Professional Level – Options Module

Advanced Taxation (China)

Monday 3 December 2007

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)

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 – 5,000,000	10‰
15,000,001 and above	3‰	5,000,001 and above	5‰

Section A – BOTH questions are compulsory and MUST be attempted

1 (a) The China Technology Development Company (China-Tech) is a wholly foreign owned company which was incorporated in China on 1 January 1997. China-Tech is the only Chinese subsidiary of US Technology Holding Company (US-Tech), a company incorporated in the United States. China-Tech is engaged in the manufacture of electronic equipment, as well as in the provision of research and development (R&D) services to US-Tech. China-Tech engaged an external tax consultant, ABC Tax Consultants, to perform a tax compliance review service in 2006. The tax consultant made the following findings during this tax review.

Under the R&D service agreement entered into between the two companies in 1997, China-Tech charges US-Tech an annual R&D service fee of RMB 5,000,000 for the three year period from 1998 to 2000. In January 1998, China-Tech and US-Tech also signed a technology licence agreement. Under this agreement, US-Tech granted China-Tech a three year licence of Technology A to manufacture Product A in China for an annual licence fee of RMB 3,000,000 for the period from 1998 to 2000. US-Tech did not send any of its employees to China to perform activities in relation to this technology licence.

Each year, China-Tech invoiced US-Tech for the R&D service provided and received US-Tech's invoice for the licence fee. China-Tech offset the licence fee against the R&D service fee and received a net cash payment of RMB 2,000,000 from US-Tech. R&D service fee and licence fee have both been recorded in China-Tech's accounting records and reported in its foreign enterprise income tax filings. Business tax has been paid on the net cash received of RMB 2,000,000, but no China tax has been paid on US-Tech's licence fee as there was no cash payment for the licence fee.

China-Tech's assessable period for business tax is one month.

Required:

(i) Identify and explain any tax non-compliance as a result of China-Tech's tax treatment of the above transactions and quantify the relevant China tax exposures. (10 marks)

(ii) Assuming the China tax authorities noted the tax non-compliances identified in (i) above when performing a tax audit on China-Tech in the year 2007, advise on the potential late tax payment interest and tax penalties that the China tax authorities may impose. (4 marks)

(b) China-Tech is considering signing a separate technology licence to obtain Technology B from US-Tech to manufacture Product B in China for the five years from 2007 to 2011. Under the draft licence agreement, US-Tech intends to provide China-Tech with the following:

(i) the licence of Technology B, for a licence fee of RMB 4,000,000 per annum; and

(ii) the right to use the trademark owned by US-Tech for Product B. The trademark will be shown on the label of China-Tech's Product B for a trademark fee of RMB 2,000,000 per annum.

China-Tech and US-Tech also intend to enter into a technical services agreement for on-site technical services for the initial two years of the licence aimed at assisting China-Tech in mastering and using Technology B. Upon China-Tech's request from time to time, US-Tech will send technicians from the US to China-Tech's site to perform these services. The service fee is fixed at RMB 1,000,000 per annum regardless of the number of requests.

Required:

As China-Tech's tax consultant, draft a letter to the company's Chief Financial Officer (CFO) advising on the business tax and withholding tax implications of the proposed licence agreement and technical services agreement and indicate how they might be restructured in order to minimise these China taxes.
(14 marks)

Appropriateness of the format and presentation of the letter and the effectiveness with which the information is communicated. (2 marks)

(30 marks)

2 **(a)** RedStars is a 50:50 equity joint venture which was incorporated in China on 1 January 2000 by Red Flag Petrochemical Company (Chinese investor) and Stars Petrochemical Company Limited (US investor). RedStars is engaged in the manufacture and sale of petrochemical products in the domestic and overseas market.

On 1 July 2007, RedStars ceased the production of Butadiene for ten days for quarterly maintenance of the production machine. The Butadiene inventories available for sale were ten tons. However, according to a sales contract signed with a Shanghai customer in June 2007, fifteen tons of Butadiene had to be delivered to the Shanghai customer on 5 July 2007. As such, RedStars borrowed five tons of Butadiene from its neighbour, a tyre factory, so it could deliver the fifteen tons of Butadiene to the customer as scheduled.

The quarterly maintenance was completed and Butadiene production was resumed on 11 July 2007. RedStars returned five tons of Butadiene to the tyre factory one week later. No accounting entries were made by RedStars or the tyre factory for the borrowing and return of the Butadiene.

Required:

Advise on the tax implications of the borrowing and return of the Butadiene between RedStars and the tyre factory. (3 marks)

(b) RedStars was recognised as an encouraged foreign investment project according to the prevailing Investment Catalogue for Foreign Investments. In 2007 the following assets were disposed of:

– Important production equipment was replaced with a new model produced by the same PRC manufacturer and the old equipment was sold to another PRC company at its net book value as at 31 December 2006. RedStars has already applied for and received a value added tax (VAT) refund for the old production equipment in 2005.
– Twenty sets of monitors used for eleven months, with an original value of RMB 12,000 each, were sold for RMB 100 each.
– A fax machine which had not been brought into use since it had been purchased, was sold at its original price of RMB 5,000.
– After being used for five months, a vehicle was sold for RMB 350,000, which is more than the vehicle's original purchase price.
– Obsolete raw materials costing RMB 50,000 were sold for RMB 8,000.

All sales are stated at their VAT inclusive price.

Required:

(i) List the value added tax (VAT) general exemption criteria for asset disposals. (6 marks)

(ii) Analyse the VAT implications for the assets disposed of by RedStars in 2007 and quantify any potential VAT liabilities, assuming that RedStars' applicable VAT rate is 17%. (12 marks)

(iii) Briefly state the income tax consequences of the disposals of assets by RedStars in 2007. (3 marks)

(c) In August 2007, RedStars sold petrochemical goods for RMB 1,200,000 plus VAT of RMB 204,000 to a distributor (a trading company). The distributor subsequently sold the goods to a customer for RMB 1,180,000 plus VAT of RMB 200,600, and was paid RMB 50,000 by RedStars as compensation for the loss on the transaction.

Required:

Explain the VAT implications for the distributor of the above transaction with RedStars. (6 marks)

(30 marks)

Section B – TWO questions ONLY to be attempted

3 (a) Company A is a wholly foreign owned enterprise engaged in the manufacture and sale of home appliances. Company A started its five year tax holiday (i.e. two-year exemption and three-year half reduction) from the year 1996. Effective from the year 2001, Company A's applicable national income tax rate is 30% and its local tax rate is 3%.

To cope with rapid business growth, Company A is planning to set up two branches in the year 2008, B1 to manufacture home appliances and B2 to sell the home appliances produced by B1. Company A's 2008 estimated taxable income for foreign enterprise income tax (FEIT) purposes (excluding B1 and B2) is RMB 10,000,000, B1's is RMB 2,000,000 and B2's is RMB 3,000,000. The following two options are available to Company A:

Option 1: B1 to be located in Jiangsu with an applicable national income tax rate of 30% and local tax rate of 3% and B2 to be located in Shanghai Pudong with an applicable national income tax rate of 15% and local tax rate of 0%.

Option 2: B1 to be located in Shanghai Pudong with an applicable national income tax rate of 15% and local tax rate of 0% and B2 to be located in Jiangsu with an applicable national income tax rate of 30% and local tax rate of 3%.

Required:

(i) Explain the general principles applicable to the calculation of the foreign enterprise income tax (FEIT) payable where an enterprise files its FEIT return on a consolidated basis for its head office and its branches. (3 marks)

(ii) Compare the potential FEIT payable by Company A under each option for the year 2008 and advise on which option is the more tax efficient. (6 marks)

(b) Company A has not distributed any retained earnings since its establishment. Due to the business' expansion, it is proposed to use RMB 10,000,000 of the retained earnings to increase the registered capital of Company A. Company A's after-tax profits for the eight years 1996 to 2003 are as listed below:

RMB in millions

1996	1997	1998	1999	2000	2001	2002	2003
2·5	3·28	3·8	3·1	3·0	5·2	6·3	7·8

Required:

(i) Advise on the potential reinvestment refund available to Company A's foreign investor under each of the following scenarios:

- **using the after-tax profit derived from the years 1996 to 1999; and**
- **using the after-tax profit derived from the years 1998 to 2001.** (8 marks)

(ii) Advise on the tax implications if in addition to the reinvestment, the Board of Company A also plans to repatriate dividends of RMB 5,000,000 to its foreign investor. (1 mark)

(iii) Assuming that the registered capital of Company A is increased as proposed in 2008, explain the circumstances in which any reinvestment refund obtained would have to be returned to the tax authorities. (2 marks)

(20 marks)

4 (a) **Define the term of 'associated enterprises' under the local tax laws and regulations in China and list eight circumstances which would normally be considered to create an associated enterprise.** (11 marks)

(b) **Briefly explain the transfer pricing adjustment methods, in proper sequence, that the tax bureau may adopt during a transfer pricing audit on the sale and purchase of tangible assets.** (4 marks)

(c) **State the actions that should be taken if an enterprise disagrees with the tax bureau's transfer pricing adjustments.** (5 marks)

(20 marks)

5 Mr Lee is a Hong Kong (HK) citizen. From 1 June 2006, he was appointed as the sales manager of Company C, a wholly foreign owned company incorporated in China. The assignment period is five years, ending on 1 June 2011. With the exception of a two month business trip to the United States (US) in 2008, Mr Lee expects to spend all of his time in mainland China during his five year assignment.

The income derived by Mr Lee during the assignment period will be as follows:

– A monthly salary of RMB 80,000 and a monthly cost of living allowance of RMB 10,000 paid by Company C.
– A monthly housing allowance of RMB 12,000 paid by Company C in arrears upon the production of an official rental receipt issued by his landlord.
– An annual bonus equivalent to RMB 400,000 paid at the year end by Company D, the foreign investor of Company C.
– A monthly rental income equivalent to RMB 15,000 from the leasing out of his apartment in Hong Kong.

Required:

(a) **Advise Mr Lee on the individual income tax (IIT) implications of his receiving each of the items of income listed above, stating how any tax due will be paid.** (8 marks)

(b) **State the general circumstances in which an individual taxpayer must perform IIT self reporting and determine whether or not Mr Lee is liable to perform IIT self reporting for his annual income during his assignment period.** (12 marks)

(20 marks)

End of Question Paper