Answer-to-Question-_1_

The Chinese tax authorities could have multiple issues with the arrangements of ACO. These are as follows:

- The form of ACO and its ownership by Chinese residents and enterprises.
-The terms of the agreement between the Shanghai factory and the UK selling branch.
- The parties and arrangements of the income from the technical support agreement.
- Whether or no the Shanghai factory constitutes a PE.

Firstly in terms of the operation of the trade/business of ACO, it appears that all manufacturing and technical expertise is in Shanghai (as noted by the technical support staff being seconded from Shanghai and not HK).

A factory is specifically listed in the HK-China DTA article 5 (2)(4) as being the type of establishment that constitutes a permanent establishment for the purposes of the agreement. The Shanghai factory is also not independent of ACO so would not be exempt for that reason. Therefore, the Chinese tax authorities would assert that the Shanghai factory constitutes a permanent establishment of ACO in China and all revenue and expenses in relation to the activities of the factory would be taxable in China.

With the assessment that the Shanghai factory constitutes a PE in China. It is likely that the Chinese tax authorities would be concerned about the UK branch arrangements, namely the sale price for the goods that the Shanghai factory provides to the UK branch as both are connected parties. Benchmarking and other transfer pricing documentation and evidence would need to be done to determine an arm's length price for this transaction to ensure that there is not a challenge or adjustment by the chinese tax authorities.

It is also likely that if the technical support agreement has the license of the patents and technical support both via the Shanghai factory and it is a PE, then questions would be raised as to why all the contract revenue paid by FCO is not attributable to this PE. Although

the 20% going to BCO could be acceptable as it would be taxed in China (although we don't know whether there are losses to utilise in BCO), the remaining 80% being taxed in HK would not be deemed acceptable because in HK non-HK sourced revenue is exempt from taxation.

It appears that ACO, the HK company, does not undertake any operating function and all work relating to its operation is undertaken in Mainland China. All its directors and owners are based in China and the meetings are also held in Shanghai.

The status of ACO would be called into question in this arrangement.

ACO is owned wholly by Mr Lin and a company he is connected with and all parties are resident in China.

Under the China-HK DTA, article 4 covers residency. For residency in China (paragrph 1(1)), it states that the place of effective management is a determining factor for being considered resident in China. However under paragraph 1(2)(iii) for residency in HK a company would just need to be incorporated in the territory.

Therefore we need to refer to the tiebreaker provisions in paragraph 2. Paragraph 2(1) raises the "centre of vital interests" clause and due to the majority of the functions of ACO (that being the board meetings) and the companies accounting books also being kept in China it would be China that ACO would be determined to be resident of for this reason.

Even if this residency argument was not put forth, ACO's profits would still be taxable in China to both Mr Lin and BCo as it would be captured in the Controlled foreign companies legislation. As both Mr Lin and BCO directly hold >10% of the shareholding of ACO each and collectively >50% of the shareholding they would be considered together as having control of ACO for the purposes of the CFC rules. Both Mr Lin and BCO would then be taxable on the profits of ACO, regardless of whether or not ACO would distribute profits to them. HK is not on the white list published by the SAT of 12 countries exempt of being captured by the CFC legislation. However, foreign tax credit (either paid or would be paid had the profits been distributed) may be deductible in China if a CFC charge is levied.

Regarding the technical support services provided by the Shanghai factory, as this is for 8 months this is over the 183 days for the income to be attributable to China.

All these different challenges would result in ACO's business operations being taxable in China in one way or another and at the 25% EIT rate (or if CFC charge to Mr Lin for his 15% equity stake in ACO - at the appropriate rate for his rate of income).

Answer-to-Question-_2__

Gonggao [2015] No.7 "Bulletin 7" lists out the following factors about the relevant factors to consider when considering the arrangements for the indirect transfer of assets to have a reasonable business purpose:

- The substance over form, if the intermediate is just a holding company for these Chinese assets then the value is connected to China.
- the amount of value in the enterprise derived from Chinese taxable assets
- the amount of income of the intermediary that is derived from Chinese sources.

For these three factors, if this is the majority of the value or income then the sale of the offshore holding company would relate directly to china sourced gains.

- The amount of tax paid in the other state. If it is no tax or minimal tax then this could be a sign that this is for the avoidance of Chinese tax. So this could help determine whether or not there is a tax avoidance purpose.

- The terms found in any relevant tax treaty. Regardless of whether or not there is a domestic provision to levy tax, if there is a clause or exemption in the relevant DTA then this takes precedence.

- Whether the same tax effect would exist with a more direct ownership

structure. If this was the case then it would be likely that the structure does not exist to avoid chinese income tax.

- The length of time that the intermediate was established for. In the bulletin they state that if the intermediate was only in existance for a relatively short time then this is a sign that it might be for the avoidance of Chinese tax on gains.

- The relationship between the intermediate and the Chinese entity. If the intermediate has no interaction other than to hold the Chinese entity as an asset then this could indicate that it is not for legitimate business purposes especially if the transferor has historically had more involvement with and interactions with the Chinese entity for whom the disposal relates.

Answer-to-Question-_3__

Regardless of the agreement that is signed it is the facts of the actual substance of the arrangements that the Chinese tax authorities will consider. Therefore the 4 points contained in their agreement are not binding on the tax authority when considering the correct tax treatment. Point 3 could though have relevance in that it restricts each parties rights to enter into contracts on the others behalf. However as they are connected parties enforcement of this is unlikely.

The relevant article of the UK/China DTA for determining the presence of a permanent establishment is contained within article 5.

The relevant paragraphs to consider are as follows:

- paragraph 1, states that a permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

In this case the office of YCO is a fixed place of business available to XCO for it's Chinese operations.

- paragraph 2, includes an office as especially constituting a permanent establishment.

YCO has an office from which these additional functions for XCO are being undertaken in China.

- The specific exemptions are included in paragraph 4.

None of these apply to the circumstances of XCO in considering whether it has a permanent establishment in China.

- Paragraph 5 states that where a person, other that an independent agent as per paragraph 6, is acting on behalf of an enterprise and habitually exercises, in a contracting state the authority to conclude contracts on behalf of an enterprise it is deemed that the enterprise has a permanent establishment in that other contracting state.

Although YCO does not sign the contract on behalf of XCO it is negotiating on behalf of it and the final contracts signed are those negatiated by YCO on behalf of XCO.

- paragraph 6 covers the independent agent clause. Although China follows the OECD in saying that just because one entity is a subsidiary of another it does not automatically make it a permanent establishment. As stated irrespective of any contract XCO and YCO sign this is not sufficient to say that they are independent.

To be independent agent, YCO would have to be both legally and economically independent.

A dependent agent, however habitually exercise the authority to conclude contracts. This is defined widely in Circular Guoshuifa (2010) 75 where it says that not only does the term "conclude contracts" refer to the signing of the contracts but also refers to the agent's authority to negotiate all elements and terms of the contract on the enterprises behalf. The test for habitually in Circular 75 would also be covered as YCO negotiates all the contracts in China.

For this reason, it would be correctly considered that this criteria to

being a dependent agent is met and that paragraph 6 does not exempt XCO from having a permanent establishment in China. And instead paragraph would apply to say that XCO does in fact have a PE in China.

As it has been determined that XCO does have a permanent establishment in China, all revenues that relate to that activity would now be subject to Chinese income tax as correctly determined by the chinese tax authorities. The other marketing and auxialiary services not part of the trade of XCO would continue to be rewarded at the 8% return on fixed costs (assuming that this has been correctly benchmarked and represents the arm's length price)and be taxable in China as revenue of YCO.

Answer-to-Question-_7__

First to be considered is whether the Xiamen tax bureau is correct in determining whether there is a PE of ICO in China. Then the tax treatment can be considered.

The relevant article in the UK/China DTA is article 5.

Paragraphs 1 and 2, are applicable as XCO has set up a fixed place of business through which the business is partly carried on and it is an office as per para 2(c) of article 5.

As this is an ongoing service centre it would not be exempted by any clauses in the DTA relating to the length of time of the activity.

The question of the exclusions under para 4 is important to consider. It needs to be considered whether or not the services that the service centre is providing are "preparatory or auxilliary" in nature.

Para 4(d) specifically mentions the collecting of information as an excluded activity under the DTA so that would not be reason enough for ICO to have a PE in China.

So the question is whether after sales tech services would be core to the business.

Circular Guoshuifa (2010) 75 provides more detail on what is considered preparatory or auxiliary. It states that a place performing activities with a preparatory or auxiliary character usually have the following characteristics:

- Such a place does not conduct business operations independently and it is not considered an essential or significant part of the enterprise

The Xiamen service centre is not independent and neither the after sales tech services or information collection would be considered an essential or significant part of the business. Although the number of staff in the UK is not given, the ratio of them to the 5 in the Xiamen service centre would also be supporting evidence that this is not essential to the business although not in itself determinative.

- the place renders activities only to its enterprise and not to any other parties.

The Xiamen service centre only renders activities to ICO.

- that the responsibilities of such a place are limited to provide administrative functions and is not directly involved in the profit generating activities.

As the after-sales technical services are by definition after-sales, the function of the staff in the Xiamen service centre are not profit generating activities. It might be argued that such services are selling points made at the original point of sale, however there is no evidence that this is the case.

For these reasons, the view that the Xiamen tax bureau came to that the activities of the service centre constitute a PE is incorrect.

Had the service centre undertaken activities that would constitute a PE, then the Xiamen tax bureau treatment of applying a 15% profit margin would be acceptable as this falls within the ranges proscribed in Guoshuifa (2010) 19 art 5.

Answer-to-Question-_8_

When considering guarantee fees there are avenues to protect the Chinese tax base, whether or not the pricing is correct which can be addressed via transfer pricing as per Chpter 10 of the OECD TPG and UN TPM equivalent or the WHT on the amount of guarantee fee paid from a Chinese enterprise to a non-resident enterprise that provides said guarantee.

For transfer pricing purposes the following factors to be considered for Chinese income tax implications for the guarantee fee paid by NCO to MCO for the guarantee on the loans is as follows:

1. What benefit NCO got from having the finance guaranteed.

Did this guarantee allow access to the finance that would not have been given without the guarantee? Or did it allow NCO a preferential interest rate? Or did it allow NCO to borrow more money than it otherwise would have been able to without the guarantee? The specific benefit in providing the guarantee would need to be identified.

2. The amount of the guarantee fee charged.

Is the guarantee fee paid less than the amount of the benefit provided by the guarantee? i.e. to ensure that NCO is not paying in excess of the benefit derived from the guarantee in guarantee fees as this would not be something an independent enterprise would do commercially.

If the guarantee fee is less than the benefit derived is this still an arm's length price for the guarantee fee?

If the amount of benefit of the guarantee can be determined and thus an appropriate arm's length price of the guarantee can be benchmarked or priced, then the Chinese tax authorities would have certainty that the guarantee fee charged is appropriate.

Once the price of the guarantee fee has been determined to be an arm's length price, then WHT on the payment of the guarantee is applied as per Bulletin of the SAT (2011) 24. As guarantee fees do not have specific provisions for WHT in the Enterprise income tax law or regulations.

Bulletin of the SAT (2011) 24 provides WHT on China sourced guarantee fees received by a non-resident companies to have an applicable tax rate akin to interest income which is presently levied at 10%. This is not inconsistent with the terms contained within the UK/China DTA.