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CHINA TAX ALERT

ISSUE 3 | February 2015

New Chinese indirect offshore disposal rules issued

Regulations discussed in this issue:

- *Announcement of the State Administration of Taxation on Several Issues Relating to Corporate Income Tax on Gains from Indirect Transfer of Assets by Non-resident Enterprises*, Gong Gao [2015] No. 7 (Announcement 7), issued by the SAT on 3 February 2015
- *Notice of the State Administration of Taxation on Strengthening the Administration of Corporate Income Tax on Gains derived by Non-resident Enterprises from Equity Transfers*, Guo Shui Han [2009] No. 698 (Circular 698), issued by the SAT on 10 December 2009
- Announcement on Corporate Income Tax Administration of Non-resident Enterprises, Gong Gao [2011] No. 24 (Announcement 24), issued by the SAT on 28 March 2011

Background

On 3 February 2015 the Chinese State Administration of Taxation (SAT) issued the long-awaited Announcement 7, replacing the PRC's indirect offshore equity disposal reporting and taxation rules in Circular 698, promulgated in 2009, with a substantially new and more comprehensive approach.

The new Announcement 7 links the determination of targeted transactions to the newly issued General Anti-tax Avoidance Rules (GAAR) measures, which set out detailed procedures for case establishment and adjudication. While this is welcome, the new enforcement mechanisms contained in Announcement 7 provide for the imposition of withholding tax and penalties, and thus place buyers in transactions potentially at equal risk as sellers. Further, there are remaining areas of uncertainty concerning the operation of the enforcement mechanisms under Announcement 7 which the SAT will hopefully clarify further upon implementation. Overall Announcement 7 will likely have a major impact on mergers and acquisitions (M&A) transactions and corporate restructurings undertaken by multinational enterprises (MNEs) involving China enterprises and assets, and MNEs should study the new rules carefully and re-examine their existing structures and potentially also historic transactions.

Announcement 7 broadens reporting scope and modifies tax collection mechanism

The new Announcement 7 rules depart significantly from the Circular 698 rules in several major respects, including:

- A much broader range of 'Chinese taxable property' is potentially subject to indirect transfer case assessment;
- Introduction of a withholding tax (WHT) mechanism coupled with a new approach to reporting transactions; and
- Inclusion of extensive guidance on the determination of whether a transaction lacks 'reasonable business purposes' and thus should be subject to tax, as well as provision of "safe harbour rules".

Regulations discussed in this issue:

- *Concerning the interpretation of "Announcement of the State Administration of Taxation on Several Issues Relating to Corporate Income Tax on Gains from Indirect Transfer of Assets by Non-resident Enterprises"*, SAT interpretative guidance issued on 3 February 2015
- *Administrative Measures for the General Anti-tax Avoidance Rules: Trial Implementation* ('GAAR Measures'), SAT Order No. 32, issued by the SAT on 2 December 2014 and effective 1 February 2015
- *Interim Administrative Measures for Source Withholding and Remittance of Non-Resident Enterprise Income Tax*, Guo Shui Fa [2009] No. 3 (Circular 3), issued by the SAT and effective from 1 January 2009

The SAT has issued, in parallel with the release of Announcement 7, interpretative guidance which clarifies the operation of the new rules. The extensive content of the Announcement 7 rules may be best considered as follows:

- Which transactions are targeted?
- How are the transactions reported and tax collected?
- What are reasonable business purposes?
- Are there specific exemptions/safe harbours?
- What other administrative matters must one be aware of?

Transactions targeted

Announcement 7 expands the scope of indirect transfer transactions potentially subject to corporate income tax (CIT) from the Circular 698 rules and provides that *"Indirect transfers of assets, including shares of Chinese resident enterprises, by non-resident enterprises, through arrangements without reasonable business purposes which aim to avoid CIT, are to be re-characterised and treated as direct transfers of Chinese taxable property in accordance with CIT Law Article 47 (i.e. the GAAR rule)"*.

"Assets, including shares of Chinese resident enterprises" extends beyond the indirect transfers of interests in the equity of Chinese tax resident enterprises at which Circular 698 was directed. Article 1 clarifies that this term *"refers to assets of a Chinese establishment or place of business, immovable property in China and equity investment in PRC resident enterprises, etc, in respect of which gains from its transfer by a direct holder, being a non-resident enterprise, would be subject to CIT in accordance with PRC laws and regulations"*. Such assets are clarified to be referable as "Chinese taxable property".

As with Circular 698, Announcement 7 directs its attention at the transfer of equity in foreign tax resident enterprises which directly or indirectly hold Chinese taxable property. However, clarifications in Article 1 also make clear that it is not solely purchase and sale of equity in the foreign tax resident enterprise which may be caught. Any transaction involving a *"transfer of equity and other similar interests"* in the foreign enterprise which *"results in transactional outcomes which are identical or similar to a direct transfer of the Chinese taxable property"* is caught. This includes *"a restructuring by a non-resident enterprise that results in a change of the foreign enterprise's shareholders"*.

As such the rules potentially capture the indirect transfer of a broad range of Chinese taxable property as caused by a broad range of offshore transactions resulting in changes in foreign enterprise share ownership. Potentially caught transactions include transfer of partnership interests or convertible debt, and share dilutions. Transactions caught are however limited to those "*without reasonable business purposes which aim to avoid CIT"*, the determination process for which is outlined below.

Fulfilment of tax filing and tax payment/WHT obligations

Where transactions fall within the scope of Article 1, and are considered to be transactions "*without reasonable business purposes which aim to avoid CIT"*, tax filing/WHT obligations are triggered, dependant on the nature of the "Chinese taxable property" being transferred.

In accordance with Articles 2 and 7, for indirect offshore transfers of assets of a Chinese establishment or place of business of a foreign enterprise (via transfer of that foreign enterprise or higher tier foreign companies), the resulting gains are to be included with the annual CIT filing of the Chinese establishment or place of business being transferred. The gains would consequently be subject to tax as part of the annual CIT assessment on that establishment or place of business, which would be taxed as a Chinese permanent establishment (PE) where a relevant double tax agreement (DTA) applies. This consequently means that the gains would be taxed at the 25 percent CIT rate applying for tax levied on an assessment basis. The penalties for non-inclusion have not been stated in Announcement 7, though presumably the ordinary penalties for underreporting of income for CIT assessment would apply (0.05 percent daily late payment interest and a penalty ranging from 50 percent to five times the amount of the unpaid tax).

Where the underlying transfer relates to Chinese immovable property or to equity in a Chinese tax resident enterprise, and these assets are not considered to be the assets of a Chinese establishment or place of business, then, instead, a WHT mechanism applies to tax the gains arising. In accordance with Articles 2 and 8, the WHT agent is the *"entity or individual who owes an obligation to the share transferor to make the relevant payments in accordance with either the relevant laws or the contract terms"*, which would typically be the buyer in an M&A transaction.

Referring to Circular 3 [2009] on WHT obligations, remittance of the withheld amount to the relevant tax authority would be required within seven days of the tax obligation arising. In accordance with Articles 8 and 15, the tax obligation would arise on the date when the share transfer contract or agreement becomes effective and/or the foreign enterprise completes procedures to recognize the changed share ownership resulting from the transaction. Article 8 also provides a backstop for the WHT mechanism, providing that the share transferor must make the tax filing if the WHT agent does not remit tax within seven days of the transaction effective date. These changes constitute a significant acceleration in the timing of tax payments as under Circular 698 the offshore seller was only obligated to pay tax when the tax authorities issued an assessment notice that recharacterised the indirect transfer.

Reporting arrangements

The transaction reporting arrangements are also significantly altered. In a change from the Circular 698 system, under which the transferor/seller was required to report a transaction to the authorities where the tax burden in the state of the transferred foreign enterprise fell under a threshold, per Announcement 7 the reporting arrangements complementing the WHT system give a certain amount of discretion on reporting to the parties to the transaction. The parties potentially involved in reporting transactions under this new system are also significantly expanded. It is left to the parties, including both the seller and buyer, as well as the transferred PRC company, to decide how they intend to comply with this reporting obligation. There are also changes being introduced to enable the tax authorities to gather information from wider sources as noted below.

Firstly, upon being notified of a transaction, the tax authorities are empowered, under Article 10, to request a range of documentation and information from the transferee, from the transferor, from the transferred Chinese enterprise (where relevant) and from tax advisors to the arrangement, and requested parties are obliged to fulfil such request.

Outside of these circumstances, it is left to parties to the transaction to volunteer information, as set out in Article 9. Given the penalty mitigation on offer, volunteering of information is most likely to occur where the conduct of counterparties is outside the control of a party to the transaction (e.g. unrelated counterparties) rather than where controlled arrangements (e.g. intra-group) are in point.

As Announcement 7 introduces a withholding obligation for the buyer, per the PRC Tax Collection and Administration Law he may be subject to imposition of a penalty of 50 percent to 300 percent of any unpaid tax. However, per Article 8, the WHT agent/buyer may be relieved from potential penalty, where neither the WHT agent nor the share transferor have paid tax, if the WHT agent voluntarily submits, to the tax authorities, specified documentation and information within 30 days of the conclusion of the transfer agreement. However, the extent of this protection is not entirely clear.

Equivalently, per Article 13 the share transferor/seller can protect itself from increased penalties where no tax payment has been made by either the WHT agent or the transferor, if it provides the tax authority with specified documentation within 30 days of the transfer agreement conclusion. Otherwise the penalty interest rate (PBOC loan base rate plus five percent) would be increased by a further five percent. Where the transfer of equity in a single overseas enterprise leads to the indirect transfer of Chinese taxable property subject to tax in two or more tax authority districts, then it would appear that the transferor would need to file separate tax returns with each of the respective in-charge tax authorities, in order for penalty mitigation to be available.

Specified documentation to be supplied under the voluntary filings includes:

- The share transfer contracts (English and Chinese);
- Corporate shareholding structure before and after the share transfer;
- Financial statements for the past two years for the foreign enterprise and subsidiaries that directly or indirectly hold Chinese taxable property;
- Explanation of the reason why tax should not be applied

Additional information which may be demanded by the tax authorities include:

- Information related to policy decision behind or implementation of the indirect transfer of the Chinese taxable property;
- In relation to the Overseas Enterprise, and its subsidiaries that directly or indirectly hold the Chinese taxable property, information in connection with the production and operation, personnel, financial records and properties, etc. as well as the internal and external audit results;
- Asset valuation report and other pricing setting materials used to determine the contract amount for the offshore share transfer;
- The status of the income tax paid overseas in respect of the indirect transfer of Chinese taxable property;
- Evidential information supporting the application of the safe harbours;
- Other related documents

Reasonable business purposes

The above reporting and tax payment obligations only apply where transactions are "*without reasonable business purposes which aim to avoid CIT*". Article 3 provides that in evaluating reasonable business purposes, *"a rounded consideration of all arrangements relating to the indirect transfer of the Chinese taxable property should be undertaken"*. The SAT interpretative guidance notes that analysis is to be conducted with regard to the "substance over form" principle.

The Announcement 7 approach is in line with the newly clarified GAAR rules (see *China Tax Alert Issue 1, January 2015*) as the accompanying SAT GAAR Q&A notes that an arrangement being 'without reasonable commercial purposes', and the purpose of an arrangement being 'to obtain a tax benefit' are the "two key elements" of a GAAR assessment. Supporting this, both Articles 1 and 11 of Announcement 7 note that the in-charge tax authorities must conduct indirect transfer investigations and adjustments in line with the GAAR rules.

In assessing how reasonable business purposes are to be determined, Announcement 7 Article 3 calls for a "comprehensive analysis of real facts and circumstances" and specifies the following factors:

1. The value of the Overseas Enterprise' equity directly or indirectly derives mainly from Chinese taxable property;
2. The assets of the Overseas Enterprise are primarily constituted out of direct or indirect investments in China, or the income of the Overseas enterprise is derived mainly, either directly or indirectly, from China;
3. The Overseas Enterprise, and/or its subsidiaries which directly or indirectly holds Chinese taxable property, actually perform functions and assume risks to an extent sufficient to evidence that the overseas structure possesses economic substance. The SAT interpretative guidance notes that operating and financial factors, such as staffing, assets and income of the transferred overseas entities, form a starting point for the analysis of the substantive economic significance of the transferred entities within the MNE group structure, and that regard to the particularities of the industry in which the MNE operates are relevant;
4. The duration of the existence of the Overseas Enterprise's shareholder and business model and relevant organisational structure. The SAT interpretative guidance gives the example of a foreign company setting up an intermediate offshore structure for holding the Chinese taxable property shortly before the indirect offshore transfer; such arrangements would negatively affect the reasonable business purposes evaluation;
5. The overseas tax treatment of the gains arising from the indirect transfer of Chinese taxable property. The SAT interpretative guidance clarifies that tax imposed in both the jurisdiction of the transferor, and the jurisdiction of the transferred company, as well as supplementary factors such as tax loss carry forwards, are to be taken into account in determining whether the foreign tax imposed is less than that which would arise from a direct transfer of the Chinese taxable property, and consequently whether the transaction gives rise to a tax benefit;
6. The substitutability, from the Share Transferor' perspective, of arrangements for the indirect investment and transfer of Chinese taxable property and arrangements for the direct investment and transfer of Chinese taxable property. The SAT interpretative guidance mentions, as factors for consideration, market access, transaction examination and approval processes, compliance considerations and transaction objectives;
7. The applicability of a PRC tax treaty or arrangement in respect of the gains arising from the indirect transfer of Chinese taxable property; and
8. Other relevant factors.

Transactions deemed to be without "Reasonable business purposes"

Under Announcement 7, certain arrangements can be "automatically" deemed to lack reasonable business purposes. Article 4 clarifies these circumstances to be where all of the following criteria are met:

1. 75 percent or more of the value of the shares of the Overseas Enterprise directly or indirectly derives from Chinese taxable property;
2. At any time within the year before the indirect transfer of Chinese taxable property occurs, 90 percent or more of the total assets (excluding cash) of the Overseas Enterprise is directly or indirectly constituted by the investment in China; or in the year before the indirect transfer of Chinese taxable property occurs, 90 percent of the income from the Overseas Enterprise directly or indirectly originates from China;
3. Although the Overseas Enterprise, or its subsidiaries which directly or indirectly hold the Chinese taxable property, are registered in the host country (region) and fulfil organisation form requirements of the law of the country of registration, the actual functions performed and risks assumed are too limited to substantiate its economic substance; and
4. The effective income tax payable overseas on the gains from indirect transfer of Chinese taxable property is lower than the potential PRC tax liability on direct transfer of Chinese taxable property.

Specific exemptions and safe harbours

On the positive side, Announcement 7 provides safe harbours as regards (i) publically traded foreign securities (both bought and sold on the same market), but specifically excluding pre-IPO investments and private placement transactions involving public stocks, (ii) transfers which would be covered by DTA relief if the transfers were treated as direct disposals of Chinese taxable property by the foreign transferor, as well as (iii) intra-group reorganisation cases, where the relevant conditions are met under Articles 5 and 6.

The intra-group reorganisation relief will apply where a commonality of ownership test is met. Either the transferor holds 80 percent of the transferee or vice versa, or a third party holds 80 percent of each, with both direct and indirect holdings considered. The percentage holding is however increased to 100 percent if the foreign enterprise being transferred derives its value more than 50 percent from Chinese immovable property.

The consideration paid by the transferor must be wholly comprised of its shares or those of another enterprise with which it has a controlling shareholding relationship (excluding shares of listed enterprises).

The PRC tax treatment of a subsequent offshore disposal of the transferred foreign enterprise must not be affected by the transaction for reorganisation relief to apply. The SAT interpretative guidance provides an example to clarify that the restructuring relief would not be available where the shares of a foreign company (holding Chinese taxable property) are transferred under another group company in a country which has a DTA with China, where this DTA provides for exemption from tax on the gains arising on a subsequent disposal of the foreign company holding the Chinese taxable property.

Importantly, the SAT interpretative guidance clarifies that the fact that a transaction fails to satisfy the requirements of the reorganisation relief should not impact on the analysis, under Article 3, of whether the transaction has reasonable business purposes.

Other administrative matters

As noted, Article 11 provides that the in-charge tax authorities must conduct indirect transfer investigations and adjustments in line with the GAAR rules. This being said, insofar as tax is to be withheld and remitted by a WHT agent, or failing this to be paid immediately by the share transferor, or alternatively, where assets of an establishment or place of business are in point, to be included in an annual CIT filing, it is not entirely clear how these tax collection approaches are to interact with the GAAR investigation and tax determination and assessment processes.

It is however noted, in Article 8, that the in-charge tax authority shall report the case up to the SAT within 30 days after the tax is paid, and SAT involvement may allow for a re-adjudication/adjustment of taxation in line with the GAAR administrative measures.

Article 19 notably abolishes, together with Circular 698, the Announcement 24 procedures under which:

(i) Where two or more offshore investors indirectly transfer the equity interest in a PRC tax resident enterprise at the same time, one of the offshore investors may file documentation for both;

(ii) Where offshore investor(s) indirectly transfer the equity interests in two or more PRC tax resident enterprises located in different tax districts then a reporting only needs to be made to one authority

Reporting must now be made to both (or more) authorities and, per Article 12, the authorities will endeavour to reach an agreement on tax calculation method, with higher tax authorities to coordinate where agreement cannot be reached.

Importantly also, Article 19 provides that the new rules, effective from the date of issuance of Announcement 7, will apply to transfers occurring before the issuance, in respect of which no Circular 698 tax filing or processing procedures have yet been conducted.

KPMG observations

More than five years have passed since the issuance of Circular 698 on 10 December 2009. In that time China's indirect offshore disposal tax rules have come to be regarded as one of the most challenging aspects of planning and managing foreign investments into China.

While the Circular 698 rules were seen as unorthodox and controversial at the time of issuance (going beyond the taxation of gains from immovable property to which indirect offshore disposal rules in Western countries were typically limited), intervening years have seen a growing acceptance of general indirect offshore disposal rules as tools in the toolbox for combating international tax-avoidance. Not only have many developing countries modeled new provisions on the Chinese rules, but even the International Monetary Fund (IMF) and Organisation for Economic Co-operation and Development (OECD) have recently recognised such rules as valid instruments to combat double non-taxation.

It is against this backdrop that the SAT has finally issued the comprehensive indirect offshore disposal rules in Announcement 7, as the second significant new international anti-avoidance measure, following the introduction of the new GAAR measures in December 2014, in response to President Xi Jinping's directive for a "crack down on international tax avoidance and evasion" made at the G20 Leaders' Summit on 16 November 2014 in relation to the OECD's Base Erosion and Profit Shifting (BEPS) initiative.

The Announcement 7 rules adhere closely to the new GAAR measures, with tax only to be applied where the transactions aim to avoid CIT and lack reasonable business purposes. This is a very welcome recognition as it should, in principle, rebalance the indirect offshore transfer rules away from the historic approach of local tax authorities, which focused on staffing, premises and other business assets/operations at the level of the offshore company, to the neglect of any arguments of reasonable business purposes, in determining whether to impose tax. In addition, the safe harbor where DTA relief would be available on a look-through is also very welcome. However, the rules also present the following significant challenges, amongst others.

WHT mechanism

The value of having a focus on tax-purpose and reasonable business purposes in determining which transactions are subject to CIT is somewhat undermined by the use of a WHT mechanism to enforce taxation. For a WHT agent to determine whether a transaction meets the reasonable business purposes test requirement would likely result in the WHT agent having to 'second-guess' what amount the authorities will eventually determine to be payable in tax following a GAAR analysis.

As non/under-withholding may be penalised to some extent, even with the defensive 30 day filing, WHT agents may have an incentive to make a worst-case scenario presumption on the 'reasonable business purpose' evaluation and withhold and remit a significant portion of the consideration to the tax authorities. If WHT agents were to seek to draw on historic precedent in the application of Circular 698, in determining whether to withhold, they might be led to withhold in all cases where commercial substance in the transferred offshore company is limited.

It is difficult to see precisely how the GAAR tax assessment and procedures, which require validation by the SAT of investigations and assessments, as well as providing an opportunity for taxpayer appeal before a tax authority adjustment can be finalised, are to interact with the WHT mechanism. In order for the tax ultimately imposed under Announcement 7 to be any way in line with a GAAR determination, it would need to be made clear that the system of appeal and re-adjudication, provided for under the GAAR Measures, will apply to indirect disposal cases, and that refunds will be speedily provided to taxpayers where required. However, historically re-adjudication and refunds have not been provided for and this would demand a sea-change in procedures by the tax authorities.

It would also be preferable for clarification to be made that a WHT agent, on making a 30-day reporting, is completely excused from WHT obligations. In this way, the complexities of refunds would be left out, and it would be left to a GAAR investigation and determination process, solely between the tax authorities and the transferor, to conclude upon and assess GAAR tax.

It is to be hoped that the SAT will clarify upon these matters in the early stages of implementing the new Announcement 7 rules.

Overall in practice, the likelihood of buyers and sellers coming to a common view on the assessment of potential tax liability for an M&A transaction, and thus on the amount to be either held in escrow or withheld and remitted by the buyer, will be complicated due to 1) the absence of any guidance in Announcement 7 on the valuation of China assets, 2) inherent uncertainties in the existing PRC capital gains assessment rules, and 3) inevitable differences in the interpretation of reasonable business purpose between the buyer and the seller. As both parties are 'on the hook' for tax enforcement, the above are likely lead to more protracted deal negotiations and heavier reliance on advisors.

Other challenges

Other observations on challenging aspects of the Announcement 7 rules are:

- **Share dilutions and debt instruments:** The broad definition of indirect transfer means that share dilutions, and transfers of instruments such as convertible debt, are potentially caught.

- **Listed share exemption:** The safe harbor does not cover pre-IPO investments and private placements of public stocks.

- **Intra-group reorganisation relief:** Many enterprises may find the requirement for transfer consideration to be comprised entirely of shares in the transferee or related company to be non-commercial and complicate restructurings. The wording of the provision also casts some doubt as to whether solely shares of the transferee and its subsidiaries could be used as consideration or whether the shares of other group companies, such as the shares of the transferee's parent, could be used. In addition, the extent to which relief might be available in a spin off situation is unclear.

- **WHT backstop:** The requirement for the transferor, on pain of penalty (which still applies at the standard penalty rate, even with the '30-day filing'), to file and pay tax where the WHT agent fails to do so sufficiently may be very difficult to comply with. Not only does the transferor need, like the WHT agent, to 'second-guess' whether the tax authorities would conclude that the arrangement lacks reasonable business purposes, but the transferor also needs to detect non-payment by the WHT agent and remit tax within seven days of the effective date of the transaction.

- **Transfers affecting multiple tax districts:** The simplified filing with one of the affected tax districts, provided for in Announcement 24, has been removed. Moreover, no clarity has been provided on the calculation of tax liabilities other than to say that the affected tax authorities are to work out an acceptable calculation and allocation approach among themselves. Lack of guidance on the basis for allocating sales consideration and acquisition costs over jurisdictions, and on acceptable valuation techniques, greatly complicates tax payer investment planning and such uncertainty can frustrate and hinder investment-making.

- **Transitional provisions:** It appears that transactions effected (i.e. transfer agreement effective date passed/shareholder register updated) prior to the effective date of Announcement 7, but which have not received tax authority assessment, are potentially caught under the new rules. Thus, all historic non-reported transfers, effected subsequent to 1 January 2008 when the GAAR was introduced in the new CIT Law, might potentially be pursued under the new rules.

It is to be hoped that the SAT look to clarify on these matters as the enforcement of the new rules gets underway. In the interim, foreign investors in China should consider the following matters:

- Open tax positions on indirect transfers taking effect from January 2008 should be reviewed.

- An assessment of the qualification for safe harbours, an evaluation of the substance and functions of entities, and a consideration of the costs and benefits of voluntary reporting should precede negotiation of contractual terms for offshore share purchase agreements, including the need for escrow arrangements or withholding.

- Detailed documentation needs to be retained to support the reasonable commercial purpose and economic substance of indirect transfers; in this regard, and for the purposes of communication with the tax authorities in the context of reporting/investigations/appeals, the assistance of professional tax advisors will be essential.

- Consideration and confirmation of availability of foreign tax credits for Announcement 7 tax in home countries is highly advisable.

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