Question 1

Tax Residency of Mr Wing

First of all, being an independent Special Autonomous Region of China, Hong Kong is independent tax jurisdiction from mainland China (thereafter referred to as China). Thus, whether Mr Wing is a Hong Kong tax resident or a China tax resident needs to be ascertained.

In China, Individual Income Tax (IIT) is calculated based on individual basis rather than on family basis. Therefore he is married to a Chinese wife has no direct impact on his tax residency.

In determining his tax residency, we need to look at China's domestic IIT law before going to the Hong Kong-China double tax agreement (DTA) right away.

China's IIT law provides that:

i) Individuals who are domiciled in China (defined as personal connections within the territory of China, e.g. household location, family relationship etc.) or individuals who are not domiciled in China but have lived in China for more than one year are subject to IIT for China sourced income and non-China sourced income if it is paid by Chinese residents.

ii) Individuals who have been lived in China for more than five consecutive years will be subject to IIT in China for the global income beginning from the sixth year.

2009-2013: Hong Kong tax resident

Based on the above rule, in years 2009-2013, although Mr Wing lives in China, it can be argued that his personal connections are still with Hong Kong, e.g. he still owns one house in Hong Kong, his parents may still live in Hong Kong so that he is a Hong Kong tax resident, he owns Hong Kong listed company's shares (of course depending on the percentage of shares he owns).

In China tax's practice, it is rare to treat non-Chinese individuals as domiciled in China (thus China tax resident) simply because of living in China, working in China or owning properties in China).

Therefore, for 2009-2013, Mr Wing is a Hong Kong tax resident.

2014: China tax resident

However, for 2014, when he has lived in China for more than 5 consecutive years after 2009, he becomes a China tax resident for IIT purpose and is subject to IIT based on global income (i.e. including China-sourced income and non-China sourced income).

Under China's IIT law, different types of income is taxed individually under different tax rate.

Salary income

It is not given in the question that whether Mr Wing's employer (i.e. a listed company) is a Chinese company or not. However, assuming the employer is a Chinese company, this is China sourced. Salary income is subject to progressive IIT rate from 3-45% with a standard monthly deduction of RMB4,800 (Although he is a Chinese tax resident, he can still have the deduction of RMB4,800 the same as expatriates.)

IIT for salary income is withheld by employer on a monthly basis.

Rental income from Shanghai house

Since the house (i.e. immoveable property) is located in China, this is obviously China-sourced income. It will be subject to flat IIT rate of 20% with deductions. Monthly rental income of RMB10,000 will be entitled to 20% deduction.

So the monthly IIT liability is 10,000 x (1-20%) x 20% = RMB1,600. This is more on self-filing purpose, or if the tenant requires an official invoice, Mr Wing would be requested to pay the IIT to local tax authorities before an official invoice can be released from local tax authorities.

Rental income from Hong Kong house

Since the house (i.e. immoveable property) is located in Hong Kong, this is non-Chinese sourced income. Theoretically, this should be captured under global income and subject to China IIT regardless of the source (with flat tax rate of 20% and deduction same as above), however, practically this could be very difficult for Chinese tax authorities to enforce the rule and impose any penalty should Mr Wing fails to report the income.

Practically, if the Hong Kong tenant requested an invoice, Mr Wing would need to pay Hong Kong tax on the rental income too. Potentially there would be double taxation in this regard and he can seek the China DTA for relief of double taxation, where tie-breaker rule for tax residency is likely to come to play and determine his residency to be in China for 2014.

Dividend from a Hong Kong listed company

The sourcing rule for dividend is based on the location of the company paying the dividend. Assuming the Hong Kong listed company is also a company registered in Hong Kong, this dividend is non-China sourced, however captured still as his global income. Therefore, it should theoretically be subject to flat IIT rate at 20% without any deduction, it would be very difficult practically to enforce this.

Annual IIT self-filing for income above RMB120,000

Obviously, Mr Wing's total annual income exceeded RMB120,000. As requested by China IIT law, an annual IIT self-filing return needs to be filed before 30 April 2015 for his 2014 income.

Question 4

Introduction

These transactions involved significant cross-border payments to related companies which is increasingly the transfer pricing audit targets since 2014 following two important tax circulars in China, i.e. Shuizongbanfa [2014] No. 146 and State Administration of Taxation (SAT) Announcement No. 16.

PE position in China for Y

As at least 100 workers are sent to work in China and given the length of the contract (i.e. almost nine months, exceeding 183 days), China tax authorities may have good grounds investigating whether Y constitute a taxable PE in China.

Under the new UK-China DTA effective from 1 January 2014, which is not provided in this exam, there are three types of PE (i.e. fixed place of business PE, agency PE, and 183 days service PE). Under the current case, it is possible for Y to constitute a fixed place PE and a service PE in China.

Labour dispatch contract - is it genuine secondment?

X would be subject to tax authorities' queries when paying the RMB45m to Y as salaries due to Y would be considered as providing service in China and derived China-sourced income.

In another tax circler Announcement 19, it is set out that under genuine secondment arrangement (fulfilling below conditions), Chinese companies can make the payment to overseas related party who is the legal employer of such workers without China tax leakage.

i) The Chinese company decides the number, criterion, working conditions of the individuals to be sent to work in China.

ii) The Chinese company has full control over the individuals' daily work (e.g. approving annual leave, etc.) and have full appraisal right for their work performance.

iii) The individuals report to Chinese company instead of to overseas related party.

iv) It has to be demonstrated that this is a dollar-to-dollar reimbursement of the salary paid by the overseas related party to the individuals. The overseas related party cannot retain any profit.

v) The payments has been subject to IIT in China on the individual's level.

It is not given in the question whether any of the above conditions are fulfilled. Thus, it is possible that the RMB45,000,000 will be subject to China income tax.

As usually there is no separate accounts for a PE in China, practically, deemed profit method is used to calculate the taxable profit attributable to a PE with the deemed profit rage from 15-50%. The worker's service is likely to be subject to deemed profit rate of 15-30% depending on negotiation with Beijing local tax authorities.

There is increasing criticism to China's deemed profit approach with obviously doesn't agree with the Authorised OECD Approach (AOA) in allocating profit to PE. Under the BEPS Action Plan, China is expected to implement changes to this in order to align with international practice.

There is also VAT implication which is a separated topic not requested under the current question.

Consultancy contract

Based on the content of the contract (e.g. operational guidance, personal training, marketing support) and no mention of whether personnel is sent to China under the consultancy contract, it is not easy to determine whether the income derived is active income or passive income.

If it's active income (i.e. for services), and if all the services are rendered remotely from the UK, it can be argued that Y has no PE in China under this contract alone.

If it's considered passive income (e.g. royalties), it may be taxed at flat rate of 10%. For instance, marketing support and guidance may be provided by providing intangibles.

When there is disagreement, it is subject to local tax authorities' assessment, in worst case, it can be subject to 12.5% effective tax rate under the deemed profit rate of 50% as discussed above (12.5% = 50% x headline tax rate of 25%).

Transfer pricing (TP) implications

These two transactions are both related party transactions which are required to be carried out on arm's length principle based on OECD guidance as well as China's domestic TP rules.

However, whether RMB45,000,000 and RMB25,000,000 service fees are arm's-length price is subject to scrutiny. Using the CUP method, question is whether there are readily available comparable. Questions to ask may include whether the large sporting event takes place in other countries.

Other method can be explored too e.g. Resale minus. X's contract price is of great importance here in comparison to the payments made by X to Y, totalling RMB65,000,000. Whether that leaves X a decent profit.

Functions taken and subsequent risks assumed by X and Y are of great importance too. Questions to ask may include who negotiate the contract with the event committee (X or Y), who bears the risks of failing to receiving payment from the event committee.

Deductibility of the payments

If Chinese tax authorities consider that the payments are not arm's length (e.g. service received by X is not of real benefit to Y, or Y is merely exerting management control over X), it may deny the deduction at X's level.

BEPS Action 7

In the discussion draft of BEPS Action 7: Prevention of artificial avoidance of PE, issued in May 2015, anti-fragmentation and contract splitting are discussed in detail as methods of multinational business trying to avoid a PE.

In this context, Y could be deemed as deliberately splitting or fragmenting the contract into the labour dispatch contract and consultancy contract. There could be "force of attraction" rule in play to deem the two contract as one.

China tax authorities are empowered to trigger the domestic GAAR (General anti-tax avoidance rule, China's new GAAR rule, just released in Feb 2015) on this arrangement if they deem it as lacking reasonable business purpose and as being a measure to evade, reduce or defer China tax. GAAR is also especially added to Art 24 of the new China-UK DTA, which is not provided in this test.

Question 5

Introduction

Capital gain from indirect transfer of Chinese shares is a heated topic in recent years following the landmark issuance of the Chinese tax circular Guoshuifa [2009] 698, so called Circular 698 which has a profound impact on foreign investment sectors and China's GAAR measures.

The measure is generally viewed as following the famous India Vodafone case, only with more stringent enforcement.

In Feb 2015, SAT Announcement 7 was issued with significant modification to Circular 698 while leaving much issues under-defined by the SAT.

Basic 698 rule

A typical structure goes: A non-resident ("offshore seller") is disposing share of an SPV which holds share of a Chinese resident to achieve the purpose of indirectly disposing shares of a Chinese company.

Circular 698 (although now superseded by Announcement 7) provides that:

i) If the SPV is located in a jurisdiction where effective tax rate is less than 12.5% or do not levy capital gain tax, the offshore seller is required to report the case to Chinese tax authorities within 30 days of concluding the contract. This reporting obligation exists regardless of whether China tax liabilities arises.

ii) If the transaction is viewed as having no "reasonable business purpose", the SPV could be looked through and the transaction is viewed as a direct disposal of Chinese shares which is subject to 10% capital gain tax in China.

iii) Retained earnings of the Chinese companies are not allowed as a deductible cost when calculating the gain. Practically only the registered capital or the initial investment cost is allowable.

The changed position, under Announcement 7, includes the following:

i) The reporting obligations are compulsory under Circler 698 (described in above item A) while re-worded as optional under Announcement 7. Offshore seller, buyer and the Chinese company itself are all capable of making the reporting.

ii) Conditions are given as to lacking Reasonable Business Purpose, if the following are all fulfilled:

- At least 75% of the value of the shares represent China taxable asset;

- At any time in the preceding 12 months, 90% of the SPV's assets represents China investment or 90% of the income comes from dividend from China investment;

- The existence of the SPV is merely for fulfilling legal formality while taking little functions and risk in the operation; and

- Foreign capital gain tax liabilities under the indirect disposal are less than China's under a direct disposal case. This is a welcome comments made as it align with international practice in the purpose test of GAAR.

iii) Tax withholding obligations are imposed on the buyer. This receives much criticism as an offshore buyer usually will not have the China tax knowledge to know how much tax to withhold.

iv) If buyer fails to withhold the tax, offshore seller is required to settle the tax liabilities with China tax authorities within 7 days of the deal completion (defined as when the SPV's shares are officially and legally transferred)

v) Buyer seems to be motivated to report the transactions to Chinese tax authorities because the penalty for failing to withhold the taxes can potentially be waived if reporting takes place within 30 days of signing the sales and purchase contract.

   But it is unwise to recklessly doing so because reporting may means tax liabilities.

vi) Group Relief is provided. Old Circular 698 captures all indirect transfer which makes bona fide intra group restructuring subject to much tax uncertainties. If following conditions are fulfilled, group relief is granted:

   - Transferor and transferee are under 80% common shareholding (or 100% if the Chinese shares are land-rich);

   - Consideration is settled with equity (i.e. no cash); and

   - There is no reduce of China taxes if there is a future direct transfer.

vii) Tax advisors may potentially be requested by Chinese tax authorities.

viii) Disposing listed shares are excluded only if the shares are purchased at the same listed market. This may well catch the private equity fund investing in pre-IPO shares.

ix) Failing to settling taxes may be subject to late payment interests calculated at the standard interest rate issued by People of Bank of China plus 5%.

<u>Conclusion</u>

While Announcement 7 leaves much issues un-clarified and bring uncertainly to business, it is viewed as a welcome step of Chinese tax authorities towards giving more detailed instructions.

With the issuance of China's GAAR measures and factoring this into new tax treaties China signs or re-negotiates, it signals a strong message to the market that China is making strong efforts in combating its anti-tax avoidance as President Xi Jinping announced in Australia's G20 meeting last year.

Question 6

Tax residency of Mr Li and Mr Hu

Since they have household registration in China and are Chinese citizens, they will be treated as China tax residents.

Setting up the BVI Co

Setting up a BVI Co by Chinese individuals has no IIT implications in China but may subject to certain foreign exchange control and round-trip investment applications.

Tax residency of the BVI Co

BVI Co may be considered as China tax resident. China CIT law defines China tax residents to cover not only companies incorporated in China but also companies incorporated overseas but having effective management control in China.

Based on the tax Circular 82, four conditions are to be examined for China tax resident:

i) The daily operations takes place in China.

ii) The important finance and human resources decisions are carried out in China.

iii) Important corporate documents (e.g. accounting record, board meeting minute) and stamp are kept in China.

iv) More than half of the directors and senior management reside in China.

Based on the given conditions, it is very likely that the BVI Co should be treated as China tax resident. However, practically this is an application and approval procedure not automatic application.

If deemed as China tax resident, BVI Co's global income would be subject to China tax at 25%. Chinese companies' dividend to the BVI Co will be exempted from withholding tax as it's between two residents.

Transferring Chinese companies to the BVI Co

This effectively converts the Chinese companies from Chinese domestic companies to foreign invested companies (FIE).

Individual income tax (IIT) at 20% may arise for Mr Li and Mr Hu. Retained earnings are not allowed to be deducted from the investment cost. Only the paid up capital or the initial investment cost is allowed.

Circular 59 does provides intra group relief for similar transactions under the same shareholding control. However, it only covers corporate transferor and is not extended to individuals.

BVI Co receives a loan from UK

There are no direct China tax implications for this.

Issue shares to PE fund in UK

This could potentially be deemed as Mr Li and Mr Hu is transferring BVI Co's shares to the UK PE fund.

China may imposes capital gain tax at 10% potentially on offshore companies for indirect disposal of Chinese shares (under Circular 698, Announcement 7 is not issued yet as at May 2014). However, there is no similar rules for Chinese Individuals, although may be possible in future.

Structuring it as issuing new shares is frequently used to circumvent the above 698 rules. However, it is not clear practically whether China tax authorities will challenge this transaction - subject to case-by-case negotiation with local tax authorities.

If BVI Co is treated as China tax resident, it is another story. Shareholders will be treated as transferring China tax residents' shares and would be subject to 20% capital gain tax.

Debt financing to Chinese companies

First of all, as the Chinese subsidiaries are FIE, there is foreign debt capacity as a foreign investment rule.

Secondly, there is China's thin capitalisation rule. Excessive interests expenses are not allowed to be deducted at Chinese companies if the debt equity ratio exceeds 2:1 (or 5:1 for financial companies), unless documents can be provided to prove that the interest expense are arm's length.

Excessive interests would be regarded as dividend and subject to relevant withholding tax.