region.

The information contained in this publication is for general guidance on matters of interest only and is not meant to be comprehensive. The application and impact of laws can vary widely based on the specific facts involved. If you are interested in learning more about the new arrangement and its impacts on your company, please contact your PricewaterhouseCoopers client service team or any of the following tax partners at PricewaterhouseCoopers.

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