

News Flash

China Tax and Business Advisory

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Our M&A Processes and Solutions ("MAPS") team is a leading service provider for M&A tax services in China market. Nationally our team comprises more than 100 full-time tax professionals in Beijing, Shanghai, Guangzhou, Shenzhen and Hong Kong. Throughout the deal process, MAPS team specialists could assist in performing buyer and vendor tax due diligence reviews and advising on tax efficient acquisition models. We also advise our clients on tax efficient investment holding structures and operation models. Whilst the Chinese tax authorities increasingly question the tax residency and qualification of foreign investors in claiming tax treaty benefits, our MAPS team helps our clients clarify with the Chinese tax authorities for their eligibility and perform the relevant application procedures.

Special Tax Treatments for mergers and spin-off transactions

Welcome again to our News Flash series covering the newly promulgated tax rules for corporate tax restructuring ("Restructuring Tax Rules"). In the previous News Flash Issues 10, 11 and 15, we reported the key features and observations on the Restructuring Tax Rules and also discussed the Special Tax Treatments for equity and asset acquisitions.

In this issue, we will focus on the Special Tax Treatments for merger and spin-off transactions. In particular, we will discuss the salient points on the treatments of tax loss and tax incentives of the pre-merger enterprises and pre-spin-off enterprises upon merger and spin-off respectively.

The discussions below are based on our interpretation of the relevant provisions in the Restructuring Tax Rules and preliminary explanation from the Chinese authorities. It is imperative to note that the Restructuring Tax Rules are extremely complicated. It is possible that the Chinese authorities may come up with further official clarifications or even make changes to some articles from time to time which may be different from our interpretation and their preliminary explanation.

Mergers qualifying for Special Tax Treatments

Besides fulfilling the five prescribed conditions set out under Caishui [2009] 59 ("Circular 59"),^① the following conditions must also be met in order to elect for the Special Tax Treatments for mergers:

- Where equity payment is involved, the amount of equity payment received by the shareholders in the course of the merger should not be less than 85% of the total consideration of the transaction;
- Where the enterprises being merged and the merged enterprise are under the same control, and consideration is not required to be paid.

When Special Tax Treatments are allowed for mergers, the merged enterprise would determine its assets and liabilities based on the original tax bases of the enterprises being merged. On the other hand, the shareholders of the merged entity would determine their respective tax bases of the equity of the merged enterprise using the original tax bases of the equity of the respective enterprises being merged. That means that the merged enterprise is not required to recognise any gain or loss when merging the assets and liabilities; whereas the shareholders are not required to recognise any gain or loss on their original equity investments. Please note that the Special Tax Treatments is only available to the equity payment consideration received by the shareholders.

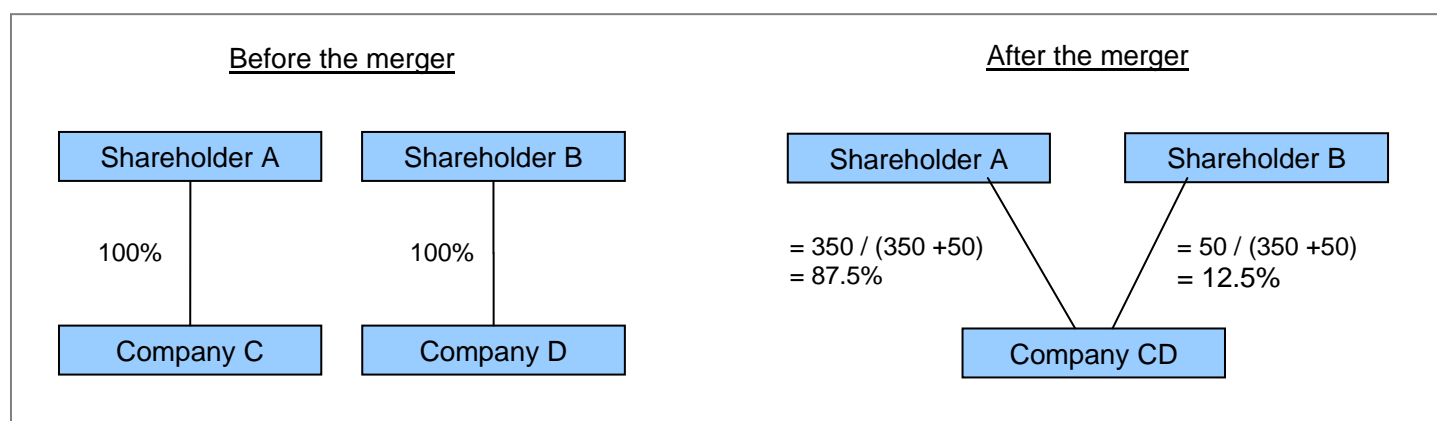
^① Please refer to Issue 11 of our News Flash for details of the prescribed conditions.

The shareholders are still required to recognise any gain or loss on their original equity investments in relation to the non-equity payment consideration.

Conversely, if a merger does not fulfil the above conditions, or if Special Tax Treatments is not elected, General Tax Treatments will apply and the merged enterprise should determine the tax bases of the assets and liabilities received from the enterprises being merged based on their fair value. If the fair value of the merged assets are higher than the original costs, then the merged enterprise can use the stepped-up value of the assets for tax depreciation / amortization purpose.

On the other hand, the enterprise(s) being merged and its shareholder(s) would have to treat the transaction as a liquidation of the enterprise(s) being merged and any gain recognised on the merger would be computed as liquidation income. We use the following numerical example to illustrate the General and Special Tax Treatments on a merger transaction.

Company C and Company D will merge to Company CD. The book value and fair value of Company C's net assets are Rmb100M and Rmb350M respectively. The book value and fair value of Company D's net assets are Rmb14M and Rmb50M respectively. Shareholder A's equity in Company C is Rmb100M and Shareholder B's equity in Company D is Rmb14M. After the merger, Company CD will issue new equity to Shareholder A and Shareholder B based on the fair value of the combined equity, which is at 87.5% and 12.5% respectively. The merger transaction is illustrated as follows:



The amount of equity payment received by both Shareholder A and Shareholder B are 100% , thereby meeting the equity payment criteria, i.e. equity payment threshold should not be less than 85% of the total consideration of the transaction. To the extent that the other prescribed conditions for Special Tax Treatments are also met, this transaction would qualify for Special Tax Treatments and Company A and Company B may elect for Special Tax Treatments for merger under the Restructuring Tax Rules.

We set out in the following tables (1) the tax bases of net assets adopted by Company CD under both Special and General Tax Treatments, (2) the tax bases of the equity adopted by Shareholders A & B under both Special and General Tax Treatments; and (3) the taxable gain recognised as liquidation income in Company C and Company D under General Tax Treatments.

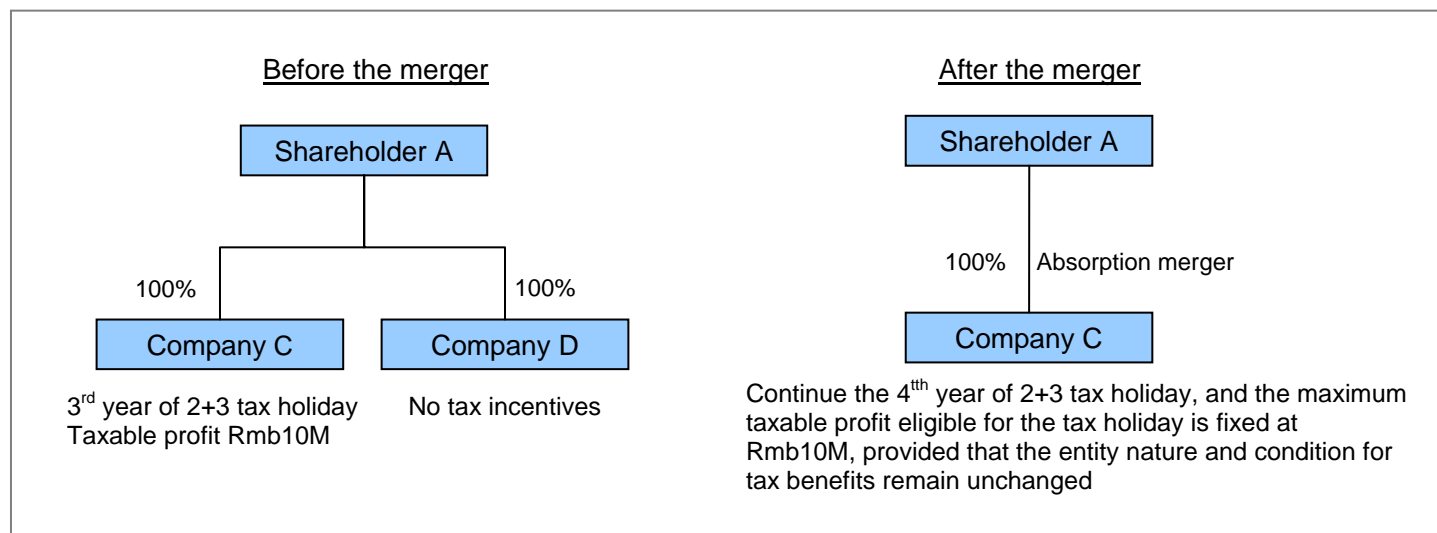
In Rmb millions	Special Tax Treatments	General Tax Treatments
(1) Tax bases of net assets adopted by Company CD	= 100 + 14 = 114	= 350 + 50 = 400
(2) Tax bases of equity investment in Company CD held by Shareholders A & B respectively	A = 100 B = 14	A = 350 B = 50
(3) Liquidation income of Companies C & D (not considering the tax implications to Shareholders A&B)	Not Applicable	C = (350-100) = 250 D = (50-14) = 36

In the above illustration, the Special Tax Treatments would allow Shareholders A and B to inherit the original tax bases of the equity they originally held in Company C and Company D (i.e. Rmb100 and Rmb14M respectively) and the merged enterprise, i.e. Company CD, to inherit the original tax bases of the assets and liabilities (i.e. Rmb114M) held under the pre-merger enterprises, i.e. Company C and Company D. On the other hand, the General Tax Treatments would allow the merged enterprise, i.e. Company CD, to step up the assets (i.e. Rmb400M) for tax depreciation / amortization purpose, but the pre-merger enterprises, Company C and Company D, would have to recognise the taxable gain as liquidation income (i.e. Rmb250M and Rmb36M respectively) and Shareholders A and B would be taxable on the liquidation distribution from Company C and Company D respectively in accordance with the Liquidation Rules.

Brought forward of tax loss and tax incentives on mergers

Under the Restructuring Tax Rules, the utilization of tax loss of the pre-merger enterprise(s) by the merged enterprise under the General Tax Treatments is specifically disallowed. Thus, enterprises undergoing a merger without satisfying the Special Tax Treatment's conditions would lose all the un-utilized tax loss before the merger. If the merger satisfies the Special Tax Treatments, the pre-merger un-utilized tax loss is allowed to carry over to the merged enterprise. However, to avoid abusive use of tax loss through merger, Circular 59 introduces a "a ring-fencing rule" to limit the use of the tax loss on mergers, i.e. to the multiple of the fair value of net assets of the enterprises being merged and the interest rate of the State bonds with the longest term issued by the State as at the end of the year during which the merger takes place.

In an absorption merger, the surviving enterprise can continue to enjoy the un-utilized preferential tax treatments brought forward prior to the merger provided that its entity nature and conditions for preferential treatments have not changed. The amount of tax benefits shall be based on the taxable income in the year prior to the merger. It will be zero if the enterprise was incurring losses. This can be depicted in the diagram below.



The pre-merger Company C in the above diagram was entitled to its 3rd year of the 2+3 tax holiday. After the absorption merger, the surviving Company C can continue to enjoy its remaining tax holiday benefits. However, the maximum amount of tax benefits the merged enterprise may enjoy would be limited to the taxable profit of pre-merger Company C in the year preceding the merger, i.e. Rmb10M in this illustration. If the pre-merger Company C was incurring a loss in the year prior to the merger, then the surviving Company C could not enjoy any tax holiday benefits. The taxable profit of pre-merger Company D is not relevant in determining the maximum taxable profit eligible for the tax holiday because it is not the surviving enterprise in the merger. In other words, if this is a newly-set up merger, i.e. none of the pre-merger enterprises survive, then there will be no carry-forward of un-utilized preferential tax treatments.

Spin-off qualifying for Special Tax Treatments

On top of the five prescribed conditions set out under Circular 59,^② all the following conditions must also be fulfilled in order to qualify for Special Tax Treatments in spin-off transactions:

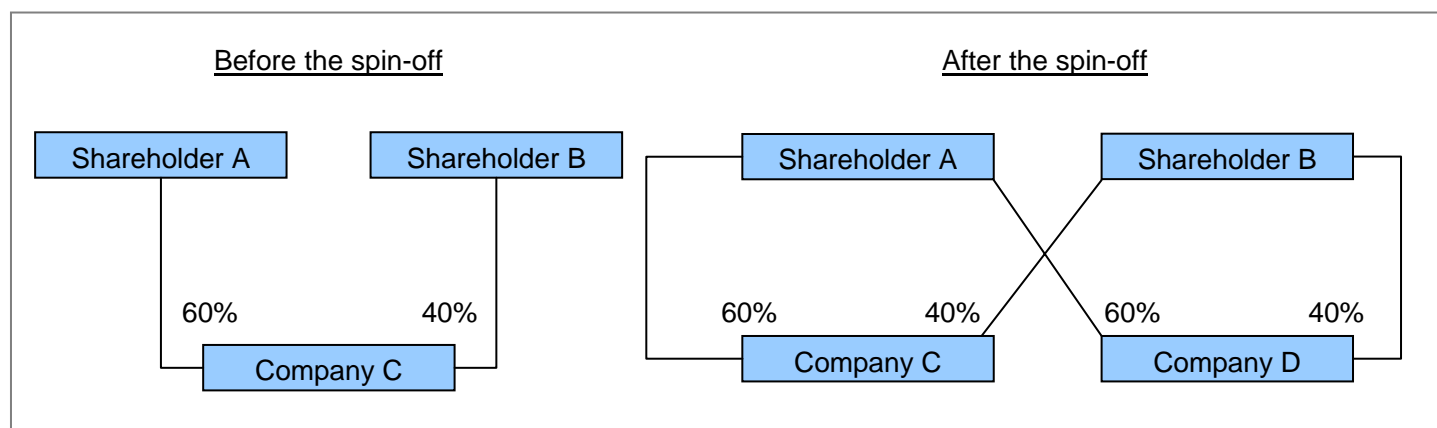
1. **Unchanged shareholding ratio:** The ratio of shareholding of the spin-off enterprises has to be the same as the original ratio of shareholding in the enterprise being spun-off.
2. **Equity payment:** Where applicable, the equity payment received by the shareholders of the enterprise being spun-off in the course of the spin-off is not less than 85% of the total consideration of the transaction.
3. **Unchanged business operation:** The spin-off enterprises and the enterprise being spun-off do not alter the original actual business operation.

Under the Special Tax Treatments, the spin-off enterprise should determine the tax bases of its assets and liabilities using their original tax bases in the enterprise being spun-off. In other words, the enterprise being spun-off is not required to recognise any gain or loss on the spun-off assets and liabilities. The income tax matters related to spun-off assets shall be inherited by the spin-off enterprises.

If no Special Tax Treatments are allowed or elected, the spin-off enterprises are required to ascertain the tax bases of the assets received based on the fair value while the enterprise being spun-off would recognise the gain or loss of the spun-off assets based on the fair value. In case the enterprise being spun-off continues to exist, any consideration received by its shareholders would be treated as a distribution received from the enterprise being spun-off. If the enterprise being spun-off no longer exists, the transaction would be treated as liquidation for CIT purposes. Let us use an illustration to explain the Special and General Tax Treatments on spin-off transactions.

Illustration of Special Tax Treatments

The book value and fair value of Company C's net assets prior to the spin-off are Rmb100M and Rmb300M respectively. Shareholder A's equity in Company C is Rmb 60M and Shareholder B's equity in Company C is Rmb 40M. Company C would spin off a group of assets with book value and fair value of Rmb85M and Rmb270M respectively to Company D. The spin-off transaction is illustrated as follows:



The above diagram shows a spin-off transaction that qualifies for Special Tax Treatments because (1) the shareholding ratios in Company C and Company D held by Shareholder A and Shareholder B remain at 60% and 40% respectively, which are the same as that prior to the spin-off; (2) No non-equity payment is received by Shareholder A nor Shareholder B; (3) we assume the business operations in Company C and Company D after the spin-off are the same as the original business operations of Company C. Accordingly, the tax bases recognised by each party involved in the spin-off transaction are as follows:

^② Please refer to Issue 11 of our News Flash for details of the prescribed conditions.

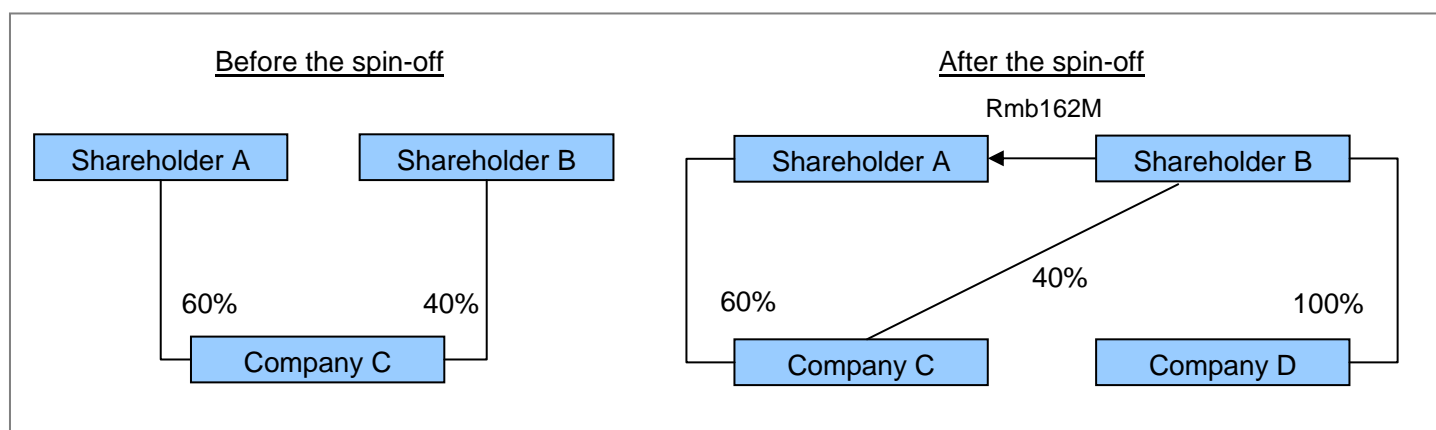
<u>In Rmb millions</u>	<u>Special Tax Treatments</u>
(1) Tax bases of assets remains in Company C after the spin-off	= 15
(2) Tax bases of assets inherited by Company D	= 85
(3) Tax bases of equity investment in Company C & Company D held by Shareholders A & B in total	A = 60 B = 40

Shareholder A and Shareholder B may determine the tax bases of the new shares in Company D as zero, or to reduce the tax bases of equity held in Company C according to the ratio of the spun-off net assets. In either situation, the tax bases of equity held in Company C and Company D by Shareholders A and B would remain to be Rmb60M and Rmb40M in total respectively.

Illustration of General Tax Treatments

By using the same illustration, Company C would spin off a group of assets to Company D with book value and fair value amounting to Rmb85M and Rmb270M respectively. However, after the spin-off, the shareholding in Company C remains unchanged but Shareholder B owns 100% of D, the spin-off enterprise. Shareholder B is required to pay Rmb162M to Shareholder A as a consideration for the spin-off.

Given that the shareholding ratio of Company D, the spin-off enterprise, is no longer the same as that of Company C, the enterprise being spun-off and Shareholder A received cash (non-equity payment) of Rmb162M representing 100% of the total consideration of the transaction, both the requirements for unchanged shareholding ratio and the 85% equity payment threshold are not met. Accordingly, General Tax Treatments would apply.



Accordingly, the tax bases recognised by each party involved in the spin-off transaction are as follows:

<u>In Rmb millions</u>	<u>General Tax Treatments</u>
(1) Tax bases of assets remains in Company C after the spin-off	= (100-85) = 15
(2) Tax bases of assets adopted by Company D	= 270
(3) Tax bases of equity investment in Company C held by Shareholders A & B	A = 60 B = 40

(4) Gain recognised by Company C in the spin-off transaction = (270-85) = 185

(5) Shareholder A treats the consideration from Shareholder B as distribution received from Company C = (270 x 60%) = 162

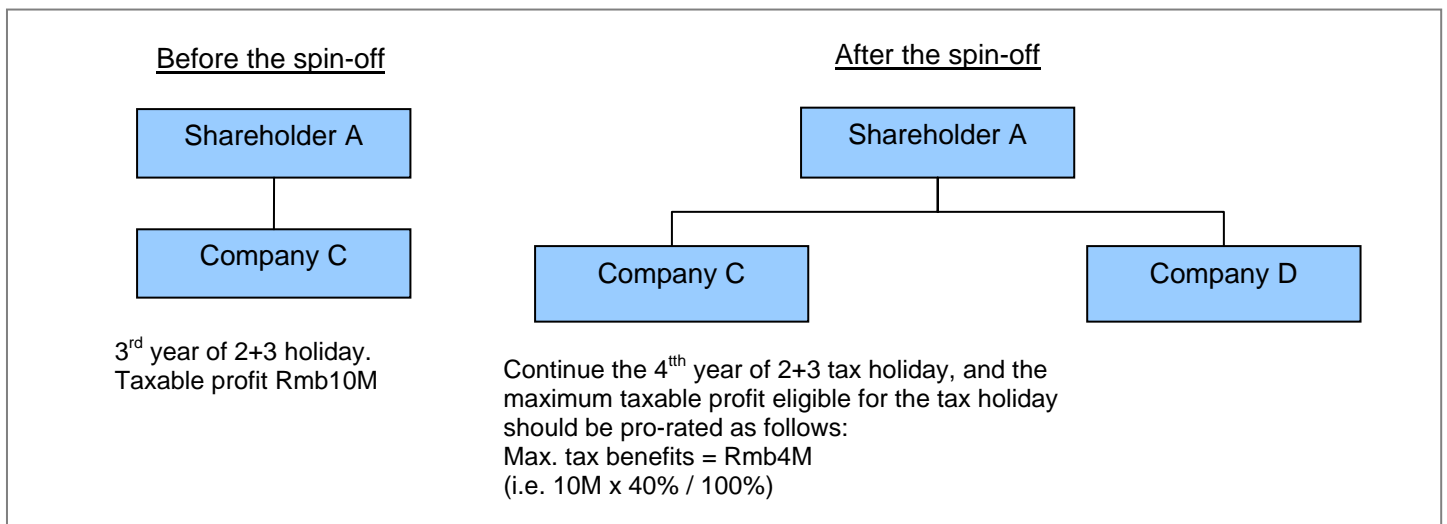
(6) Tax base of equity investment in Company D held by Shareholder B = 162

One condition for Special Tax Treatments requires the enterprise being spun-off not to alter its original business operation. A lot of the spin-off transactions involve elimination of a business line or to spin off a business division. If the tax authority perceives that as altering the original business operation, many spin-off transactions would not be eligible for Special Tax Treatments. It is worth attending to the views of the tax authorities in practice.

Brought forward of tax loss and tax incentives on spin-offs

The Restructuring Tax Rules have specifically disallowed tax losses of any enterprises involved in the spin-off transaction to be carried forward and utilized by each other under General Tax Treatments. For Special Tax Treatments, the un-utilized tax loss of the spin-off enterprise shall be pro-rated and shared according to the ratio of the value of spun-off assets to the value of the total assets, and it can continue to be utilized by the spin-off enterprises according to the original expiry period.

With respect to the un-utilized tax preferential treatments available to the enterprises prior to the spin-off, the surviving enterprise may continue enjoying its un-utilized tax preferential treatments brought forward, provided that the entity nature and the conditions for the preferential treatments remained unchanged. However, the amount of tax benefit is limited to the multiple of the taxable income in the year prior to the spin-off and the ratio of assets of the surviving enterprise after the spin-off to the total assets prior to the spin off. This is shown in the diagram below.



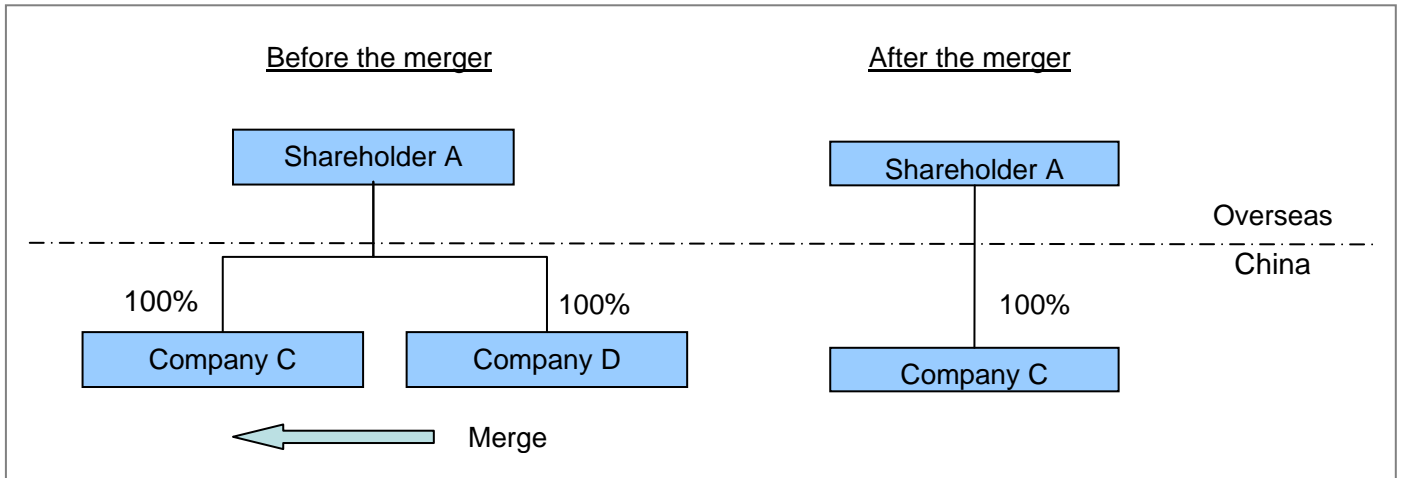
Assuming Company C has a tax holiday benefit and it had taxable profits of Rmb10M in the preceding year prior to the spin-off, and it will spin-off 60% of its assets to Company D, then the maximum tax benefits that Company C, the surviving enterprise, can enjoy is limited to Rmb4M and no benefit can be enjoyed by Company D after the spin-off.

PwC Observations

- **Whether foreign investors can conduct cross-border mergers and spin-off on Special Tax Treatments basis is still uncertain**

Circular 59 has only allowed Special Tax Treatments for a few types of cross-border corporate restructuring. It is uncertain whether foreign investors can merge or spin-off their China investment under the current

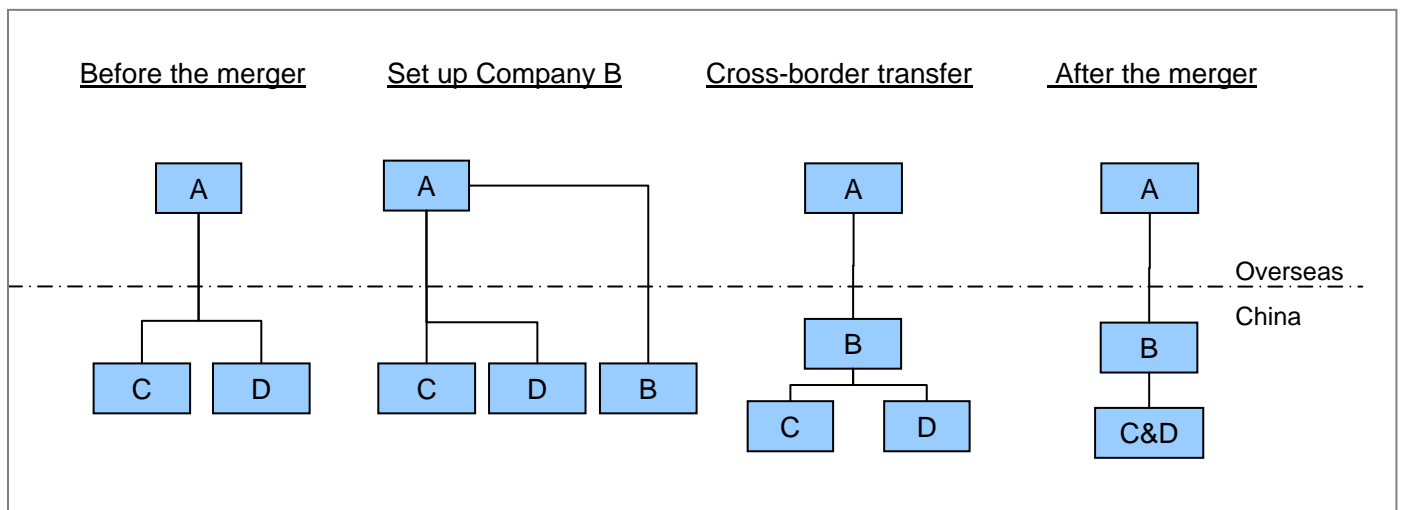
Restructuring Tax Rules using Special Tax Treatments. The following example shows a typical merger of two Chinese entities by their common foreign shareholder.



If we look into the merger requirement, both Company C and Company D are under the common control of Shareholder A. Essentially, this merger should be allowed assuming all other prescribed conditions are fulfilled. However, as foreign shareholder is involved, it would be questionable whether the cross-border restructuring requirement should apply. Unfortunately, Circular 59 does not specifically address cross-border restructurings relating to mergers and spin-offs. Accordingly, foreign investors who would like to apply for Special Tax Treatments when merging or spinning-off their China investment may need to seek clarifications from their local tax bureaus.

▪ **Multiple steps transfer is feasible**

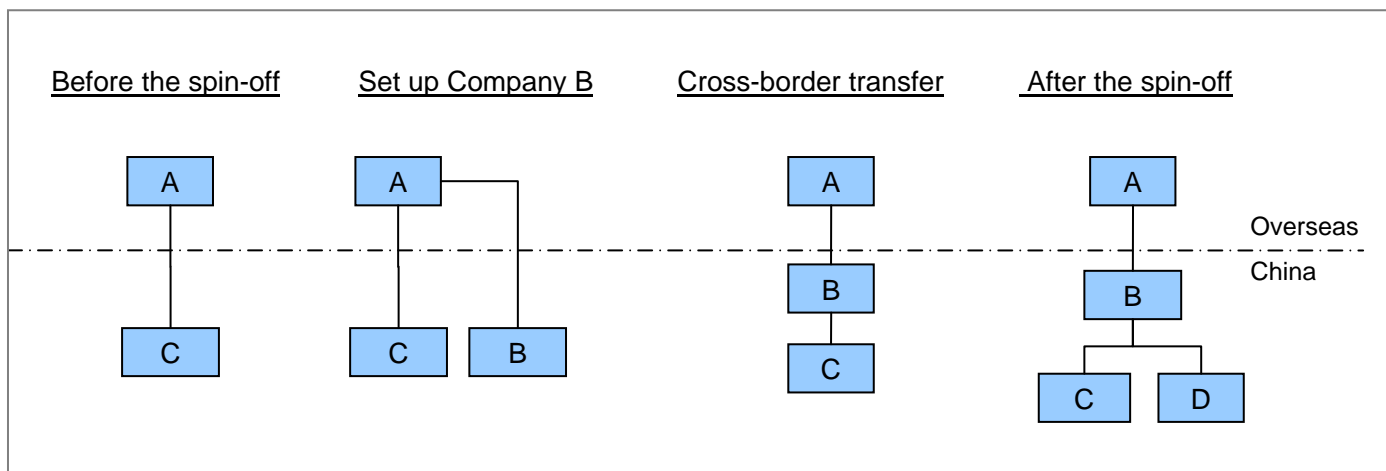
While there is a lack of clarity on whether the foreign investors are able to adopt Special Tax Treatments in mergers and spin-off transactions under Circular 59, in some circumstances, foreign investors may explore other ways to reach the same destination. Let us use some examples to demonstrate the possibility of using a multiple-steps transfer for mergers and spin-off transactions where foreign shareholders are involved.



Shareholder A intends to merge Company C and Company D. Given the limitation on cross-border restructuring through direct merging Company C and Company D under Shareholder A, Shareholder A may consider the following multiple steps:

- (1) Shareholder A sets up 100% owned Company B in China
- (2) Shareholder A transfers its equity in Company C and Company D to its 100% directly owned Company B
- (3) Company B undergoes a merger of Company C and Company D

The multiple steps result with merging Company C and Company D. Similarly, if Shareholder A would like to spin-off Company C into Company C and Company D, the same principle can apply as follows:



- (1) Shareholder A sets up 100% owned Company B in China
- (2) Shareholder A transfers its equity in Company C to its 100% directly owned Company B
- (3) Company B undergoes a spin-off of Company C into Company C and Company D

With the multiple steps, Shareholder A can achieve its original desired structure on Special Tax Treatments basis. However, Shareholder A would need to carefully consider whether the new structure would cause any implications in future operation. For instance, there is more administrative burden to maintain Company B, which does not need to exist under the original desired structure. Additional cash may be tied up in Company B for the initial set up. More importantly, in case Company C & Company D would eventually be sold, the new structure may cause tax inefficiency as Company B would need to pay CIT on capital gain at a higher rate (subject to 25% tax rate) as compared with the case when Shareholder A is a foreign entity (subject to 10% withholding tax rate). Accordingly, foreign investors should need to evaluate the costs and benefits in designing their multi-steps transfer in their corporate restructuring exercises.

- **Limited tax benefits can be achieved under mergers and spin-off transactions**

In the case of mergers, the Restructuring Tax Rules only allow tax losses to be carried forward under Special Tax Treatments and apply a ring-fenced formula to limit the utilization of carried forward tax losses. These would effectively deter enterprises to use mergers for the sole purpose of utilizing other company's tax losses. Similarly, the Chinese authorities use taxable income of the pre-merger / pre-spin-off enterprises in the year prior to the merger or spin-off transaction as a basis to limit the maximum tax benefits that can be inherited by the merged / spun-off enterprises. Apparently, the Chinese authorities do not encourage investors to exploit additional tax benefits through mergers and spin-off transactions. As a result, not all the tax benefits carried forward from the pre-merger / pre-spin-off enterprises could be captured for on-going utilization.

- **Using a tax loss company to merge a profitable company by absorption**

Interestingly, the ring-fencing rule has limited the tax loss to be utilized based on the multiple of the fair value of the net assets of the enterprises being absorbed and the interest rate of the State bonds with the longest term issued by the State as of the end of the year during which the merger takes place. Literally, only the tax loss of the enterprise being absorbed would be limited by this formula. Thus, instead of absorbing a tax loss company under an absorption merger, shareholders may arrange to use the tax loss company to absorb the profitable company, under which all the tax loss of that company would be preserved on the basis that such company continue to exist after merger and its tax losses would not be limited by the ring-fencing formula. It is not certain whether the Chinese authorities would adopt this view as we are given to understand that it was not originally intended under the Restructuring Tax Rules.

- **Determination of the fair value under merger and spin-off transactions**

In the business world, a merger or a spin-off has the effect to unlock business potentials and achieve synergies or efficiencies. Thus, the merged assets / spun-off assets could worth much higher than the standalone assets prior to the merger / spin-off. Circular 59 has put a significant emphasis on "fair value" of the restructuring transactions. Unfortunately, it does not provide a clear definition of "fair value". Nevertheless, we believe that the principle and methodologies reflected in the Chinese accounting standards and those adopted by professional valuers should serve as a helpful reference and be respected by the Chinese authorities.

Normally, a transaction value on the merged assets / spun-off assets agreed among the unrelated shareholders prior to the merger / spin-off should be adopted as the fair value. However, it would be a good practice, in defending the transaction price against potential enquiries or challenges from the Chinese tax authorities, to present their own valuation reports prepared by independent valuers, if readily available. In case of related party mergers or spin-off, such valuation reports should be more convincing in justifying the arms-length pricing.

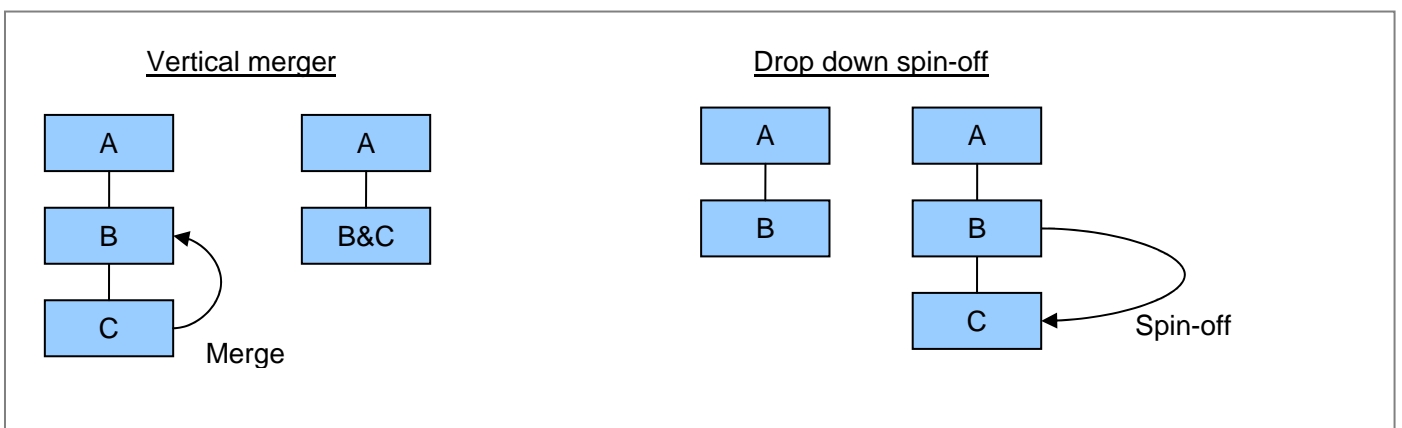
Circular 59 requires enterprises involved in mergers / spin-off (and other specific restructuring) to produce relevant information / evidence to justify their adoption of Special Tax Treatments in the annual Corporate Income Tax returns. We believe that valuation reports would likely be included as in the requisite information to be submitted. It would be helpful if the Chinese authorities could issue further guidelines in this aspect before the next filing season.

- **Investors should be aware of inheriting hidden tax liability after conducting merger and spin-off**

Under Special Tax Treatments, the CIT matters related to the enterprises prior to the merger or spin-off transactions would be inherited by the merged / spin-off enterprise. Unless the merger or spin-off transactions are conducted by the same shareholder(s), it is advisable to conduct due diligence to ascertain the potential tax risks that may be inherited. Similarly, if an investor is intending to acquire a spin-off enterprise, the CIT matters prior to the spin-off should also be examined. Investor should not simply assume that the Chinese tax matters, not only limited to income tax but also other types of taxes, of a newly merged enterprise or a spin-off enterprise, are spotless.

- **Uncertainties on vertical merger and drop-down spin-off**

Circular 59 did not address the tax treatments for vertical merger or drop-down spin-off, as illustrated in the diagrams below:



While the above transactions are fairly common in many foreign jurisdictions, Circular 59 does not specifically mention the tax treatments of these types of transactions. It is not certain whether the enterprise being merged / spun-off in the above situations would be treated as liquidation. If this is the case, investors should not expect to be able to avail any Special Tax Treatments for vertical merger or drop-down spin-off transactions.

Conclusion

The Restructuring Tax Rules lay down the criteria for investors to obtain tax deferral benefits under mergers and spin-off transactions. They also provide explanations on how the tax loss and tax incentives should be treated. However, there are still a number of unclear issues that need to be clarified. It is unrealistic for the Restructuring Tax Rules to address all types of mergers and spin-off transactions, each of which has its own characteristics. At this stage, different local-level tax bureaus may have different interpretations on how the provisions in the Restructuring Tax Rules should apply. More clarifications will be provided when investors, professional bodies and the tax authorities gain more practical experience on merger and spin-off transactions in China.

As mentioned, each merger and spin-off transaction has its own characteristics. Investors should perform a detailed analysis of the tax implications on the shareholders, pre-merger / spin-off enterprises as well as the surviving enterprises after the merger / spin-off with specific reference to their case before deciding on whether to opt for Special Tax Treatments.

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

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