Professional Level – Options Module

Advanced Taxation (China)

Monday 1 June 2009

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 need only 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

	Rate
Income tax for domestic and foreign enterprises	25%

Entrepreneurs who receive production or operation income derived from private industrial or commercial enterprises

Level	Annual taxable income (RMB)	Rate	Quick deduction factor (RMB)
1	5,000 or below	5%	0
2	5,001– 10,000	10%	250
3	10,001 – 30,000	20%	1,250
4	30,001 – 50,000	30%	4,250
5	Over 50,000	35%	6,750

Individual income tax

Employment income

Grade	Taxable income on which employee bears the tax/employer bears the tax (RMB)	Rate %	Quick deduction factor (RMB)
1	500/475 or below	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 factor (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

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 and foreign enterprises	60% of the amount subject to a maximum of 0·5% of the sales/business income of the year.

Section A – BOTH questions are compulsory and MUST be attempted

1 Super-BVI is a company incorporated in the British Virgin Islands. In 2001, Super-BVI established Super-DG, a wholly-owned foreign enterprise, in Dong Guan, to manufacture and sell baby-cars. Super-DG manufactured products A and B in Dong Guan. Product A was sold at RMB 380 per unit to customers in Europe. To solicit orders the staff of Super-DG regularly travelled overseas to attend product exhibitions and to visit customers. Product B was sold at RMB 280 per unit to customers in China.

In 2004, Super-BVI established Super-HK, a wholly-owned subsidiary in Hong Kong, to purchase car-seats from suppliers in Asia for resale to customers in Europe. Super-HK has no establishments in China. Although different products were sold, Super-DG and Super-HK had 50% of their European customers in common; and there was overlapping and lack of co-ordination in the area of services provided to customers. Distribution channels and customer lists were not shared; and efforts to promote products and to explore markets were duplicated. The management of the Group have been discussing how this inefficiency could be reduced.

By late 2007, because of the US sub-prime crisis, the reduction in export tax refund and the appreciation of RMB, the Group's profit had declined substantially. The management of the Group held a meeting to discuss measures to improve profitability. It was decided that in order to improve efficiency, to reduce costs and to expand the market, Super-DG would no longer be responsible for the sale of its products. All overseas sales would be handled by Super-HK, while all domestic sales would be handled by a domestic trading company. Starting from 1 January 2008, the following restructuring of the Group's activities was implemented:

(1) Manufacture and sale of Product A

- (i) Super-DG and Super-HK have entered into a contract processing arrangement. Super-HK purchases the raw materials and provides them to Super-DG for processing. Super-DG charges a processing fee of RMB 100 per unit and exports the finished products to Super-HK.
- (ii) Super-HK sells the finished products to customers overseas.

(2) Manufacture and sale of Product B

- (i) Super-DG continues to manufacture Product B in Dong Guan.
- (ii) The finished products are sold at RMB 180 per unit to a trading company, a domestic enterprise newly established by Super-BVI, for resale to customers in China.

(3) The salesmen, distribution channel and customer lists of Super-DG have been transferred to Super-HK and the trading company at their fair value.

As a result of the restructuring, the enterprise income tax (EIT) liability of Super-DG for 2008 has dropped by 44%, as shown below:

	2007 RMB000	2008 RMB000
Turnover	19,500	10,500
Cost of operations	(12,000)	(7,020)
Gross profit	7,500	3,480
Selling expenses	(2,250)	–
Management expenses	(1,500)	(1,350)
Financial expenses	(1,050)	(630)
Net profit	2,700	1,500
EIT rate	15%	15%
EIT payable	405	225

In May 2009, the local tax authority conducted a tax audit and held a meeting with Super-DG to discuss the decline in Super-DG's profits. The local tax authority queried the change in Super-DG's operations, the reasonableness of the decline in its EIT tax liability, and whether the restructuring of its activities is for tax-avoidance purposes. Given the associated relationship with Super-HK and the domestic trading company, the local tax authority advised Super-DG that it would adjust the transfer pricing transactions and consequently Super DG's profits.

You are the tax advisor to Super-DG. Mr Summers, the Financial Controller of Super-DG, has sought your advice on the queries raised by the local tax authority.

Required:

Assuming today's date is 1 June 2009, prepare a report for Mr Summers addressing all of the China tax issues set out below.

(a) Associated enterprises

- **(i) Define the term 'associated enterprises' under the Chinese tax laws and regulations;** (2 marks)
- **(ii) State the circumstances normally considered as creating an associated enterprise;** (4 marks)
- **(iii) Advise whether Super-DG, Super-HK and the domestic trading company would be considered as associated enterprises.** (1 mark)

(b) Transfer pricing adjustments

- **(i) Define 'arm's length principle' in the context of transfer pricing;** (2 marks)
- **(ii) State the circumstances in which the tax payable in relation to a transaction between associated enterprises may be adjusted;** (3 marks)
- **(iii) Explain the transfer pricing adjustment methods, in proper sequence, that the tax authority may adopt during a transfer pricing audit;** (4 marks)
- **(iv) Explain the actions that can be taken by Super-DG if it disagrees with the transfer pricing adjustments proposed by the tax authority.** (4 marks)

(c) Business restructuring and tax avoidance

Advise how Super-DG can defend its tax position that the restructuring of its business activities is not for the purposes of tax avoidance. (15 marks)

Professional marks will be awarded in question 1 for the appropriateness of the format and presentation of the report and the effectiveness with which the information is communicated. (2 marks)

(37 marks)

2 Novak Ltd (Novak) is a company engaging in the manufacture and sale of machinery in Shenzhen. Novak produces two machines, Machine A for export and Machine B for domestic sale. Details of Novak's activities in 2008 are as follows:

(1) 50,000 units of Machine A were exported at the free on board (FOB) price of RMB 200 each (exclusive of value added tax (VAT)); and 20,000 units of Machine B were sold locally at RMB 150 each (exclusive of VAT).

(2) Raw materials for producing Machine A were: material A1 imported for RMB 4,000,000 (exclusive of VAT and customs duty) and material A2 purchased locally for RMB 1,000,000 (exclusive of VAT).

(3) Raw material B used for producing Machine B was purchased locally for RMB 2,000,000 (exclusive of VAT).

(4) Raw material C used for producing both Machine A and Machine B was purchased locally for RMB 1,200,000 (exclusive of VAT).

(5) The applicable VAT rate and customs duty rate are 17% and 10%, respectively.

Novak is a VAT general taxpayer, and is required to use the 'exempt, credit and refund' method to account for the VAT liabilities on its exports. In 2007, China's export tax refund policy underwent drastic adjustments and effective from 1 July 2007 , the tax refund applicable to Novak was further decreased from 13% to 9%. Faced with the increase in costs brought about by the reduction in export tax refund, Novak is considering the following alternative modes of operation for the manufacture and sale of Machine A, in order to minimise its VAT and customs duty costs:

(i) Enter into a contract processing arrangement with Niko Ltd (Niko), Novak's parent company in Hong Kong. Raw material A1 will be purchased by Niko and provided to Novak for processing. Novak will charge a processing fee of RMB 120 for each unit and export Machine A to Niko. Niko will then sell Machine A to customers overseas.

(ii) Enter into an import processing arrangement with Niko. Raw material A1 will be purchased by Niko and sold to Novak for processing. Novak will sell Machine A to Niko for onward sale to customers overseas.

Novak is also considering the possibility of using a bonded logistic park to lower its VAT cost of raw material A2.

As the tax consultant to Novak, the company has approached you for advice.

Required:

Assuming today's date is 1 June 2009, write a letter to Novak Ltd's managing director which:

(a) Compares the value added tax (VAT) and customs duty costs of the existing mode of operation (non-bonded export trade) with the two alternative modes being considered and recommend the mode of operation that constitutes the best alternative.

Note: you should support your advice with calculations of the VAT and customs duty costs in each case.
(19 marks)

(b) Briefly explains how a bonded logistic park can be used in conjunction with the alternative as recommended in (a) to lower the VAT cost of purchasing raw material A2.

Note: you should ignore the tax implications of a permanent establishment. (6 marks)

Professional marks will be awarded in question 2 for the appropriateness of the format and presentation of the letter and the effectiveness with which the information is communicated. (2 marks)

(27 marks)

Section B – TWO questions ONLY to be attempted

3 Mike Johnson is a US citizen. He has been employed by ATM Inc (ATM), a US company, since January 2002. On 1 January 2008, he was transferred to Sino Co (Sino), ATM's subsidiary and a wholly-owned foreign enterprise in China. As the expatriate regional marketing manager of Sino, Mike travels frequently to neighbouring countries in the performance of his duties. During the year 2008, Mike spent 190 days on overseas trips.

Mike's salary of RMB90,000 per month was paid by Sino in China, but recharged to ATM. Believing that Mike is entitled to the tax relief for temporary visitors, Sino has not withheld or reported any individual income tax (IIT).

In a recent review of Sino's IIT compliance procedures by the local tax authority, it transpired that Sino had failed to comply with all of its IIT reporting and withholding compliance obligations. The tax authority has ordered Sino to make corrections by a stipulated deadline and has imposed fines on Sino.

Required:

(a) Explain the tax relief for temporary visitors and discuss whether Mike Johnson is entitled to the relief. (5 marks)

(b) State the late payment surcharges and fines that may be levied against Sino Co by the tax authority, if the tax relief for temporary visitors is held not to apply to Mike Johnson. (3 marks)

(c) Explain the procedures available to Sino Co if it disputes the tax imposition activities of the local tax authority. (5 marks)

(d) To avoid the pitfalls of entering into disputes with the tax authorities, it is important that taxpayers ensure that they properly comply with the tax requirements and react promptly should problems arise.

Prepare a list of actions that Sino Co should take to ensure proper compliance with the tax requirements and its prompt reaction should problems arise. (5 marks)

(18 marks)

4 BlueSky Ltd (BSL), a Chinese-foreign equity joint venture, is engaged in the manufacture of household appliances. BSL was issued with a business licence in March 2009, and commenced its business with a registered capital of RMB 5,000,000. BSL is contemplating the following transactions during 2009:

(1) Acquiring a real estate property for RMB 4,000,000, for which a real estate ownership certificate will be issued. BSL will then mortgage the property to borrow RMB 3,200,000 from the bank.

(2) Leasing half of the real estate property to Red Star for a term of two years. Under the lease, Red Star will pay rent to BSL of RMB 35,000 per month plus 10% of Red Star's gross turnover from the business conducted in the property.

(3) Leasing Machine A for five years for an annual rental of RMB 300,000. Machine A has a useful life of five years and will belong to BSL at the end of the lease.

(4) Leasing Machine B for three years for an annual rental of RMB 200,000. Machine B has a useful life of six years and will be returned to the lessor at the end of the lease.

(5) Entering into a four-year technology licence agreement with ABC Inc (ABC), the foreign joint venturer of BSL. BSL will pay an annual licence fee of RMB 1,500,000 for the right to use ABC's Technology X to manufacture Product Y in China. To assist BSL in using Technology X, under a separate technical service agreement, ABC will provide on-site technical services for the first year of the licence for an annual service fee of RMB 500,000.

Required:

(a) Explain the stamp duty and turnover tax implications of transactions (1) to (4) above, in each case support your explanations with reasons and/or reference to the relevant authority. (9 marks)

(b) Explain the stamp duty, turnover tax and withholding tax implications of transaction (5) above, supporting your explanations with reasons and/or reference to the relevant authority and indicating how the transactions might be restructured in order to minimise the tax liabilities. (9 marks)

(18 marks)

5 Assume today's date is 1 December 2008.

Michael Mak, a Hong Kong citizen, is the Chief Finance Officer of C&C Ltd (C&C), a foreign investment enterprise in China. After working for C&C for six years, his employment was terminated on 30 November 2008; and he will return to Hong Kong in December 2008. Michael has the following concerns:

(1) Under his China employment contract, he will receive a compensation payment of RMB 200,000 upon the termination of his employment. As this is a compensation for his loss of employment, he believes that the payment is not income from employment and so not taxable. (4 marks)

(2) He is entitled to receive an annual discretionary bonus which is calculated based on C&C's profit level for the preceding year. However, C&C's annual accounts for the year ended 31 December 2008 will only be finalised in March 2009. C&C has agreed to pay him the bonus in December 2008 based on the company's estimated results if he wishes to receive the bonus before leaving China, or alternatively, he will have to wait until April 2009 when the company's accounts are finalised. He is thinking of receiving the bonus in April 2009 after he has ceased employment, so that the bonus would not be subject to withholding tax. (4 marks)

(3) Throughout his employment, he has been living in C&C's quarter free of charge. Although his last day of employment is 30 November 2008, he is allowed to continue to live in the quarter, free of charge, until the end of December or the day he departs China, if earlier. Alternatively, C&C has offered him a housing allowance of RMB 15,000 in cash, if he moves out of the quarter on 1 December 2008. (3 marks)

(4) During his employment, he was granted two batches of stock options to acquire shares in C&C Holding, the Hong Kong parent company of C&C, with shares listed on the Hong Kong Stock Exchange. All the options are unconditional. Based on the current share price, one batch of the options is profitable if exercised now, but the second batch is at a marginal loss. He is thinking of exercising the first profitable batch and selling the shares either before or after he returns to Hong Kong; but he may let the loss-making batch lapse unless somebody is interested in buying the option. In his opinion, the share price should remain steady until the end of February 2009. (7 marks)

Required:

Explain the China tax implications of each of the four issues and where alternative courses of action are indicated, advise on how the maximum tax saving can be achieved.

(18 marks)

End of Question Paper