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# Answers

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**1 Report to Mr Anderson of Excel Computers Asia Ltd**

To: Mr Anderson  
From: Tax advisor  
Date: 1 December 2008  
Subject: China tax position of Excel Computers Asia Ltd (EAL) and the representative office (RO)

EAL is engaged in the distribution of ECI's products in the Asia Pacific region, including China; and has registered a RO in Shanghai to provide liaison and marketing services. You have requested me to address all the China tax issues regarding the sale of network computers in China, the activities of the RO and the individual income tax (IIT) reporting for the Chief Representative of the RO. My comments on the various matters are as follows:

**(a) Sale of network computers**

- (i) Although the RO is a permanent establishment (PE) of EAL in China, it only provides liaison services in China and the critical steps of the business' activities (sourcing, sales negotiation and conclusion) are all done outside China by EAL. Hence, it could be substantiated that none of the income of EAL is derived through its PE in China and it should not, therefore, be regarded as China-sourced income subject to enterprise income tax (EIT).

For value added tax (VAT) purposes, as the dispatching location of the goods is not within China, the sales are not made within China and hence the sales of EAL should not fall into the scope of charge of VAT.

- (ii) The import customs duty and VAT liabilities are the legal obligations of the importer of the goods into China. Being the seller, EAL is not obliged to bear them under the prevailing customs and VAT regulations in China.

**(b) Representative Office in Shanghai**

- (i) Under the prevailing China tax rules and regulations, a representative office (RO) is not a separate entity. In fact, it is regarded as a mere extension of the overseas head office for the purposes of providing liaison and auxiliary activities in China. As such, it is not allowed to engage in any business or profit seeking activities. Depending on the activities conducted by the RO, the income generated therefrom will be subject to business tax (BT) and EIT in China.

Under the tax circular, *Guoshuifa* (1996) 165, the following activities have been identified as taxable activities of a RO and the income generated therefrom will be subject to both BT and EIT:

- agency trading activities by the RO of a trading company;
- services provided by the RO of a consulting company, including accounting, tax and legal firms;
- services provided by the RO of a group of companies or a holding company to its member companies;
- advertisement contracting or agency business by the RO of an advertising company;
- services for tourists provided by the RO of a travel agency;
- investment advice or other consulting services provided by the RO of a bank/financial institution;
- services to customers provided at different stages of transportation operations by the RO of a transportation company; and
- other taxable activities provided by a RO.

Under the same circular, there are certain activities which are regarded as activities exempt from tax; namely:

- work undertaken in relation to the production, manufacture or sale of its head office's products (trade in self-produced goods);
- carrying out market research in China;
- providing information on market conditions; and
- liaison and other preparatory and auxiliary activities.

The term 'head office' is narrowly construed as the overseas organisation that established the RO and shall not include any other related organisations within the group. Moreover, the exemption does not apply to agency or service activities or other similar or related activities undertaken by a RO on behalf of its head office.

If the RO is determined as subject to China tax, it will be subject to BT at 5% on its gross income and EIT at 25% on its net income. In terms of the tax base, depending on the actual situation of the RO, the tax authorities may assess the taxes on an actual basis, a deemed basis or a cost plus basis.

- (ii) The RO will be subject to both BT and EIT because it also provides services to ECI, which is a group company and not its head office. Moreover, the services provided are not purely liaison work.

- (iii) Pursuant to *Guoshuifa* (2003) 28, the RO will be required to adopt the cost-plus method for determining its tax base. Under the cost plus method, China-sourced income is calculated to be approximately 117.65% of a RO's operating expenses. The operating expenses shall be certified by a Chinese certified public accountant. Net income is deemed to be 10% of gross income.

In ascertaining the operating expenses, the following expenses will be excluded:

- Costs of the new office may be spread over a maximum of five years, subject to the tax authority's approval (*Guoshuifa* (1998) 63). The quarterly portion is therefore RMB 18,750 (RMB 375,000/(5 x 4)).
- Bank interest income cannot be used to offset against the expenses.
- The penalty for tax non-compliance should be taken out of the expenses (*Guoshuifa* (1991) 726).
- The deductible amount of entertainment expenses is restricted to 60% of the amount incurred. The amount to be excluded is therefore RMB 300,000 (RMB 750,000 x 40%).

The deemed gross income is therefore:

$$\begin{aligned} &= \text{RMB } (2,213,000 - 356,250 + 2,000 - 3,000 - 300,000) \times 117.65\% \\ &= \text{RMB } 1,830,340 \end{aligned}$$

$$\begin{aligned} \text{BT} &= 5\% \text{ on gross taxable income} \\ &= \text{RMB } 1,830,340 \times 5\% = \text{RMB } 91,517 \end{aligned}$$

$$\begin{aligned} \text{EIT} &= 25\% \text{ on deemed profit} \\ &= \text{RMB } 1,830,340 \times 10\% \times 25\% = \text{RMB } 45,758 \end{aligned}$$

- (iv) Under the cost-plus method, the expenses of an RO should be separately recorded, as they will be used as the basis to compute the BT and EIT liabilities. Therefore, the expenses should be minimised as long as it is commercially justifiable, so as to minimise the BT and EIT liabilities of the RO. However, please note that the China tax authorities would generally consider that the expenses of a RO should include all the routine disbursements from the bank accounts of the RO as well as some unavoidable expenses for operating the RO (e.g. rent, salaries, etc).

### (c) Chief Representative of the RO

- (i) Pursuant to *Guoshuifa* (1994) 148, the chief representative of a RO who works in a China-based RO is not entitled to the benefit of the 90-days (or 183 days if any double tax agreement applies) exemption rule on foreign paid income as his salary is deemed to be borne by the RO. Therefore, even though Mr Tan's salary is paid and borne by EAL and he stays in China for less than 183 days, he will be subject to individual income tax (IIT) on his income on a time apportionment basis.

The IIT payable in the particular month is the tax liability calculated on the whole of the monthly salary x (the number of work days spent in China in the particular month/the total days in the particular month).

- (ii) The RO in China will be the paying agent responsible for withholding tax from Mr Tan's salary. Each month the tax withheld must be paid over to the tax bureau within the first seven days of the following month.
- (iii) Article 32 of the *Administration Law on Levying and Collection of Taxes* (ALLCT) states that where a taxpayer or withholding agent fails to settle a tax payment within the prescribed time limit, the tax authorities shall, in addition to ordering the taxpayer or withholding agent to pay the tax within the prescribed time limit, impose a late payment surcharge calculated at a daily rate of 0.05% on the tax overdue.

Article 69 of ALLCT further states that the tax authorities can impose a penalty ranging from 50% to 300% of the amount of tax under-withheld on the tax withholding agent (EAL) who failed to withhold tax properly. The outstanding tax will then be recovered from the taxpayer (Mr Tan) rather than EAL.

- (iv) If tax has not been paid or is underpaid, the tax authorities may demand payment of the tax undercharged within a three-year period. However, under special circumstances (e.g. if the amount of the tax payment exceeds RMB 100,000), the statutory period for recovery of the tax may be extended to a maximum of five years (ALLCT, Art 52).

For tax evasion and tax deceit cases, there is no time bar for recovery of the outstanding taxes and late-payment surcharges.

I hope the above addresses all your concerns regarding the China tax implications. Should there be any questions, please let me know.

**End of Report**

Managing director  
Ningbo Property Development  
Client's address

1 December 2008

Dear Sir

It was a pleasure to meet with you last week to discuss the commercial property development you have agreed with Advance Technology Ltd (ATL), my advice in relation to which is given below.

**(a) China tax implications relating to the sale and purchase of commercial properties**

**Ningbo Property Development (NPD)**

(1) Business tax (BT)

All units and individuals engaged in the provision of taxable labour services, the assignment of intangible assets, or the sale of immovable properties within China, are liable to pay BT (*Provisional Rules on Business Tax* (BTPR), Art 1). The sale of a newly constructed building by the unit or individual who constructed the building is also regarded as a taxable labour service subject to BT (*Business Tax Implementing Rules* (BTIR), Art 4). BT is generally determined by multiplying the gross turnover by the applicable tax rate (i.e. 3% for construction and 5% for the sale of immovable properties).

The taxable turnover of businesses selling or assigning immovable assets or land use rights is the total selling price less the purchase price of the property or land use right (*Guoshuihan* (2005) 83). Therefore, the BT liability on the sale will be RMB 19,125,000, i.e. RMB (420,000,000 – 37,500,000) x 5%.

Units which sell buildings which they have newly constructed, i.e. engage in 'self-construction', are also assessed on a deemed amount of business turnover, as determined by the tax authorities in accordance with BTIR, Art 15 (BTIR, Art 19).

(2) Stamp duty (SD)

According to the SD regulations, 0.03% SD will be imposed on the transfer of the property. The SD liability is, thus, RMB 126,000 (i.e. RMB 420,000,000 x 0.03%). SD is payable by both parties to the transaction, in this case NPD and ATL.

(3) Land appreciation tax (LAT)

According to the tax regulations, LAT applies to the sale or transfer of land-use rights, buildings and their attached facilities in China. LAT is payable on the increased value gained by the taxpayer through the assignment of real estate. The increased value is the amount of income derived through the assignment of real estate after deduction of certain deductible items.

In calculating the increased value, the following items are deductible (*Provisional Rules on Land Appreciation Tax* (PRLAT), Art 6):

- (i) cost of land use rights, including deed tax;
- (ii) costs for the development of land, the construction of new buildings and auxiliary structures;
- (iii) expenses for the land development, the construction of new buildings and auxiliary infrastructure, i.e. selling expenses, management expenses and financial expenses related to the real estate development project;
- (iv) the assessed price paid for old buildings;
- (v) taxes related to the assignment of real estate, including business tax and stamp duty when assigning real estate; and
- (vi) any other items allowed as deductions by the Ministry of Finance.

Interest payments at market rate may be deducted in full if they can be confirmed by a certification from a financial institution. The other expenses to be deducted for real estate development must be kept within 5% of the total value calculated according to (i) and (ii) above. Interest payments for which certification cannot be provided for separately and other real estate development expenses may be deducted at up to 10% of the sum of (i) and (ii) above.

A taxpayer engaged in a real estate development project is also allowed an additional deduction of 20% of the deductible items (i) and (ii) set out above.

Stamp duty paid at the time the real estate is assigned may be deducted (*Provisional Rules on Land Appreciation Tax Implementation Rules* (LATIR), Art 7(5)). A deduction will be granted accordingly for the SD that has been paid and charged as a management expense by a real estate development enterprise in accordance with the relevant provisions of the Financial System for Construction and Real Estate Development Enterprises. Other LAT payers are permitted to deduct the SD that was paid at the time the real estate was assigned when calculating LAT.

The LATIR, Art 7 further clarifies the deductibility of development costs, which include:

- compensation fees for land expropriation and dismantling and removal of buildings;
- pre-construction engineering expenses;

- construction and installation expenses;
- expenses for infrastructure projects;
- expenses for auxiliary public utilities; and
- expenses incurred in the direct organisation and management of the development project.

Therefore, in NPD's case, the LAT payable due to the transfer of the commercial properties will be RMB 40,653,750; the detailed calculation of which is given in the annexure to this letter.

(4) Enterprise income tax (EIT)

Income from the sale of real estate is subject to EIT at 25%. EIT is payable on taxable income, which is determined as revenue for the assignment of real estate less the cost of land use rights, the development cost, the other taxes payable (SD, BT and LAT) and the other real estate development expenses.

Interest payment for which certification cannot be provided are not deductible.

Thus, EIT payable is RMB 11,492,562 (i.e.  $(420,000,000 - 38,625,000 - 165,500,000 - 126,000 - 19,125,000 - 40,653,750 - 110,000,000) = 45,970,250 \times 25\%$ )

**Advanced Technology Ltd (ATL)**

Stamp duty

As stated above, SD imposed on the transfer of property is payable by both parties to the transaction. Thus, ATL will also have a SD liability of RMB 126,000 (i.e.  $RMB\ 420,000,000 \times 0.03\%$ ).

**(b) Alternative arrangement to mitigate China tax**

NPD and ATL can establish a joint venture (JV) to develop the commercial properties. NPD will contribute the land use rights, while ATL will contribute cash as capital. After completion of the development project, NPD will transfer its equity interest in the JV to ATL.

**(1) Mitigating the tax exposure of NPD**

*Caishuizi* (1995) 48 states that the transfer of real estate (which includes land use rights, buildings and properties attached to the land) as an investment into an enterprise is temporarily exempt from LAT. Thus, only the subsequent transfer of the same real estate would be subject to LAT. However, according to *Caishui* (2006) 21, this exemption does not apply if the investment enterprise is engaged in property development or the investor is a property developer. Nevertheless, the market value of the land use rights at the time of transfer to the JV will not be very different from the original cost, such that any increased value will be much lower than that under the original arrangement. Moreover, the subsequent disposal of the equity interest in the JV is not subject to LAT. Therefore, the LAT liability will be considerably reduced.

Where an enterprise contributes intangible assets (which include land use rights) into an investment and participates in the profits and losses and risk sharing of the investment, the transfer of such intangible assets is exempt from BT (*Guoshuifa* (1993) 149 and *Caishui* (2002) 191).

Furthermore, according to *Caishuizi* (2002) 191, NPD is exempt from BT when it disposes of the equity interest in the JV.

**(2) Mitigating the tax exposure of ATL**

Under the original arrangement, ATL will have to pay SD on the total consideration of RMB 420,000,000. Under the alternative arrangement, the cash contribution by ATL into the JV will not attract any tax; and at the conclusion of the project SD will be payable only on the transfer of equity interest, the value of which should be much lower than RMB 420,000,000. Therefore, again, the SD liability will be reduced.

(Note: marks will be given for any other reasonable answers to part (b)).

Please do not hesitate to contact me again if you require any further information.

Yours faithfully

Tax Consultant

## ANNEXURE

### Calculation of land appreciation tax (LAT) liability of NPD

	RMB	RMB
Revenue for the assignment of real estate		<u>420,000,000</u>
Deductible items:		
(i) Cost of land use rights	37,500,000	
Deed tax	<u>1,125,000</u>	38,625,000
(ii) Development costs		
Compensation fees for land expropriation and dismantling and removal of buildings	25,000,000	
Pre-construction engineering expenses	5,000,000	
Construction and installation expenses	72,500,000	
Expenses for infrastructure projects	26,000,000	
Expenses for auxiliary public utilities	10,000,000	
Expenses incurred in the direct organisation and management of the development project	<u>27,000,000</u>	165,500,000
(iii) Interest and other real estate development expenses (38,625,000 + 165,500,000) x 10%		20,412,500
(iv) Additional deduction for real estate development projects (38,625,000 + 165,500,000) x 20%		40,825,000
(v) Business tax		19,125,000
		<u>284,487,500</u>
Increased value (420,000,000 – 284,487,500)		135,512,500
Ratio of increased value to value of deductible items (135,512,500/284,487,500)		47.63%
Applicable tax rate		30%
LAT payable = increased value x 30% = 135,512,500 x 30%		<u>40,653,750</u>

### 3 Evergreen Ltd

#### (a) Contract processing arrangement

Under this arrangement, Evergreen will provide raw materials to the WOFE for processing and the finished goods will be exported out of China. There is no passing of the title of either the raw materials or the finished goods from Evergreen to the WOFE. The WOFE will only receive a processing fee for the work done.

Therefore, the raw materials can be imported under bonded treatment, such that customs duty and import value added tax (VAT) need not be paid unless they are used for purposes other than the approved export processing. The WOFE should apply for bonded treatment with the government authorities, and complete the necessary registration and reconciliation procedures for the export processing contracts. The subsequent export of the finished goods produced using those raw materials will be exempt from export VAT as there is no sale of goods under contract processing, as the title and risks of the raw materials and processed goods are with Evergreen.

If Evergreen provides the machinery at nil consideration for the use of the WOFE, the machinery will also be exempt from import customs duty and VAT.

The processing fee derived by the WOFE can also be exempted from 17% output VAT. However, the input VAT incurred by the WOFE on local purchases (e.g. accessory materials, utilities) cannot be recovered nor refunded, thus this will become a real cost to the WOFE and should be charged to its cost of goods sold.

#### (b) Import processing arrangement

An import processing arrangement is essentially a buy and sell arrangement, whereby the WOFE will buy and import raw materials from Evergreen, process them and then sell and export the finished goods back to Evergreen.

The general rule is that raw materials crossing the border would be subject to import VAT at 17% and customs duty. If the raw materials will only be subject to 'processing' in China and the finished goods will be exported (regardless of whether this is under import processing or contract processing), the WOFE may apply to the China customs office for 'bonded treatment'. Under 'bonded treatment', the imported raw materials will be exempt from import VAT and customs duty. The raw materials will however, be subject to custom's supervision.

The export sale of the finished goods will be exempt from output VAT, and the WOFE can also receive from the tax authority a refund of the input VAT incurred on local purchases (e.g. accessory materials, utilities). However, the VAT incurred on local purchases can only be fully refunded if the refund rate is 17%. If the refund rate is lower than 17%, part of the VAT incurred on local purchases cannot be refunded. The amount of irrecoverable and non-refundable VAT is calculated as: (FOB price of

export sales – CIF value of import bonded raw materials ascertained by the Customs) x (output VAT rate – VAT refund rate). The irrecoverable amount is a cost and should be charged to the 'cost of goods sold'.

- (c) Under the *Individual Income Tax Implementing Rules* (ITTIR), tax relief is provided for temporary visitors to China. Edmond's remuneration relating to his services rendered in China will be exempt from individual income tax (IIT) if ALL of the following three conditions are fulfilled.

The first condition is that the aggregate number of days that Edmond stays in China in any 12-month period does not exceed 183 days. In counting the days the rule of 'days of physical presence' applies, i.e. the days when Edmond is in China and the day of arrival or departure, irrespective of the time and the purpose of the stay, will be counted as separate days. If Edmond enters and departs on the same day, it is counted as one day (*Guoshuifa* (2004) 97, Art 1). If Edmond stays in China for more than 183 days in any 12-month period, he will not be eligible for the tax exemption and will thus be taxable in China.

The second condition is that Edmond's remuneration is paid by an employer who is not a resident of China. As it is stated that Edmond's remuneration would continue to be paid by Evergreen in Hong Kong, then assuming that Evergreen is not a tax resident in China, this condition is fulfilled.

The third condition is that the payment of Edmond's remuneration is not to be borne by any permanent establishment which the employer, Evergreen, has in China. This condition is arguably fulfilled based on the following:

- (i) The remuneration is paid by Evergreen to Edmond. The subsequent recovery of a lump sum amount from the WOFE is arguably not remuneration paid to Edmond, but only represents a service fee or compensation in return for the assistance provided by Evergreen.
- (ii) It is also arguable that the WOFE is not a permanent establishment 'which Evergreen has in China', unless the WOFE does represent Evergreen in carrying out certain activities in China and thus, is acting as a permanent establishment of Evergreen.

Provided the above arguments can be made, it is likely that Edmond will be eligible for the exemption as long as Evergreen ensures that the aggregate number of days he stays in China do not exceed 183 days in any 12-month period. Also, that Edmond's remuneration continues to be paid by Evergreen in Hong Kong and it is not directly recharged to the WOFE as salary cost.

However, if it is the intention of Evergreen to recharge Edmond's remuneration to the WOFE as salary cost, the exemption will not be available.

## 4 Home Appliances Ltd

### (1) Relocation allowance

The lump sum joining fee of RMB 80,000 paid in cash and in relation to the employment services to be performed in China is taxable. However, if the lump sum payment were to be changed to an actual reimbursement of relocation and moving expenses, it will be exempt from individual income tax (IIT) *Guoshuifa* (1997) 54, as long as the expenses are reasonable and incurred by the expatriate.

According to *Guoshuifa* (2004) 80, prior approval from the tax authorities is no longer required. However, supporting documents and valid commercial invoices must be submitted to the tax authorities for review when filing the tax returns. The tax authorities may request supplementary documents and reserve the right to make adjustments if the supporting documents are not sufficient to prove the reasonableness of such a claim.

### (2) Performance bonus

The bonus is related to the employment services in China; so it should be included as taxable employment remuneration in the month of receipt and subject to IIT at progressive tax rates ranging from 5% to 45%. In accordance with *Guoshuifa* (2005) 9, a lump sum annual bonus shall be treated as a separate monthly salary by the taxpayer when calculating the IIT to be withheld by the withholding agent when making the payment. The monthly tax allowance cannot be deducted again as it has already been offset against the regular monthly income; and any unrelieved part of this tax allowance cannot be set-off against the lump sum bonus. The applicable tax rate and quick deduction are determined based on the quotient of the employee's lump sum annual bonus divided by 12 months. The calculation formula is as follows:

IIT liability = lump sum annual bonus x tax rate – quick deduction

For resident taxpayers, i.e. expatriate employees who have resided in China for more than five years, the tax calculation on a lump sum bonus will be subject to a slightly different rule. The lump sum bonus is taxed separately from the regular monthly income. The monthly tax allowance will be set-off against the regular monthly income but any unrelieved part of this tax allowance can be set-off against the lump sum bonus.

### (3) Stock options

According to *Caishui* (2005) 35, the granting of stock options will not trigger IIT at the time of grant.

*Caishui* (2005) 35 states that stock option income will arise when the acquisition price of the stock upon the exercising of the stock option (i.e. the exercise price) is lower than the market price of the stock at the date of exercise (i.e. the closing price). In this case, the difference between the closing price and the exercise price is determined as stock option income. The stock option income is associated with the employee's performance during his or her employment and therefore, will be classified as 'salary and compensation' from employment. Where an employee exercises stock options without actually purchasing the underlying stock and receives instead a cash payout equivalent to the difference between the market value at exercise and the grant price (i.e. a 'cashless' exercise), the income should also be recognised as salary income. The salary income relating to the exercise of the options should be calculated separately from the monthly salary.

*Caishui* (2005) 35 also clarifies that if the employee transfers the stock option before exercise, the net income from the transfer shall be regarded as income from wages and salaries and subject to IIT. *Guoshuihan* (2006) 902 further specifies that the 'net gain from the sale of stock options' is income generated from the transfer of stock options. If the employee previously purchased the stock options at a discount, the net gain from the sale of the options is the difference between the sale price and the discounted purchase price.

In accordance with *Guoshuihan* (2000) 190, if it can be proved to the satisfaction of the tax bureau that a portion of the option (and hence the gain) is related to the services of the employee before the commencement of the China employment, such portion will not be taxable. By the same token, the gain from the exercise of share options will be taxable if it is related to services rendered in China even though it is accrued or received by the employee after the completion of the employment and departure from China. Nevertheless, if the cost relating to the options exercised is not borne by an entity in China, the related gain can be exempt from IIT where the employee exercises the options after the departure from China.

Gains on the subsequent disposal of shares in respect of which an option has been exercised are not income from employment but income from the assignment of property. *Caishui* (2005) 35 clarifies that income from the transfer of stocks listed on a Chinese Stock Exchange is tax-exempt. Gains from the sale of overseas shares are taxable for expatriate employees only if they are taxable in China on their worldwide income because they have lived in China for more than five years.

### (4) Housing allowance

The monthly cash allowance of RMB 15,000 for employment in China is taxable. However, if the cash allowance were to be changed to an actual reimbursement of rental expenses, it will be exempt from IIT (*Guoshuifa* (1997) 54).

As in the case of a reimbursement of actual relocation expenses (see (1) above) according to *Guoshuifa* (2004) 80, prior approval of the applicability of the exemption from the tax authorities is no longer required. However, supporting documents such as rental agreements and valid official invoices (i.e. faipao) must be submitted to the tax authorities for review when filing the tax returns. The tax authorities may request supplementary documents and reserve the right to make adjustments if the supporting documents are not sufficient to prove the reasonableness of such an allowance.

## 5 Best Buy Ltd (BBL)

(a) The following tax factors should be considered when deciding the discount policy to be adopted:

- (1) If the goods are sold at a 10% discount, can the discount be deducted from the taxable profit?
- (2) If the goods are sold at a 10% discount, will the discount be allowed for value added tax (VAT) purposes?
- (3) Can the value of the cash coupons be deducted from the taxable profit?
- (4) When the customers use the cash coupons to purchase goods, will the goods be treated as sales subject to VAT?
- (5) When the customers use the cash coupons to purchase goods, will the company be required to withhold individual income tax (IIT)?
- (6) When the customers redeem the bonus points for cash, will they be subject to IIT?

(b) The China tax implications for the different discount policies are analysed as follows:

#### (1) A 10% discount will be given on any purchase

Value added tax (VAT): As a retailing enterprise, BBL will be subject to VAT with respect to its sales of goods. The sales discount will be allowed for VAT purposes such that the output VAT will be computed on the net of discount price.

Enterprise income tax (EIT): In computing the taxable profit of BBL, the discount can be deducted from the taxable profit and the net of discount price will be recorded as the sales revenue of the goods.

Individual income tax (IIT): No IIT should arise on the customers purchasing the goods.

#### (2) For every purchase of RMB 100, a coupon for RMB 10 will be given for settlement of any further purchase.

VAT: The output VAT should be computed based on the gross sales amount of RMB 100 only. However, when the customers use the cash coupons to purchase goods, it is not at all certain whether the goods should be treated as sales subject to output VAT.

EIT: The value of the cash coupon will be treated as promotional expenses of BBL and as such, will be allowed as an income tax deduction.

IIT: According to *Guoshuihan* (2000) 57, the cash coupons should attract IIT on the customers as 'other income'. BBL is required to deduct the withholding tax. As the customers are offered the cash coupons free at no additional cost, the IIT should be borne by BBL, and the cost of this will be allowed for EIT purposes.

- (3) For every purchase of RMB 100, the customer will receive 100 bonus points. At the end of the year, every bonus point can be redeemed for RMB 0.10.**

VAT: The output VAT should be computed based on the gross sales amount of RMB 100.

EIT: The value of the bonus points will not be allowed as an income tax deduction.

IIT: It is arguable whether the bonus points should attract IIT on the customers.

#### **Recommendation**

From the tax perspective, a 10% discount on sales is the best policy as the total tax liabilities under VAT, EIT and IIT are the lowest.

- (c)** Some potential non-tax benefits that may arise from adopting the second policy of giving out coupons:

(i) It may give an incentive to the customers to buy goods in the multiple of RMB 100.

(ii) It may give an incentive to the customers to buy more than they originally wanted in order to use up the coupons.

(Note: marks will be given for any other reasonable answers)

		<i>Marks</i>	
<b>1</b>	<b>(a)</b> Sale of network computers		
	<b>(i)</b> Trading profit non-China sourced – so not taxable	2	
	Sales not within China – so not subject to VAT	<u>1</u>	3
	<b>(ii)</b> Customs duty and import VAT borne by importer		2
	<b>(b)</b> RO in Shanghai		
	<b>(i)</b> RO not a separate entity	1	
	Taxable activities (any 5)	5	
	Exempt activities (any 2)	2	
	Definition of head office/activities on behalf of head office	1	
	BT and EIT on RO (2 x 0.5)	<u>1</u>	10
	<b>(ii)</b> RO subject to BT and EIT		2
	<b>(iii)</b> Explanation of cost-plus method	2	
	Ascertainment of operating expenses/calculation of gross income	4	
	Calculation of BT and EIT payable (2 x 0.5)	<u>1</u>	7
	<b>(iv)</b> Tax minimisation under cost-plus method		3
	<b>(c)</b> Chief representative of the RO		
	<b>(i)</b> Subject to IIT on time apportionment basis	2	
	Basis for calculating IIT	<u>1</u>	3
	<b>(ii)</b> Paying agent is RO	0.5	
	When IIT is paid	<u>0.5</u>	1
	<b>(iii)</b> Late payment surcharge	1	
	Penalty	<u>1</u>	2
	<b>(iv)</b> Statutory time bars	1.5	
	Tax evasion and deceit cases	<u>0.5</u>	2
	Appropriate format and presentation of report	1	
	Effectiveness of communication	<u>1</u>	2
			<u><b>37</b></u>

		<i>Marks</i>	
<b>2</b>	<b>(a)</b> Tax implications for NPD		
	BT payable on sale of property, including quantification	2	
	BT payable on self-construction	1	
	SD payable on transfer of property, including quantification	1	
	LAT		
	Scope of charge	1	
	Deductible items (6 x 0.5)	3	
	Interest payments, other expenses and additional deduction	2	
	Deduction for SD	1	
	Deductible development costs (6 x 0.5)	3	
	Calculation of LAT payable	3	
	EIT		
	Scope of charge	2	
	Calculation of tax payable	0.5	
	Tax implications for ATL		
	SD payable	0.5	20
	<b>(b)</b> Alternative arrangement to mitigate China tax		
	Alternative arrangement – use of JV	2	
	Tax effect on NPD		
	LAT	2	
	BT	2	
	Tax effect on ATL		
	SD	1	7
	Appropriate format and presentation of letter	1	
	Effectiveness of communication, including use of annexure	1	2
			<b>29</b>
<b>3</b>	<b>(a)</b> Tax implications under contract processing arrangement		
	Import of raw materials	1.5	
	Export of finished goods	1.5	
	Import of machinery	1	
	Processing fee	2	6
	<b>(b)</b> Tax implications under import processing arrangement		
	Import of raw materials	1.5	
	Export of finished goods	2.5	4
	<b>(c)</b> Exemption for temporary visitors	1	
	1st condition for exemption – number of days	1	
	2nd condition for exemption – non-China employer	0.5	
	3rd condition for exemption – not borne by China PE	0.5	
	Extent to which 2nd and 3rd conditions can be considered satisfied	2.5	
	Recommendation	1.5	7
			<b>17</b>

		<i>Marks</i>	
<b>4</b>	Relocation allowance		
	Cash payment taxable	1	
	Reimbursement of actual expenses	2	3
		<hr/>	
	Performance bonus		
	Taxable in the month of receipt	0.5	
	A separate monthly salary	0.5	
	Deduction of monthly tax allowance	1	
	Calculation formula	1	
	Resident taxpayers	1	4
		<hr/>	
	Stock options		
	At the time of grant	0.5	
	Exercise of stock options	2	
	Transfer of stock options	1.5	
	Related to prior services	1	
	Gain accrued after departure from China	1	
	Subsequent disposal of shares	2	8
		<hr/>	
	Housing allowance		
	Cash allowance taxable	1	
	Reimbursement of rental expenses	1	2
		<hr/>	
			<hr/> <b>17</b> <hr/>
<b>5</b>	<b>(a)</b> Tax factors to be considered (any 4)		4
	<b>(b)</b> 10% discount to be given		
	VAT implications	1	
	EIT implications	1	
	IIT implications	1	
	Coupons to be given		
	VAT implications	2	
	EIT implications	1	
	IIT implications	2	
	Bonus points to be given		
	VAT implications	1	
	EIT implications	1	
	IIT implications	1	
	Recommendations	1	12
		<hr/>	
	<b>(c)</b> Non-tax factors to be considered (any 1)		1
			<hr/> <b>17</b> <hr/>