Answer-to-Question-_1_

ACo is a UK resident company and is therefore subject to Enterprise Income tax ("EIT") on income generated/sourced in China only.

The establishment of Bco as a holding company and owner of the patent may be subject to challenge under the General anti-avoidance legisation in Article 47 of the EIT law. The corporation tax rate in Hong Kong is 16.5% and the witholding tax ("WHT") rate under the China/HK treaty is 5% versus the 10% WHT rate under the China/UK treaty. The China tax authorities have the power to make special tax adjustments if there is no reasonable business purpose for a transaction and the tax rate is obviously lower. Special tax adjustments can involve recharcterisation of transactions or organisations. In this case, I would suspect that the China tax authorities would question the exisitence of BCo given the sole purpose would appear to be a reduction in tax and not a reasonable business purpose. Therefore I would expect the China authorities to treat BCo as transparent for China EIT purposes.

ACo has entered into an agreement with a domestic China entity DCo. Under the EIT law, related parties are defined as those who own 25% of shares directly or indirectly or those who are under effective control of another. As the agreement means DCo will sell all products to FCo (a wholly owned subsidiary of ACo), rent the manufacturing equipment from ACo and license the patent from BCo, ACo ultimately has control over the business operations of DCo regardless of the fact that it appears not to have a shareholding in the company. Therefore, DCo would be deemed a related party and the transfer pricing regulations within Articles 45-50 in the EIT law become relevant to all the transactions with DCo.

The 2 UK residents that will be providing technical assistance in China are working on behalf of DCo and will be paid by DCo. As such the salary earned whilst in China and borne by the Chinese company will be subject to Individual Income Tax in China from day 1 and DCo will withold this tax on payment to the employees.

As the 2 UK resident employees are within China for only 5 months which is less than the 183 day threshold stipulated within the UK/China double taxation agreement, no permanent establishment of ACo exists in China under article 5 3 (b).

The rent paid to ACo for the manufacturing equipment will constitute a royalty under article 12 3 (b)of the China/UK double tax agreement and as such will be subject to a 10% WHT on 60% of the gross amounts of the royalties. As ACo is resident in the UK it is therefore taxed on its income earned in China through the WHT mechanism.

The rent will be deductible in DCo for EIT purposes on the assumption that the amount charged is arms length/resonable given the above discussion that DCo and ACo are likely to be deemed related parties for EIT purposes.

The royalty payment from DCo to Bco for use of the patent is likely to be deemed as a payment to ACo per above discussion. As such a 10% WHT will be deducted from the payment under artcle 12 3 (a) of the UK/China DTA. Further, this will be deductible in DCo for EIT purposes on the basis it is an arms length rate.

The sale of goods from DCo to FCo will again need to be done under an arms length price. Although these entities are likely related per discussions above, they are two domestic China entities and as such the risk of challenge from a transfer pricing perspective is relatively low. It may be however that DCo benefits from the reduced 15% rate for EIT purposes on the basis it is a high technology company. In this case, as FCo will be subject to the usual 25% EIT rate the pricing between Dco and FCo could be challenged by the China tax authorities.

In summary, the two key areas of challenge in this scenaio would be:
1. The business purpose of BCo in HK, likely resulting in the entity being deemed transparent

2. The related party nature of DCo given the business activities are ultimatly controlled by ACo and its subsidiaries under the agreement. In whch case all transactions (rent,

royalties, sale of goods) will be subject to the transfer pricing regulations in China and the arms length nature can be challenged.

---------DO-NOT-EDIT-THIS-DIVIDER----------

Answer-to-Question-_2__

Although China has not legally adopted the transfer pricing guidance of the OECD, it has endorsed and captured a lot of the underlying principles within the domestic Enterprise Income Tax ("EIT") law.

The relevant tax legislation for transfer pricing matters in China is the EIT Law articles 40-50, the implementation rules of the EIT law articles 110-120 and Guishuifo circular No.2 special measures released in 2009.

Under the legislation, the China tax authorities are able to make a special adjustment and increase taxable income to at least the median of a "reasonable" comparable range. Penalties of RMB 50k may be charged alongside interest on any underpaid tax if any adjustment is required. A surcharge on the interest of 5% is also applied, although may be waived in the case that contemperaneous documentation is in place to support the comparables determined by the company.

The primary basis for pricing intercompany transactions is the "arms length principle". This means the pricing between two related parties should be comparable to the pricing between two unrelated/independent parties.

Determination of a relevant comparable transaction is highly subjective and should focus on the following;

1. Contractual terms - this includes the time and place of the transaction (e.g a different season may impact pricing), the delivery terms and associated risks, the method of payment (e.g. any credit or iterest), the volume of the transaction (e.g. volume discounts could impact price), any post sale services.

2. Business strategy - companies my for example target sales to distributors at a lower bulk discount rate rather than selling direct to consumers whcih would impact price. A company may be targeting specific customers or industry and therefore the startegy of the business needs to be considered and compared.

3. Contributions to the transactions e.g. risks and value drivers. For example you may have limited risk distribution entity or a toll manufacturing entity. In these cases a routine cost plus return would be expected rather tha an entity that bears risk and whome would expect an additional non routine return.

4. The nature of the transaction/comparability of products purchased or sold - it should be considered whether the transaction itself is an intangible transaction e.g. licence of a patent or technology, sale of goods, service agreement e.g. for manufacturing or R&D services. For products things such as trademarks, brand, specification, quality, grade, shape, package would all need to be considered to ensure there is a reasonable comparable.

5. Economic/market conditions - comparables should be within the same industry and within the same geographical regions as these factors can independently have an impact on the pricing. This should include social, political and economic factors. For example a independent party selling the same product into a country with special customs requiring a particular shape or colour of a product would inflate the price.

The China transfer pricing regime is rigorous with documentation mandatory, annual 9 form filing requirements required alongside the tax return and a significant number of audits. Therefore it is important that a company can fully support the comparables it applies to support its pricing methodology.

The comparability of controlled transactions and independent transactions does not require the two to be identical as this would be in most cases impossible. The tax authorities would accept comparables which are similar in substantial and important aspects. Limitations on availability of data also make comparables difficult.

The only way to get certainty over the intercompany pricing and comparables is to enter into an advanced pricing agreement with the tax authorities. This can be a lengthy process and is only available where intercompany transactionsa re in excess of 40m RMB.

---------DO-NOT-EDIT-THIS-DIVIDER----------

Answer-to-Question-_3__

China HS is a wholly foreign owned enterprise ("WFOE") of UK HS and is resident in China and therefore subject to Enterprise Income Tax ("EIT") on its worldwide income.

Joan spend 4 months (less than 183 days) in China and therefore the duration in China alone would not create a permanent establishmnet for UK HS. However, China HS entered into a contract in China on behalf of UK HS. Under Article 5 (5) of the UK/China double taxation agreement ("DTA") this would create a dependent agent permanent establishment. Any profits attributable to the permanent establishment of UK HS is therefore taxable in China under article 7 of the UK/China DTA.

As software owned by UK HS is being used by the permanent establishment in China a royalty should be charged by UK HS under arms length terms. Any royalty income earned by UK HS is then subject to WHT at 10% under artile 2 (a) of the China/UK DTA.

The high school agreement would constitute business income of the peremanent establishment subject to enterprise Income Tax at a rate of 30% (plus 3% local taxes).

Joan is a UK resident contractor under the direction/work contract of HS UK. Therefore the remuneration received would be employment income covered under article 15 of the UK/China DTA. Although Joan is engaged in teaching activities it is not of an independent nature and as such would not fall within article 14 of the DTA for independent personal services.

Joan is UK resident and was present in China for 4 months which is less than the 183 days under article 15 2 (a) of the UK/China DTA and therefore Joan would not be subject to Individual Income Tax ("IIT") in China.

Joan is paid by UK HS and also meets requirement 2 (b) of Article 15.

Article 2 (c) specified that the remuneration is not borne by a permanent establishment ("PE") or fixed base that the employer has in the other state. Per above, UK HS has a permanent establishment in China and a fixed place of business where Joan has been working. Therefore her costs should be attrbuted to the PE. In this case, Joan therefore becomes taxable to IIT in China.

Under the DTA to avoid double taxation, a tax credit would be available for any China tax paid against the tax burden in the UK.

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Answer-to-Question-_4__

1. Residency under the Individual Income Tax ("IIT") Law is determined by two methods. Firstly, if the individual is deemed to be domicilied in China meaning they have a residence, economic and/or familiy interest in China they would be domiciled and therefore resident in China for IIT purposes and subject to IIT on worldwide income.

Secondly an individual would be deemed resident depending on the duration of stay within China. If an individual is present within China for more than 5 years they would be deemed resident in China.

Therefore to be non resident in China an individual should spend less than 5 years within China and not be domicilled in China.

China residents are taxable in China on their worldwide income.

2. If the individual is not domicilled in China the IIT liability is primarily based on duration of stay. However, other factors wil also determine the IIT liability such as whether the costs are borne domestically in China or by an overseas entity/individual, whether the income is earned within China or overseas and also the seniority/position of the role.

If an individual is within China for more than a day but less 90 days (or 183 days if the person is resident in a treaty country) then the individual is not resident in China for IIT purposes. If costs are being borne by a China resident then IIT will be due immediately on that income otherwise no other income is subject to IIT.

If an individual is present in China for between 90 days (183 days for treaty countries) and a year the individual is subject to IIT on China earned income only whether it is borne by a China entity or overseas. For these pursposes you are unable to deduct short periods of absence (less than 30 consectutive days or 90 cumulative days).

If an individual is in China for more than a year but less than 5 years the individual is China resident and subject to IIT on worldwide income as a resident of China. However, the individual can apply to the tax authorities to ensure that they are only taxed on the China sourced income.

If an individual is within China for more than 5 years they are Chinese resident and subject to IIT on worlwide income.

If within the 5 years an individual leaves China for 30 consecutive days or more than 90 cumulative days within any given tax year (1 Jan to 31st Dec), they will break their residency and the 5 year clock will restart.

If in year 6 the individual leaves China for 30 consecutive days or more than 90 cumulative days they break the residency for that particular year but the 5 year clock does not restart and the residency will eed to be roken for every subsequent year. To restart the 5 year clock and fully break the residency the indvidual would need to spend less than 183 days within China in a given tax year.

For senior personal that have a dual role inside and outside CHina, they do not benefit from the exemption on income earned outside of CHina. They would be taxable on any income earned in China and and income earned outside CHina where it is borne by a Chinese company. This for example includes Chief representatives of representative offices.

There are 3 types of people sublect to IIT, residents, non residents and expats.

Employment income is taxed in 7 progessive income tax bands from 5-45% with standard and quick deductions available for each band.

Personal income is taxed in 3 progressive income tax bands.

Dividends, roylties and interest are taxed on flat rates.

Expats have cetain benefits e.g. accomodation, education grants, language courses, housekeeping etc which if reasonable (between 30-40% of gross salary) will not be subject to IIT.

Further annual bonuses are taxed seperately under a more favourable regime.

---------DO-NOT-EDIT-THIS-DIVIDER----------

Answer-to-Question-_7__

Business activities in China are subject to enterprise Income Tax ("EIT") in China under the following 3 categories:

1. Resident companies - these are enterprises established in CHina of effectively managed within China and are subject to EIT on worldwide income.
2. Representative offices ("RO") - these are subject to income on their Chinese income and income effectively linked to the RO
3. Non resident companies, these are split two fold
    i) Non resident with a permanent establishment - subject to income on their Chinese income and income effectively linked to the RO
    ii) Non resident with no permanent establishment - subject to EIT on China sourced income only.

Yang Damin is Chinese resident and therefore subject to individual income tax ("IIT") on any income earned as part of his appointment by RCo.

Initially Yang Damin is contacting clients and collecting premiums only. He is therefore not entering into contracts or generating revenues. To qualify as a representative office without a permanent establishment the actvities of the individual must be limited to liasing between the o/seas company and the customers, collecting information, gathering market research etc with no revenue generating activities. In this scenario therefore it would appear that the initial activities are of a RO and therefore EIT would not be due. An application should be made to register the RO, there have been issues within China of illegal ROs due to the open ability of foreign investers to expand into China in his manor.

Representative offices are not a legal person in China and RCo is therefore assuming risks and liabilities.

Attributing taxable income to a RO is difficult, however per abve the limited activities of Yang Damin would suggest there would be no taxable income in China.

If a branch were to be established to increase China activities there would be a permament estabishment under 2 (b) Article 5 of the UK/China double tax agreement ("DTA").

The branch is not a legal person in China, and as part of RCo, RCo shall assume the civil liability for the operational activities of its branch within the territory of China.

The registration of a branch is simpler than that for a foreign investment enterprise. RCo would need to file an application to the Approval Authority, accompanied by its articles of ssociation, registration certificate issued by the UK, and other relevant documents (e.g. proof of providing minimum operating funds, the name of the appointed representative of the branch, presumably Yang Damin, etc).

Once approved RCo can register the branch and obtain a business license. The license itself is evidence of the existence of a branch and aids the permanent establishment determination for tax purposes.

As a permanent establishment the branch is taxable as a China resident entity subject to tax on all income associated to the permanent establishment at 25%.

Transfer pricing between RCo and the permanent establishment would need to be considered to ensure the relevant profits are attributed and this can be subject to challenge by the tax authorities.

Under the UK/China doule tax agreement tax credits may be due to prevent any risk of double taxation