ADIT

Chartered Institute of Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

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SUGGESTED SOLUTIONS

PART A

Question 1

ACO has a PE in China according to Article 5 of China-UK Tax Treaty, because BCO is its sole sale agent, and profits from sale products earned by ACO through BCO and the payment received for its secondment of its employee (as a manager in BCO) from BCO will be attributed to the PE, therefore is liable for Chinese enterprise income tax according to Article 7 of China-UK Tax Treaty.

Royalties received by ACO for licensing the patent to BCO shall be taxed in China at a limited tax rate no more than 10% of gross amount of the royalties according to Article 12 of China-UK Tax Treaty.

Rent received by ACO for the rental of the equipment to BCO shall be taxed in China on 60% of gross amount of the rent at a limited tax rate no more than 10% of gross amount of the rent according to Article 12 of China-UK Tax Treaty.

Dividends received by ACO shall be taxed in China at limited tax rate no more than 5% of gross amount of the dividends according to Article 10 of China-UK Tax Treaty, because ACO directly owns BCO's more than 25% capital which required by the Tax Treaty for application of limited tax rate.

BCO shall receive the payments from ACO at arm's length price for its providing services as a sale agent.

The manager shall pay individual income tax in China for his/her salary of work in China according to Article 15 of China-UK Tax Treaty, because his/her stay in China is more than 183 days in 2016, and his/her salary of work in China actually is borne by BCO, a Chinese company.

Question 2

The legal framework

Article 47 of the Enterprise Income Tax Law, Article 120 of the Implementing Regulation on the Enterprise Income Tax Law, the provisions of Chapter 10 of Guoshuifa [2009] No. 2, and Order of SAT No. 32 (2014)

The content of basic rules (not including procedural issues)

Where an enterprise, which is within the personal scope of the Enterprise Income Tax Law, makes arrangement without any reasonable business purpose, resulting in the decrease of taxable income or other tax benefits, the tax authorities have rights to make a tax adjustment through a reasonable method. The main purpose of an arrangement is to reduce, exempt, or defer the payment of taxes shall be regarded as without any reasonable business purpose.

Applied scope

The following tax avoidance arrangements taken by an enterprise shall be under the investigation of tax authorities: the abuse of tax preferences, the abuse of tax treaty, the abuse of the legal form of corporation, tax avoidance arrangements related to the use of tax haven, and other tax avoidance arrangements without reasonable business purposes. All tax avoidance arrangements have characteristics as follows: (1) with sole or main purpose of obtaining tax benefits, and (2) obtaining tax benefits through methods that are line with provisions of tax law but inconsistent with economic substance thereof. The arrangements are not covered by the GAAR if they are irrelevant to cross-border transactions or payments, or are relevant to tax fraud.

Tax adjustments made potentially by tax authorities

Tax adjustments measures made potentially by tax authorities includes: (1) re-characterization of all or part of transactions under an arrangement; (2) disregard of the existence of targeted parties of transactions for tax purposes, or treating targeted parties and other parties of a same transaction as same entities; (3) re-characterizing or re-attributing among all parties of transactions items of income, deductions, tax preferences, and foreign tax credits; and (4) other reasonable adjustment measures.

Relationship with other domestic anti-avoidance regimes and tax treaty

Where an arrangement by an enterprise falls within the scope of the regime of transfer pricing, cost sharing, controlled foreign company, thin capitalization, or other special tax adjustments, the application of provisions relevant to those regimes shall be prior.

Tax treaty does not prevent the application of the GAAR. However, where an arrangement by an enterprise is relevant to provisions on beneficial owner, limitation on tax benefits, or other issues related to the implementation of tax treaty, provisions on those issues related to the implementation of tax treaty shall be prior to be applied.

PART B

Question 3

Chinese tax authority will treat the management agreement as a mixture agreement, under which the payment by DCO will be split as different items for the purposes Chinese income taxation.

Director's fee will be split from the payment by DCO and be levied individual income tax in China under Article 16 of China-UK Tax Treaty.

Two technical consultants will be treated as Chinese residents according to Chinese individual income tax law, and therefore need to pay individual income tax in China for their salary earned in China, which need to be split from the payment by DCO.

The business income earned by CCO, which will also be split from the payment by DCO, is taxable income in China because 3-year-technical consultation services by 2 technical consultants in China will constitute a Service PE under Article 5 of the China-UK tax treaty.

The payment by DCO to CCO needs to be in line with the arm's length principle because of affiliated relationship between CCO and DCO.

PART C

Question 4

Part 1

Article 4 of China-UK Tax Treaty.

Part 2

Not. If he/she has a domicile in the territory of China, he/she is regarded as a resident individual in China, and therefore his/her worldwide income shall be taxable in China. If he/she has no domicile in the territory of China, he/she is regarded as a non-resident individual in China, and therefore his/her income derived from the territory of China shall be taxable in China according to provisions of Chinese Individual Income Tax Law.

Part 3

DTA between Chinese inland and HK will be applied. Bryn is regarded as a resident in HK, because he exercises his employment and has an apartment in HK.

Question 5

The RO in Shanghai is a PE of the company in China according to Art.5 of China-UK Tax Treaty and therefore is liable to pay enterprise income tax in China.

According to Guohuifa [2010] No.18 and Gonggao [2016] No. 28 issued by the SAT, the amount of taxable income of the RO shall be calculated by the formula as follows: amount of taxable income = [cost (or expenses)/ (1- deemed profit rate)]×deemed profit rate. Expenses in 2016 shall be two employees' salary plus all other expenses, i.e., 0.5 million+1 million+2 million.

The UK resident shall pay individual income tax in China because he/she has stayed and worked in China for 12 months, according to Art.15 of China-UK Tax Treaty. Chinese resident is also liable to pay individual income tax in China for his/her salary according to Chinese Individual Income Tax Law in this case.

Question 6

Andrew was not Chinese resident and stayed in China less than 183 days in 2014, thus his salary paid by ECO for his work for the RO is not liable for Chinese tax according to Article 15 of China-UK Tax Treaty and Guohuifa [1994] No.148. However, his salary of 2015 shall be taxed in China, because his stay in China was more than 183 days.

In 2016, Andrew was employed as a legal representative of FCO, a China resident company, thus he is a senior personnel in FCO. According to Article 3 of the Implementing Regulation of Chinese Individual Income Tax Law, he shall be regarded to stay in China for 365 days in 2016, and thus be a Chinese resident. All salary paid by FCO in 2016 shall be taxed in China.

All salary paid by GCO to Andrew for his work outside China is not liable for Chinese tax, according to Article 15 of China-UK Tax Treaty, Article 6 of the Implementing Regulation of Chinese Individual Income Tax Law, and Guohuifa [1994] No.148.

Question 7

Part 1

If HKCO was a resident in Chinese mainland, HKCO would be liable to pay Chinese enterprise income tax at 25% for its business profits, and there are no withholding taxes on distribution of dividends to XCO according to the Chinese Enterprise Income Tax Law. Otherwise, HKCO would be a HK resident and liable to pay profit taxes for its profits earned in HK at 16.5%, and withhold 10% of dividends distributed to XCO according to Article 10 of the Tax Arrangements between HK and Chinese Mainland. In addition, if HKCO did not distribute its profits to XCO without any reasonable business purpose, CFC rules under Chinese Enterprise Income Tax Law would be applied to XCO. Therefore, in latter circumstances, total tax burden assumed by XCO and HKCO together is bigger than that in former circumstances, even though XCO may claim HK income taxes credit when its dividends received from HKCO are taxed in China.

Part 2

It is very difficult to consider the place of effective management of HKCO locates in Chinese mainland, because 3 directors of HKCO domicile in HK, they deal with management of HKCO in HK and make business decisions with other 2 directors via video conference, day-to-day management of HKCO is made by HK manager in HK, and main business of HKCO happens in HK. Therefore, the requirements on which a Chinese controlled company registered abroad may be identified as Chinese resident company under Guoshuifa [2009] No. 82 are not met in this case. By contrast, it is very evident that HKCO is controlled by XCO indirectly through ZCO. The shareholding of HKCO by XCO is line with the requirements on which a CFC may be identified under the Chinese income tax law. Based on the above, it seems that the arguments of HKCO are weaker than that of Xiamen tax authority.