
Answers

The suggested answers are of the nature of general comment only. They are not offered as advice on any particular matter and should not be taken as such. No reader should rely on the suggested answers as the basis for any decision. The examiners expressly disclaim all liability to any person in respect of any indirect, incidental, consequential or any other damages relating to the use of the suggested answers.

1 Report to Mr Summers of Super-DG:

To: Mr Summers
From: Tax advisor
Date: 1 June 2009
Subject: China tax positions of Super-DG

It was my pleasure to meet with you last week to discuss the various tax issues of Super-DG. Super-DG is engaged in the manufacture and sale of baby-cars. You have requested me to address all of the China tax issues regarding the associated relationship with Super-HK and the domestic trading company, the transfer pricing adjustments and whether the restructuring of Super-DG's activities would be regarded as for tax-avoidance purposes. I provide my comments as follows:

(a) Associated enterprises

- (i) Under the prevailing China tax rules and regulations, business transactions between associated enterprises shall be carried out at arm's length. Associated enterprises are defined by Art 51 of the *Regulations on Implementation of Administration of Tax Collection* (RIATC) as companies, enterprises or other commercial entities which are related through:
- direct or indirect ownership or control over capital, operations, buying and selling, etc;
 - direct or indirect ownership or control by a third party; or
 - other relations with associated mutual benefits.
- (ii) The following circumstances are normally considered as creating an 'associated enterprise':
- The enterprise, directly or indirectly, owns 25% or more of the total share capital of the other enterprise, or *vice versa*.
 - A third party directly owns or controls 25% or more of the total share capital of both the enterprise and the other enterprise.
 - Debt between the enterprise and the other enterprise amounts to 50% or more of its total capital, or 10% or more of the debt of the enterprise is guaranteed by the other enterprise.
 - More than half of the senior management such as directors or managers, or one (or more than one) executive director of the enterprise is appointed by the other enterprise.
 - The enterprise's business operations depend on the other enterprise's proprietary technology.
 - The other enterprise controls the enterprise's supply of raw materials and spare parts (including prices and terms of transaction, etc).
 - The other enterprise controls the enterprise's sales of products (including prices and terms of transaction, etc).
 - Other relationships exist where there is effective control of the enterprise's business operations and transactions, or there are other connections of interest, including family members and relatives.
- (iii) Since Super-DG, Super-HK and the domestic trading company are all controlled by Super-BVI, they would be considered as associated enterprises.

(b) Transfer pricing adjustments

Given the associated relationship, the transactions between Super-DG, Super-HK and the domestic trading company should be priced on an arm's length basis. If not, there may be the risk that the tax bureau would challenge the transfer pricing transactions and relevant enterprise income tax (EIT) and value added tax (VAT) adjustments would be made retroactively.

- (i) The arm's length principle is not statutorily defined in the Chinese transfer pricing rules and regulations but reference is normally made to Article 9 of the OECD Model Tax Convention where the 'arm's-length principle' is defined as where 'conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly'.
- (ii) Art 54 of RIATC provides the following circumstances in which the tax payable in relation to a transaction between associated enterprises may be adjusted:
- where purchase prices are not consistent with business transactions between independent enterprises;
 - where interest paid or received on loans are more or less than would be acceptable between non-associated enterprises; or the interest rate is more or less than the normal interest rate for similar loans;
 - where labour service fees are not charged or paid, as would normally be the case between independent enterprises;
 - where fees or business transactions (e.g. assignment of assets, provision of property rights) are not charged or paid, or are not priced at a level, as would normally be the case between independent enterprises; and

- any other circumstances where pricing is not in accordance with what is normal for business transactions between independent enterprises.
- (iii) If the tax bureau considers that there has been a reduction in tax liability due to the pricing of transactions on other than an arm's length basis, it has the power to adjust the transaction prices by reference to one of the following transfer pricing adjustment methods:
- The comparable uncontrolled price method where adjustments will be based on the pricing of the same or similar business activities among unrelated parties.
 - The resale price method where adjustment will be made by subtracting an appropriate mark-up from the price at which the goods are subsequently resold to an unrelated third party.
 - The cost plus method where adjustments will be made by adding reasonable expenses and a profit margin to the cost.
 - Other appropriate methods. If the above three methods are not applicable, the tax bureau may choose other reasonable methods, such as the comparable profit method, net profit method, split profit method, etc.

If transfer pricing adjustments are to be made, Super-DG can participate in deciding which is the best method to adopt.

- (iv) According to *Guoshuifa* (2004) 143, if Super-DG disagrees with the transfer pricing adjustments proposed by the tax authorities, it should take the following actions:
- Super-DG must pay any taxes due together with any late payment surcharges and penalties under the law and regulations, even though it disagrees with the transfer pricing adjustments, before the tax objection mechanism can be set in motion.
 - Super-DG may then appeal to a higher level tax bureau within sixty days after receiving the tax payment receipts issued by the in-charge tax bureau, submitting relevant documents regarding prices and costs.
 - If Super-DG disagrees with the higher level tax bureau's judgment on appeal, it may further appeal to the People's Court within fifteen days after receiving the notice of the judgment from the higher level tax bureau.

(c) Business restructuring and tax avoidance

In view of the substantial decline in Super-DG's profit, the tax authority will certainly query the group restructuring and the transfer pricing transactions. There is a risk that the tax authority will regard the restructuring and transfer pricing transactions as for tax avoidance purposes and make tax adjustments accordingly. However, there are valid commercial reasons for the business restructuring and Super-DG may provide the following explanations to defend itself that it is not avoiding tax:

- (i) Before the business restructuring, Super-DG and Super-HK had 50% of their European customers in common. There was overlapping and lack of co-ordination in the areas 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 had been discussing how this inefficiency could be reduced. The business restructuring has been implemented to improve efficiency, to reduce costs and to raise overall profitability of the Group.
- (ii) Starting from 1 January 2008, Super-DG is no longer responsible for the sale of its products. It processes Product A for Super-HK, which handles all sales to European customers. Product B is sold to a newly established domestic trading company, which handles all sales to local customers. There is better co-ordination of the sales effort. Cost is lowered, efficiency is improved, and the Group's profitability is increased. The business restructuring therefore is for commercial purposes and not for tax avoidance.
- (iii) The price of its products and its profitability is determined by the responsibilities and risks taken by Super-DG. After the business restructuring, the responsibilities and risks taken by Super-DG are reduced, resulting in lower profitability. Although its revenue is reduced, its operation costs and management costs are much lower than before, resulting in a higher rate of return. The net profit rate is maintained at 14.29%, which is higher than the rate for 2007 of 13.85%. This further explains that the business restructuring is to improve overall efficiency and profitability, and not for avoiding tax.
- (iv) The lower transfer price charged for the goods sold to the domestic trading company is to compensate the trading company for the responsibilities and risks it has taken up. After the restructuring, the trading company is responsible for procuring sales, bearing selling and distribution costs, taking credit risk and providing after sale services. The lower transfer price is well justified.
- (v) The amount charged for processing and sales is on an arm's length basis, i.e. the amount charged is comparable to that charged between independent parties. Super-DG can provide the basis of the amount charged, and prove that the quantum is reasonable and not excessive compared to that charged by an independent party for similar types of services. The basis will be consistently applied each year and does not represent a transfer of profit from Super-DG to Super-HK and the domestic trading company.
- (vi) The transfer of salesmen, distribution channel and customer lists to Super-HK and the trading company has been made at fair value, on which Super-DG has paid the relevant tax. Therefore, the profit made by Super-HK and the domestic trading company should not be treated as transferred from Super-DG.

I hope the above addresses all your concerns regarding the China tax issues of Super-DG. Should there be any questions, please let me know.

End of Report

Managing Director
Novak Ltd
Client's address

1 June 2009

Dear Sir,

It was a pleasure to meet with you last week to discuss the value added tax (VAT) and customs duty costs of Novak Ltd (Novak) under the alternative modes of operations, my advice in relation to which is given below.

(a) Comparison of VAT and customs duty costs under alternative modes of operations

Non-bonded export trade

Under the existing mode of operation, the import of raw materials would be subject to import VAT at 17% and customs duty at 10%. The export sale of Machine A will be exempt from output VAT, and Novak can receive from the tax authority a refund of the input VAT incurred on local purchases (raw materials A2 and C). 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 the local purchases cannot be refunded. This amount will become a real cost (VAT cost) to Novak and should be charged to its cost of goods sold. The VAT cost is calculated as follows (*Guoshuifa* (2002) 11):

$$\begin{aligned} \text{VAT cost} &= \text{FOB price of export sales} \times (\text{output VAT rate} - \text{VAT refund rate}) \\ &= \text{RMB } 200 \times 50,000 \times (17\% - 9\%) \\ &= \text{RMB } 800,000 \end{aligned}$$

There is no provision for a refund of the import customs duty and this becomes a cost to Novak, calculated as follows:

$$\begin{aligned} \text{Customs duty cost} &= \text{Value of import raw materials} \times \text{duty rate} \\ &= \text{RMB } 4,000,000 \times 10\% \\ &= \text{RMB } 400,000 \end{aligned}$$

Contract processing arrangement

Under this arrangement, Niko Ltd (Niko) will provide raw materials to Novak 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 Niko to Novak. Novak 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 VAT need not be paid unless they are used for purposes other than the approved export processing. Novak 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 Niko.

The processing fee derived by Novak can also be exempted from 17% output VAT. However, the input VAT incurred by Novak on local purchases (raw materials A2 and C) cannot be recovered nor refunded, thus this will become a real cost (VAT cost) to Novak and should be charged to its cost of goods sold. The VAT cost is calculated as follows (*Caishui* (2005) 165):

$$\begin{aligned} \text{VAT cost} &= \text{Input VAT on raw material C} \times \frac{\text{value of Machine A}}{\text{value of Machines A and B}} + \text{input VAT on raw material A2} \\ &= \text{RMB } 1,200,000 \times 17\% \times \frac{\text{RMB } 120 \times 50,000}{\text{RMB } 120 \times 50,000 + \text{RMB } 150 \times 20,000} + \text{RMB } 1,000,000 \times 17\% \\ &= \text{RMB } 306,000 \end{aligned}$$

Tutorial note: In some areas, the value of Machine A may be calculated based on the FOB price of RMB 200 instead of the processing fee of RMB120.

Import processing arrangement

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

The general rule is that raw materials crossing the border would be subject to import VAT at 17% and customs duty at 10%. 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), Novak 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 Novak can also receive a refund of the input VAT incurred on local purchases (raw materials A2 and C). However, as in the case of normal non-bonded export trade, 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 irrecoverable amount is a cost (VAT cost) and should be charged to the 'cost of goods sold', which is calculated as follows (*Guoshuifa* (2002) 11):

$$\begin{aligned}\text{VAT cost} &= (\text{FOB price of export sales} - \text{value of import bonded raw materials}) \times (\text{output VAT rate} - \text{VAT refund rate}). \\ &= (\text{RMB } 200 \times 50,000 - \text{RMB } 4,000,000) \times (17\% - 9\%) \\ &= \text{RMB } 480,000\end{aligned}$$

Conclusion

From the tax perspective, the second mode of operation, contract processing, is the best alternative as the non-refundable VAT and customs duty are the lowest.

(b) Use of bonded logistic park (BLP)

BLPs have recently been established to facilitate the development of the logistics and warehousing industries. From a VAT perspective, local purchases of raw materials transferred into BLPs are treated as exports; and the taxpayer can receive a refund of the input VAT incurred on these purchases.

On the basis that Novak will adopt contract processing for the manufacture and sale of Machine A, it can adopt it in conjunction with the use of a BLP to further lower its VAT costs on purchases of raw material A2. Arrangement should be made with the supplier of raw material A2 to sell the raw material to Niko, instead of Novak. A logistic company in the BLP will be appointed by Niko to handle the transportation of raw material A2 into the BLP. Novak will then arrange to import the raw material from the BLP under bonded treatment; and receive a refund of the input VAT incurred on the purchase of raw material A2, which is calculated as: (value of raw material x duty rate); i.e. $\text{RMB } 1,000,000 \times 17\% = \text{RMB } 170,000$.

It should, however, be noted that operation costs will be increased; and the use of a BLP should only be considered if the reduction in the VAT cost exceeds the increase in operation cost.

Please do not hesitate to contact me again if you require any further information, or you wish to discuss the use of a BLP further.

Yours faithfully,

Tax Consultant

3 (a) Tax relief for temporary visitors

A temporary visitor is an individual who has lived in China, continuously or cumulatively, for a total of 90 days or less during a calendar year (or 183 days or less during the treaty prescribed period if a tax treaty applies). Temporary visitors are exempted from individual income tax (IIT) on the portion of their employment income derived from within China which is paid by an overseas employer, and which is not borne or deemed to have been borne by the overseas employer's establishment in China.

According to the terms of *Guoshuifa* (1994) 148, an expatriate holding a position with a foreign investment enterprise (FIE) would be eligible to be exempted from IIT on foreign-paid income if his or her physical presence in China does not exceed 90 or 183 days in a calendar year or other treaty prescribed period. Since Mike's stay in China does not exceed 183 days, he may be entitled to the temporary visitors' tax relief.

However, some local tax authorities take the view that expatriates who work for FIEs (e.g. equity joint ventures, contractual or cooperative joint ventures or wholly-owned foreign enterprises) in China are not entitled to the temporary visitors' tax relief. It is therefore advisable to confirm with the relevant local tax authority on the issue of whether Mike is entitled to the tax exemption for foreign-paid income paid to temporary visitors.

(b) Potential late payment surcharges and tax penalties

If a withholding agent fails to keep records, supporting documents and other information relating to tax withholding and payment, a fine of up to RMB 5,000 may be imposed. A fine of up to RMB 10,000 may also be imposed on a withholding agent who fails to submit statements or relevant information to the tax authorities on its withholding activities before the stipulated deadline (*Guoshuifa* (2005) 205, Art 5; *Administration Law on Levying and Collection of Taxes* (ALLCT), Art 61 and 62).

Article 32 of the 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 fine ranging from 50% to 300% of the amount of tax under-withheld on the tax withholding agent (Sino) who failed to withhold tax properly. The outstanding tax will then be recovered from the taxpayer (Mike) rather than Sino.

(c) Procedures available to Sino Co if it disputes the tax imposition activities of the local tax authority

A taxpayer (Mike in this case) or withholding agent (Sino in this case) may disagree with the tax authorities on:

- (1) the imposition and collection of taxes and overdue tax surcharge (*Tentative Tax Administrative Review Regulations* (TARR), Art 8(1)); or
- (2) the order for tax withholding behaviour on withholding agents (TARR, Art 8(1)).

If Sino wishes to object to the imposition of tax, the tax in dispute and any surcharges demanded shall be settled before the tax objection mechanism can be set in motion (ALLCT, Art 88). Thereafter, Sino may apply to the appropriate tax authorities at the superior level for an administrative review of the case. Application for the review shall be made within 60 days from the date on which Mike was informed of the subject tax administrative measures taken by the tax authorities or the date on which the tax and surcharges in disputes were settled or guaranteed (TARR, Art 13 and 14). The administrative review procedure is conducted in writing in principle. The tax review authorities may conduct investigations, examination of documents and obtain testimonies from the parties involved (TARR, Art 13 and 14).

The appropriate tax review authorities have to make a decision within 60 days from the acceptance of the review application (TARR, Art 43). If the tax case is complicated and the tax review authorities cannot make a decision within the stipulated time limit, upon the approval of the person-in-charge of the tax review authorities and notification to the relevant entities/persons involved in the review, the time limit can be extended by a maximum of 30 days (TARR, Art 43). If the tax review authorities fail to make a decision within the prescribed time limit, or Sino is not satisfied with the decision, legal proceedings may be instituted with the People's Court. Such proceedings shall be instituted within 15 days from the date of receipt of the tax administrative review decision or by the end of the review period (TARR, Art 22).

If Sino does not appeal within the stipulated period and does not act in accordance with the tax review decision or final tax review decision, the tax authorities may order mandatory enforcement or apply to the People's Court for mandatory enforcement (TARR, Art 45).

(d) List of actions to ensure tax compliance and prompt reaction

- (1) Review operations periodically to identify any tax inefficiency or non-compliance areas.
- (2) Set up monitoring systems to ensure proper compliance.
- (3) Build proper communication channels with the tax authorities to stay abreast of changes and alert to early warning signals.
- (4) Consult regularly with tax advisers.
- (5) Make use of advance tax rulings in uncertain situations.
- (6) Be fully aware of taxpayers' rights and obligations.
- (7) Should a tax dispute arise:
 - (i) ensure action is proper and timely; and
 - (ii) deal with the problem early.

Delay tactics are not the right approach to tax disputes in China.

4 (a) Transactions (1) to (4)

Stamp duty (SD) implications

- (1) Documentation of rights and licences, including Property Ownership Certificates, industrial and commercial business licences, trademark registration certificates, patent certificates and land use certificates are subject to SD at RMB 5 per document (*Provisional Rules on Stamp Duty* (PRSD) Appendix). Therefore, SD at RMB 5 each is payable on the Real Estate Ownership Certificate.

Documents transferring a title to property whether by purchase, sale, inheritance, gift, exchange or division are subject to SD at 0.05% of the stated value (PRSD Appendix). The SD payable is thus RMB 2,000 (RMB 4,000,000 x 0.05%).

Contract documents issued for loans are subject to stamp duty at the rate of 0.005% on the loan amount (PRSD Appendix). The SD payable on the mortgage loan agreement is thus RMB 160 (RMB 3.2m x 0.005%).

- (2) Contracts for the leasing of housing should be subject to stamp duty at 0.1% of the leasing fee (PRSD Appendix). As it is a two-year lease without a fixed amount of rental being specified in the agreement, BSL must pay duty at the fixed rate of RMB 5 when the agreement is first signed and executed. Then, when the rental income is actually paid additional duty will be payable at the applicable rate on the rental amount. In practice, this additional stamp duty can be paid on an annual basis.
- (3) According to *Guoshuifa* (2003) 45, as the lease period is the same as the life of the equipment, it is treated as a finance lease. According to *Guoshuidizi* (1988) 30, a finance lease is taxed under the category of a loan contract at 0.005% of the loan amount. The SD payable on the lease is thus RMB 75 (RMB 300,000 x 5 x 0.005%).
- (4) Since the lease period is substantially less than the life of the machine, it is treated as an operating lease. It is taxed under the category of property leasing at 0.1% of the leasing fee. The SD payable is thus RMB 600 (RMB 200,000 x 3 x 0.1%).

Value added tax (VAT) implications

- (3) According to *Guoshuihan* (2000) 514, if there is a transfer of title at the end of the lease, the transaction is taxed under VAT. The VAT payable by the lessor is RMB 43,590 (RMB 300,000/1.17 x 17%) for each of the five years.

Business tax (BT) implications

- (1) The sale of immovable properties located in China is subject to 5% BT (*Business Tax Implementing Rules* (BTIR), Art 4). The BT payable by the seller is thus RMB 200,000 (RMB 4,000,000 x 5%).
- (2) Rental income from the lease of property is subject to 5% BT under the category of service. BSL will have to pay BT at 5% on the total rental income.
- (4) According to *Guoshuihan* (2000) 514, if there is no transfer of the title at the end of the lease, the transaction is taxed under the category of service, i.e. under BT. The BT payable by the lessor is RMB 10,000 (RMB 200,000 x 5%) for each of the three years.

(b) Transaction (5)

Stamp duty (SD) implications

Technology contracts, including technology development, transfer, consultancy and service contracts are subject to stamp duty at 0.03% of the stated value (PRSD Appendix). Thus, the SD payable is RMB 450 (RMB 1,500,000 x 0.03%) on the technology licence agreement; and RMB 150 (RMB 500,000 x 0.03%) on the technical service agreement.

Business tax (BT) and withholding tax (WHT) implications

As the income is sourced from China, the licence fee paid to ABC should be treated as a royalty and subject to 5% BT and 10% WHT. As the payer of the fee, BSL must act as the withholding agent and remit the BT and WHT to the tax authorities. The BT and WHT payable is calculated as follows:

BT = Licence fee x 5% = RMB 1,500,000 x 5% = RMB 75,000

WHT = (Licence fee – BT) x 10% = RMB (1,500,000 – 75,000) x 10% = RMB 142,500

According to *Caishuwaizi* (1982) 143, ABC's on-site technical service agreement for the first year to assist BSL in using Technology X will be treated as part of the technology licence agreement. Thus, the service fee of RMB 500,000 will be treated as part of the technology licence fee and subject to BT and WHT in the same way as the technology licence fee. As above, as the payer of the fee, BSL will have an obligation to withhold and remit the BT and WHT to the tax authorities. The BT and WHT payable is calculated as follows:

BT = Service fee x 5% = RMB 500,000 x 5% = RMB 25,000

WHT = (Service fee – BT) x 10% = RMB (500,000 – 25,000) x 10% = RMB 47,500

According to *Caishuizi* (1999) 273, a technology licence fee for a period after 1 October 1999 can be exempted from BT, but only if the taxpayer engaged in the technology transfer has made a written application, together with the confirmed contacts to the tax authorities. The BT on the technical service fee to assist BSL in using the technology can also be exempted, but only if the technical service fee is included in the same technology licence agreement, and the technical service fee and technology licence fee are charged in the same invoice issued by ABC to BSL.

In order to minimise the tax liabilities, the technology licence agreement and the technology service agreement should be structured as follows:

- ABC should include the technical service fee in the technology licence agreement, and BSL should apply to the tax authorities for exemption from the 5% BT on both the technology licence fee and the technology service fee.
- When ABC invoices BSL for the above fees, ABC should include both the technology licence fee and the technology service fee in the same invoice to ensure that the technical service fee can enjoy the BT exemption.

- 5 (1) The compensation (or severance payment) paid to Michael upon the termination of his employment is taxable as an employment-related benefit, which includes severance payments or one-off compensation (*Individual Income Tax Implementing Rules*, Art 8(1)). Being a substantial sum, if included in his income in the tax year in which it is received, such a payment could produce a substantial tax liability. *Caishui* (2001) 157 and *Guoshuifa* (1999) 178 provide relief to taxpayers who receive such payments.

In accordance with *Caishui* (2001) 157, an amount up to three times the average annual remuneration at the locality of the taxpayer's employment for the previous year is exempt from tax. Payments exceeding this amount are subject to tax. Under *Guoshuifa* (1999) 178, the taxable amount can be spread over the number of years of employment, up to a maximum of 12 years.

The hypothetical salary of the taxpayer based on the spread of income is computed using this formula:

Hypothetical salary = $[A - (B \times 3)]/C$

Where:

A = severance pay/compensation

B = average annual remuneration at locality

C = years of employment (limited to a maximum of 12 years)

The average annual remuneration at the locality is the figure computed based on the previous year's information, which is released by the local social security bureau on an annual basis. This figure should also be used as the basis for calculating housing fund and various contributions for social security for local employees.

- (2) Even if it is received after the cessation of employment, the bonus is related to the employment services rendered 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 agents (C&C in this case) when making the payment. The fixed monthly deduction cannot be deducted again as it has already been offset against the regular monthly income; and any unrelieved part of this deduction cannot be set-off against the lump sum bonus. However, as Michael is a resident taxpayer, i.e. an expatriate employee who has resided in China for more than five years, any unrelieved part of this deduction can 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:

$$\text{IIT liability} = \text{Lump sum annual bonus} \times \text{tax rate} - \text{quick deduction}$$

To achieve the maximum tax saving, Michael should choose to receive the bonus in December 2008 before he leaves China. As he is a resident taxpayer in 2008 and he will have no regular monthly income in December, he will be able to enjoy the fixed monthly deduction of RMB 4,800 and his total IIT liability will be reduced.

- (3) Under *Guoshuifa* (1997) 54, a housing allowance received in a non-cash form by expatriates should be exempt from IIT. According to *Guoshuifa* (2004) 80, prior approval of the applicability of the exemption from the tax authorities is no longer required. In other words, there will be no additional tax cost arising from the free use of the quarter after 30 November 2008. However, if he chooses to receive the RMB 15,000 cash allowance and moves out of the quarter on 1 December 2008, the allowance will be fully taxable in the month of receipt. It is obvious that, from a tax perspective, the maximum tax saving can be achieved from staying in the quarter until departure.
- (4) According to *Caishui* (2005) 35, the granting of stock options will not trigger IIT at the time of the grant. Stock option income will arise when the option is exercised if 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). 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 is classified as 'salary and compensation' from employment. It is not relevant whether or not the employee is still employed by the same employer who granted the option at the time the option is exercised. The salary income relating to the exercise of 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 the 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. Therefore, if the cost relating to the options exercised is borne by C&C, the gain from the exercise of the first batch and from the transfer of the second batch, if any, will be taxable in China.

Gains on the subsequent disposal of the 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 world-wide income because they have lived in China for more than five years. Since the shares are listed in Hong Kong, to achieve maximum tax savings, if Michael believes that the share price will not drop significantly before end of February 2009, it is advisable to sell the shares after he has returned to Hong Kong when he will no longer be taxable in China on his world-wide income.

		<i>Marks</i>	
1	(a) Associated enterprises		
	(i) Definition	2	
	(ii) Circumstances creating an associated enterprise (any four at 1 mark each)	4	
	(iii) Conclusion	1	7
		<hr/>	
	(b) Transfer pricing adjustments		
	(i) Definition of arm's length principle	2	
	(ii) Circumstances in which tax payable may be adjusted (any three at 1 mark each)	3	
	(iii) Transfer pricing adjustment methods	4	
	(iv) Actions to be taken if disagree with transfer pricing adjustments		
	Point (1)	1.5	
	Point (2)	1.5	
	Point (3)	1	13
		<hr/>	
	(c) Business restructuring and tax avoidance		
	Risk of being challenged by the tax authority	1	
	Reason for restructuring	2	
	Effect of restructuring	3	
	Reason for lower profits	3	
	Justification for lower transfer price	2	
	Amount charged on arm's length basis	2	
	Transfer made at fair value	2	15
		<hr/>	
	Appropriate format and presentation	1	
	Effectiveness of communication	1	2
		<hr/>	
	Total		37
			<hr/>
2	(a) Comparison of value added tax and customs duty costs under		
	Non-bonded export trade		
	VAT and CD treatment of imported raw material, export sales and local purchases	3	
	Calculation of VAT cost	1.5	
	Treatment and calculation of CD cost	1.5	6
		<hr/>	
	Contract processing arrangement		
	VAT and CD treatment of imported raw material and export processing	3	
	VAT treatment of processing fee and local purchases	2	
	Calculation of VAT cost	2	7
		<hr/>	
	Import processing arrangement		
	VAT and CD treatment of imported raw material	2	
	VAT treatment of export sales and local purchases	1.5	
	Calculation of VAT cost	1.5	5
		<hr/>	
	Conclusion		1
	(b) Use of bonded logistic park (BLP)		
	VAT treatment of raw material transferred into BLPs	1.5	
	How BLP is used in conjunction with contract processing	3	
	Calculation of VAT refund	0.5	
	Increased costs of operation	1	6
		<hr/>	
	Appropriate format and presentation	1	
	Effectiveness of communication	1	2
		<hr/>	
	Total		27
			<hr/>

		<i>Marks</i>	
3	(a) Tax relief for temporary visitors		
	90 or 183-days rule	2	
	Expatriate holding position with FIE	1.5	
	Local tax authorities' views	1.5	5
		<hr/>	
	(b) Potential late payment surcharges and tax penalties		
	Fails to keep records etc. relating to tax withholding and payment	1	
	Fails to settle a tax payment within the prescribed time limit	1	
	Fails to withhold tax properly	1	3
		<hr/>	
	(c) Procedures for disputes over the tax imposition activities		
	Grounds for disputes	1	
	Application for the administrative review	2	
	Legal proceedings instituted with the People's Court.	2	5
		<hr/>	
	(d) Tax management checklist (any five items 1 mark each)		5
	Total		<hr/> 18
4	(a) Stamp duty payable on		
	Real Estate Ownership Certificate	0.5	
	Documents transferring a title to property	0.5	
	Contract documents issued for loans	0.5	
	Contracts for the leasing of housing	1.5	
	Finance lease of Machine A	1.5	
	Operating lease of Machine B	1	
	Value added tax payable on finance lease of Machine A	1.5	
	Business tax implications		
	Sale of immovable properties	0.5	
	Rental income from lease of the property	0.5	
	Operating lease of Machine B	1	9
		<hr/>	
	(b) Technology licence agreement	0.5	
	Technology service agreement	0.5	
	BT and WHT on licence fee	2	
	BT and WHT on service fee	2	
	Exemption from BT	2	
	Restructuring of licence agreement and service agreement	2	9
		<hr/>	
	Total		<hr/> 18
5	(1) Taxability of compensation payment	1	
	Determining the taxable amount	2	
	The formula	1	4
		<hr/>	
	(2) Taxability of annual bonus	2	
	Treatment for resident taxpayer	1	
	Action to achieve maximum tax savings	1	4
		<hr/>	
	(3) Taxability of housing allowance	2	
	Action to achieve maximum tax savings	1	3
		<hr/>	
	(4) Taxability of stock options		
	At the time of grant	0.5	
	Exercise of stock options	1.5	
	Transfer of stock options	1	
	Gain accrued after departure from China	2	
	Subsequent disposal of shares	1	
	Action to achieve maximum tax savings	1	7
		<hr/>	
	Total		<hr/> 18