Professional Level – Options Module

Advanced Taxation (China)

Monday 2 June 2008

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

This paper is divided into two sections:

Section A – BOTH questions are compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

Tax rates and allowances are on pages 2–3.

Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.
This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants

Paper P6 (CHN)

ACCA

SUPPLEMENTARY INSTRUCTIONS

1. You should assume that the tax rates and allowances shown below will continue to apply for the foreseeable future.
2. Calculations and workings need only be made to the nearest RMB.
3. All apportionments should be made to the nearest month.
4. All workings should be shown.

TAX RATES AND ALLOWANCES

The following tax rates and allowances are to be used in answering the questions.

Enterprise income tax rates

Income tax for domestic enterprises

Annual taxable income (RMB)	Rate
1 – 30,000	18%
30,001 – 100,000	27%
100,001 and above	33%

Income tax for Sino-foreign joint ventures and foreign enterprises

For ordinary joint ventures	33%
Group A lower rate	15%
Enterprises in Special Economic Zones and manufacturing enterprises in Economic and Technology Development Zones	
Group B lower rate	24%
Manufacturing enterprises in the old urban districts of Special Economic Zones and manufacturing enterprises in Coastal Open Zones	

Individual income tax rates and quick deduction factors

Employment income

Grade	Taxable income on which employee bears the tax/employer bears the tax (RMB)	Rate %	Quick deduction factor (RMB)
1	Under 500/475	5	0
2	501 – 2,000/476 – 1,825	10	25
3	2,001 – 5,000/1,826 – 4,375	15	125
4	5,001 – 20,000/4,376 – 16,375	20	375
5	20,001 – 40,000/16,376 – 31,375	25	1,375
6	40,001 – 60,000/31,376 – 45,375	30	3,375
7	60,001 – 80,000/45,376 – 58,375	35	6,375
8	80,001 – 100,000/58,376 – 70,375	40	10,375
9	Over 100,000/70,376	45	15,375

Individual service income

Net of tax income (RMB)	Before tax income (RMB)	Rate	Quick deduction (RMB)
1 – 16,000	1 – 20,000	20%	0
16,001 – 37,000	20,001 – 50,000	30%	2,000
37,001 and above	50,001 or above	40%	7,000

Business tax

		Rate
Group A	transportation, construction, communication, culture and sports	3%
Group B	hotels, restaurants, tourism, warehousing, advertising, transfer of intangible property, sale of real estate	5%
Group C	finance and insurance	5%
Group D	recreation	5%–20%

Land appreciation tax

	The ratio of increased value against the value of deductible items	**Rate**
For the part	50% or below	30%
For the part	Above 50% to 100%	40%
For the part	Above 100% to 200%	50%
For the part	Above 200%	60%

Value added tax (VAT)

For small size taxpayers	6% (4% for commercial enterprises)
For ordinary taxpayers	17% for the sale or import of itemised goods, processing and repairing
	13% for the sale or import of itemised goods

Deductible entertainment expenses

For domestic enterprises

Annual net sales (RMB)	**Rate**
1 – 15,000,000	5‰
15,000,001 and above	3‰

For foreign invested enterprises

Manufacturing and trading businesses		**Service providers**	
Annual net sales (RMB)	**Rate**	**Annual net sales (RMB)**	**Rate**
1 – 15,000,000	5‰	1 – 15,000,000	10‰
15,000,001 and above	3‰	15,000,001 and above	5‰

Section A – BOTH questions are compulsory and MUST be attempted

1 Nova Company Limited (Nova) is a company incorporated in Hong Kong. It is considering setting up a wholly owned foreign enterprise (WOFE) Newco, in the downtown urban area of a city in southern China. Newco will only be engaged in the manufacturing of Product X, all of which will be exported to various foreign customers.

The financial forecasts relating to the costs to be incurred by Newco for manufacturing each unit of Product X, as well as the unit selling price of Product X are given below:

		RMB
(1)	Purchase price (excluding value added tax (VAT)) of accessory materials to be purchased from local Chinese suppliers	100
(2)	Cost (excluding VAT) of utilities to be consumed in the production process	100
(3)	Purchase price (excluding VAT and customs import duty) of key raw materials to be imported from foreign suppliers	1,000
(4)	Conversion costs (e.g. labour costs, depreciation of equipment, etc, other than the costs for materials and utilities)	300
(5)	FOB export unit selling price (converted into RMB) of Product X	2,000
(6)	China VAT levy rate for all the materials and utilities to be purchased	17%
(7)	China customs import duty rate for raw materials to be imported	10%
(8)	China customs export duty rate for Product X	0%
(9)	China VAT export refund rate for Product X	13%

Nova wishes to minimise the Chinese customs duty and VAT costs of conducting its intended export business, and the management is evaluating the following business models as legitimate ways in which to do this.

(1) Contract manufacturing

Under this model, Newco will act as the processor ('the Processor') of the foreign customer ('the Consignor'). The Consignor provides the Processor with imported key raw materials at no charge, and the Processor purchases the accessory materials in the local market. Thereafter, the Processor processes the raw materials into Product X, and returns Product X to the Consignor. In return, the Consignor pays a processing fee to the Processor so that the Processor can earn a profit after recovering its costs (e.g. labour costs, depreciation of fixed assets, purchases of local accessory materials, utilities, etc).

(2) Import manufacturing

Under this model, Newco will purchase raw materials from both foreign and local suppliers, and hold the title of these raw materials and the finished products throughout the production cycle. After processing the raw materials into Product X, Newco will sell Product X to the foreign customer and receive the sales proceeds from the customer.

(3) Non-bonded export trade

Under this model, Newco will purchase raw materials from both foreign and local suppliers, and hold the title of these raw materials and the finished products throughout the production cycle. After processing the raw materials into Product X, Newco will both sell Product X to the foreign customer and ship the products out of China, and receive the sales proceeds from the customer.

Newco is required to use the 'exempt, credit, refund' method to account for the VAT liabilities on its sales of goods to foreign customers.

Required:

Prepare a report for the management of Nova Company Limited in which you:

(a) Explain Newco's Chinese customs duty and value added tax (VAT) costs in carrying out the export business under each of the above three different business models, and advise which business model should be adopted so as to minimise Newco's customs duty and VAT costs at the current VAT export refund rate for Product X of 13%. (18 marks)

(b) Explain the effect on the advice given in (a) above if the Chinese tax authorities were to reduce the VAT export refund rate for Product X to 0%. (15 marks)

Marks are also available for the appropriateness of the format and presentation of the report and the effectiveness with which the information is communicated. (2 marks)

Note: in the case of both parts of the report you should support your explanations/advice with relevant supporting calculations.

(35 marks)

2 Company X and Company Y were formed as two separate legal entities incorporated in different cities in China, and manufacturing different products for sale in China. Both companies were 100% directly owned by the same parent company – Company Z, which is a company incorporated in Singapore.

In order to streamline its operations in China, Company Z decided to merge Company X and Company Y into a single legal entity and an absorption merger of Company X and Company Y took place on 1 January 2001. Following the merger Company X survived and became the head office of the post-merger entity (hereinafter referred to as 'Head Office'), whilst Company Y was dissolved and became the branch of the post-merger entity (hereinafter referred to as 'Branch Y'). The post-merger entity (i.e. Company X) is still 100% owned by Company Z.

After the merger, both the Head Office and Branch Y continued to carry out the same business activities as the pre-merger entities Company X and Company Y did before the merger. The Head Office and Branch Y continue to maintain separate books of account so as to accurately account for the profit or loss of their own operations.

Profit and loss information for the pre-merger entities and the post-merger entity is as given below:

Pre-merger profit and loss (in RMB):

	Year 1998	Year 1999	Year 2000
Company X	3,000,000	4,000,000	3,000,000
Company Y	(2,000,000)	(3,000,000)	(4,000,000)

Post-merger profit and loss (in RMB):

	Year 2001	Year 2002	Year 2003
Head Office	5,000,000	6,000,000	4,000,000
Branch Y	(3,000,000)	(1,000,000)	16,000,000

Additional information:

1. Company X's first profit making year was 1998. Prior to the merger it was subject to income tax at the reduced rate of 15% and also entitled to the following tax incentives: two years' tax exemption from the first profit making year; followed by a 50% tax rate reduction for the next three years.
2. Company Y's income tax rate prior to the merger was 30% and it was not entitled to any tax holidays.
3. Both Company X and Company Y pre-merger and the Head Office and Branch Y post-merger are exempted from local income tax.

Required:

(a) Explain the general tax treatment of each of the following issues after the merger:

(i) the 'two-year exemption, three-year 50% reduction' enjoyed by Company X before the merger; and (7 marks)

(ii) the utilisation of tax losses incurred by Company Y before the merger. (3 marks)

(b) State, giving reasons, the income tax rates applicable to the Head Office and Branch Y respectively for each of the three years 2001, 2002 and 2003. (7 marks)

(c) Explain the general implementation rules applicable to the determination of taxable income and tax payable in the case of a merged entity such as Company X where one of the branches incurs losses. (8 marks)

(d) State, giving reasons, the taxable income of and income tax payable by the merged entity, Company X, for each of the three years 2001, 2002 and 2003. (8 marks)

(33 marks)

Section B – TWO questions ONLY to be attempted

3 **(a)** Company A and Company B are both wholly owned foreign enterprises (WOFE) established in China in 1996. Company A owns an office building which was purchased in 1998. Due to business development needs, the management of Company A sold the office building to Company B in May 2007.

Information relating to the office building is as follows:

(1) The selling price was RMB 200 million.
(2) The original purchase price of the office building was RMB 252 million and accumulated depreciation as at 30 April 2007 was RMB 150 million.
(3) According to the asset evaluation report issued by the property valuation agent, the evaluated price of the office building was RMB 220 million and the depreciation discount rate for revaluation purposes was 60%. The related evaluation fee for the office building was RMB 50,000.

Required:

Explain the business tax, stamp duty and land appreciation tax implications for Company A of the sale of the office building. Support your explanations with calculations of any resulting tax liabilities. (8 marks)

(b) The management of Company A had also considered injecting the office building into Company E as a capital contribution based on the proposed selling price of RMB 200 million.

Required:

Explain the business tax, land appreciation tax and foreign enterprise income tax implications for Company A if the proposed capital investment had been made. (8 marks)

(16 marks)

4 Company C is a wholly owned foreign enterprise (WOFE) established in January 2000 in the Guangzhou Economic and Technological Development District (GETDD). The formation of the GETDD development district was approved by the State Council of China. The approved business scope of Company C is to manufacture chemical goods, and distribute chemical goods imported from overseas. According to its business licence, the term of Company C's approval is 20 years.

Company C commenced operations on 1 January 2002. During the two-year pre-operating period from January 2000 to December 2001, the company engaged in the construction of its plant, and all the expenses incurred during this pre-operating period were capitalized. Company C obtained approval from the local government to lend its excess working capital to another company during the pre-operating period and received interest income in return (see table below).

After it commenced operations on 1 January 2002, Company C manufactured chemical products and sold them on the local market. It also imported chemical products for onward distribution to the local market, but did not perform any processing/manufacturing on such imported products.

Details of the profits earned by Company C for the years 2002 to 2006 inclusive are set out below:

Year	2000 RMB	2001 RMB	2002 RMB	2003 RMB	2004 RMB	2005 RMB	2006 RMB
Revenue from loan interest	300,000	400,000	0	0	0	0	0
Revenue from the trading of imported goods	0	0	20,000,000	25,000,000	30,000,000	35,000,000	28,000,000
Revenue from sales of self-manufactured products	0	0	15,000,000	40,000,000	35,000,000	25,000,000	55,000,000
Total profit for the year	300,000	400,000	3,000,000	4,000,000	5,000,00	6,000,000	7,000,000

Required:

(a) Assuming Company C carries out only manufacturing activities in the GETDD, state, giving reasons:

(1) the enterprise income tax rate applicable to Company C for the years to 2006; and
(2) the income tax incentive for which Company C is eligible.

Note: the 3% local income tax is waived by the Guangzhou local government for those foreign investment companies located in the GETDD for those years enjoying a tax holiday. (4 marks)

(b) Explain the effect of the incentive identified in (a) above on the income tax rate(s) applicable to Company C for each of the years 2000 to 2006 inclusive. (12 marks)

(16 marks)

5 **(a)** Mr Chan is a Singapore citizen. He has been the Chief Finance Officer of Company F, a wholly owned foreign enterprise (WOFE) in China, from its establishment in January 2000. He is also an appointed director of the board of Company F. In addition to his normal monthly salary for his role in management, he is entitled to an annual director's fee for this directorship.

Required:

(i) Explain the general individual income tax implications of the director's fee received by Mr Chan. (2 marks)

(ii) Explain the individual income tax implications if Mr Chan did not receive any remuneration specifically for his role in management but only a director's fee from Company F. (5 marks)

(b) On 1 January 2006, Mr Chan was granted stock options of 5,000 shares in Company F's US investor at the price of USD 10 per share. The vesting period for the shares was two years. Mr Chan exercised all of the stock options on 1 January 2008 and the market price of the shares on the exercising day was USD 25 per share.

Mr Chan resided in China throughout the two years from 1 January 2006 to 1 January 2008.

Required:

(i) Advise Mr Chan of the individual income tax implications of the grant and exercise of the stock options, calculating the tax due (if any).

Note: the relevant exchange rate is to be taken as USD 1 = RMB 7·3. (5 marks)

(ii) Advise Mr Chan on the individual income tax implications (if any) if he were to sell the shares obtained as a result of exercising the stock options. (4 marks)

(16 marks)

End of Question Paper