

Tax Analysis

Hong Kong Tax

Newly published advance ruling takes a hard line in determining the locality of profits

Hong Kong SAR

Davy Yun

Tax Partner

Tel: +852 2852 6538

Email: dyun@deloitte.com.hk

Silent Li

Senior Tax Manager

Tel: +852 2852 6399

Email: silli@deloitte.com.hk

On 28 February 2014, the Hong Kong Inland Revenue Department (IRD) published an advance ruling case¹ on the locality of trading profits. In the ruling, which was issued on 11 October 2013, the IRD concluded that the profits are onshore sourced and, therefore, the taxpayer will be chargeable to Hong Kong profits tax.

This Tax Analysis overviews the territorial system of taxation in Hong Kong and the IRD's general interpretation and practices. We then provide our observations and comments on this newly published ruling.

Territorial concept – source of profits

Hong Kong operates a territorial tax system, under which only profits that have a source in Hong Kong are assessable to profits tax (commonly referred to as “onshore profits”). Offshore profits generally are not subject to profits tax. The territorial principle, enshrined in Section 14 of the Inland Revenue Ordinance, states that only profits arising in or derived from Hong Kong are chargeable to profits tax. While the principle seems simple, the application of the source of profits rule in individual cases has been a contentious issue between taxpayers and the IRD. A number of tax cases concerning the source of profits have been litigated and decisions have been issued by various levels of the Hong Kong courts (e.g. *Hang Seng Bank*, *ING Baring*, *Magna Industrial Co.*, among others). Case law, therefore, has established the basic principles for determining the locality of profits.

Broad guiding principle

The broad guiding principle in determining the source of profits is that “one looks to see what the taxpayer has done to earn the profits in question and where he has done it.” In other words, it is necessary to identify the activities that produced the relevant profits and where those operations took place.

Trading profits

The Privy Council ruled in the *Hang Seng Bank* case — the seminal case on the locality of profits — that the determining factor is the place where the contract for both purchases and sales is effected. Thus, purchases and

¹ Advance ruling case no. 54 as per Appendix 1

sales generally are regarded as important operations that produce trading profits. The meaning of "effected," however, may be subject to differing interpretations.

In the *Magna Industrial Co. Ltd* case, the judge confirmed that, in determining the source of profits, one looks to see what the taxpayer has done to earn the profits and where he has done it. The court confirmed that the place where goods were purchased and sold is important for a trading business. But there are other factors, such as how the goods were procured and stored, how the sales were solicited, how the orders were processed, how the goods were shipped, how the financing was arranged and how payment was effected.

In the *ING Baring* case, the Court of Final Appeal (CFA) endorsed the broad guiding principle, and also made it clear that, in determining the source of profits, the focus should not be on antecedent or incidental activities, but rather on the geographical location of the more important activities that give rise to the relevant profits.

Agency rule

In determining the source of profits, the acts of overseas agents should be taken into account if the profits were derived through an agent. The CFA held in *ING Baring* that it was not necessary to establish that the transaction that produced the profits was carried out by the taxpayer or its agent in the full legal sense. It was sufficient if the transaction was carried out on the taxpayer's behalf and for his account by a person acting on his instructions.

IRD interpretation and practices

The IRD's views on the basic principles for determining the source of profits are found in the 2012 Departmental Interpretation and Practice Notes² No. 21 (Revised) – Locality of profits (DIPN 21). DIPN 21 takes case law into account and reiterates the importance of the "operations test" for determining the source of profits, i.e. what the taxpayer has done to earn the relevant profits and where he has done it.

Trading profits

The IRD states in DIPN 21 that, "when Lord Bridge said in *Hang Seng Bank* that profits from buying and reselling of commodities were derived from the place where the contracts of purchase and sale were effected, he could not merely mean legally executed (as this would depend on formal legal rules of offer and acceptance). The Department agrees with the approach in *Magna* and will contemplate all the relevant operations carried out to earn the profits, including the solicitation of orders, negotiation, conclusion, trade financing, shipment and performance of the contracts, in determining the source of trading profits." In other words, the IRD apparently interprets "effected" to encompass *all* steps from the pre-contract stage to post-contract operations.

The IRD also makes it clear that in DIPN 21 that, in its view, the question of apportionment does not arise in relation to trading profits. Trading profits will either be wholly taxable or wholly non-taxable.

Agency rule

DIPN 21 provides that activities of a person carried out overseas should not be readily attributed to a taxpayer in Hong Kong. DIPN 21 also rejects the proposition that the source of profits of one member of a group of companies can be ascribed to the activities of another member: "it is necessary to examine the operations of the taxpayer irrespective of the fact that the taxpayer may be a company within a group. The source of profits must be attributed to the operations of the taxpayer which produce them and not to the operations of the other members of the group. The operations of the group should not be looked at on the question of source. However, in appropriate cases, if a related company is acting on behalf of the taxpayer, then the activities of the related company will be considered to see if appropriate weight should be accorded thereto."

Advance ruling Case No. 54

The advance ruling in Case No. 54 involves a trading company (Taxpayer) that purchases garments from overseas related manufacturers and resells them to unrelated overseas customers. The Taxpayer will share office space with a related company in Hong Kong (Company C). The Taxpayer has established a branch outside Hong Kong (Overseas Branch) and maintains liaison offices overseas (Overseas Offices).

² DIPNs contain the IRD's interpretation and practices in relation to the law. They are issued for the information of taxpayers and their tax representatives and are not legally binding.

Under the contemplated operations, an overseas marketing company (Company F) will negotiate the terms of sales with customers and introduce customers to the Taxpayer's Overseas Branch, which will be responsible for collecting the purchase orders and initiating sales confirmations. The offer and acceptance of sales transactions will be concluded and centralized by executives in the Overseas Branch. The Overseas Branch also will initiate purchase orders with the overseas manufacturers. The Overseas Offices will monitor the production of goods and follow up on shipment schedules with the Overseas Manufacturers. The Overseas Branch will generate sales invoices evidencing that Hong Kong is the port of loading and country of origin of the goods to customers and prepare full sets of export documents.

The Taxpayer maintains bank accounts in Hong Kong for trade settlement. It has obtained trade financing from a bank in Hong Kong secured by a guarantee from its related Hong Kong company, Company C. Letters of credit are handled by the Taxpayer in Hong Kong.

(An extract of the facts is set out in Appendix 1 of this analysis; Appendix 2 contains a diagram of the group structure, contemplated trading operations and a table showing activities to be done in Hong Kong and overseas.)

Our observations

IRD ruling

The IRD ruled that the profits are onshore sourced and, therefore, the Taxpayer will be chargeable to Hong Kong profits tax. According to the commentary notes published:

- The IRD regards the obtaining of trade facilities from banks as one of the activities that gives effect to the terms and conditions of the contracts of purchase and sale. The IRD points out that the issuing of letters of credit and the negotiation and settlement of trade debts are an integral part of a trading company's business and cannot be ignored for all practical purposes in a commercial context. In this case, the Taxpayer's Hong Kong office obtains trade financing from a Hong Kong bank. The IRD is of the view that the Taxpayer's operations enable the group to obtain trade financing at a lower cost and, hence, it is the operations performed in Hong Kong that enable the Taxpayer to earn the profits in question.
- The IRD concludes that the extent of the Taxpayer's involvement during the initiation, negotiation and/or conclusion stages of the trading transactions is not apparent. The IRD is not clear whether the Taxpayer has the right to reject a particular purchase order initiated by Company F or whether the directors of Company C can transact business on behalf of the Taxpayer.
- The IRD takes the position that if all parties involved have been attributed an arm's length rate of profit having regard to their functions, assets and risks, it will be difficult to conclude that profits attributed to the Taxpayer in Hong Kong should have a source outside Hong Kong.

Our comments

Trade financing is a determining factor?

The Taxpayer's activities in Hong Kong are limited to trade financing, including maintaining bank accounts for payments and collection, and arranging letters of credit. The IRD seems to regard trade financing as the income-producing activity (what the taxpayer has done to earn the profits in question), with the result that the profits generated are Hong Kong sourced and subject to profits tax.

The IRD's approach and conclusions in this case are surprising. In determining the source of profits, it is necessary to identify the location of the "dominant factors" in the earning of the profits; in particular, no apportionment is allowed for trading profits (i.e. trading profits are either wholly onshore or wholly offshore). As noted above, the *ING Baring* decision confirmed that antecedent or incidental activities should be disregarded in determining the source of profits. While trade financing clearly is "part" of trading operations, other aspects of trading operations, such as where the purchase and sale is initiated, negotiated and concluded, cannot be ignored. The location of trade financing is not conclusive of where the taxpayer's profits arise unless it is the dominant factor in producing the profits in question. In most cases, trade financing is one of the ancillary back office functions that are antecedent or incidental activities and should be disregarded in determining the source of profits.

In a 1989 decision, the Board of Review made a determined effort to identify the "dominant factors" that produce trading profits.³ The Board held that "the profits which the Commissioner has sought to tax did not arise because of or from the activities which took place in Hong Kong which were no more than the procedural processing of paper including the

³ D59/89 (1989) 5 IRBRD 11.

receipts of the proceeds of sale and the payments for the goods which were purchased. Profit does not arise from receipt of money or payment of money when considering trading transactions of this nature. Likewise, profit does not arise from the processing of orders which reflect negotiations which have already been concluded elsewhere. The fact that Hong Kong was used to finance the sales does not make Hong Kong the source of the profit. Such activities are all ancillaries in cases such as these before us and are not the determining factor in locating the source of the profits."

In DIPN 21, the IRD stated that the meaning of "effected" (of the contracts of purchase and sale) should involve all of the relevant operations carried out to earn the profits, including the solicitation of orders, negotiation, conclusion, trade financing, shipment and performance of the contracts. However, in the present case, it appears that the IRD has elevated the importance of trade financing above all the other functions (which take place outside Hong Kong). We do not believe this is a proper approach.

Acts of overseas office, overseas branch and overseas agents

In the commentary section of the ruling, the IRD states that the extent of the Taxpayer's involvement during the initiation, negotiation and/or conclusion stages of the trading transactions is not apparent. However, it should be noted that the Taxpayer established its own overseas branch for the initiation, negotiation and conclusion of sales and purchases and its own offices to monitor the production of goods and follow up on shipment schedules. Additionally, the Taxpayer has Company F located overseas for the referral of overseas customers to the Taxpayer. The IRD does not clearly explain why the activities of the Overseas Branch and overseas offices are disregarded in determining the source of profits.

The IRD notes in the ruling that it is not clear whether the Taxpayer has the right to reject a particular purchase order initiated by Company F. What if the Taxpayer can demonstrate that Company F is acting under its instruction, on its behalf and for its account to initiate the order? If so, Company F's activities (soliciting orders) performed overseas should be considered in determining the source of the profits since Company F would be the agent of the Taxpayer. In such a case, could it still be concluded that the profits derived are onshore sourced?

The IRD is also not clear as to whether the directors of Company C (a Hong Kong company) can transact business on behalf of the Taxpayer. We believe that as Company C is a Hong Kong company, if its directors transact business on behalf of the Taxpayer in Hong Kong, this will have implications for the source of profits. However, based on the published ruling, we do not have additional information in this regard. We do think that if the IRD is uncertain as to particular facts it considers important for the purposes of the ruling, it may ascertain the information with the ruling applicant or state its assumptions in the ruling (which the IRD often does). We do not think that a ruling based on unclear information is a useful reference for the general public.

Profits attributed to Hong Kong taxpayer

The IRD states in the commentary to the ruling that if all parties involved have been attributed an arm's length rate of profit having regard to their functions, assets and risks, it will be difficult to conclude that the profits attributed to the Taxpayer in Hong Kong should have a source outside Hong Kong. The published information only states that the Taxpayer will pay a marketing fee to Company F and it has no other details on the transfer pricing arrangement for the contemplated operations. The IRD does not clearly articulate the rationale for reaching its conclusion. The IRD appears to be saying that if the overseas parties have been reasonably remunerated for what they do outside Hong Kong, the profit left with the Hong Kong company (i.e. the Taxpayer) must be for what the Hong Kong company has done in Hong Kong. If this is the IRD's position, it apparently ignored the acts performed by the Taxpayers' overseas establishments (branch and offices) and agents outside Hong Kong, which should be attributed to the Taxpayer as discussed above.

Going forward

Advance rulings are published as general information for the public; while such rulings do not have any legal binding effect on taxpayers, they do generally reflect the IRD's views on the issues that they address.

The ruling in Case No. 54 is not favourable to taxpayers. It is not certain whether there is any unpublished information that would affect the IRD's conclusions. However, based on the published information and as stated in the above analysis, the IRD seems to have taken a rigid approach to determining the locality of profits. If the IRD did not agree with the position for which ruling approval was sought in case no. 54, it could simply have issued an adverse ruling and not published it. The fact that the IRD decided to publish the ruling indicates that they wish to take a more rigid stance on offshore claims for trading profits. We consider that advance ruling no. 54 is a step backwards in the development of the source principle. It seems likely that, going forward, it will not be easy for the IRD to agree to offshore claims, particularly if the case involves some activities in Hong Kong, such as trade financing. In this connection, affected taxpayers should seek professional advice before planning any offshore structures/operations and lodging offshore claims. Taxpayers with existing offshore operations should carefully revisit their current offshore claims before the IRD seeks to examine or re-examine them.

Appendix 1 - Advance Ruling Case No. 54

(Extracted from IRD website: <http://www.ird.gov.hk/eng/ppr/advance54.htm>)

1. The provisions of the Ordinance

This ruling applies in respect of section 14 of the Inland Revenue Ordinance ("IRO").

2. Background

- (a) The Company is a private limited company incorporated in Hong Kong. It is jointly owned by Family A based in Country A and Family B based in Country B. All the Company's directors are non-Hong Kong residents.
- (b) Family A and Family B are partners in garment industry. Each owns 50% of Company C, a company incorporated in Hong Kong.
- (c) Companies D1 and D2 based in Country D and Company E based in Country E (collectively "the Overseas Manufacturers") are the garment subsidiaries of Company C.
- (d) Company F in Country F, which is wholly owned by Family A, coordinates all the marketing activities. Family A directors and key executives of Group A based in Countries A, D and E contact customers, negotiate sales and purchase, initiate purchase orders from customers, route purchase and sales orders to the Overseas Manufacturers.
- (e) Shipments are arranged by the Overseas Manufacturers to customers directly. The goods will not pass through Hong Kong.
- (f) Company C pays a fee to Company F based on 5% of turnover introduced by Group A ("the Marketing Fee").

3. The arrangement

- (a) The Company is set up as an intermediary between unrelated overseas customers and the Overseas Manufacturers. It purchases garments from the Overseas Manufacturers and resells them to the customers.
- (b) The Company shares an office with Company C and maintains a registered office in Hong Kong through an accounting firm.
- (c) The Company has established a branch outside Hong Kong ("the Overseas Branch").
- (d) The Company maintains a liaison office in Country D and is in the process of establishing a similar office in Country E (collectively "the Overseas Offices").
- (e) Some employees presently working for the Overseas Manufacturers will be re-deployed to the Overseas Branch and the Overseas Offices.
- (f) Family A directors will represent Company F to negotiate the terms of sales with customers. Customers will be introduced by Company F which will not have authority to conclude sales agreements with customers. All inquiries and contacts will be passed to the Overseas Branch.
- (g) The Marketing Fee to Company F will be paid by the Company.
- (h) The Overseas Branch is in charge of collecting purchase orders and initiating sales confirmation. The offer and acceptance of sales transactions will be concluded and centralized by executives in the Overseas Branch.
- (i) The Overseas Branch will initiate purchase orders to the Overseas Manufacturers.
- (j) The Overseas Offices will monitor production of goods and follow up shipment schedules with the Overseas Manufacturers.
- (k) The Overseas Branch will generate sales invoices, showing that Hong Kong is the port of loading and country of origin of goods, to customers and prepare full set of export documents. Copies of these documents will be passed to the Company's Hong Kong office for negotiation and factoring.
- (l) The Company maintains bank accounts in Hong Kong for payments to the Overseas Manufacturers and collection of receipts from customers. It has obtained receivable finance from a bank in Hong Kong secured by a guarantee from Company C.
- (m) The Company will employ an accountant and an administrative clerk in Hong Kong to handle letters of credit ("LC"), present documents to the bank, operate bank accounts and keep records.
- (n) All the banking documents will be signed by the directors of Company C stationed in Hong Kong.

4. The ruling

The Company will be chargeable to Hong Kong Profits Tax under section 14 of the IRO in respect of its profits derived from transactions described in the arrangement.

5. The period for which the ruling applies

The ruling will apply for the years of assessment 2013/14 to 2015/16.

6. The material assumptions in respect of a future event or any other matter made by the Commissioner

The Commissioner has not made any assumption.

7. Date of ruling issued

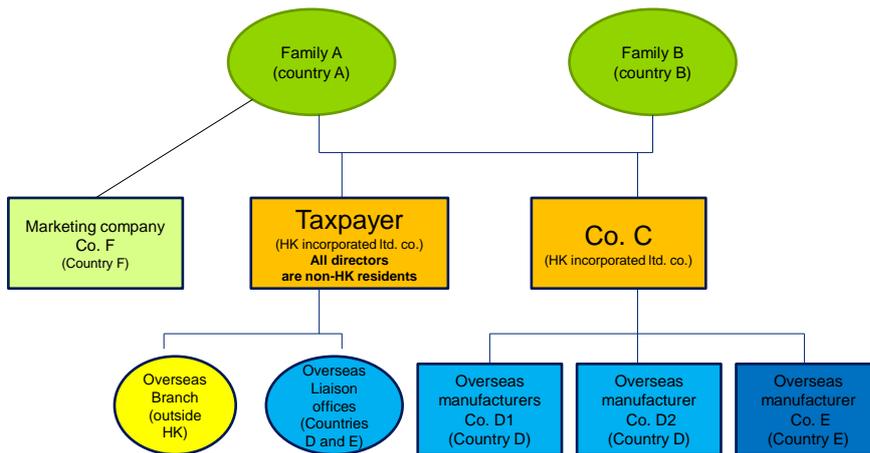
11 October 2013.

8. Commentary

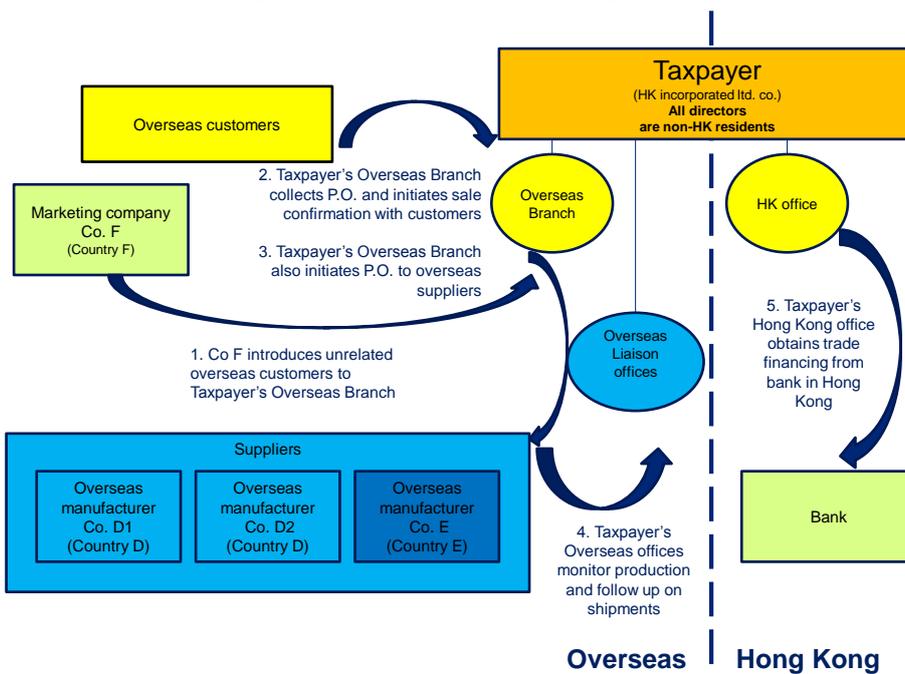
- (a) Under section 14 of the IRO, every person who carries on a trade, profession or business in Hong Kong is chargeable to profits tax on the profits arising in or derived from Hong Kong.
- (b) The business of a trading company is recognised as involving the effecting of the contracts of purchase and sale. The concept “effecting” should involve more than the decision to accept an offer. It should be comprehended that obtaining trade facilities from banks is to give effect to the terms and conditions of the contracts of purchase and sale.
- (c) The issuing of LC and the negotiation and settlement of trade debts are an integral part of a trading company’s business. They cannot be ignored for all practical purposes within a commercial context.
- (d) If all parties involved have been attributed an arm’s length rate of profit having regard to their functions, assets and risks, it will be hard to conclude the profits attributed to the Company in Hong Kong should have a source outside Hong Kong.
- (e) In the present case, the Company’s involvement during the initiation, negotiation or conclusion stage of the trading transactions is not apparent. It is not clear whether the Company can have the right to reject any particular purchase order initiated by Company F, or the directors of Company C can transact business on behalf of the Company.
- (f) The goods may pass through Hong Kong since they can be loaded in Hong Kong with Hong Kong as its country of origin of the goods.
- (g) The Company’s Hong Kong office operates bank accounts in Hong Kong and negotiates trading documents with the bank for receivable finance. It handles all banking documents endorsed by Company C’s directors in Hong Kong to give effect to the settlement of the trading transactions. The operations of the Company enable the group to obtain trade finance with lower cost. It is the operations performed in Hong Kong that enable the Company to earn the profits in question.

(This commentary is not a legally binding statement.)

Advance ruling case no. 54 – group structure



Advance ruling case no. 54 – trading flow



Appendix 2 - Advance Ruling Case No. 54

Table showing activities carried out in Hong Kong and overseas

In Hong Kong	Outside Hong Kong (overseas)
<ul style="list-style-type: none">• Maintain registered office• Maintain bank accounts for payments to suppliers and collections from customers• Arrange letters of credit• Sign banking documents• Shown as port of loading in the invoices, although goods will not pass through Hong Kong	<ul style="list-style-type: none">• Negotiate the terms of sales with customers (by Co. F)• Collect purchase orders (by Overseas Branch)• Initiate sales confirmation (by Overseas Branch)• Conclude sales transactions (by Overseas Branch)• Initiate purchase orders with the overseas manufacturers (by Overseas Branch)• Monitor the production of goods and follow up on shipment schedules with overseas manufacturers (by Overseas Liaison Offices)• Generate sales invoices and prepare export documents (by Overseas Branch)• Arrange shipment (by overseas manufacturers)

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Beijing

Kevin Ng

Partner
Tel: +86 10 8520 7501
Fax: +86 10 8518 7501
Email: keving@delloitte.com.cn

Hong Kong SAR

Sarah Chin

Partner
Tel: +852 2852 6440
Fax: +852 2520 6205
Email: sachin@delloitte.com.hk

Shenzhen

Constant Tse

Partner
Tel: +86 755 3353 8777
Fax: +86 755 8246 3222
Email: contse@delloitte.com.cn

Chongqing

Claude Gong

Partner
Tel: +86 23 6310 6206
Fax: +86 23 6310 6170
Email: clgong@delloitte.com.cn

Jinan

Eunice Kuo

Partner
Tel: +86 531 8518 1058
Fax: +86 531 8518 1068
Email: eunicekuo@delloitte.com.cn

Suzhou

Frank Xu / Maria Liang

Partner
Tel: +86 512 6289 1318 / 1328
Fax: +86 512 6762 3338
Email: frakxu@delloitte.com.cn
mliang@delloitte.com.cn

Dalian

Frank Tang

Partner
Tel: +86 411 8371 2888
Fax: +86 411 8360 3297
Email: ftang@delloitte.com.cn

Macau SAR

Quin Va

Partner
Tel: +853 8898 8833
Fax: +853 2871 3033
Email: quiva@delloitte.com.hk

Tianjin

Jason Su

Partner
Tel: +86 22 2320 6680
Fax: +86 22 2320 6699
Email: jassu@delloitte.com.cn

Guangzhou

Constant Tse

Partner
Tel: +86 20 8396 9228
Fax: +86 20 3888 0121
Email: contse@delloitte.com.cn

Nanjing

Frank Xu

Partner
Tel: +86 25 5791 5208
Fax: +86 25 8691 8776
Email: frakxu@delloitte.com.cn

Wuhan

Justin Zhu

Partner
Tel: +86 27 8526 6618
Fax: +86 27 8526 7032
Email: juszhu@delloitte.com.cn

Hangzhou

Qiang Lu

Partner
Tel: +86 571 2811 1901
Fax: +86 571 2811 1904
Email: qilu@delloitte.com.cn

Shanghai

Eunice Kuo

Partner
Tel: +86 21 6141 1308
Fax: +86 21 6335 0003
Email: eunicekuo@delloitte.com.cn

Xiamen

Lynch Jiang

Partner
Tel: +86 592 2107 298
Fax: +86 592 2107 259
Email: lijiang@delloitte.com.cn

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National Tax Technical Centre

Email: ntc@delloitte.com.cn

National Leader

Leonard Khaw

Partner
Tel: +86 21 6141 1498
Fax: +86 21 6335 0003
Email: lkhaw@delloitte.com.cn

Eastern China

Bill Ye

Partner
Tel: +86 21 6141 1261
Fax: +86 21 6335 0003
Email: bye@delloitte.com.cn

Northern China

Julie Zhang

Partner
Tel: +86 10 8520 7511
Fax: +86 10 8518 1326
Email: juliezhang@delloitte.com.cn

Southern China (Mainland/Macau)

German Cheung

Director
Tel: +86 20 2831 1369
Fax: +86 20 3888 0121
Email: gercheung@delloitte.com.cn

Southern China (Hong Kong)

Davy Yun

Partner
Tel: +852 2852 6538
Fax: +852 2520 6205
Email: dyun@delloitte.com.hk

If you prefer to receive future issues by soft copy or update us with your new correspondence details, please notify Wandy Luk by either email at wanluk@deloitte.com.hk or by fax to +852 2541 1911.

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