Professional Level – Options Module

Advanced Taxation (China)

Monday 1 December 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 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 Excel Computer Asia Ltd (EAL) is a company incorporated in Singapore. Excel Computer Inc (ECI), a US corporation, is its ultimate parent company. The principal business of ECI includes the development and production of network computers; whereas EAL is engaged in the distribution of ECI's products in the Asia Pacific region, including China.

All the pricing, sales terms and contracts are negotiated and concluded by EAL's personnel in Singapore via telephone discussions, faxes or e-mails directly with the customers. EAL maintains only a very low buffer level of inventory at a regional level, in its warehouse in Hong Kong. In nearly all cases, EAL purchases the goods from ECI after EAL has secured sales to customers. Thus, in the case of customers residing in China, once a sale is secured arrangements are made for the delivery of the goods directly from the production plants of ECI outside China to the customer in China.

In 2008, EAL registered a representative office (RO) in Shanghai to provide liaison services. The RO handles the various communications with the Chinese customers on behalf of EAL and provides the after sales support. It also collects market information for ECI.

The RO employs five local Chinese staff. Mr Peter Tan, the Vice President of EAL, acts as the chief representative of the RO. Mr Tan is stationed in Singapore, and travels to Shanghai once every two months for a period not exceeding five days. EAL applied for and obtained a business visa for his stays in China, and bears his whole salary. Believing that Mr Tan is not subject to individual income tax (IIT) in China, EAL has not withheld or reported any IIT.

The total amount of expenses incurred by the RO in the first quarter of 2008 were as follows:

	RMB 000
Salaries and allowances	450
Leasehold improvement (decoration costs for the new office)	375
Individual income tax borne for staff	57
Interest income from bank deposit	(2)
Advertising expenses	580
Penalty on late stamping of office lease contract	3
Entertainment expenses	750
	2,213

You are the tax advisor to EAL. Mr Anderson, the Financial Controller of EAL, has sought your advice on the China tax implications of various issues for EAL and its RO.

Required:

Assuming today's date is 1 December 2008, prepare a report for Mr Anderson addressing the China tax issues set out below.

(a) Sale of network computers

(i) Advise whether or not the business activities of Excel Computer Asia Ltd (EAL) would be subject to value added tax (VAT) and enterprise income tax (EIT), assuming that the representative office (RO) is classed as a permanent establishment (PE) of EAL in China. (3 marks)

(ii) Advise whether or not EAL will be subject to customs duty and import VAT in respect of the network computers sold into China. (2 marks)

(b) Representative office in Shanghai

(i) Explain the general tax position of a RO in China, clearly identifying those activities that are taxable and those that are exempt. (10 marks)

(ii) By reference to the general principles identified in (i) above, advise whether or not EAL's RO will be subject to tax in China. (2 marks)

(iii) Assuming the RO is subject to tax in China, using the cost-plus method, advise on the amounts of business tax (BT) and EIT payable in respect of the RO for the first quarter of 2008. (7 marks)

(iv) Explain how a RO using the cost-plus method can minimise its China tax liabilities. (3 marks)

(c) Chief representative of the RO

(i) Advise whether or not Mr Tan's monthly salary will be subject to individual income tax (IIT). (3 marks)

(ii) Assuming that IIT is payable, state by whom and by when the IIT due each month will have to be paid over to the China tax authorities. (1 mark)

(iii) State whether or not EAL will be liable for any outstanding taxes or for any non-compliance fines as a result of its failure to withhold IIT on Mr Tan's monthly salary. (2 marks)

(iv) State the statutory time bars for the tax authority to recover back taxes from a taxpayer or tax withholding agent. (2 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)

(37 marks)

2 Ningbo Property Development (NPD) is a company engaged in the development and sale of commercial buildings in City K, China. In May 2008, NPD was approached by Advanced Technology Ltd (ATL) to develop commercial properties for ATL.

In October 2008, NPD acquired a piece of land in City K for the price of RMB 37,500,000 and obtained the land use rights. ATL has agreed to sign an agreement with NPD to purchase all the commercial properties developed on that land from NPD for a total consideration of RMB 420,000,000.

NPD has estimated the following costs for the development of the commercial properties:

(1) Cost of land use rights: RMB 37,500,000
(2) Deed tax on land use rights: RMB 1,125,000
(3) Compensation fees for land expropriation and dismantling and the removal of buildings: RMB 25,000,000
(4) Pre-construction engineering expenses: RMB 5,000,000
(5) Construction and installation expenses: RMB 72,500,000
(6) Expenses for infrastructure projects: RMB 26,000,000
(7) Expenses for auxiliary public utilities: RMB 10,000,000
(8) Expenses incurred in the direct organisation and management of the development project: RMB 27,000,000
(9) Other real estate development expenses: RMB 110,000,000
(10) Financial expenses related to the development project (for which certification issued by a financial institution cannot be provided): RMB 17,500,000

Required:

As tax consultant to Ningbo Property Development (NPD) write a letter to NPD's managing director which:

(a) Advises on the China tax implications for NPD and Advanced Technology Ltd (ATL) of the sale and purchase of the commercial properties.

Note: you should support your advice with calculations of the resulting tax liabilities. (20 marks)

(b) Suggests and explains one alternative arrangement for the development of the commercial properties that would mitigate the exposure to China tax. (7 marks)

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

(29 marks)

Section B – TWO questions ONLY to be attempted

3 Evergreen Ltd (Evergreen) commenced business in Hong Kong in 1998 as a manufacturer and exporter of radios. In order to take advantage of the low labour and other costs in China, Evergreen is contemplating establishing a wholly-owned foreign enterprise (WOFE) in Shenzhen to process and assemble the different components.

Evergreen is considering two alternatives:

(1) Entering into a contract processing arrangement with the WOFE. Under this arrangement:

(i) Evergreen will provide the raw materials, production skills, training and supervision for the locally recruited labour and the manufacturing plant and machinery.
(ii) The WOFE will provide the factory premises, the land and the labour.
(iii) Plant and machinery owned by Evergreen will be transferred to the factory for the WOFE's use.
(iv) The production manager of Evergreen, Mr Edmond Chan, will be seconded to the WOFE to supervise and monitor the processing works. During his stay in Shenzhen, Edmond will remain as an employee of Evergreen and continue to be remunerated by Evergreen. He will stay in a hotel in Shenzhen and will be responsible for his own spending in China. In return for his services, the WOFE will pay a lump sum amount to Evergreen upon the completion of the assignment. It has been agreed that, if Edmond is subject to tax in China, the China tax will be borne by Evergreen. It is, however, not yet certain how long he will be required to stay in Shenzhen.
(v) The WOFE will charge a processing fee and export the completed radios to Evergreen.

(2) Entering into an import processing arrangement with the WOFE. Under this arrangement:

(i) Evergreen will sell the raw materials at cost to the WOFE for processing.
(ii) The WOFE will own the inventory and the work in progress, and sell the completed radios to Evergreen.
(iii) The price of the completed radios paid by Evergreen will represent more or less the expenses incurred by the WOFE, after offsetting the price of the raw materials supplied by Evergreen.

Required:

(a) In relation to the contract processing arrangement, explain the customs duty and value added tax (VAT) implications for the WOFE in respect of the imported materials and machinery provided by Evergreen Ltd, the goods exported after processing and the processing income. (6 marks)

(b) In relation to the import processing arrangement, explain the customs duty and VAT implications for the WOFE in respect of the imported materials and the goods exported after processing. (4 marks)

(c) Determine whether or not Edmund Chan will be eligible for exemption from individual income tax (IIT) in respect of his stay in Shenzhen.

Note: your answer should clearly identify the necessary conditions for exemption and the basis on which they may or may not be satisfied by the proposed contract processing arrangement. (7 marks)

(17 marks)

4 Home Appliances Ltd (HAL) is a listed domestic enterprise engaged in the manufacture and sale of home appliances in China. In order to encourage its key personnel to remain in its employment and to attract new employees, the management of HAL is considering providing its senior expatriate executives with the following employment benefits:

(1) Relocation allowance

A lump sum joining fee of RMB 80,000 will be paid to subsidise the new employees' relocation and moving costs. This amount will be repayable to HAL if the employee resigns during the probation period. (3 marks)

(2) Performance bonus

A performance bonus, which will be paid in cash, will be determined according to the financial results of HAL for each year and the annual appraisal reports on the individual members of staff. (4 marks)

(3) Stock options

Stock options to purchase the shares of HAL will be granted to expatriate executives such that they can choose to transfer or exercise the options at the end of a three year vesting period at the exercise price pre-determined at the date of grant of the options. If the options are not transferred or exercised within six months from the end of the vesting period, the rights will lapse. If the options are exercised, the employees will be free to sell the shares purchased by the exercise of the share options. (8 marks)

(4) Housing allowance

A monthly housing allowance of RMB 15,000 will be paid to subsidise the employees' housing costs. (2 marks)

Required:

Advise Home Appliances Ltd (HAL) on the taxability of the above employment benefits. In each case, support your advice with reasons and/or the authority and identify any changes to the proposals that will enable the employment benefit to become exempt from individual income tax (IIT).

(17 marks)

5 Best Buy Ltd (BBL), a foreign invested shopping mall, is considering conducting some promotional activities to celebrate its ten years anniversary. The sales director has suggested offering the following different kinds of discount to customers:

(1) A 10% discount will be given on any purchase in the shopping mall.

(2) For every purchase over RMB 100, a coupon for RMB 10 will be given for every multiple of RMB 100, which the holder can use for the settlement of any further purchase in the shopping mall within one month.

(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.

BBL is assessed as a general value added taxpayer. BBL's applicable VAT rate is 17%; and its income tax rate is 25%.

Required:

(a) Identify the tax factors that should be considered by Best Buy Ltd (BBL) when deciding on the discount policy to be adopted. (4 marks)

(b) Advise on the value added tax (VAT), individual income tax (IIT) and enterprise income tax (EIT) implications of each of the three discount policies and recommend which alternative constitutes the best policy. (12 marks)

(c) State ONE non-tax factor the management of BBL might wish to consider before implementing option (2), giving out coupons. (1 mark)

(17 marks)

End of Question Paper