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DCO was established in the PRC and is a tax resident in China under the EITL.

BCO is a Hong Kong Company. However, it may be regarded as a PRC resident enterprise if its place of effective management is in the PRC. Two ACO employees have been working for DCO for 3 years and they are also in charge of BCO's business operations in China. If BCO's business operation is focused mainly in China, it is likely that BCO may be regarded as a PRC resident enterprise. The question did not deal with this fact, so let's assume that BCO is a non-resident enterprise.

ACO, though incorporated in UK, may be regarded as having a service PE in China as the two employees of ACO has been providing services to DCO. The status of DCO as a subsidiary of ACO would not lead to the conclusion that ACO has a PE, but by sending employees to China to work for DCO for more than 6 months may

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suggest that ACO has established a service PE in China under Circular Guoshuihan (2006) 694.

DCO manufactures electronic products within China and sells the same in China. The domestic income from the sales revenue will be taxed at the rate of 25% under the head EIT. DCO will also be subject to VAT at the rate of 17%. Consumption is not chargeable on electronic products.

No VAT will be charged on the goods exported by DCO to BCO. However, DCO and BCO are associated enterprise as they are both 100% owned by ACO. According, the sale price between DCO and BCO will be scrutinized by the PRC tax authority to see if the price has been reasonable and arrived at on a arm's length basis according to the transfer pricing rules.

Hong Kong is a separate tax jurisdiction and the PRC tax authority will check if

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the sale price to BCO is too low so as to reduce the profit and taxable income of PCO in China, which enterprise income tax rate of 25% is higher than the profit tax rate of 16.5% in Hong Kong.

The PRC tax authority may apply the CUP method to compare the price with those in similar transactions between the independent status. The cost-plus or resale price model may be adopted, especially with the latter. reference will be made to the resale price of BCO to foreign client to see if the profit margin earned by BCO is reasonable.

For the purpose of GAAR, if the PRC tax authority considers that the sale price to BCO is too low, it has the power to adjust the price to recover the tax. The profit of BCO in HK may have to be adjusted correspondingly under the arrangement between PRC and HK for avoidance of Double Taxation.

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As ACO and DCO are associated enterprise, and ACO is not a financial institution, the interest payments are deductible on the part of DCO only if the interest rates do not exceed the rates of financial institutions for the same type of loan over the same 3-year period. If the PRC tax authority considers that the interest rate is too high, the excess interest may be regarded as dividend and also be subject to the 10% withholding tax.

Also, the interest expenses are not likely deductible as ACO has 10m paid-up capital and the loan amounts to 25m, which is in excess of the 2:1 debt-to-equity ratio under the thin capitalization rule. In any event, the interest expenses would be regarded as passive income of ACO and subject to the withholding tax at the rate of 10% under the Treaty.

Under the Treaty, royalties for the patent

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~~sub~~ shall be subject to the withholding tax of 10% of the adjusted amount of the royalties, i.e. 70% of the gross amount of the royalties.

Again, there is the same transfer pricing issue ~~for~~ ~~activities~~ determining the reasonableness of the royalty amount. The PRC tax authority will assess the function to be performed and risks to be borned by the relevant parties.

The administrative fees of RMB 5 million paid between the associated enterprises are likely not deductible on the part of DCO as it involves the management activities of the operation of DCO. Such fees may be chargeable as taxable income of ACO.

However, as ACO has a service PE in China, ~~as~~ and such administrative ~~a~~ fees are effectively connected with the service PE, such fees may be chargeable at the rate of 25% of EIT.

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Under Art 16 of the Treaty, since the two ACO employees have stayed in China for more than 183 days, and their salary, though paid by ACO in UK, are sourced within China, they may be subject the Individual Income Tax at the progressive rate in China.

The employees may need to apply for the tax credit under the Treaty if they are still tax residents in UK and their worldwide income is subject to tax.

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It is likely that Mr Zhang is regarded as a non-resident in China as he has lived in HK since 2009 and there is nothing in the question suggesting that his family ties and economic ~~connected~~ connections are situated in China.

The MOF and SAT jointly issued a circular (Caishui (2008) 159) in Dec 2008 that reconfirms the taxation principle that individual partners are subject to ~~enterprise~~ individual income tax on income allocable from the partnership of which they are the partners.

In this case, the dividends of RMB 5m and the revenue of RMB 10m are treated as income allocable to Mr. Zhang (as to 80% based on his % interest in the partnership) and to Ms Wen (as to 20%).

However, currently, it is not entirely clear how the foreign partners should pay tax on income derived from the partnership and it is

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expected that more guidance will be issued in the respect.

Under IITL Art 3(2), a progressive scale of IIT rates ranging from 5% to 35% applies to production and business income derived by partners in a partnership. Please also note that the partnership income will be allocated to Mr. Zhang and Ms Wen and taxed regardless of whether it has been distributed. A partnership agreement may not allocate all income to only certain partners.

~~There is no indication~~

It is unclear whether the income to be allocated to Mr Zhang as a non-resident would be treated as dividend under the Mainland China/HK Tax Arrangement, if that is the case, the tax so charged shall not exceed 10% of the gross amount of ~~the gross~~ the dividend, but not 5% as Mr Zhang is an individual, not a company.

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We may argue that the income from the partnership is dividend under the Arrangement, as dividends are defined as "income from shares or other rights" as Mr. Zhang is entitled to the income based on his interest in the partnership agreement.

From the perspective of the partnership, Business Tax is levied on the revenue from the consulting services, which is also regarded as the taxable income as Revenue from the Provision of Labour Services Sourced in China.

The dividend income of the partnership is also regarded as taxable income as they are income derived from profit distributions of its 10% equity interest in the Suzhou company. If the Suzhou company is not listed in China, 100% of the dividend will be taxable as it is sourced in China.

In accordance with Caishui (2000) 91, the income of the individual partners may be determined by either the actual method or the deed

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deemed taxable income method.

For the RMB 3 million in wages and salaries, they are deductible provided that they are reasonable. And the PRC tax authority may examine the position and experience of the employees to determine if the wages are reasonable. The tax on the wages must be withheld by the employer.

The contributions to an affiliated employee's fund are deductible to certain limit of the wages.

The RMB 2m in leasing expenses are deductible so long they are incurred for the production of the taxable income. Leasing the business office is one of the examples.

Other indirect taxes are also dedectible if they are levied in relation to the business of the partnership.

The RMB 1m salary to Ms Wen is deductible

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if it is reasonable but it is likely that the PRC tax authority will closely examine it as Ms Wen is a connected person of the partnership and the amount of the wage is relatively high.

Ms Wen herself, assuming she is a PRC tax resident, will be subject to the Individual Income Tax at the progressive rate and the tax will be withheld by the employer.

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N Ltd as a PRC Company is the tax resident in the PRC.

M Ltd as a UK Company is the non-tax-resident in the PRC.

According to Art 13 (3), the term "technical fees" means payments of any kind to any person in consideration for any services of a technical, supervisory or consultancy nature.

M Ltd's obligation (1) providing technical documents and obligation (3) supervising the design and construction of the hotel apparently fall within the scope of Art 13(3), and the relevants fees for M Ltd to perform the above obligations shall not exceed 10% of 70% of the gross amount of the technical fees attributable to these obligations.

It is clear that obligations (1)-(4) are all related to the development of the hotel in

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Shanghai and the services will be provided in Shanghai, so the fees to be generated would be considered as income sourced within China.

M Ltd's obligations (3) and (4) fall outside the scope of Art. 13 and the question arise as to whether M Ltd will be considered as having established a PE in China by virtue of its services to be provided.

It is likely that M Ltd will need to send its employees or engage the contractors in Shanghai to supervise the design and construction of the hotel and to manage and operate the hotel for 5 years.

As such, it is likely that M Ltd will need a fixed place of business for actively managing the hotel for 5 years. Such activities are obviously not of a preparatory or auxiliary nature. As such, a PE will exist.

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If a PE exists, Art. 13 (1) and (2) shall not apply as M Ltd will be regarded as carrying on business in China through a permanent establishment. It may be arguable that providing technical documents was made directly by M Ltd and does not involve the PE and as such, the tax rate of 10% should still apply to such fee.

However, for obligations (3), (4), it is likely they will be regarded as effectively connected with the PE and exclude the application of Art. 13 and the treaty benefit can't be enjoyed.

It is unclear whether obligation (4) for the provision of debt financing will be performed through the PE.

If obligations (1) and (4) are not performed through the PE, fees related to obligation (1) will be charged at 10% of the adjusted gross amount under Art 13., and fees related to obligation (4)

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will be subject to the standard withholding tax of 10%.

For fees related to obligations (3) and (4), they will be charged at the 25% enterprise income tax on the part of PE, and the N Ltd as payer will have the withholding obligations.

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(1) An individual who is usual resident of China is liable to pay individual income tax on his worldwide income. The test for residence in China is whether the individual usually or habitually resides in China due to household registration, family or economic relationship (IITIR, Art. 2)

This domicile test refers to the taxpayer's personal connections within China. An individual who temporarily lives abroad and who must return to China due to the above connections is regarded as a usual resident in China (Guoshuifa (1994) 89)

(2) Yes, an individual resident in China is required to pay IIT on his worldwide income.

Further, expatriates who have lived in China for a continuous 5-year period are also thereafter subject to IIT on their world-

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wide income if they continue to live in China.

The rationale of such rule is to ensure that the PRC government will have sufficient tax revenue even if a number of the PRC citizens have temporarily worked in other countries while keeping his family ties in China. If the PRC government adopts the source principle only, it will have difficulty in identifying all potential taxpayers since the identities of the PRC residents are readily available based on their household registration.

(3) Yes, Ms Lin is liable to IIT in 2015.

Ms Lin may be regarded as domiciled in China in 2015. Ms Lin's decision to purchase a house in Shanghai, moved her family to Shanghai and signed a 10-year employment contract with the Chinese company showed that the family and economic relationship

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are all found in Shanghai instead of Singapore. It is expected that she will stay in China for 10 years, a pretty long period of time. Her Singapore citizenship would not prevent her from being regarded as a tax resident in China.

Even if she is not regarded as being domiciled in China, as Ms Lin has lived in China for more than a year since 2014, subject to approval by the competent tax authority she may be taxed only on the portion of her income which is derived from China.

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QUESTION NUMBER 5

B Ltd is a UK Company and is a non-resident enterprise in the PRC.

The key question is whether the sale of the production equipment and the provision of the training services are regarded as sourced within China. If they are, they will be subject to the withholding tax of 10%

For income from sale of goods, source is determined according to the place where the trading activities take place. From the question, it is unclear where the parties negotiate about and enter into the sales contract. If such activities take place in China, it may be subject to withholding tax as other gains.

The fees from the training services are sourced within China, as the service activities will take place in China.

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Further, Guoshuifa (2010) 19 Art. 6 provides that where the non-resident enterprise enters into contract involving the provision of equipment and after-sales services (such as installation) with Chinese resident enterprise, and such contract fails to clearly allocate the income attributable to the sale of goods and the provision of services, the tax authority has the right to deem the amount of services income by applying the portion that would apply in similar contracts or deem the service income to be no less than 10% of the contract value.

It is likely that the PRC tax authority will exercise such right in this case, as it is unclear which part of RMB 20 m is for the sale of goods and which is for the after sales service.

Further, B Ltd will be regarded as having a service PE in China, as the employees deployed have worked for more than 6 months

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In any 12 months period. By the job nature, it is likely that such employees have been working on a fixed place of business for installing and maintaining the equipment for A Ltd.

If B Ltd is regarded as having a service PE and the fees from such after sales services are effectively connected with the PE, they will be subject to the enterprise income tax at the rate of 25%.

Further, the deployed employees will be subject to the Individual Income tax under Art. 16 of the Treaty, as they have worked in China for more than 183 days. As a result, such employees may need to apply for the tax credit if their world wide income is taxable in UK.

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