

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2024

MODULE 2.02 – CHINA OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Both of ACO and BCO are Chinese resident companies. DCO is a resident company in the UK and a related party of affiliated transactions with ACO and BCO. ECO is a resident company in the Hong Kong and controlled by ACO, and therefore transactions between DCO and ECO can be regarded as affiliated transactions.

The royalties for licensing the patent of making electronic mobile paid by DCO to ACO would be taxed in the UK, but the tax so charged shall not exceed 10 percent of the gross amount of the payment received by ACO, according to Art. 12(2)(a) of China-UK Tax Treaty.

The rents for leasing the equipment paid by DCO to ACO would be taxed in the UK, but the tax so charged shall not exceed 10 percent of the adjusted amount of the payment received by ACO, which means 60 percent of the gross amount of the rents paid by DCO, according to Art. 12(2)(b) of China-UK Tax Treaty.

The dividends paid by DCO to BCO would be taxed in the UK, but tax so charged shall not exceed 5 percent of the gross amount of the dividends, according to Art. 10(2) of China-UK Tax Treaty.

The dividends paid by DCO to BCO are likely to be tax-exempted in China, according to tax incentives provided specially by Chinese government to companies locate in Hainan Free Trade Port.

However, the establishment of BCO is likely to be challenged by Chinese tax authorities as a conduit company without any substance inserted into transactions between ACO and DCO for the purposes of reducing Chinese tax burden of ACO.

ECO is a CFC of ACO, which is likely to be challenged by Chinese tax authorities under the Chinese CFC rules if its profits were not distributed to ACO without any reasonable business purpose. In addition, the pricing of transactions between DCO and ECO shall be in line with arm's length principle, otherwise would be challenged and adjusted by Chinese tax authorities.

Moreover, two employees would be considered as resident individuals and taxed only in China for the payment received for their employment exercised in the UK, according to Art. 15(2) of China-UK Tax Treaty.

Question 2

According to Art. 1 of the Announcement on Relevant Individual Income Tax Policies for Overseas Income by the China's Ministry of Finance and the China's State Taxation Administration (Gonggao [2020] No.3), the following income shall be deemed as income derived from outside China:

- 1) Income obtained from the provision of labour services outside China due to office, employment or performing contracts, among others.
- 2) Income from author's remunerations paid and borne by an enterprise or any other organization outside China.
- 3) Income obtained from granting various franchises to be used outside China.
- 4) Income related to production and business activities obtained from the production and business activities conducted outside China.
- 5) Income from interest, dividends and bonuses obtained from an enterprise, other organization or non-resident individual outside China.
- 6) Income obtained from the lease of property to a lessee for use outside China.
- 7) Income obtained from the conveyance of the real estate outside China, the transfer of stocks, equities and other equity assets (hereinafter referred to as "equity assets") formed by investments in an enterprise or other organization outside China, or the conveyance of other property outside China. However, where, at any time within the three years (36 consecutive calendar months) before the transfer of the equity assets formed by investments in an enterprise or other organization outside China, more than 50% of the fair value of the assets of the invested enterprise or other organization is directly or indirectly derived from the real estate inside China, the income obtained shall be deemed as the income derived from inside China.
- 8) Contingent income paid and borne by an enterprise, other organization or non-resident individual outside China.
- 9) Where it is otherwise provided for by the Ministry of Finance or the State Taxation Administration, such provision shall prevail.

PART B

Question 3

According to Art. 2(2) of the Chinese Enterprise Income Tax Law, an enterprise that is established within Chinese Mainland, or which is established under the law of a foreign country(region) but whose place of effective management locates within Chinese Mainland, may be identified as a resident enterprise for the purpose of the Chinese Enterprise Income Tax Law.

XCO was set up in the UK, thus we need to consider if XCO's place of effective management locates within Chinese Mainland, for determining whether XCO is a resident company in Chinese Mainland or not.

According to Art. 4 of China's Regulation on the Implementation of the Enterprise Income Tax Law, the place of effective management refers to a place in which there is a comprehensive and substantial management and control with respect to business operation, personnel, finance and properties of whole enterprise.

Further, According to Art. 2 of the Circular on Issues about the Identification of Chinese-Controlled Enterprises Incorporated Abroad as Resident Enterprises Based on the Place of Effective Management (Guoshuifa [2009] No.82, issued by the STA), a Chinese controlled enterprise incorporated abroad may be identified as a resident enterprise if it concurrently meets four factors as follows:

- 1) The places where the senior management and the senior management bodies responsible for the routine production and business management of the enterprise perform their functions are mainly located within Chinese Mainland;
- 2) The financial decisions (about borrowing, lending, financing, financial risk management, etc.) and the personnel decisions (about appointment, dismissal, payment, etc.) of the enterprise are made by the bodies or persons within Chinese Mainland or are subject to the approval of the bodies or persons within Chinese Mainland;
- 3) The enterprise's primary properties, account books, company seals, minutes and archives of the meetings of the board of directors and shareholders are located or preserved within Chinese Mainland; and
- 4) The enterprise's directors or senior management with 1/2 or more of the voting rights usually live in Chinese Mainland.

As for XCO, two of its executive directors live in Shenzhen and its business decision mainly made in Shenzhen, and all records are also kept in Shenzhen, it could be considered to concurrently meet above four factors listed by the Guoshuifa [2009] No.82, issued by the STA. Therefore, XCO should be regarded as a resident company in China.

Moreover, XCO was incorporated in the UK and is a national in the UK, to which Art. 24(1) of the China-UK Tax Treaty would be applicable. Therefore, it would constitute a breach of Art.24(1) of the China-UK Tax Treaty if XCO could also be considered as having its residence in China according to Art.4 of the China-UK Tax Treaty and absent other relevant different circumstances.

Question 4

Under the issuance contract, the payment obligation to investors by GCO is calculated at a fixed percentage of the invested capital each year within the issuance period, the invested capital will be paid back to the investors at the end of the issuance period, and investors can not have any company rights to GCO. Based on the above-mentioned facts, it can be considered that investors of such kind of securities actually enjoy debt-claims to the issuer. and therefore the income derived by investors may be regarded as interest, according to Art.11(4) of the China-UK Tax Treaty.

The only “profit related” element in the security concerned is that the issuer is not required to make any interest payments in loss years, but is allowed to carry forward the payment obligation into future profitable years. However, this mechanism is not a “profit participation”, but at best a “condition of profitability” which is not covered by Article 11(4) of the China-UK Tax Treaty.

Therefore, according to Art.11(2) of the China-UK Tax Treaty, such interest may be taxed in China, but the tax so charged shall not exceed 10 per cent of the gross amount of the interest.

However, Penalty charges for late payment shall not be regard as interest, according to Article 11(4) of the China-UK Tax Treaty, and would be covered by Art. 21 of the China-UK Tax Treaty. According to Art. 21(1) of the China-UK Tax Treaty, such penalty charges shall be taxed only in the UK where beneficial investors live.

PART C

Question 5

According to Art.4(2) of the China-UK Tax Treaty, Mr Zhang is a resident in the UK.

Mr Zhang did not become a resident in the UK solely for the purpose of rendering the services to the Chinese embassy located in London, therefore, according to Art.19(1)(b) of the China-UK Tax Treaty, Mr Zhang's salary shall be taxed only in the UK.

Mr Zhang remains being a national of China after his retirement even though he is still a resident in London. Therefore, according to Art.19(2)(b) of the China-UK Tax Treaty, Mr Zhang's pension shall be taxed only in China.

Question 6

Ms Liu's tax liability for 2021 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 paid by the Chinese social media company and the remuneration paid by the British publisher would be considered as royalties under Article 12 of the China-UK tax treaty, according to which the remuneration would be considered as being sourced from the UK and taxable in the UK, however, the consideration paid by the Chinese company was not sourced from the UK and not taxable in the UK.

Both items of income shall be taxed in China at a reduced flat rate of 14%.

Ms Liu is entitled to claim tax credits for taxes paid to the UK.

Question 7

ICO is a resident in the UK, and KCO is a resident in China. According to Art. 5 of the Implementing Regulations for the Chinese Enterprise Income Tax Law, the warehouse can be considered as a “establishment and/or place” in China.

In general, the warehouse shall not constitute a PE of ICO in China, according to Art. 5(4) of China-UK Tax Treaty.

It seems that the claim of the tax bureau would be backed up by following facts: (1) KCO and ICO are closely related enterprises; (2) KCO’s store constitutes a fixed place of business for KCO; and (3) The business activities carried on by ICO at its warehouse and by KCO at its store constitute complementary functions that are part of a cohesive business operation, i.e. storing goods in one place for the purpose of delivering these goods as part of the obligations resulting from the sale of these goods through another place in the same State.

However, the above-mentioned facts should not be considered when identifying the preparatory or auxiliary character of activities carried on at a fixed place of business, if there are no same provisions as that of Art.5(4.1) of OECD Tax Treaty Model 2017, according to which the preparatory or auxiliary character of activities carried on at a fixed place of business must be viewed in the light of other activities that constitute complementary functions that are part of a cohesive business and which the same enterprise or closely related enterprises carry on in the same State.

Therefore, according to the wording of Art. 5(4) of China-UK Tax Treaty, the warehouse shall not be considered as a PE of ICO in China.

Question 8

MCO is a resident in China, and NCO is a resident in the UK.

MCO's office in London constitutes a PE in the UK.

Dividends of RMB 10 million received from NCO is subject to tax in the UK, but tax charged shall not exceed 10 percent of the gross amount of the dividends, according to Art. 10(2)(c) of the China-UK Tax Treaty.

Losses of RMB 5 million attributable to the office in the UK cannot be offset by the profits derived by MCO in China, but can be offset by the dividends received by MCO from NCO, according to Art. 17 of the Chinese Enterprise Income Tax Law.

After offsetting, the profits of RMB 5 million derived in the UK shall be taxable in China, and China shall eliminate double taxation via credit method, according to Art. 23 of the China-UK Tax Treaty.