THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2023

MODULE 2.02 – CHINA OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

According to Art. 2 of the Announcement of the State Taxation Administration on Issues Concerning "Beneficial Owners" in Tax Treaties (Gonggao [2018] No. 9 issued by the STA), following factors are generally considered as adverse factors in determining the applicant of tax treaty benefits as a beneficial owner:

- The applicant is obliged to pay to residents of a third country (region) 50% of the income or more within the prescribed time limit; the "obligations" include agreed obligations and the circumstance where there is no agreed obligation but the payment has been made.
- The business activities engaged in by the applicant fail to constitute substantive business activities. Substantial business activities include substantive manufacturing, distribution, management and other activities. Whether the business activities engaged in by the applicant are substantive shall be judged according to the functions actually performed and the risks assumed by the applicant. The substantive investment holding and management activities engaged in by the applicant may constitute substantive business activities. For the applicant engaging in the investment holding and management activities that do not constitute substantive business activities and engaging in other business activities at the same time, if the other business activities are not significant enough, such business activities do not constitute substantive business activities.

Therefore, there are two adverse factors that have negative impact on determining DCO as beneficial owner: (a) DCO is responsible for the investment management in China, having 3 employees who work in the UK, shareholding in ECO, and small amount of cash, without any accounts payable. This means DCO does not have independent capacity of operation, investment and financing; (b) DCO needs to pay 80% of dividends derived from ECO to BCO within one month after its receipt of dividends from ECO.

There are safe harbor rules in Chinese tax law. According to Art. 4 of the Announcement of the State Taxation Administration on Issues Concerning "Beneficial Owners" in Tax Treaties (Gonggao [2018] No. 9 issued by the STA), when the income obtained from China by the following applicants is dividends, the applicants may be identified directly as "beneficial owners" without the need to conduct a comprehensive analysis based on the factors set forth in Article 2 of this Announcement: (a) the government of the other contracting state; (b) a resident of the other contracting state that is a listed company in the other contracting state; (c) an individual resident of the other contracting state; (d) an applicant of which 100% shares are directly or indirectly held by one or more persons set forth in subparagraphs (a) through (c), and the intermediate layers indirectly holding shares are residents of China or residents of the other contracting state.

According to Art. 5 of the Announcement of the State Taxation Administration on Issues Concerning "Beneficial Owners" in Tax Treaties (Gonggao [2018] No. 9 issued by the STA), the proportion of shareholding required by Articles 3 and 4 of this Announcement shall reach the prescribed proportion at any time during the 12 consecutive months before the dividends are obtained.

Listed company ACO in HK directly owns 100% of shares in DCO resident in HK by BCO resident in the UK, however, BCO is not a resident in HK or in China, therefore, the safe harbor rules mentioned above cannot be applicable to DCO.

According to Art. 3 of the Announcement of the State Taxation Administration on Issues Concerning "Beneficial Owners" in Tax Treaties (Gonggao [2018] No. 9 issued by the STA), when the income obtained from China by an applicant is dividends, even though the applicant fails to meet the conditions for a "beneficial owner," the applicant shall be identified as a beneficial owner if the person who directly or indirectly holds 100% shares of the applicant meets the conditions of a "beneficial owner" and falls either of the following circumstances: (a) the person mentioned above meeting the conditions for a "beneficial owner" is a resident of the country (region) where the applicant is a resident; (b) person mentioned above meeting the conditions for a "beneficial owner" is a resident of the country (region) where the applicant is a resident, but both the person and the intermediate layers indirectly holding shares are eligible persons. For the purpose of this article, "meeting the conditions for a "beneficial owner" means that a person may be identified as a "beneficial owner" after a comprehensive analysis conducted according to Article 2 of this Announcement; and an "eligible person" means a person enjoying the treatment under the tax treaty signed between China and the country (region) of residence of the person when the income obtained from China by the person is dividends, which is the same as or more preferential than that may be enjoyed by the applicant.

a) BCO resident in the UK directly owns 100% of shares in DCO, and its shareholding has lasted more than 12 consecutive months before the dividends are obtained.
b) BCO is responsible for the operation of products, investment management and brand maintenance as a China's regional headquarter, having business office and about 100 employees in the UK, and is not liable for paying to residents in a non-contracting state (region) of tax treaty 50% of the income or more. This means that BCO has its substantial business activities. Therefore, BCO can be considered meeting the conditions for a beneficial owner.
c) BCO is a resident in the UK, not in HK. Dividends received from a resident in China by BCO will be subject to tax rate 5% according to the China-UK Tax Treaty, which is the same as that may be enjoyed by DCO according to the Chinese Mainland-Hong Kong Tax Arrangement.

Base on these facts, DCO can be considered meeting the conditions for a beneficial owner, and thus can enjoy reduced tax rate in the Chinese Mainland-Hong Kong Tax Arrangement on dividends derived from ECO.

Question 2

The legal framework

Art. 34 and Art. 35 of the Announcement on Issuing the Administrative Measures of Special Tax Investigation and Adjustment and Mutual Agreement Procedure (Gonggao [2017] No.6 Issued the STA in China).

According to Art. 34 of the Announcement, where the prices paid or collected on the trading in labour services between an enterprise and any of its affiliated parties fails to conform to the arm's-length principle, which results in the reduction of the taxable income or the amount of income of the enterprise or the affiliated party, the tax authority may make special tax adjustments.

A trading in labour services which conforms to the arm's-length principle shall be a beneficial trading in labour services, and price shall be fixed on the basis of the regular business practice of a non-affiliated party under identical or similar circumstances and the fair transaction price.

"Beneficial labour services" means the labour service activities which can bring about direct or indirect economic benefits to a labour service recipient and the non-affiliated party is willing to purchase or conduct by itself under identical or similar circumstances.

Intra-group services non-beneficial to the recipient members within an MNE group:

According to Art. 35 of the Announcement, non-beneficial labour services mainly include the following circumstances:

1) Labour service activities that the recipient accepts from its affiliated parties, and that has purchased or implemented by itself;
2) The labour services of control, administration, and supervision, etc., that the recipient accepts from its affiliated parties and implements for the purpose of guaranteeing the investment interests of the direct or indirect investors of the labour service recipient. Such labour service activities mainly include:
    a) activities related to the board of directors, the shareholders' meetings, the board of supervisors, and issuance of shares and other activities serving shareholders;
    b) activities related to the preparation and analysis of the operating reports or financial reports of labour service recipient's direct or indirect investors, group headquarters and regional headquarters;
    c) the fundraising activities related to the operation and capital operation of the labour service recipient's direct or indirect investors, group headquarters and regional headquarters;
    d) financial, taxation, personnel, and legal activities, etc., conducted for group decision-making, regulation, control and compliance; and
    e) other similar circumstances.
3) Labour services that the recipient accepts from its affiliated parties, and implements not for itself but obtains additional income simply because of being affiliated to the enterprise group. Such labour service activities mainly include:
    a) the restructuring activities of the group with resource integration effects and scale effects to the labour service recipient, such as changes in the legal form, debt restructuring, equity acquisition, asset acquisition, merger, and division, among others;
    b) relevant activities that can reduce financing costs and other benefits to the labour service recipient due to the improvement of the credit rating of the enterprise group; and
    c) other similar circumstances.
4) Labour service activities that the recipient accepts from its affiliated parties, and for which compensation has been made in any other affiliated transactions. Such labour service activities mainly include:
    a) services related to patents or know-hows which are compensated in the payment of royalties;

   b) services related to loans compensated in loan interest payments; and
   c) other similar circumstances.

5) Affiliated labour service activities which are not related to the functions performed and risks assumed by the labour service recipient or fail to meet the operational needs of the labour service recipient.
6) Other affiliated labour service activities that cannot bring about direct or indirect economic benefits to the labour service recipient, or the non-affiliated party is unwilling to purchase or implement by itself.

PART B

Question 3

HCO and John are residents in the UK, received dividends from China. According to Art.10(1) of the China-UK Tax Treaty, those dividends they received may be taxed in China.

However, according to Art.10(2)(b) of the China-UK Tax Treaty, the tax charged by China shall not exceed 15 per cent of the gross amount of the dividends where those dividends are paid out of income or gains derived directly or indirectly from immovable property within the meaning of Article 6 by an investment vehicle which distributes most of this income or gains annually and whose income or gains from such immovable property is exempted from tax.

HCO and John invested in a REITs in Shanghai, the operation of which is in line with the requirements mentioned in Art.10(2)(b) of the China-UK Tax Treaty. Therefore, the tax charged by China shall not exceed 15% of the gains they received from the REITs.

HCO is a non-resident enterprise under the Chinese Enterprise Income Tax Law. Dividends derived from the REITs meet the requirements mentioned in Art.3(3) of the Chinese Enterprise Income Tax Law. Therefore, according to Art.91 of the Regulation on the Implementation of the Chinese Enterprise Income Tax Law, dividends derived by HCO may be taxed in China at a tax rate of 10%.

John is a non-resident individual under the Chinese Individual Income Tax Law. Dividends derived by him from REITs would be taxed at a tax rate of 20% according to the provisions of the Chinese Individual Income Tax Law. However, the provisions of the China-UK Tax Treaty take precedence over the provisions of the Chinese Individual Income Tax Law. Therefore, dividends derived by John may be taxed in China at a tax rate of 15%.

Question 4

Part 1

FCO constitutes a PE in China, through activities of GCO.

GCO is a subsidiary of FCO, thus an independent entity, and it is generally not deemed as a PE of FCO merely because of the fact that GCO controls FCO, according to Art.5(7) of the China-UK Tax Treaty.

However, GCO solely works for FCO, and habitually plays a principal role leading to the routine conclusion of sale contracts with Chinese customers by FCO without material modification. Those facts mean that GCO actually acts as a dependent agent of FCO, and its activities already go beyond marketing activities. According to Art.5(5) and (6) of the China-UK Tax Treaty, FCO has a PE in China.

Part 2

GCO and FCO are related parties, transactions between them shall be in line with arm's length principle.

For its marketing activities for FCO, GCO receives 5% of the sale revenue received by FCO from sales of advertising space to Chinese customers. Such fee shall be reviewed whether it is an arm's length price, if not, it shall be adjusted.

In addition, as a dependent agent of FCO, GCO should be paid by FCO for its agent activities at arm's length price.

PART C

Question 5

XCO is a large international shipping company resident in the UK, its rental of two boats on bare boat basis for 2 years is not an independent business project, and the consideration received for its rental of two boats is not more than 10% of annual income derived from international traffic, thus can be considered as its incidental business activities, according to Art. 2(4)(c) of the Announcement on Issues of the Implementation of Tax Treaties (Gonggao [2018] No.11 Issued the STA)

YCO uses one of boat for the transportation of chemicals from China to Malaysia, which means that that boat is operated in international traffic. Therefore, the profits derived from the payment received by XCO from YCO for the rental of that boat shall be taxable only in the UK, not be taxable in China, according to Art.8(1) and (2) of the China-UK Tax Treaty.

However, YCO use another boat for the transportation of chemicals from a port in North China to another port in South China, which means that this boat is not operated in international traffic. Therefore, the profits derived from the payment received by XCO from YCO for the rental of that boat is not derived from the operation of ships in international traffic, may be taxable in China, not only in the UK, according to Art.8(1) and (2) of the China-UK Tax Treaty.

Question 6

RMB 20,000 received by Ms Huang shall not be taxable in China.

Ms Huang is a resident in the UK, as an independent director of ZCO resident in China, whose income is derived from director's fee in her capacity as a member of the board of directors of ZCO may be taxable in China, according to Art.16 of the China-UK Tax Treaty.

However, RMB 20,000 received by Ms Huang is not derived in respect of her separate professional services other than in her capacity as a member of the board of directors of ZCO. She stays in China just few days for her presence at shareholder meeting and making academic presentation, and without a fixed base for making academic presentation.

Therefore, according to Art.14 of the China-UK Tax Treaty, RMB 20,000 received by Ms Huang shall be taxable only in the UK, and not be taxable in China.

Question 7

ICO is a resident in the UK, and KCO is a resident in China. Normally, gains from the alienation of the pharmaceutical patent between them shall be only taxable in the UK according to Art. 13(6) of China-UK Tax Treaty.

However, the alienation of the pharmaceutical patent between ICO and KCO is not line with the normal course of business, because of the facts that (1) the price for the alienation is on an annual basis and the amount of annual payment will be determined at 5% of net sales of each current year, and (2) KCO may not license or resell the patent to any third party without ICO's permission. This means that KCO does not really own the ownership of the patent, and the whole price for the alienation of the patent is not a lump-sum, more like royalties for licensing the patent. Therefore, in substance, ICO licenses its pharmaceutical patent to KCO, which is under the guise of the sale contract.

According to Art. 23 of China-UK Tax Treaty, Nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax evasion and avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to this Agreement. Thus, Art. 47 of the Chinese Enterprise Income Tax Law, the local tax authority in Shenzhen can make a special tax adjustment and re-characterize the alienation of the pharmaceutical patent as licensing the pharmaceutical patent, according to the substance of the transaction.

Therefore, according to Art. 12(1) and (2) of China-UK Tax Treaty, RMB 20,000,000 received by ICO is royalties, which may be taxable in China and be subject to withholding tax at a tax rate of 10%.

Question 8

MCO is a resident in the UK, which has gains from China because of the alienation of its shareholding in NCO.

Apparently, such shareholding is not more than 25% of shares in NCO, thus as to gains from the alienation of such shareholding, it seems that MCO shall not be taxable in China, only in the UK, according to Art. 13(5) of China-UK Tax Treaty.

However, according to Art. 13(4) of China-UK Tax Treaty, Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.

The market value of immovable property (vine yards) owned directly and indirectly (via LCO) by NCO: 40% × 10 billion + 80% × 90% × 5 billion = RMB 7.6 billion

The rate of market value of shares in NCO derived directly and indirectly from immovable property: 7.6 ÷ 10 = 76%

Therefore, gains derived by MCO from the alienation of shares in NCO deriving more than 50% of their market value directly and indirectly from immovable property situated in China.

According to Art. 13(4) of China-UK Tax Treaty, MCO may be taxable in China.