



Chartered  
Institute of  
Taxation  
Excellence in Taxation

# **THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION**

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## **PAPER 2.02 – CHINA OPTION**

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### **ADVANCED INTERNATIONAL TAXATION (JURISDICTION)**

Suggested solutions

## **PART I**

### Question 1

Mr Wing's tax liability for 2014 is based on his residence status. It is very likely that he will be treated as domiciled and thus resident in Chinese Mainland for tax purposes, considering the fact that he has lived and worked in Shanghai since January 2009 (center of vital interest), and has his family there.

Mr Wing has lived in Chinese Mainland for more than five years, thus all his worldwide income is taxable in Chinese Mainland.

His salary is taxed at progressive rate after a standard monthly deduction. The tax is withheld by the employer.

The rental income from house in Shanghai is subject to tax at a flat rate (after a standard deduction) in Chinese Mainland.

If Mr Wing is taxed as a resident of Hong Kong for HK tax purposes, he should rely on the tier-breaker rules in the Double Taxation Arrangement between Hong Kong and Mainland China for relief.

His rental income derived from house in HK and dividend income are sourced in HK and taxable there. However, he is entitled to claim tax credits for taxes paid to HK when he is taxed in Chinese Mainland on those income sourced from HK.

## Question 2

Ms Fang's tax liability for 2014 is based on her residence status. Because of her Chinese household registration and her exchange student status, she will be treated as a resident of China for tax purposes.

The Chinese scholarship she was given is not taxable in the UK under Article 20 of the China-UK tax treaty, and also is not taxed in China because of Chinese tax incentives for education.

The income derived from translation and remuneration to author are sourced from the UK and taxable in the UK.

These items of income are also taxed in China. The income derived from translation is taxed as service fees at a flat rate. The remuneration to author is taxed at a reduced flat rate. Ms Fang is entitled to claim tax credits for taxes paid to the UK.

## PART II

### Question 3

Michael is a resident of UK, and general partnership enterprise is a transparent entity for income tax purposes in China. Michael is a non-resident in China and does business through a Chinese partnership enterprise.

Profits distributed to Michael by the partnership enterprise is sourced in China and is regarded as the item of income which is derived by private industrial and commercial households from their productions and business operations for income tax purposes, and is taxed at progressive rates.

As a partner, Michael's salary paid by the partnership enterprise will be regarded as a part of profits distributed in advance to him, and as the item of income of private industrial and commercial households from their productions and business operations for income tax purposes.

The total amount of Michael's salary and profits from partnership enterprise determines which level in progressive tax rates is applicable to them.

Michael is a resident of UK, according to China's Individual Income Tax Law, his three time short visit in 2014 will not made him as a resident of China for tax purpose for that year. So Michael is a non-resident in China and does business through a Chinese partnership enterprise.

Profits distributed to Michael by the partnership enterprise are sourced in China. Since general partnership enterprise is a transparent entity for income tax purposes in China, all these profits are regarded as the item of income that are derived by private industrial and commercial households from their productions and business operations for income tax purposes, and are taxed at progressive rates.

As a partner, Michael's salary and reimbursement from that 5,000 RMB paid by the partnership enterprise will be regarded as a part of profits distributed in advance to him. The total amount of Michael's salary, reimbursement and profits from partnership enterprise determines which level in progressive tax rates is applicable to them.

#### Question 4

Y Ltd. is not a resident of China for tax purposes. Under labor dispatch contract, it rendered catering services in China for more than 183 days in 2014, and thus had a service PE in China under Article 5(3) of the China-UK tax treaty. Therefore China had a right to tax on business income derived from catering services rendered by Y Ltd.

Salaries paid to 100 workers were taxable income and were also subject to Chinese Individual Income Tax under Article 15 of the China-UK tax treaty, for those workers stayed in China for more than 183 days in 2014 and their salaries were borne by X Ltd, a Chinese resident.

It is very likely that two contracts concluded by Y Ltd. with X Ltd. will be treated as an artificial arrangement for disguising the fact that Y Ltd. actually furnished services for a same catering service project, if Y Ltd cannot show the evidence to verify all consultancy services furnished outside of China.

Chinese tax authority may invoke the GAAR which permit a substance over form approach and regard two contracts between Y Ltd. and X Ltd. as one same catering project. And then, all income earned by Y Ltd. would be taxable income in China.

### **PART III**

#### Question 5

Concept of indirect alienation of shares in Chinese domestic companies by a non-resident corporation of China. Substance over form and justification of China's taxing right to the indirect alienation.

Are there any tax relief based on arguments of a normal company restructuring within a company group?

Are there any tax relief based on arguments of having any other "reasonable business purposes"?

What if the Chinese domestic real estate company whose shares are indirectly alienated?

How to apply tax treaty to income derived from the indirect alienation.

As per the ADIT examination regulations, tax rules issued fewer than five months from the exam will not be a requirement. So the tax regulation applied in this answer will still be the circular 698 in 2009 and the follow-up circular 24 in 2011 rather than Circular 7 in 2015.

Based on the regulation of circular 698, Chinese tax authorities has the look-through power of intermediate holding companies with respect to indirect share transfer of Chinese entities.

The look-through power will be considered when the intermediate holding company located in a jurisdiction where the effective tax rate of capital gains from the alienation of the shares is lower than 12.5% or which exempts offshore capital gains from the alienation of shares from corporate income tax, unless there are reasonable business purposes within.

In circular 698, it remains not entirely certain what will be construed as a "lack of reasonable commercial purposes", but lack of commercial and physical substance at the intermediate holding company level, such as lack of business operations, assets, liabilities or employees other than the investments, would probably be considered as a lack of "reasonable commercial purposes" and be disregarded by the Chinese tax authorities in practice.

If the transfer is proved by the taxpayer that it meets the very requirement of reorganization in circular 59, then there may a tax relief apply.

When the capital gains derived from this transfer been considered as the income for China and has been taxed in a foreign country which has tax treaty with China, taxpayer may ask Chinese tax authorities for tax credits.

### Question 6

Alienation of their shares in Chinese domestic companies to BVI holding company:

- Whether it belongs to a company restructuring with special purposes within a company group?
- Whether Mr. Li and Mr. Hu are subject to tax on alienation of shares in China?

Residence status of BVI holding company:

- Piercing veil of company for tax purposes?
- Is it regarded as a Chinese resident under Enterprise Income Tax Law of China?

Making a loan from Bank of London:

- Is there Chinese withholding tax on interest?
- Are Chinese thin capitalization rules applicable?
- Is the China-UK tax treaty applicable?

Issuing shares to a private equity fund based in the UK:

- Is there Chinese withholding tax on dividends?
- Is the China-UK tax treaty applicable?