THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2021

MODULE 2.02 – CHINA OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

ACO is a UK resident company and BCO is a Hong Kong intermediary company for the purposes of Chinese business arrangement made by ACO. DCO is a Chinese resident company and controlled by ACO a related party, conducting affiliated transactions with ACO and BCO.

The royalties of licensing the patent paid by DCO to BCO would be taxed in China, but the tax so charged shall not exceed 10 percent of the gross amount of the payment received by BCO, according to Art. 12(2) of the China Mainland-HK Tax Arrangement.

However, the establishment of BCO would be challenged by Chinese tax authorities as a conduit company inserted into transactions between ACO and DCO for the purposes of reducing Chinese tax burden of ACO.

According to Art. 12(2) of China-UK Tax Treaty, the royalties paid directly by DCO to ACO would be taxed in China at a withholding rate of not exceed 10 percent, which is higher than that mentioned in Art. 12(2) of the China Mainland-HK Tax Arrangement.

According to Art. 12(2) of Hong Kong-UK Tax Treaty, royalties paid by BCO to ACO would enjoy a lower withholding rate of not exceed 3 percent.

Base the above-mentioned, transactions among ACO, BCO and DCO would be regarded by Chinese tax authorities as a treaty shopping arrangement and tax benefits enjoyed by BCO would be denied based on Art. 25 of the China Mainland-HK Tax Arrangement, and Art. 4 of the Fourth Protocol Amending the China Mainland-HK Tax Arrangement.

The relevant royalties would be reconsidered to be received directly by ACO and would be taxed according to Art. 12(2) of China-UK Tax Treaty.

In addition, the amount of royalties paid by DCO to BCO shall be in line with arm's length principle, otherwise would be challenged and adjusted by Chinese tax authorities.

Moreover, in view of the reinvestment made by ACO with dividends received from DCO, ACO may enjoy temporary exemption of withholding taxes on the reinvested dividends, which is stipulated in the Circular on Enlarging the Applicable Scope of the Policy of Temporary Exemption of Withholding Taxes on the Direct Investment Made by Foreign Investors with Distributed Profits (Caishui [2018] NO. 102, issued by the Ministry of Finance, the State Taxation Administration, the National Development and Reform Commission, and the Ministry of Commerce).

Because of its two employees stay in China for more than 183 days each year, they would be considered as resident individuals in China according to Chinese Individual Income Tax Law. However, according to the tier-breaker rules in Art. 4 of China-UK Tax Treaty, two employees may be considered as resident individuals in the UK based on the facts that they stayed in China only for their works as managing director of DCO other than other purposes. Nevertheless, in view of being managing director of DCO, director's fee derived by two employees from DCO may be taxed in China, according to Art. 16 of China-UK Tax Treaty.

Question 2

The legal framework is 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 in China 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.

PART B

Question 3

ECO is a Chinese resident company, FCO is a UK resident company, and Wendy is a UK resident individual.

FCO conducted two transactions in China, one was related to the personal activities of an entertainer exercised in China, and the other was related to the provision of dress and modeling services by itself.

For the former transaction with the amount of RMB 10 million yuan, the profit derived by FCO from such transaction may be taxed in China, according to Art. 17(2) of the China-UK Tax Treaty, and Art.4 of the Announcement on Issues relevant to the Implementation of Tax Treaties (Gonggao [2018] No. 11 issued by the STA).

For the latter transaction with the amount of RMB 200 thousand yuan, according to Art.4 of the Announcement on Issues relevant to the Implementation of Tax Treaties (Gonggao [2018] No. 11 issued by the STA), the provision of dress and modeling services by FCO cannot be regarded as a part of the personal activities of an entertainer exercised in China. Therefore, the profit derived by FCO from such latter transaction will be taxed in China according to Art. 7 of the China-UK Tax Treaty. FCO may not be taxed in China because its dress and modeling services performed by its 5 employees in China did not constitute a PE.

RMB 6.5 million yuan received by Wendy from FCO was derived from her personal activities as an entertainer in China, therefore shall be tax in China, according to Art. 17(1) of the China-UK Tax Treaty, and Art.4 of the Announcement on Issues relevant to the Implementation of Tax Treaties (Gonggao [2018] No. 11 issued by the STA).

PART C

Question 4

The legal framework is the Announcement on Issues Concerning Enhancing the Administration of the Advance Pricing Arrangement (Gonggao [2016] No. 64, issued by the STA).

APAs available in China includes the following three types: unilateral APAs between enterprises and Chinese tax authorities, bilateral APAs and multilateral APAs between Chinese tax authorities and treaty partners tax authorities.

An enterprise carried out related transactions with annual amount of more than RMB 40 million yuan for the three years prior to the tax year in which the competent tax authority issues "The Notice of Tax Matter" related to notifying the acceptance of enterprise's intent for the APA.

An APA may apply for related transactions over a period of 3 to 5 consecutive years starting from the tax year in which the competent tax authority issues "The Notice of Tax Matter" related to notifying the acceptance of enterprise's intent for the APA.

Question 5

GCO is a Chinese resident company, and HCO is a UK resident company and an intermediate holding company without any substantial business activities.

HCO cannot be qualified as a beneficial owner of the dividends paid by GCO, according to Art.10(2) of China-UK Tax Treaty, and Art. 2 of the Announcement on Issues Concerning the "Beneficial Owner" in Tax Treaty (Gonggao [2018] No. 9, issued by the STA).

However, UK government indirectly holds 100% shares of HCO through an international investment institution established by it, therefore, HCO can be regarded as a beneficial owner, according to Art. 4(4) of the Announcement on Issues Concerning the "Beneficial Owner" in Tax Treaty (Gonggao [2018] No. 9, issued by the STA).

With the shareholding that had reached the prescribed proportion at any time during the 12 consecutive months before the dividends was obtained, as a beneficial owner of the dividends, HCO may enjoy tax benefits according to Art.10(2) of China-UK Tax Treaty. In other words, HCO' claim can be justified.

Question 6

ICO and KCO are UK resident companies, thus the merger between them is a corporate reorganization related to non-resident enterprises and assets located in China, for the purposes of Chinese income tax.

There are special conditions for non-resident enterprises to apply for enjoy the treatment of the tax-free corporate reorganization, which are prescribed in Art. 7(1) 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). Such conditions are clarified further by Art. 1 of the Announcement on Issues Concerning the Application of Special Tax Treatment in the Equity Transfer on Non-resident Enterprises (Gonggao [2013] No. 72, issued by the STA)

According to tax rules mentioned above, for enjoying the treatment of the tax-free corporate reorganization, any equity acquisition transaction between non-resident enterprises, including equity transfer of Chinese resident enterprises resulted from the split-up or merger of non-resident enterprises, shall be the facts that a non-resident enterprise transfers its equity in a Chinese resident enterprise into another non-resident enterprise 100% directly or indirectly held by it.

However, for Chinese income tax purposes, KCO, a non-resident company 100% directly or indirectly held by ICO, transfers its equity in a Chinese resident company into its parent company ICO, another non-resident company. Therefore, the equity acquisition transaction between them resulted from the merger is not line with the special conditions for non-resident enterprises to apply for enjoy the treatment of the tax-free corporate reorganization in China.

In other words, ICO' claims cannot be justified, and thus ICO may be taxed on its gains derived from the shares-transferring resulted from the merger.

Question 7

MCO is a resident company in the UK controlled by Ms. D, Ms. D and Mr. B are spousal relationship. Thus, MCO, Ms. D and Mr. B are related parties for the Chinese income tax purposes.

Normally, according to Art. 13(5) of China-UK Tax Treaty, gains derived by MCO from the transfer of 4% shares in QCO to RCO, an independent third party, may not be taxed in China, because its shareholding in QCO is less than 25%.

However, according to Art. 4(3) of the Announcement on Issues concerning the Provisions of Capital Gains in tax treaties (Gonggao [2012] No. 59, issued by the STA), shareholdings of related parties in a Chinese resident company can be regarded as shareholding of a non-resident in the Chinese resident company when determining whether the shareholding of such non-resident is line with the conditions mentioned in Art. 13 of Chinese-foreign tax treaties.

In view of the facts that MCO and Mr. B are related parties, shareholdings in QCO by Mr. B and MCO may be aggregated in the determination of the shareholding of MCO in QCO, according to Art. 4(3) of Gonggao [2012] No. 59. As a result, the MCO’s shareholding in QCO may be considered as 54% of shares in QCO, exceeding 25% of shares in QCO.

Therefore, gains derived by MCO from the transfer of 4% shares in QCO may be taxed in China, according to Art. 13(5) of China-UK Tax Treaty.