

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.

Unveiling of Long-awaited Corporate Income Tax Administrative Measures for Corporate Restructuring

In our News Flash [2009] Issue 11, we reported that the State Administration of Taxation ("SAT") and the Ministry of Finance ("MOF") jointly issued a circular Caishui [2009] No.59 ("Circular 59") in April 2009 setting out the framework and rules for Corporate Income Tax ("CIT") treatments in relation to corporate restructuring. However, there were quite a number of unclear issues, both technical and procedural, in Circular 59. As a result, both taxpayers and Chinese tax authorities had difficulty in adopting and complying with the relevant tax policies as per Circular 59 for their corporate restructuring that took place in the last 2.5 years. This resulted in high compliance risks to both sides. In addition, this uncertainty in tax consequences has discouraged enterprises to undertake corporate restructuring. Obviously, the SAT was aware of such undesirable situation. The SAT began to formulate a set of detailed administrative and procedural measures to facilitate the implementation of Circular 59 as well as clarifying some policy-type technical issues arising from Circular 59.

The SAT finally issued the long-awaited notice entitled "The Administrative Measures of Corporate Income Tax Treatments for Corporate Restructuring" (Guojia shui wu zong ju gong gao [2010] No. 4, "Public Notice 4") dated 26 July 2010. Public Notice 4 provides the detailed guidance on documentation and procedural requirements for all types of corporate restructuring covered under Circular 59. At the same time, the SAT also took the opportunity to clarify certain policy-type technical issues left behind by Circular 59 in Public Notice 4.

In this Issue of News Flash, we would like to set out the salient points of Public Notice 4 and share with you our insights and observations.

(Note: You may refer to our News Flash 2009 Issues 11, 15 and 16 for more background of Circular 59.)

Salient points

It is interesting to note that unlike the prior practice of the SAT's circulars, this Public Notice 4 is indexed as a "public notice". This Public Notice 4 contains 37 articles. The following are the salient points:

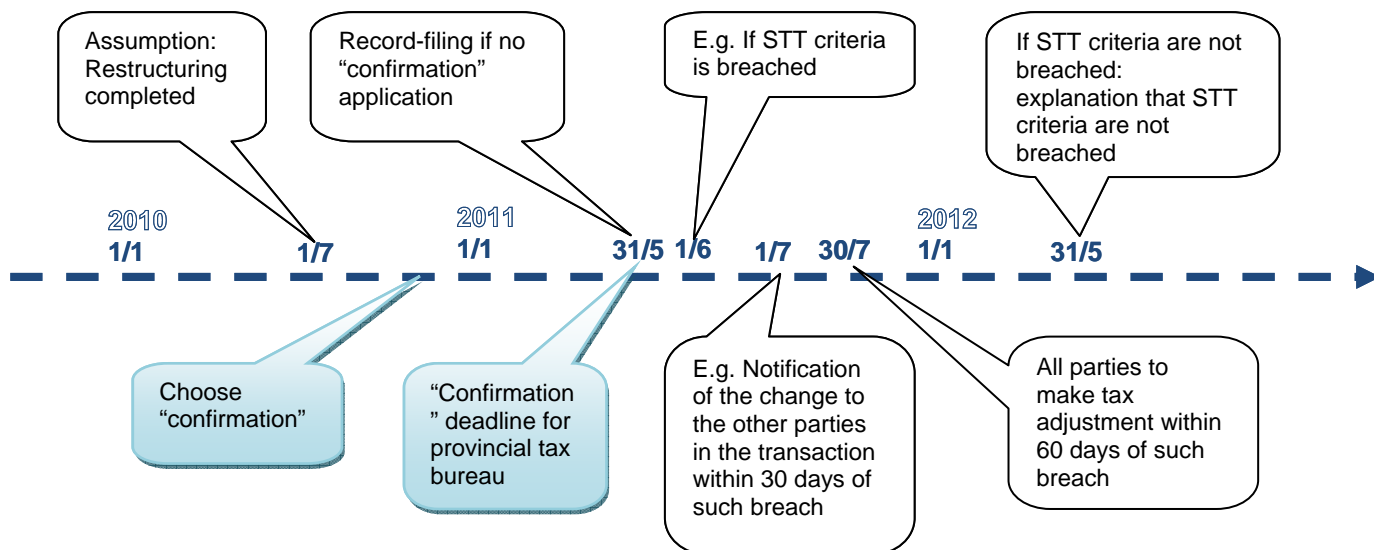
General clarification

- Public Notice 4 provides very detailed guidance on documentation and procedural requirements for all types of corporate restructuring under both the general tax treatments (“GTT”) and special tax treatments (“STT”). Among them, it is important to note that the fair value of the assets and liabilities are always emphasized and valuation reports issued by Chinese recognised appraisal institutions are required to be submitted to the Chinese tax authorities in most cases.
- The same tax treatment, either GTT or STT, has to be adopted by all parties involved in corporate restructuring transactions (collectively called “restructuring parties”). This requirement is essential and logical for the purpose of Chinese tax administration because if the different parties to a single corporate restructuring are allowed to adopt different tax treatments, it would leave room for inconsistency and difficulty to administer.
- Consideration to be paid by an acquiring enterprise in a corporate restructuring transaction can be in the form of shares of companies. Circular 59 stated that share payment should refer to the shares of the acquiring enterprise or its “controlling enterprise”. Public Notice 4 now clarifies that “controlling enterprise” shall refer to an enterprise directly invested by the acquiring enterprise. It is out of our expectation to see this because in some other foreign jurisdictions’ corporate restructuring rules, such term refers to the holding company of the acquiring enterprise instead.
- Public Notice 4 is made effective from 1 January 2010. It provides transitional requirements for corporate restructuring which took place in 2008, 2009 and up to the time of the release of Public Notice 4.
 - Situation (1): Where the corporate restructurings were completed prior to the release of Public Notice 4 and qualifying for STT, the restructuring parties should prepare documentation as stipulated by Public Notice 4 and undergo record-filing with their in-charge tax authorities.
 - Situation (2): Where the restructuring parties choose to seek “confirmation” on the STT with the tax authorities, they should follow the procedures in Public Notice 4 (discussed in the following section of “Clarification on STT”).
 - Situation (3): For corporate restructuring transactions completed in 2008 and 2009 but the tax treatments (either GTT or STT) of which have not been settled, the tax authorities and the restructuring parties may determine the tax treatments in accordance with the requirements under Public Notice 4.
- Public Notice 4 also clarifies a few other issues, such as, how to determine the completion date and year of a corporate restructuring transaction, who are the “leading party” in a corporate restructuring, etc. which are mechanical for determining the adoption of the relevant tax treatments.

Clarification on STT

Circular 59 allowed the restructuring parties to elect for the STT (which is essentially a tax deferral treatment) provided that certain prescribed conditions are satisfied. Public Notice 4 now provides a set of detailed procedures for the restructuring parties to elect for the STT:

- Public Notice 4 provides a set of timeline for the restructuring parties to adopt STT and seek “confirmation” from the relevant tax authorities. It also provides taxpayers and tax authorities with detailed guidance on the follow-up reporting and reviewing procedures after a STT election. This is to ensure that proper reporting actions will be taken by the restructuring parties as well as the tax authorities in case the STT criteria are breached. The timeline is depicted in the following diagram:



- If the STT criteria are breached within the prescribed period after the completion of the restructuring (e.g. if the 12 months or 36 months holding period is breached), the restructuring parties have to make tax adjustments within 60 days of the breach. More importantly, they have to re-calculate the gain or loss of the restructuring, based on the fair value at the time of the original restructuring and adjust the CIT return for the year in which the original restructuring took place. Public Notice 4 does not mention whether there would be penalty and surcharge if the parties involved make the tax adjustments within the prescribed timeframe. Instead, it just indicates that delay in making the tax adjustments would be dealt with in accordance with the Chinese Tax Administration and Collection Law.
- One of the prescribed conditions for enjoying STT is that the corporate restructuring should be aiming at achieving "reasonable commercial purposes"; or in other words, not for tax avoidance purposes. Public Notice 4 requires the restructuring parties electing for STT to provide the following information to justify the "reasonable commercial purposes" of the corporate restructuring in their record-filing or "confirmation" application where relevant. They are also the factors that the Chinese tax authorities would refer in assessing "reasonable commercial purposes" of a corporate restructuring transaction:
 1. Form of the restructuring, i.e. the detailed background and timing of the transactions, and the business mode before and after it;
 2. Form and substance of the restructuring, i.e. the legal rights and obligations arising from the restructuring or the legal consequence, and the ultimate outcome;
 3. Potential changes to the tax profile of all the restructuring parties;
 4. Changes to the financial positions of all the restructuring parties;
 5. Whether the restructuring will give rise to any abnormal economic benefits or potential obligations to any of the parties involved which would not arise under the ordinary market principles; and
 6. Any non-tax resident enterprise(s) participating in the restructuring.
- For a restructuring that is eligible for STT, if elected, the typical documents to be submitted to the Chinese tax authorities are listed below. It appears to be rather burdensome for the restructuring parties:
 - General introduction of the restructuring, including the commercial purposes;
 - The restructuring agreement or contract concluded by all parties involved;
 - Valuation reports issued by Chinese recognised appraisal institutions;
 - Documents which can verify the fair value of the share consideration received by the seller;
 - Documents which can prove that the restructuring satisfies all the conditions of STT;
 - Other documents required by the tax authorities.
- According to Circular 59, if the restructuring parties elect for STT, they are required to undergo record-filing with their respective in-charge tax authorities during annual CIT filing. Public Notice 4 now allows them to obtain a

“confirmation” of the STT from the tax authorities, if they need it. The application for the “confirmation” has to be made by the “leading party” of the restructuring to its in-charge tax bureau and then reported to the provincial-level tax authorities for “confirmation”.

- A ring-fencing formula was set forth in Circular 59 in order to limit the utilisation of tax loss on mergers. Public Notice 4 clarifies that the limit is an annual limit rather than a one-off limit. This should be welcome by the restructuring parties of a merger if they have such situation.
- Circular 59 sets out very harsh rules for the grandfathering of tax incentives under merger and spin-off. Public Notice 4 now provides a more lenient treatment for merger / spin-off that in a case of STT:
 - Where there are tax incentives applicable on an enterprise basis and qualifying for transitional treatments stipulated in Article 57 of the CIT Law which are unutilized at the time of the merger / spin-off, the surviving enterprise may enjoy the unutilized tax incentives of all the pre-merger / pre-spin off enterprises without limit, provided that the nature and conditions for the tax incentives do not change after the completion of the restructuring.
 - Where there are new tax incentives provided under the CIT Law¹, the surviving enterprise may fully utilise the remaining tax incentives after the completion of the restructuring.
- For multiple-step restructuring taking place within a 12-month period and spreading over 2 consecutive tax years, the parties may elect to apply STT in the 1st year or choose to pay tax in the 1st year and then claim tax refund in the 2nd year.
- Cross-border equity transfer transactions that have adopted STT as specified in Circular 59² are subject to the documentation requirements under Circular [2009] No.3³ (“Circular 3”) and Circular [2009] No.698⁴ (“Circular 698”).

PwC observations

Overall

As its title suggested, Public Notice 4 is aimed to provide a set of detailed procedures and documentation requirements for the restructuring parties and the Chinese tax authorities to report and assess the CIT treatments on the corporate restructuring. Meanwhile, it has also provided some clarity on certain principles and policies matters. As compared to Circular 59, Public Notice 4 is good in the sense that it serves as a platform for the restructuring parties and the Chinese tax authorities to address and resolve the tax treatments for corporate restructuring. This should be helpful as it provides more clarity for corporate restructuring transactions which have taken place in the last 2.5 years and also for upcoming ones in the future. Unfortunately, Public Notice 4 does not offer a more lenient interpretation of the STT criteria and a wider adoption of STT (essentially tax deferral) for more cases of corporate restructuring. This would continue to leave many corporate restructuring in a difficult situation because they would be subject to the possible upfront payment of CIT (cash-flow issue), in particular for those corporate restructuring for listing and capital-raising purposes. Practically the absence of tax neutrality could impair or discourage enterprises to undertake corporate restructuring which should otherwise be important for achieving economy of scale, synergy, elimination of production capacity duplication and asset redundancy, etc.

¹ Article 89 of the DIR of the CIT Law

² Article 7.1 and Article 7.2 of Circular 59

³ Circular[2009] No. 3 was issued by the SAT and entitled <Provisional Measures on the Administration of Withholding Corporate Income Tax at Source for Non Tax-Resident Enterprises>

⁴ Circular [2009] No.698 was issued by the SAT and entitled <Reinforcing the Administration of Corporate Income Tax Collection on Income Derived from Equity Transfers by Non-Tax Resident Enterprises>

What is helpful

- Circular 59 allowed the parties to a restructuring with the STT election to undergo record-filing process only in the course of their annual CIT filings. This was aimed to provide them with the flexibility and efficiency to undertake business transactions before having to undergo tedious and lengthy tax clearance procedures. However, such restructuring with STT would always be subject to scrutiny and challenge by the Chinese tax authorities at a later stage after the record-filing process. In normal circumstances, the in-charge tax bureaus would likely examine the tax treatments upon the filing of annual CIT returns. Now Public Notice 4 allows the restructuring parties to seek “confirmation” of the STT from the provincial-level tax authorities in advance of their annual CIT filings.

However, this “confirmation” can only be entertained after the restructuring is completed. Hence, effectively, the certainty may only be available a few months earlier than the normal CIT annual filing period when the in-charge tax bureaus would scrutinize the tax treatments adopted in the restructuring. On the other hand, it is not impossible for the in-charge tax bureaus to drag on their determination on scrutinizing the STT adopted in a restructuring. Public Notice 4 now requires the provincial-level tax authorities to provide the “confirmation”, if allowed, by the end of the CIT annual filing period after the year of restructuring. This would also help the restructuring parties to get the certainty within a reasonable timeframe.

It appears that the SAT attempts to impose a compulsory response timeline on the local-level tax bureaus to the taxpayers’ application. It still needs to wait and see how the local-level tax bureaus would react to such applications and timeline.

- Further, for cross-border equity transfer transactions eligible for STT that are addressed in Circular 59, they have to comply with the documentation requirements pursuant to the previous Circular 3 and Circular 698. This means that approval from the provincial-level tax authorities is required regardless of whether the restructuring parties lodge an application for “confirmation” or not. This approval requirement would provide certainty on the tax treatments of these types of cross-border restructuring schemes. Conversely, this could also be a burden to the restructuring parties as they do not have a choice, as opposed in the “confirmation” situation.
- Circular 59 broadly introduced “reasonable commercial purposes” as one of the prescribed criteria for enjoying STT, without too much elaboration. Now Public Notice 4 is helpful as it shows what factors the SAT would like to refer to for assessing the reasonable commercial purposes of a corporate restructuring. It is not surprising that the factors are more descriptive rather than setting measurable thresholds, because different corporate restructuring could have different commercial purposes.
- Circular 59 set forth very harsh rules for the grandfathering of unutilized tax incentives under merger / spin-off. Public Notice 4 now provides more lenient treatments. On one hand, it upholds the restriction in Article 9 of Circular 59 as far as the merger / spin-off is subject to GTT. On the other hand, where the merger / split qualifies for STT and STT is elected, then the unutilized tax incentives of all the pre-merger and pre-spin off enterprises would be allowed to be carried forward to the surviving enterprises after the merger / spin-off. Such clarification is to restore the fact that MOF/SAT Circular 59’s stipulation should not override what have been provided by the CIT Law. This clarification must be welcome by many taxpayers.
- Public Notice 4 provides clearer and foreseeable consequences for the restructuring parties upon breaching the STT criteria, i.e. tax adjustments shall be made based on fair value at the time the restructuring took place. It appears that no penalty and surcharge is triggered provided that the tax adjustment is made within the prescribed time frame as Public Notice 4 only says that delay in making the tax adjustments would be dealt with in accordance with the Chinese Tax Administration and Collection Law. This is fair and considerate treatment to the taxpayers because in reality there may be commercial situations (non-tax reasons) forcing the STT criteria to be breached which are beyond the control of the restructuring parties.
- The administrative procedures are now clearer and more practicable. The rights and responsibilities among the restructuring parties, and between taxpayers and the tax authorities, are divided clearly. For instance, the restructuring parties have to adopt the same tax treatments, i.e. either GTT or STT; valuation reports should be

ready at the time the restructuring takes place, etc. All of them should now be able to understand their respective compliance obligations.

- Public Notice 4 also provides clarification on how to deal with multiple-step restructuring within a 12-month period and spreading over 2 consecutive tax years. With the choice of electing STT in the first year, it would help the cash flow of the restructuring parties if they expect that the multiple-step restructuring would satisfy the STT criteria after it is completed.

What is challenging

- On the flip side, the documentation requirements under Public Notice 4 are numerous and tedious. Valuation reports issued by a Chinese recognized appraisal institution are required for most types of restructuring, no matter GTT or STT is adopted. It may not be convenient if the restructuring is a global one and China assets are just part of it, and the valuation is made on a global basis. More documents are needed for transactions that elect for STT. Besides the legal contracts, the parties involved also have to submit documents to substantiate the “reasonable commercial purposes”, the tax basis and fair value of the shares and assets transferred and how the STT criteria are satisfied.
- Another challenging area lies with the effectively retrospective effect of Public Notice 4. Public Notice 4 requires the parties to restructuring transactions that took place in the past 2.5 years and eligible for STT to prepare documentation for record-filing. With time passed, the restructuring parties may now have difficulty in collecting and compiling all the documents that are required. It would also be difficult for Chinese valuation appraisers to work out retrospectively the values of the shares and assets at the time when the restructuring took place.
- It is disappointing to see the harsh thresholds for enjoying STT under Circular 59 have not been removed or modified, in particular, the “75% significance threshold”⁵ and the “85% equity-payment ratio (boot)”⁶. This may have undesirable tax consequences on many restructuring transactions that are carried out for genuine business reasons. For instance, if a company acquired 70% shares of a listed company from its major shareholders but has practical difficulties to further acquire the remaining shares which are held by the public investors, then the parties involved in the transaction would not be able to apply the STT since the 75% significance threshold is not satisfied. Public Notice 4 does not offer any more lenient or flexible treatment for restructuring transactions that are carried out for listing purpose.
- Last but not least, Public Notice 4 has not made any distinction between external restructuring and internal restructuring, and not offered more lenient treatments to internal restructuring.

What is still uncertain

- For restructuring that took place in 2008 and 2009 for which the GTT was adopted in the 2008 and 2009 annual CIT returns, Public Notice 4 does not clarify whether the restructuring parties are required to prepare documentation retrospectively based on the Notice for future inspection by the tax authorities. Apart from the documentation requirement, Public Notice 4 is just suggesting that if the tax treatments for a restructuring in 2008 and 2009 have not been settled, then such case may be handled in accordance with Public Notice 4. This could give rise to different interpretations, namely would the adoption of the tax treatments (either GTT or STT) in the CIT returns for 2008 and 2009 be regarded as “settled”.
- Pursuant to Circular 59, cross-border restructuring transactions that are not specified therein⁷ have to be specially approved jointly by the MOF and SAT. Unfortunately, Public Notice 4 does not specify how this article should operate. So it still remains unclear what criteria the MOF and SAT would use in approving STT for other types of cross-border restructuring. In practice, since the issuance of Circular 59, we have noticed that many

⁵ Article 5.2 of Circular 59

⁶ Article 5.4 of Circular 59

⁷ Article 7.4 of Circular 59

companies have approached the SAT for clarification in regard to the tax treatments for their cross-border restructuring transactions, in particular the eligibility for STT. So far, the SAT has not released any further guidelines.

The absence of further clarification in Public Notice 4 may be interpreted as no change in the stance of the SAT on the restrictive adoption of STT for cross-border restructuring transactions. We will continue to reflect to the SAT officials the difficulties and unreasonableness of such restrictive adoption of STT for many cross-border restructuring which serve clear commercial purposes, such as listing of China assets overseas.

- There are still quite a number of outstanding practical issues that Public Notice 4 has not addressed. Just to name a few:
 - Does a vertical merger (i.e. a holding company absorbing its investee / subsidiary) qualify for STT treatment?
 - Where a foreign holding company is put onto liquidation as part of a group restructuring, would it be a deemed disposal of its Chinese investee company, and would the deemed gain, if any, be subject to China tax?
 - Whether the merger / spin-off of foreign investment enterprises in China proposed by their common foreign holding company are considered as cross-border restructuring, and qualify for STT if all the STT criteria are met?

Suggested actions

It is advisable for the restructuring parties that have undergone corporate restructuring before the release of Public Notice 4 to assess the impact of Public Notice 4 and take immediate actions as follows depending on their situations:

- **STT adopted:** The restructuring parties have to collect and compile all the relevant information and documentation and undergo record-filing with their in-charge tax bureaus in order to ensure full compliance in light of this new development. They should be mindful of the presentation and wording of their case in order to accurately represent that the restructuring has satisfied all the criteria for STT; in particular, how to present and describe the reasonable commercial purposes in accordance with Public Notice 4 deserves due care. It is likely that their in-charge tax bureaus would probably resume the examination of the STT adopted in light of Public Notice 4. The restructuring parties should get ready to respond to the enquiries or challenge from their in-charge tax bureaus.
- **“Confirmation” for STT:** Where the restructuring parties find it necessary or useful to seek “confirmation” for their STT adoption from their in-charge tax bureaus, they may proceed by following the procedures and documentation requirements as stipulated in Public Notice 4. Although the key role for such “confirmation” application rests with the “leading party”, it is still very important for the other restructuring parties to work with their respective in-charge tax bureaus to ensure that all the tax authorities receive the same messages and recognize the same positions taken by all the restructuring parties.
- **Re-opening of the case:** There could be cases where the tax treatments adopted under Circular 59 were less favorable, and Public Notice 4 now offers more lenient treatments. For instance, if the restructuring parties did not claim the unutilized tax incentives which were not allowed per Circular 59’s restriction, they may now be allowed for more lenient treatments provided in Public Notice 4. The restructuring parties may approach their in-charge tax bureaus to re-open the case to claim such benefits.
- **Actions of the local-level tax bureaus:** We believe that in light of Public Notice 4 which provides more clarity on procedural matters as well as on some policy-type technical issues, some local-level tax bureaus may be keen to re-visit some cases, especially STT cases, even if they were “settled” in the past. The restructuring parties in such cases should not take it for granted that their STT adoption previously would be free from further scrutiny and adjustments.

- **Follow-up to ensure eligibility for STT:** If STT is elected, the restructuring parties should ensure that there is no breach of criteria by any party within the prescribed periods. Each of them should ensure they are complying with their obligations and responsibilities for reporting to their respective in-charge tax bureaus. They should also agree amongst themselves on how to handle the tax adjustments in case of breach of the STT criteria by any or all the parties.
- **Step-up of tax basis:** In a GTT case, most restructuring parties would focus on the calculation of the gains, and the resulting tax liabilities. It is equally, if not more, important to ensure the acquiring party in a restructuring is allowed to adopt the step-up tax basis for the assets acquired (as stipulated in the CIT Law⁸). It is advisable for them to take a more proactive approach to draw the attention and agreement from their in-charge tax bureaus before or right after the restructuring.

With the clarifications in Public Notice 4, enterprises intending to undergo restructuring transactions in the future will have a better chance of a successful STT treatment if they plan the restructuring carefully. If there are any unclear issues, clarification with the in-charge tax authorities at an early stage is recommended.

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Unlike the prior practice of the SAT's circulars, this Public Notice 4 is indexed as a "public notice", instead of an internal instruction to the local-level tax bureaus, such as Guoshuifa, Guoshuihan, etc. In the past, some local-level tax bureaus had held up tax policies issued by the SAT in the form of internal instructions, and not enforced them locally due to various reasons. We observed that some local-level tax bureaus did not enforce Circular 59 effective from 1 January 2008, or just took a "wait-and-see" attitude. Since Public Notice 4 is a public notice, it becomes effective and enforceable upon issuance without the need for the local-level tax bureaus to announce it locally. We believe that this is the intention of the SAT to make a strong statement that the tax policies as per Circular 59 and Public Notice 4 must be implemented and enforced at local levels. As such, we believe that from now on, more and more local-level tax bureaus would gear up their effort to implement the tax policies stipulated in Circular 59 and Public Notice 4.

PwC has been in frequent dialogue with the SAT drafters to reflect the concerns and difficulties brought about by Circular 59 to corporate restructuring, and offered our views and recommendations to achieve better policies and practices. Now Public Notice 4 has set forth more comprehensive and practicable procedural and documentation requirements for determining the tax treatments of the corporate restructuring. It has also clarified a few policy-type technical issues. However, we are not satisfied to see there are still some unclear issues left unattended, and some unreasonable and impractical treatments. This is still not helpful to eliminate the uncertainty in tax consequences for corporate restructuring in some cases. We will continue to follow up with the Chinese tax authorities with the hope to shape a more friendly tax environment in China for corporate restructuring. In due course, we will share the latest developments, our observation and insights with you through various channels.

⁸ Article 75 of the DIR of the CIT Law

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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