Chartered Institute of Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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Suggested Solutions

PART A

Question 1

According to Article 5 (3)(a) of the Agreement between China and the United Kingdom for the Avoidance of Double Taxation (the 'China-UK DTA')), ACO has a Permanent Establishment in Mainland China because its employees worked for its interest in DCO for more than 183 days. In addition, the interest on the 3-year loan and royalties related to the patent license may be as regarded being effectively connected with the ACO's Permanent Establishment in China and are taxable as business profits of the Permanent Establishment in Mainland China.

The ratio between the amount of the 3-year loan to DCO (RMB 25 million) and the paid-up registered capital of DCO (RMB 10 million) is more than 2:1, the debt-equity ratio for thin capitalisation under *Caishui* [2008] No 121. Interest paid by DCO to ACO for loan amounts in excess of that ratio (ie RMB 5 million) is not deductible by DCO.

ACO's employees did not work for the interest of DCO, so the administrative fee paid by DCO to ACO is not in consideration of services provided for DCO and is not deductible by DCO.

BCO has no personnel in Hong Kong and is not effectively managed in Hong Kong; rather, its effective management is in Mainland China. According to Article 4 of the Arrangement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income between Hong Kong and Mainland China (the 'Arrangement'), BCO is regarded as resident in Mainland China. It is thus not entitled to enjoy tax benefits under the Arrangement and is liable to pay tax on its worldwide income in Mainland China.

Salaries or wages earned by the two UK resident individuals in 2015 are taxable in China.

Question 2

According to Article 4 of the Arrangement Mr Zhang is a resident of Hong Kong for tax purposes.

The partnership enterprise is a transparent entity, not a taxpayer under the Enterprise Income Tax Law (the 'EITL').

As partners, Mr Zhang and Ms Wen are liable to pay individual income tax on the income earned through the partnership.

According to Chinese tax rules, income earned by the partnership is separated into two types, business income and dividends. For the calculation of business income, all costs and expenses may be deducted except for salaries paid to partners. Thus, RMB 1 million salary paid to Ms Wen may not be deducted; the business income earned by the partnership in 2015 is RMB 5 million (RMB 10 million income –RMB 2 million in leasing expenses – RMB 3 in wages = RMB 5 million net business profit)

All income earned by the partnership enterprise is allocated to the partners based on their interests in the partnership. Therefore, Mr Zhang had business income of RMB 4 million (RMB 5 million * 80%) and dividend income of RMB 4 million (RMB 5 million * 80%), and Ms Wen had business income of RMB 1 million (RMB 5 million * 20%) and dividend income of RMB 1 million (RMB 5 million * 20%). The RMB 1 million salary paid to Ms Wen is treated as an advance on the business income allocated to her.

Mr Zhang's and Ms Wen's business income in 2015 is taxed at progressive tax rate of 5%-35% (Articles 2(2) and 3(2) and Schedule 2 of the Individual Income Tax Law (the 'IITL')). However, under *Caishui* [2011] No 62, they can deduct 'necessary expenses'' in the amount of RMB 3,500 monthly or RMB 42,000 annually.

In China, dividends are taxed at the rate of 20% (Article 3(5) of the IITL). The dividends allocated to Ms Wen will be taxed at this rate.Under Article 10(2) of the Arrangement, dividends earned by Mr Zhang are taxable at a reduced tax rate of 10% (not 5% because the partnership only owns 10% of shares in the invested company).

PART B

Question 3

Based on M Ltd's first and second contractual obligations, M Ltd seems to be providing supervision services but these are treated as the provision of know-how under Article 12 of the China-UK DTA. The payments are therefore treated as royalties and subject to Chinese withholding tax.

Income earned by M Ltd due to the provision of management services after the construction of hotel (its third contractual obligation), will be treated as business income.

The business income earned by M Ltd is taxable income in China because 5-year management of the hotel will constitute a Permanent Establishment under Article 5 of the China-UK DTA.

Based on the contractual liability (4) of M Ltd., Any payments made to M Ltd in respect of direct debt financing for the operation of the hotel will be treated as interest and subject to Chinese withholding tax.

The Chinese tax authority will treat the technical service and management supporting contract as a mixed contract, under which income earned by M Ltd will be split into different items of taxable income in China.

PART C

Question 4

Part 1

Article 1 of the IITLprovides that an individual is tax resident in China and subject to Chinese taxation on a worldwide basis if he or she is domiciled in China or is not domiciled in China but has stayed in China for at least one year. Article 2 of the Implementing Regulations for the IITL (the 'IITL Regulations') provides that Chinese domicile is established if an individual habitually resides in China because of household registration, family or economic involvement,. Article 3 of the IITL Regulations provides that temporary absences from the territory of China that do not exceed 30 days at one time or 90 days in the aggregate are disregarded for this purpose.

Part 2

Not necessarily. Article 6 of the IITL Regulations provides that an individual who is not domiciled in China but has stayed in China for more than one year but less than 5 years will, with approval of the tax authorities, only be taxed on his or her income from Chinese sources, with foreign source income taxable in China from the sixth year.

Part 3

Ms Lin is domiciled in China from January 2015 because she has signed a 10 year employment contract to work in china and moved her family to China. As a Chinese domiciliary, Ms Lin is liable to Chinese income tax on Chinese and foreign source income. Article 3 of the income tax treaty between China and Singapore does not change this result.

Question 5

B Ltd has a Service Permanent Establishment in China because of its provision of services in respect of designing, production, installation, testing equipment that it sells and technical training for over 6 months in China, according to Article 5 of the China-UK DTA.

The RMB 20 million paid by A Ltd under contract will be split into a price for equipment and a price for services using a reasonable standard. Business profits attributable to B Ltd's Permanent Establishment in China are taxable in China.

The UK-resident employees working in China are liable to individual income tax in China because they have stayed in China for 12 months, according to Article 15(1) of the China-UK DTA.

Question 6

Article 5 of the Implementing Regulations for the EITL (the 'EITL Regulations') provides that any business agent, either an entity or individual, entrusted by a non-resident enterprise, to carry out productive activities or other business operations in China, including habitually concluding contracts, or handling warehousing or delivery of goods, etc., on behalf of the non-resident enterprise, is regarded as an 'establishment or place' of the non-resident enterprise in China on which the non-resident enterprise is taxable in China.

Yes. Under Article 5 of the China-UK DTA, there are two types of business agent, dependent agent and independent agent. If a dependent agent has and habitually exercises in China authority to conclude contracts, except for handling warehousing or delivery of goods, on behalf of a non-resident enterprise, the non-resident enterprise has a Permanent Establishment in China and is taxable on the business profit attributable to that Permanent Establishment. An independent agents, such as a broker or general commission agent, is not generally regarded as creating a Permanent Establishment of a non-resident enterprise in China, provided that the agent is acting in the ordinary course of its business in China. However, if the activities of such an agent are devoted wholly or almost wholly on behalf of the non-resident enterprise in China, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, the agent shall not be deemed to an independent agent. In such circumstance, the non-resident enterprise will be regarded as having a Permanent Establishment in China and will be taxed on the business profit attributable to that Permanent Establishment.

Yes. The commission fee of RMB 2 million is taxable in China. According to the EITL, Mr Yang is treated as BCO's business agent and acted on behalf of BCO in concluding BCO's contract with ACO . Thus BCO may be regarded to have an 'establishment or place' in China for purposes of the EITL. Accordingly, BCO must pay enterprise income tax on its business income derived through its 'establishment and place' in China. . There is no tax treaty between China and the Virgin Islands that would change this result.

Question 7

According to *Caishui* [2009] No 59, the transactions made by XCO, YCO and Mr Sun are regarded as equity acquisitions. However, XCO's transfer of 90% of the equity of ZCO to YCO and Mr Sun's sale of the remaining 10% of equity in ZCO to YCO for RMB 10 million may be regarded as a restructuring of the enterprise which enjoys special tax-free treatment. Thus, XCO and YCO do not need to pay enterprise income tax in China on the transactions between them.

Under the IITL, Mr Sun is liable to pay individual income tax on the RMB 10 million consideration received for transferring his 10% equity in ZCO. However, Mr Sun is a UK resident and under Article 13 of the China-UK DTA the income will not be subject to individual income tax in China.