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RSM Tax Advisory (Hong Kong) Limited

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Welcome to Tax Flash – RSM Tax Advisory (Hong Kong) Limited's Newsletter Covering Technical Development in Taxation

LESSONS FROM CHINA TAX CASES

In recent years, tax authorities in China have strengthened tax administration and monitoring by using big data analytics to identify dubious cases for tax reviews, investigations and audits. Depending on the case nature, the statute of limitations normally ranges from 3 to 10 years, whilst there is no time bar for blatant or wilful tax cases. Taxpayer and withholding agent's non-compliance penalties can be upto 500% and 300% of the outstanding tax respectively plus late fees (0.05% per day) and penalty interests (corresponding loan interest rate of People's Bank of China + 5%). In some cases, taxpayers and their legal representatives may even be blacklisted on the tax authority's official website.

Summarised below are the highlights of some of the recently published tax cases:

Intra-group Financing

Case highlight

- The tax authority, through a listed company's announcement, noticed that one of the subsidiary companies intended to obtain significant funding from the Group's other affiliated companies.
- The tax authority examined the Group's prior years' vouchers and documents and noted that in the past years, some borrowers have claimed interest expense deduction for Enterprise Income Tax ("EIT") for funding transactions that had neither loan agreements entered nor supported by valid Value Added Tax ("VAT") invoices.
- The finance staff explained to the tax authority that for a few group companies that were in urgent need of short-term financing, there was not enough time to arrange for entrusted loans and loan contracts and no interest income was actually charged by the related fund providers.

Tax results

- Borrower's tax deductions on "interest expenses" without any valid supporting documents were disallowed.

- For interest-free loan arrangements with related parties, since they did not follow the arm's length principle, deemed taxable interest income was assessed by the tax authority.
- For transactions without loan agreements entered, comparable market interest rates were used to calculate the lender's deemed interest income on the loans provided.
- More than RMB48 million of additional EIT was made up.

Lessons

- Tax compliance and implications related to intra-group financing and “cash-pooling” arrangement should be examined and reviewed.
- Proper documentation should be maintained to substantiate intra-group transactions.
- Transactions between related parties should be set at arm's length prices.

Service Fee or Royalty?

Case highlight

- Company A in China has entered into a Consulting Service Contract with Company B in Europe and remitted a silicon carbide consulting service fee to Company B. However, no EIT had been withheld by Company A on behalf of Company B.
- During the interview by the tax authority, Company A's finance staff explained that since all the related consulting services were rendered outside China, the service fee should not be subject to any China taxes.
- The tax authority reviewed the contract, related technical materials, Company A's financial statements, etc. and noted that:
 - ✓ The contract had various confidentiality and restricted usage clauses. There were also terms about

the right of use, right of disposal, ownership, etc.

- ✓ The contract also stipulated that one party should not transfer relevant data and drawings to a third party without the consent of the other party. The data and drawings should be returned at the end of the contract period.
- ✓ Company B had limited participation in the implementation.
- ✓ There was no guarantee of the implementation results.

Tax results

- The tax authority was of the view that the payment should be a royalty rather than a service fee according to prevailing tax laws and regulations.
- EIT and late fees were imposed.

Lessons

- Taxpayers (i.e. overseas recipients) and their tax withholding agents (i.e. payors in China) should analyze and report to the tax authority the income nature appropriately to avoid tax non-compliance risks.
- Transaction documents and business terms are important to substantiate the arrangement and income nature.

Transfer Pricing Adjustments for 10 Years

Case highlight

- Company D is a full-fledged manufacturing company in China held by an overseas based Group.
- Company D's principal business includes procurement, production and sales of paper products. It also undertakes management, research and development functions.
- During a transfer pricing (“TP”) investigation, the tax authority noticed that in the past ten years, Company D had

paid overseas affiliates about RMB67 million for technical services and the use of trademarks of the Group.

Tax results

After reviewing the provided information related to the Group's China and overseas entities and digging into Company D's factual business operations, the tax authority noted that:

- The technical service fee paid by Company D was calculated at a much higher rate on the company's sales compared with those charged to the Group's other overseas companies.
- Company D had already mastered the said manufacturing technology.
- The technical service agreement only mentioned the services would cover the whole process of production, operation and management, but did not mention any details and specifications about the technical contents of the services.
- The tax authority was of the view that the service fee arrangement aimed to shift Company D's profits overseas to avoid China tax.
- Tax adjustments were imposed with additional EIT plus penalty interests paid by Company D.

Lessons

- Transfer pricing arrangements of full-fledged manufacturing companies in China (especially those with high-tech enterprise qualifications) with their overseas related parties have always been the focus of transfer pricing investigation.
- Tax authorities will look at whether the taxpayer's transfer pricing policy complies with the principle of matching functions, risks and benefits.
- Once a special tax investigation is conducted, the tax authority is empowered to look into the last 10 years and impose penalty interests.

Combating Arrangements of Using Overseas Shell Company

Case highlight

- In a tax audit, it was discovered that Company E in China concealed nearly RMB20 million of taxable income for the period from January 2015 to March 2021 by using an overseas company to bill and collect sales to overseas customers.
- The overseas company was set up in a low tax jurisdiction with no office premises nor employees overseas. All the business operations of the shell company were actually conducted by Company E's local employees in China.
- For some of these employees, a portion of their remuneration was paid overseas. No Individual Income Tax ("IIT") related to the "overseas remuneration" was withheld and reported to the tax authority in China.

Tax results

- The case was determined as tax evasion.
- Underpaid taxes (including EIT, VAT and IIT) were recovered.
- Late fees were charged.
- Non-compliance fine was imposed.

Lessons

- Tax authorities in the world have tightened up their measures in combating cross-border arrangements which have no or weak economic substance.
- There is no time bar for tax recovery in blatant or wilful cases.
- In addition to underlying taxes, late fees and non-compliance penalties will be imposed.
- Taxpayers and their management may even be blacklisted and prosecuted.

Parent Company Constituted a Tax Presence of its Subsidiary Company

Case highlight

- Company G is a sino-foreign joint venture established in China.
- When the tax authority conducted a foreign investment survey, it was found that Company G, for commercially justifiable reasons, set up an overseas subsidiary (Company H) for entrepot trade.
- Company H had no employee. It had only one director who lived in China.
- Sales contracts with overseas customers were negotiated and concluded by the sales staff of Company G in China through emails.
- Company H opened an offshore bank account with a bank in China to handle cashflows.

Tax results

- The tax authority held that the agency functions performed by Company G in China constituted a Permanent Establishment (“PE”) of Company H, and thus Company H’s China-sourced income should be taxable in China.
- Company G was designated to withhold and pay EIT on behalf of Company H.
- Late fees were levied.

Lessons

- Business activities and operations conducted in China by a non-resident company through its employees or dependent agent can constitute a “tax presence” in China with the China-sourced income subject to EIT.
- Cross-border business arrangements should be reviewed in light of prevailing tax legislations and applicable double tax treaty/arrangement for tax risk management.

Proactive tax risk management is crucial for taxpayers and tax withholding agents. Tax cases can serve as a reminder to taxpayers (and the tax withholding agents) of the importance of tax compliance and the potential consequences of non-compliance. It may also reveal changes in tax laws or applications of tax laws that taxpayers may not be aware of. Taxpayers should (i) ensure they are following tax laws and regulations correctly; (ii) comply with the latest requirements; and (iii) understand the best practices to minimize the risk of a tax controversy (e.g. maintaining accurate records and submitting tax returns on time). Professional tax advisers should be consulted timely in tax controversies, investigations and audits.

RSM Tax Advisory (Hong Kong) Limited

RSM Hong Kong's dedicated and experienced tax specialists can:

- Advise on tax efficient holding and operational structures for new cross-border investment, including the formation of Hong Kong and Chinese business entities
- Review existing cross-border investment structures, advise on identified deficiencies, quantify any potential exposure from such deficiencies, and further advise on restructuring approach and procedures
- Assist clients to discuss and clarify matters with tax officials, including transfer pricing and advance rulings
- Act as client representative in tax audits and tax investigations
- Provide transaction support services on mergers and acquisitions, including tax due diligence, deal structure advice, tax health checks, related human resources arrangements and other tax compliance and consultation services
- Provide tax expert witness services at Courts
- Act as tax advisor on transfer pricing and tax compliance reviews for IPO applications
- Advise on human resources and structuring employment arrangements in a tax-efficient manner
- Advise on tax equalisation schemes
- Provide tax compliance services for individual and corporate clients in Hong Kong and China

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