Answers

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1 China Technology Development Company (China-Tech)

(a) (i) China-Tech has the following tax non-compliance for the three years from 1998 to 2000.

R&D service agreement
According to the PRC tax regulations, the R&D services provided by China-Tech should be subject to 5% business tax (BT), based on the total R&D service fee income of RMB 5,000,000 per year, not on the net cash receipt of RMB 2,000,000 per year. As such, China-Tech has underpaid BT on the R&D service fee income of RMB 150,000 (5% of RMB 3 million) in each of the above three years. 2

Licence fee
According to the PRC tax regulations, as income sourced from China, the licence fee paid to US-Tech should be treated as a royalty and subject to 5% BT and 10% withholding tax (WHT). Although there was no cash payment, US-Tech will still be deemed to have received the licence fee income from China-Tech because it issued invoices to China-Tech and effectively received the payment by offsetting its licence fee income against its R&D service fee payable to China-Tech. 1
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China-Tech, as the payer of the fee, has the obligation to withhold and remit the BT and WHT to the China tax authorities. The WHT must be remitted within five days of the fee being paid and the BT within ten days of the end of the month in which the fee is paid, given that China-Tech's assessment period for BT is one month. 1
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The calculation of BT and WHT is as follows:
BT = Licence fee x 5%
WHT = (Licence fee – BT) x 10%

In China-Tech's case, the underpaid withholding BT and FEIT will be calculated as follows:
Underpaid BT = RMB 3,000,000 x 5% x 3 years = RMB 450,000 0·5
Underpaid FEIT = (RMB 3,000,000 – RMB 150,000) x 10% x 3 years = RMB 855,000 0·5

According to Caishuizi (1999) 273, the technology licence fee for the period after 1 October 1999 can be exempted from BT, but only if the taxpayer engaged in the technology transfer has made a written application, together with the confirmed contracts to the China tax authorities. As US-Tech has not obtained this BT exemption approval from the China tax authorities the licence fee income should have been subject to BT. 2

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(ii) The tax non-compliance will be subject to both late tax payment interest and penalties.

For the period before 30 April 2001

Underpaid BT and WHT: The tax authority may impose a fine up to five times the tax underpaid according to the old PRC Tax Administration Law and late tax payment interest of 0·2% per day. 2

For the period starting from 1 May 2001

Underpaid BT and WHT: The tax authority may impose a fine ranging from a half to five (0·5 to 5) times of the tax underpaid according to the new PRC Tax Administration Law and late tax payment interest of 0·05% per day. 2

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(b)

ABC Tax Consultants
Firm's address

The Chief Financial Officer
China Technology Development Company
Company address

3 December 2007

Dear Sir

In response to your recent enquiry, we set out below our advice regarding the proposed licence and technical service agreements between China-Tech and its foreign holding company, US-Tech.

The fee income which US-Tech will derive from the five year licence of the technology and trademark relating to Technology B, will be income sourced from China. As such it will be subject to China business tax (BT)

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and withholding tax (WHT) at 5% and 10% respectively, which China-Tech, as the payer of the fee, will have an obligation to withhold and remit to the China tax authorities. 1

According to Caishuiwaizi (1982) 143, US-Tech's on-site technical services agreement for the initial two years aimed at assisting China-Tech in mastering and using Technology B will be treated as part of the technology licence. Thus, the service fees of RMB 1,000,000 per annum for 2007 and 2008 will be treated as part of the technology licence fee and subject to China BT and WHT in the same way as the technology licence fee. Again as above, China-Tech, as the payer of the fee, will have an obligation to withhold and remit such taxes to the China tax authorities. 2

However, if written application, including details of the contract is made to the tax authorities, it is possible to be exempted from the BT on the technology licence fee in accordance with Caishuizi (1999) 273. 1

Also per Caishuizi (1999) 273, the BT on US-Tech's technical service fee can also be exempted, but only if the technical service fee is included in the same technology licence agreement, and the technical service fee amount and the technology licence fee amount are charged in the same invoice issued by US-Tech to China-Tech. 3

However, according to Guoshuifa (2000) 166, the BT cannot be exempted in the case of the trademark licence fee, regardless of whether this is part of the main agreement, or is entered into as a separate agreement. 1

Further, where a trademark licence fee forms part of a large agreement, Guoshuifa (2000) 166, gives China tax officers the authority to deem as much as 50% of the total contract sum as the trademark licence fee where they consider that the split of fees between the trademark licence and the technology licence in the same agreement is unreasonable or inaccurate. 2

In order to minimise the liability to China taxes, the proposed agreements in respect of Technology B should be structured as follows:

– US-Tech should include the technical service fee in the technology license agreement, and China-Tech should apply to the China tax authorities for exemption from the 5% BT on both the technical service fee and technology licence fee. 2

– When US-Tech invoices China-Tech for the above fees, US-Tech should include both the technical service fee amount and the technology licence fee amount on the same invoice, to ensure that the technical service fee can enjoy the BT exemption. 1

– US-Tech should include the technology licence and the trademark licence in two separate agreements so as to reduce the possibility of any arbitrary assessment by a China tax officer as to the split of fees between technology licence and trademark licence. 1

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We trust the above satisfies your requirements, but please contact us further if you require any additional assistance or clarification.

Yours faithfully

ABC Tax Consultants

Appropriate style and presentation 1
Effectiveness of communication 1

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2 RedStars

(a) The nature of the Butadiene borrowing and return between RedStars and the tyre factory is a barter transaction. A barter transaction is a special purchase and sale activity. The settlement between the buyer and seller is by mean of goods at same price instead of currency. In this regard, both the buyer and the seller should properly treat the delivered goods as a sale and calculate output VAT and the goods received as a purchase and calculate input VAT. In addition, for input VAT credit purposes, appropriate invoices (i.e. VAT invoices) should be obtained. 2

Thus, RedStars should treat the goods borrowed from the tyre factory as a purchase activity and get a VAT invoice from the tyre factory in order to claim input VAT credit. At the same time, the tyre factory should treat the transaction as a sale for which it will issue VAT invoice and calculate output VAT. 0·5

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The goods returned to the tyre factory, should be treated by RedStars as sale and a VAT invoice should be issued to the tyre factory and output VAT calculated. The tyre factory should treat it as a purchase and obtain the VAT invoice from RedStars to claim input VAT credit. 0·5

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(b) (i) According to Guoshuihanfa (1995) 288 and Caishui (2002) 29, used yachts, motorcycles, and motor vehicles, are VAT exempt if the selling price is lower than the original cost. However, if the selling price is more than the original cost or the taxpayer engages in the business of used yachts, motorcycles and motor vehicles, the VAT tax rate is 4% with a half reduction i.e. 2%. 2

Other types of asset are VAT exempt if the following three conditions are satisfied. Otherwise, a 4% VAT tax rate with a half reduction i.e. 2% is applied for both normal rate and small-scale taxpayers. 1

– the asset is listed on the fixed assets register of the enterprise; 1
– the asset is treated as fixed assets and has been used in the past; and 1
– the selling price is lower than the original cost. 1

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(ii) Domestic production equipment

According to Guoshuifa (2006) 111, for domestic equipment purchased by a foreign investment enterprise (FIE), the governing tax authorities shall supervise the asset for five years. If the FIE transfers, donates, sub-lets or reinvests such equipment during the supervision period, the value added tax (VAT) refunded should be repaid to the governing tax authority. The formula to calculate the refunded VAT to be repaid is as follows: 2

The refunded VAT to be repaid = A x (B/C) x applicable VAT rate 1
Where:
A = the equipment price stated in the VAT invoice;
B = the net book value of the equipment; and
C = the original value of the equipment.

As RedStars sold the domestic production equipment within the five year supervision period, the VAT refund obtained in 2005 should be repaid to the governing tax authority. 1

However, as the domestic production equipment will have met the three conditions for VAT exemption for used assets, the sale of domestic production equipment would be VAT exempt. 1

Twenty sets of monitors

Since the monitors will have met the three conditions for exemption, the sale of the twenty sets of monitors would be VAT exempt. 1

Fax machine

As the fax machine had not been brought into use, the sale cannot meet the second VAT exemption condition and thus, will be subject to VAT at 4% with a half reduction. 1·5

The potential VAT liability is RMB 5000/(1 + 4%) x 4% x 50% = RMB 96 0·5

Vehicle

Because the selling price is higher than the original cost, the sale does not meet the third VAT exemption condition and thus, the vehicle will be subject to VAT at a rate of 4% with a half reduction. 1·5

The potential VAT liability is RMB 350,000/(1 + 4%) x 4% x 50% = RMB 6,731 0·5

Obsolete raw materials

The obsolete raw materials are not fixed assets, thus VAT exemption is not applicable. The sale of obsolete raw materials will be subject to VAT at a rate of 17%. 1·5

The potential VAT liability is RMB 8000/(1 + 17%) x 17% = RMB 1,162 0·5

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(iii) The loss from the sale of the obsolete raw materials will be a deductible expense in the calculation of RedStars' production or business income. 0·5

Where an enterprise assigns or disposes of a fixed asset before it is fully depreciated, the proceeds received are gross income for enterprise income tax (EIT) purposes, from which the residual value of the asset plus any costs of assignment or disposal are permissible deductions. Thus, the disposal of the monitors and the vehicle are likely to give rise to a loss and a profit respectively for EIT purposes, whereas the disposal of the old equipment (at book value) and the fax machine (at its original cost) will probably be tax neutral. 1·5 1

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(c) Selling goods at cost is where a manufacturing enterprise sells goods to a commercial company at or above the price that the commercial company sells the same goods to the final consumers; and the manufacturing enterprise then uses profit sharing or other forms of benefit to compensate the commercial company for its loss. 1

Guoshuifa (1997) 167 stipulates that in such circumstances, a general VAT taxpayer (i.e. the commercial company) shall make an adjustment for the benefits received from the supplier (i.e. the manufacturing enterprise) by making a transfer out of the input VAT calculated for the value of the compensating benefit received. The calculation formula is stipulated in Guoshuifa (2004) 136 as follows: 2

Input VAT transferred out = A/(1 + B) x B 1
Where:
A = the value of compensating benefit; and
B = the applicable VAT rate.

The commercial company is not allowed to issue a VAT invoice for the compensation received from the manufacturing company. 1

As such, when calculating its VAT liability for the month, the distributor should make a transfer out of the input VAT for the compensation of RMB 50,000 received from RedStars calculated as follows:

Input VAT transferred out = RMB 50,000/(1 + 17%) x 17% = RMB 7,265 1

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3 Company A

(a) (i) According to Articles 91 and 92 of Implementation Rules for The Income Tax Law of The People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises, where the enterprise files its foreign enterprise income tax (FEIT) return on a consolidated basis, and different FEIT rates apply to the related branches, each branch's taxable income should be calculated separately and FEIT paid at the different FEIT rates. 1

After the offsetting of the losses against the profits for each branch, FEIT shall be paid on the remaining profits based on the FEIT rate applicable to the profit-making branch. A branch that has incurred losses shall offset those losses using profits of the subsequent year and FEIT shall be paid on the profit remaining after the offsetting of such losses based on the branch's applicable FEIT rate. Further, FEIT shall be paid on the offsetting amounts based on the FEIT rate applicable to the branch that offsets the losses incurred by another branch. 2

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(ii) According to Guoshuifa (1997) 49, production and business income of branches established in China by foreign investment enterprises (FIEs) that undertake production, commodity trade and services shall be subject to the same FEIT rate as local enterprises with the same kind of business, and shall be reported on a consolidated basis by the headquarters. 1·5

If a FIE both produces and sells its products in China on its own account, the profits from the selling of the self-produced products shall be subject to the FEIT rate of the local area where the products are actually produced, regardless of whether the enterprise sells the products through a sales office or not and regardless of how the sales office accounts for the sale, and shall be reported on a consolidated basis by the headquarters. 2

The 2008 potential FEIT for Company A under each option is thus, as follows:

Option 1
FEIT payable = 10,000,000 x 33% + (2,000,000 + 3,000,000) x 33% = RMB 4,950,000 1

Option 2
FEIT payable = 10,000,000 x 33% + (2,000,000 + 3,000,000) x 15% = RMB 4,050,000 1

Based on the above, the adoption of Option 2 will minimise the FEIT liability for Company A, as the FEIT rate applicable to the manufacturing branch B1 is lower in Shanghai Pudong than in Jiangsu. 0·5

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(b) (i) The increasing of the registered capital of a foreign investment enterprise (FIE) before the profits are distributed is a qualifying investment, entitling a foreign investor to a refund of 40% of the tax paid on the reinvested amount, subject to the approval of the tax authorities. 1

The amount of tax refundable is computed by the formula:

Tax refund = A/[(1 – (B + C)] x B x D 1
Where:
A = the reinvestment amount;
B = the originally applicable national income tax rate;
C = the originally applicable local income tax rate; and
D = the reinvestment tax refund rate i.e. 40%

Company A was exempted from FEIT in 1996 and 1997, so both the applicable national income tax rate and local income tax rate were zero. For 1998, 1999 and 2000, Company A's profits were subject to 15% national income tax rate and a 0% local income tax rate. For 2001, a 30% national income tax rate and a 3% local income tax rate were applicable. Therefore, the two options will result in reinvestment tax refunds of: 1·5

Using profits derived from 1996 to 1999:
Reinvestment tax refund = (10m – 2·5m – 3·28m)/(1 – 15%) x 15% x 40% = RMB 297,882 1·5

Using profits derived from 1998 to 2001:
Reinvestment tax refund = (3·8m + 3·1m + 3·0m)/(1 – 15%) x 15% x 40% +
(10m – 3·8m – 3·1m – 3·0m)/(1 – 33%) x 30% x 40%
= RMB 716,733 1·5

Using the after tax profit derived from the years 1998 to 2001 is clearly beneficial as only the reinvestment of profits from the years 1998 to 2001 will result in a tax refund. 0·5

However, to ensure that the reinvested profits are actually allocated to those years, the foreign investor will have to provide relevant supporting documentation to the tax authorities, verifying the year(s) to which the reinvested profits are attributable. Otherwise, the tax authorities may use the method(s) they consider appropriate to determine the attributable year(s). 1

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(ii) The FEIT Law stipulates that the profit derived by a foreign investor from a foreign investment enterprise (FIE) (i.e. the dividends paid out of the after-tax profit) is exempt from withholding tax (WHT). Thus, there will be no tax implications from the payment by Company A of the proposed dividend of RMB 5,000,000. 1

(iii) According to Guoshuifa (2000) 49, a reinvestment tax refund granted to a foreign investment enterprise (FIE) shall be returned to the tax authorities if the foreign investor transfers or disposes of its equity interest in the reinvested enterprise within five years of the reinvestment; except in circumstances where the transfer of the reinvested enterprise is as a result of a group reorganisation due to reasonable business purposes and as a result the reinvested enterprise is transferred to a company that is directly or indirectly owned by the foreign investor who obtained the tax refund or by the person(s) who own the foreign investor. 2

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4 (a) Associated enterprises refer to companies, enterprises and other economic entities that have any of the following relationships with other enterprises:

(i) Direct or indirect ownership or control with respect to finances, business operations or purchases and sales.
(ii) Direct or indirect ownership or control with a common third party.
(iii) Any other relationship in respect of an association of reciprocal interests. 3 x 1 = 3

Eight circumstances normally considered as creating an associated enterprise are as follows:

(i) The other enterprise directly or indirectly owns 25% or more of the shares of the enterprise or *vice versa*.
(ii) A third party directly owns or controls 25% or more of the shares of both the enterprise and the other enterprise.
(iii) Debt between the enterprise and the other enterprise accounts for 50% or more of its total capital, or if 10% or more of an enterprise's debt is guaranteed by another enterprise.
(iv) More than half of the directors or high level management of the enterprise, such as managers, or one (or more than one) executive director(s) are/is appointed by the other enterprise.
(v) The enterprise's business operations depend on the other enterprise's proprietary technology.

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(vi) The other enterprise controls the enterprise's supply of raw materials and spare parts (including prices and transaction conditions).
(vii) The other enterprise controls the enterprise's sales of products (including prices and transaction conditions).
(viii) Other relationships exist where there is effective control of the enterprise's business operations and transactions, or there are other connections of interests, including family members and relatives. 8 x 1 = 8

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(b) Transfer pricing adjustment methods for sales and purchases of tangible assets include:

(i) The comparable uncontrolled price method where adjustments will be based on the pricing of the same or similar business activities among unrelated parties.
(ii) The resale price method where adjustments will be made by subtracting an appropriate markup from the price at which the goods are subsequently resold to an unrelated third party.
(iii) The cost plus method where adjustments will be made by adding reasonable expenses and a profit margin to the cost.
(iv) Other appropriate methods. If the above three methods are not applicable, the tax bureau may choose other reasonable methods, such as the comparable profit method, net profit method, split profit method, etc. 4 x 1 = 4

(c) According to Guoshuifa (2004) 143, an enterprise should take the following actions if it disagrees with the tax authority's transfer pricing adjustments:

(i) The enterprise must pay any taxes due together with any late payment surcharges under the law and regulations, even though it disagrees with the transfer pricing adjustments, before the tax objection mechanism can be set in motion. 2
(ii) The enterprise may then appeal to a higher level tax bureau within sixty days after receiving the tax payment receipts issued by the in-charge tax bureau, submitting relevant documents regarding prices and costs. 1·5
(iii) If the enterprise disagrees with the higher level tax bureau's judgment on appeal, it may further appeal to the People's Court within fifteen days after receiving the notice of the judgment from the higher level tax bureau. 1·5

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5 Mr Lee

(a) Mr Lee will live in China for more than one year, but not more than five years in total. Therefore, he will be subject to individual income tax (IIT) on his China sourced income, plus any income that is paid to him by an individual or enterprise located in China. 2

The IIT treatment of the income received will thus be as follows:

(1) The monthly salary and monthly cost of living allowance are PRC-sourced incomes. Therefore, Company C should withhold Mr Lee's IIT each month and file IIT returns with the tax bureau. 1

(2) According to the PRC tax regulations, housing allowance received in a non-cash form or on a reimbursement basis by an expatriate can be exempted from IIT. Thus, the housing allowance reimbursed by Company C should be excluded from Mr Lee's monthly taxable income. 1·5

(3) Of the annual bonus received for the year 2006, only seven months (i.e. 1 June to 31 December 2006) relates to Mr Lee's China assignment. Thus, only 7/12ths of this annual bonus will be subject to IIT and Company C should withhold IIT on this portion of annual bonus. 1

The annual bonuses received for the years 2007 to 2010, are all PRC-sourced income as they relate to his China assignment. Therefore, the full amount should be subject to IIT by Company C. 0·5

Of the annual bonus received for the year 2011, only five months (i.e. 1 January to 1 June 2011) will relate to his China assignment. Thus, only 5/12ths of this annual bonus will be subject to IIT by Company C. 1

(4) The monthly rental income is non PRC-sourced income. Therefore, as Mr Lee will live in China for less than five years, it should not be subject to IIT in China. 1

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(b) According to the IIT self reporting regulations, an individual taxpayer should perform IIT self reporting where:

- the taxpayer's annual income is more than RMB 120,000;
- the taxpayer derives salary and wages from two or more sources in PRC;
- the taxpayer derives income from outside of China;
- the taxpayer receives taxable income for which there is no withholding agent; or
- in other situations specified by the State Council. 4

Individuals who have no domicile in the territory of China and have stayed in the territory of China for less than a full year in the tax calendar year are not required to perform IIT self reporting. 1

Those taxpayers whose annual remuneration exceeds RMB 120,000 should perform IIT self reporting by no later than 31 March of the subsequent year, whether or not IIT has been paid through the internet, mail, going to the tax bureau in person or other stipulated manners. If the taxpayer fails to perform IIT self reporting within the designated period, a fine of not more than RMB 2,000 may be imposed and in a serious case, a fine ranging from RMB 2,000 to RMB 10,000 may be imposed. 3

Mr Lee's IIT self reporting responsibilities during his assignment period will therefore, be as follows:

For the years 2006, 2008 and 2011, although his annual income exceeds RMB 120,000, he will not be liable to follow IIT self reporting as he has no domicile in China and his PRC stays are for less than the full year for each of those years. 2

For the years 2007, 2009 and 2010, his annual income exceeds RMB 120,000 and he has already stayed in China for a 'full' year, so he will be liable to perform IIT self reporting by no later than 31 March of the subsequent year. 2

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