THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2022

MODULE 2.02 – CHINA OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

ACO, BCO, DCO and ECO are Chinses resident companies, and FCO is a UK resident company, thus the equity swap among them is a corporate reorganization related to non-resident enterprises and assets located outside China, for the purposes of Chinese income tax.

There are special conditions for enterprises to apply for enjoy the treatment of the tax-free corporate reorganization related to assets located abroad, which are prescribed in Art. 7(3) of the Circular on Issues Concerning the Enterprise Income Tax Treatment on Enterprise Reorganization (Caishui [2009] No. 59, jointly issued by the Ministry of Finance and the STA).

According to tax rules mentioned above, for enjoying the treatment of the tax-free corporate reorganization, when any equity swap transaction between resident enterprises is related to the cross-border equity acquisition transaction, it shall be limited to the facts that a Chinese resident enterprise invests its equity in enterprises (regardless of residents or non-residents enterprise) into another wholly and directly owned non-resident enterprise.

However, for Chinese income tax purposes, ECO, a Chinese resident company, transferred its 30% of equity in a wholly owned non-resident company into ACO, another Chinese resident company, for all equity in BCO and DCO, two Chinese resident company that wholly owned by ACO. Therefore, the equity acquisition transaction between ACO and ECO resulted from the equity swap is not line with the special conditions for resident enterprises to apply for enjoy the treatment of the tax-free corporate reorganization in China.

In other words, claims of ACO and ECO cannot be justified, and thus both parties to the swap transaction may be taxed on their gains derived from the equity swap transaction.

Therefore, ACO shall be taxed on the taxable income amount to RMB 30 million yuan (70 million-50 million+30 million-20 million) from gains derived from the transfer of equity in BCO and DCO, and ECO shall be taxed on the taxable income amount to RMB 60 million yuan (100 million-40 million) from gains derived from the transfer of 30% of equity in ECO.

In addition, ECO shall be taxed on gains derived from the transfer of 30% of equity in ECO in the UK, according to Art. 13(5) of the China-UK Tax Treaty, however, it may apply for enjoying foreign tax credit for such UK income taxes in China, subject to a limit of tax credit, according to Art. 23 of the China-UK Tax Treaty and relevant provisions of Chinese Enterprise Income Tax Law.

Question 2

The legal framework

The Circular on Policies Concerning the Preferential Enterprise Income Tax Treatment in Hainan Free Trade Port (Caishui [2020] No.31, issued jointly by the Ministry of Finance and the STA)

The Circular on Policies Concerning the Individual Income Tax Treatment of High-End and Urgently-Needed Talents in Hainan Free Trade Port (Caishui [2020] No.32, issued jointly by the Ministry of Finance and the STA)

Preferential Enterprise Income Tax Treatment

The enterprise income tax on enterprises in encouraged industries which are registered and conduct substantial operations in Hainan Free Trade Port shall be levied at a reduced tax rate of 15%.

The income obtained by enterprises in tourism, modern service industry, and high-tech industries established in HFTP from their new overseas direct investments shall be exempt from enterprise income tax, on the condition that (a) such income is the business profits obtained from an overseas branch office newly established, or from dividends corresponding to the new overseas direct investment gained from an overseas subsidiary of which the enterprise holds 20% or more of the shares; and (b) the statutory enterprise income tax rate of the country (region) where investment is made is not less than 5%.

If the unit value of any fixed and/or intangible assets, other than houses and buildings, newly purchased (or constructed or developed) by an enterprise established in HFTP is not more than 5 million yuan (inclusive), such fixed and/or intangible assets is allowed to be included in the costs and expenses for the current period at one time and deducted in the calculation of taxable income, instead of being depreciated and amortized annually; and if the unit value of the fixed and/or intangible assets mentioned above is more than 5 million yuan, the period of depreciation and amortization may be shortened or the method of accelerating depreciation and amortization may be adopted.

Preferential Individual Income Tax Treatment

For high-end and/or urgently-needed talents working in HFTP:

- The the portion of actual tax burden of individual income tax in excess of the rate of 15% shall be exempted;

- The income eligible for the preferential treatment mentioned above includes the comprehensive income (including income from wages and salaries, remuneration for labor services, author's remuneration and royalties) and business income obtained from HFTP, and the income from talent subsidies recognized by Hainan Province.

PART B

Question 3

According to Chinese Individual Income Tax Law, wages and salaries, remuneration for labor services, author's remuneration, and royalties obtained by a resident individual shall be referred to as the comprehensive income, and shall be calculated individual income tax on a consolidated basis, less the amount of basic deductibles, special deductibles and special additional deductibles.

In 2019, the amount of taxable income on the comprehensive income obtained by Mr. Zhang from domestic and foreign sources is 300,000+200,000-60,000-30,000-40,000-20,000= RMB 350,000 yuan.

In 2019, the amount of tax payable on the comprehensive income is RMB 55,580 yuan, the amount of tax payable on dividends is RMB 20,000 yuan, therefore, the total amount of tax payable on all items of income obtained by Mr. Zhang from domestic and foreign sources is 55,580+20,000=RMB 755,580 yuan.

For salaries derived from the UK, the limit of foreign tax credit is 55,580×200,000÷(300,000+200,000)=RMB 22,232 yuan. For dividends derived from the UK, which is referred to as other items of income in China, the limit of foreign tax credit is 100,000×20%= RMB20,000 yuan. Thus, the limit of foreign tax credit for all items of income derived from the UK is 22,23 2+20,000= RMB 42,232 yuan.

Mr. Zhang actually paid income taxes in the UK is 60,000+10,000=RMB 70,000 yuan, exceeding the limit of tax credit of RMB 42,232 yuan, therefore, he can only enjoy the foreign tax credit of RMB 42,232 yuan in 2019 for British taxes on his income derived from the UK, the uncreditable foreign tax of RMB 27,768 yuan may be credited against the balance of the limit of tax credit on income derived from the UK within subsequent five tax years

Therefore, the amount of individual income tax payable that Mr. Zhang shall pay in China on his all income obtained in 2019 is 55,580+20,000-42,232= RMB 33,348 yuan.

PART C

Question 4

The claim of the local tax authority shall not be agreed.

Peter was a UK resident individual without any physical presence in China during 2019.

The local broker company in Xiamen carried on its normal business, and was not the dependent agent of Peter for the purpose of Peter's performance in China.

According to Art. 17(1) of the China-UK Tax Treaty, Peter shall be regarded as an entertainer, and shall be taxed on income derived from his performance exercised in China.

However, because of Peter's absence and non-performance in China, Art. 17(1) of the China-UK Tax Treaty shall not be applied to the payment received by him.

Meanwhile, because of no fixed base established by Peter and no any independent personal services performed in China, Art. 14 of the China-UK Tax Treaty shall not be applied to the payment received by him.

The payment received by Peter may be considered as other income, according to Art. 21 of the China-UK Tax Treaty, and thus shall be taxable only in the UK.

Therefore, in China, Peter did not have tax liability for the payment received by him from the university during 2019.

Question 5

For Ms. Huang

On the one hand, she owns permanent home and the center of vital interests (having 100% of shares in XCO and being employed by it) in China.

On the other hand, she will stay in the UK for a period of 2020-22, which is long enough for her to be regarded as a UK resident individual, according to the UK income tax law.

However, Ms. Huang shall be regarded as a Chinese resident individual, according to Art.4(1) and (2) of China-UK Tax Treaty, and therefore a non-resident individual in the UK.

For XCO

Ms. Huang plays a key role in the decision-making of XCO, and participating in the business management of XCO in the UK during 2020-2022.

XCO is registered in China, majority directors locate in China, business assets, account books and financial documents are kept in China, and routine business management locates in China as well.

Based on the factors mentioned above, the place of effective management of XCO shall be regarded to locate in China, and thus shall be deemed to be a resident company in China, according to Art.4(3) of China-UK Tax Treaty.

During 2020-2022, XCO furnishes its services through its employee, Ms. Huang, for a period aggregating more than 183 days, thus shall be deemed to have a permanent establishment in the UK, according to Art.5(3) of China-UK Tax Treaty.

Question 6

ICO is a UK resident companies, and KCO is a Chinese resident company, thus the shareholding of ICO in KCO is related to a cross-border shareholding and dividends distributed between a non-resident enterprises shareholder and a resident enterprise in China, for the purposes of Chinese income tax.

There are special conditions for non-resident enterprises to enjoy tax treaty benefits concerning dividends distributed by a resident company in China, which are prescribed in Art.10(2) of China-UK Tax Treaty.

Apparently, after increasing its shareholding in KCO, ICO would have 25% of shares in KCO that would meet requirements set in Art.10(2)(a) of China-UK Tax Treaty, and thus would enjoy the reduced tax rate 5% for dividends derived from KCO.

However, substantially, the main purpose of increase of shareholding by ICO would be considered to take advantage of the tax benefits granted in Art.10(2)(a) of China-UK Tax Treaty, if considering the decrease of shareholding by ICO soon after receiving dividends distributed by KCO, from a prospective of the whole transaction of changing the shareholding in KCO.

In other words, according to Art.10(7) of China-UK Tax Treaty, for all dividends paid by KCO, the reduced tax rate 5% shall not be applied. Whereas, Art.10(2)(c) of China-UK Tax Treaty shall be applied, and thus the withholding tax rate for in China shall be 10%.

Therefore, tax authorities would challenge the main purpose of changing the shareholding by ICO to improper use of Art. 10(2)(a) of China-UK Tax Treaty, and ICO shall be taxed on all dividends paid by KCO at tax rate of 10% in China.

Question 7

Before 2021

MCO is a resident company in the UK, and NCO is a subsidiary of MCO in China. Thus, MCO and NCO are parent-subsidiary relation for the Chinese income tax purposes.

NCO engaged in its normal business on its own behalf, including wine marketing and selling, even though the wine produced by its parent company. According to Art. 5(7) of China-UK Tax Treaty, the fact that a resident company in a contracting state controls or is controlled by another company resided in the other contracting state shall not itself constitute either company a PE of the other.

Therefore, NCO shall not be a PE of MCO in China before 2021.

After 2021

MCO is still a resident company in the UK. However, NCO is not a subsidiary of MCO in China, because MCO sold out all shares in NCO and not a shareholder of NCO any more. Thus, MCO and NCO are not parent-subsidiary relation for the Chinese income tax purposes.

In view of the facts that NCO is acting in the ordinary course of its business after starting its new business as a general commission agent, NCO would be regarded as an independent agent of MCO, even though its activities have been devoted almost wholly on behalf of MCO.

According to Art. 5(6) of China-UK Tax Treaty, when the activities of an independent agent are devoted wholly or almost wholly on behalf of an enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, the agent will not be considered an agent of an independent status. In this regard, NCO and MCO are not related parties of a same group, thus NCO may still keep its independent status.

Therefore, according to Art. 5(6) of China-UK Tax Treaty, NCO shall not be a PE of MCO in China after 2021.