Professional Level – Options Module

Advanced Taxation (Hong Kong)

Thursday 8 December 2016

Time allowed: 3 hours 15 minutes

This question 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 and 3

Do NOT open this question paper until instructed by the supervisor.

This question paper must not be removed from the examination hall.

Paper P6 (HKG)

Think Ahead ACCA

The Association of Chartered Certified Accountants

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 should be rounded down to the nearest HK$.
3. Apportionments need only be made to the nearest month, unless the law and prevailing practice require otherwise.
4. All workings should be shown.
5. Ignore provisional tax and statutory tax reductions, unless specified otherwise.

TAX RATES AND ALLOWANCES

The following 2015/16 tax rates, allowances and deductions are to be used in answering the questions.

Profits tax rates

Companies	16·5%
Unincorporated business	15%

Salaries tax rates

First $40,000	2%
Next $40,000	7%
Next $40,000	12%
On the remainder	17%
Standard rate	15%

Allowances

	$
Basic allowance	120,000
Married person's allowance	240,000
Single parent allowance	120,000
Child allowance – 1st to 9th child (each)	100,000
– additional allowance in the year of birth (each)	100,000
Dependent parent/grandparent allowance – basic	20,000/40,000
– additional	20,000/40,000
Dependent brother/sister allowance	33,000
Disabled dependant allowance	66,000

Deductions

	$
Self-education expenses (maximum)	80,000
Home loan interest (maximum)	100,000
Elderly residential care expenses (maximum)	80,000
Mandatory provident fund contributions (maximum)	18,000

Depreciation allowance rates

Initial allowance:	
Plant and machinery	60%
Industrial buildings	20%
Annual allowance:	
Computers	30%
Motor cars	30%
Furniture and fixtures	20%
Machines	10%–30%
Industrial buildings	4% or formula
Commercial buildings	4% or formula

Stamp duty rates

Stock		0·2% + $5

Immovable property

Conveyance on sale and agreement for sale (ignoring marginal reliefs)

	Scale 1	Scale 2
Up to $2,000,000	1·5%	$100
$2,000,001 to $3,000,000	3·0%	1·5%
$3,000,001 to $4,000,000	4·5%	2·25%
$4,000,001 to $6,000,000	6·0%	3·0%
$6,000,001 to $20,000,000	7·5%	3·75%
$20,000,001 and above	8·5%	4·25%

Conveyance on sale and agreement for sale chargeable with special stamp duty

Holding period	
Not exceeding six months	15% or 20% as applicable
Between six and 12 months	10% or 15% as applicable
Between 12 and 24/36 months	5% or 10% as applicable

Conveyance on sale and agreement for sale chargeable with buyer's stamp duty 15%

Lease

(a)	Key money, construction fee etc only	As for conveyances (above)
(b)	Rent only (as a percentage of the average yearly rent)	
	Undefined term	0·25%
	Not exceeding one year	0·25%
	More than one year but not exceeding three years	0·5%
	Exceeding three years	1·0%
(c)	Key money, construction fee etc and rent	
	Key money, construction fee etc	4·25% of the consideration
	Rent	As for rent-only lease (above)

Section A – BOTH questions are compulsory and MUST be attempted

1 Sino Good Ltd (Sino) is incorporated and centrally managed in China. Sino carries on a retailing business through various retail outlets in China. Since 1 July 2016, Sino has entered into a consignment agreement with KK Ltd (KK) in Hong Kong to sell Sino's products to customers in Hong Kong. Under the agreement, KK is responsible for promoting and selling Sino's goods at certain retail spots in Hong Kong, and receives a commission of 1% of the Hong Kong gross sales in return for its services. An inventory of goods is shipped from Sino to KK on a regular basis, and KK is obliged to submit sales reports to Sino on a monthly basis. An extract of Sino's sales report for the quarter ended 30 September 2016 is as follows:

(in HK$)	**Hong Kong**	**China**	**Total**
Gross sales	10,000,000	7,000,000	17,000,000
Cost of goods sold	(2,000,000)	(1,400,000)	(3,400,000)
Gross profits	8,000,000	5,600,000	13,600,000
Operating expenses:			
Agency fee	(100,000)	–	(100,000)
Shipment	(5,000)	–	(5,000)
Hong Kong tax	(50,000)	–	(50,000)

In October 2016, Sino received a remittance from KK in the amount of $9,850,000 after deduction of KK's agency fee and Hong Kong tax from the gross sale proceeds.

Mr Li, the chief executive officer of Sino, is calling for a meeting to discuss the following:

(1) Given that Sino is not a Hong Kong company and does not have any operations in Hong Kong, what is the basis for the payment of Hong Kong tax, and can indemnification be sought from KK?

(2) To be in line with the group's long-term strategy, Mr Li is considering expanding into the Hong Kong market by incorporating a wholly-owned subsidiary in Hong Kong. Sino will supply goods to the subsidiary for sale in Hong Kong based on the group's pricing strategy. This strategy is yet to be determined.

(3) Mr Li has discussed his expansion idea with the sales manager of KK, Mr Chan. Mr Chan offered an alternative for Sino to consider, which is the acquisition of an inactive Hong Kong subsidiary of KK (Loss Company). Loss Company currently carries a significant tax loss incurred from its previous operations which ceased two years ago. Under the Hong Kong tax law, the tax loss is eligible to be used to offset any future assessable profits generated by Loss Company, leading to extra value to the Sino group.

(4) In order to finance the start-up operations of the Hong Kong subsidiary, Sino intends to extend an interest-bearing loan to the Hong Kong subsidiary by depositing the loan into the bank account of the Hong Kong subsidiary in Singapore so that the interest income for Sino from such a loan is not chargeable to profits tax in Hong Kong.

Required:

As the tax consultant engaged by Sino Good Ltd, prepare a report for Mr Li addressing each of the following issues from a Hong Kong tax perspective:

(a) Current operations:

(i) Based on the Inland Revenue Ordinance and Rules, the circumstances in which a non-resident company can be assessable to profits tax in Hong Kong, and if found to be so assessable, how the chargeable profits will be ascertained. (5 marks)

(ii) The Hong Kong profits tax implications for Sino Good Ltd arising from the sales operations in Hong Kong via KK Ltd, together with the basis of tax assessment and the justification for the deduction of the tax amount by KK Ltd. (5 marks)

(b) Expansion proposal:

(i) The Hong Kong profits tax position of Sino Good Ltd and its Hong Kong subsidiary based on Mr Li's expansion idea and any potential transfer pricing risks to be considered when the pricing strategy is determined. (9 marks)

(ii) The general rules governing the treatment of tax losses for corporations carrying on business in Hong Kong under the Inland Revenue Ordinance; and the ability to utilise the tax losses if Sino Good Ltd acquires the shares in Loss Company as suggested by Mr Chan. (8 marks)

(iii) The Hong Kong tax implications for the Hong Kong subsidiary in respect of the interest incurred on the loan extended from Sino Good Ltd as proposed by Mr Li. (4 marks)

Professional marks will be awarded in question 1 for the appropriateness of the format and presentation of the report and the effectiveness with which the advice is communicated. (4 marks)

(35 marks)

2 Mary is currently employed by Today Ltd (Today) but has recently been approached and offered a more senior position in another Hong Kong company, Future Ltd (Future). Both companies are managed and controlled in Hong Kong. The preliminary employment terms proposed by Future are as follows:

(1) A lump sum welcome bonus of $100,000 payable upon signing the employment contract with Future. At the request of Mary, the bonus will be paid to her before she commences her employment with Future so as to avoid it being taxed.

(2) A monthly salary of $200,000 before deduction of a 5% contribution to Future's retirement fund.

(3) Mary will be given an option to choose one of the following share-based benefits:

  (i) an unconditional option to purchase 500,000 shares in Future at a favourable exercise price; or

  (ii) an award of 500,000 shares in Future, 50% of which will have a vesting period of 12 months during which Mary is required to remain in Future's employment. The rest of the shares are not vested.

(4) Mary will be required to travel to China regularly for approximately 100 days in a year and provide services to the China associates in the same group. Following each trip, Mary must submit a detailed work report to the China associates so as to justify the recharge by Future of an amount representing the portion of Mary's salary as attributable to her services in China to those China associates. At the request of Mary, Future will issue a letter to the Hong Kong Inland Revenue Department to prove the number of days of her service outside Hong Kong, so as to support her claim for a reduction in her Hong Kong tax liability based on her services being partly rendered outside Hong Kong.

Required:

(a) Based on the Inland Revenue Ordinance, explain the general principles in determining the taxability of the different items of income received from an employment including fringe benefits; and discuss the tax treatment of each of items (1) to (3) receivable by Mary. (14 marks)

(b) Based on the Inland Revenue Ordinance, critically comment on Mary's claim of reducing her Hong Kong tax liability on the basis of her services being partly rendered outside Hong Kong, as described in item (4) above.

Note: For this part only, ignore the Comprehensive Double Taxation Agreement (CDTA) signed between Hong Kong and the PRC. (3 marks)

(c) Assuming that Mary is a resident of Hong Kong and is assessed to China individual income tax in respect of the income attributable to her services rendered in China, explain whether Mary is eligible for exemption from China tax, based on Article 14 of the CDTA signed between Hong Kong and the PRC (as extracted below). You should clearly identify the crucial factors necessary for the CDTA exemption to be available.

Note: You may assume that Articles 15, 17 to 20 are irrelevant.

'Article 14 Income from Employment

1. Subject to the provisions of Articles 15, 17, 18, 19 and 20, salaries, wages and other similar remuneration derived by a resident of One Side in respect of an employment shall be taxable only in that Side unless the employment is exercised in the Other Side. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that Other Side.

2. Notwithstanding the provisions of paragraph 1 of this Article, remuneration derived by a resident of One Side in respect of an employment exercised in the Other Side shall be taxable only in the first-mentioned Side if all the following 3 conditions are satisfied:

  (a) the recipient is present in the Other Side for a period or periods not exceeding in the aggregate 183 days in any 12-month period commencing or ending in the taxable period concerned, and
  (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the Other Side, and
  (c) the remuneration is not borne by a permanent establishment which the employer has in the Other Side.' (4 marks)

(d) Assuming that Mary is chargeable to tax in both Hong Kong and China in relation to the income attributable to her services rendered in China, advise on the possible relief or measures which are available to Mary to avoid double taxation, based on the Hong Kong Inland Revenue Ordinance and Article 21 of the CDTA signed between Hong Kong and the PRC (as extracted below).

'Article 21 Methods for Elimination of Double Taxation

2. In the Hong Kong Special Administrative Region, double taxation shall be avoided as follows:

   Subject to the provisions of the tax laws of the Hong Kong Special Administrative Region … Mainland tax paid in the Mainland of China in accordance with the provisions of this Arrangement in respect of any item of income derived from sources in the Mainland of China by a resident of the Hong Kong Special Administrative Region shall be allowed as a credit against Hong Kong Special Administrative Region tax imposed on that resident. However, the amount of the credit shall not exceed the amount of Hong Kong Special Administrative Region tax in respect of that item of income computed in accordance with the tax laws and regulations of the Hong Kong Special Administrative Region.' (4 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

3 HK Ltd (HKL) is a company incorporated in Hong Kong, which designs and manufactures furniture in Hong Kong for sale in the US. Its factory premises in Tai Po have been owned and used by HKL for manufacturing since 1980. Raw materials are purchased from both Hong Kong and overseas suppliers by sending purchase orders from HKL's office in Central.

HKL has a sales team comprised of a sales director, Mr Au who owns a controlling interest in HKL, one sales manager, Mr White, and eight salesmen. HKL has a sales office in the US where the sales manager and salesmen are stationed. Mr White and the salesmen are responsible for soliciting sales from customers in the US and negotiating terms (as dictated by HKL) with those customers. After negotiations, Mr White enters into a sales contract with the customer and sends the sales contract to Mr Au by email.

If Mr Au believes HKL can produce the furniture in the order, he instructs HKL's factory to manufacture the furniture. Otherwise, he will instruct Mr White to purchase the required furniture from a list of manufacturers in Taiwan prescribed by him, in which case Mr White will send a purchase order to the manufacturer in Taiwan directly from the US. The purchase price is always agreed between Mr White and the Taiwan manufacturer on an arm's length basis. All the manufacturers in Taiwan are independent parties and are not related to HKL.

All the US customers pay HKL for their purchases by sending cheques to its sales office in the US. All the furniture is shipped to the customers directly from the respective manufacturers' factories.

The current year's accounts of HKL show the following sales to US customers:

		HK$
(i)	Sales of furniture manufactured in Hong Kong	60 million
	Cost of furniture sold thereof	48 million
(ii)	Sales of furniture manufactured in Taiwan	30 million
	Cost of furniture sold thereof	24 million

Mr Au plans to move HKL's manufacturing operations to Vietnam. He is considering two alternatives:

(1) HKL would engage a Vietnam entity to manufacture the furniture for a fee. The Vietnam entity would provide the factory premises, utilities and labour force. HKL would provide, without consideration, the designs, raw materials, machinery (from its Tai Po factory) and technical and managerial know-how. The legal title to the raw materials and finished goods would remain with HKL.

(2) HKL would engage a Vietnam entity which has all the resources, including raw materials, to manufacture the furniture and sell the same to HKL, again for a fee. HKL would sell its machinery, which has been used for the manufacture of furniture in the factory in Tai Po, to the Vietnam entity at its fair market value for use in the manufacture of the furniture in Vietnam.

In both cases, the factory premises in Tai Po will be sold.

Required:

(a) Discuss whether HK Ltd's profits from the sale of furniture under the current arrangements should be subject to, or exempt from, Hong Kong profits tax. (12 marks)

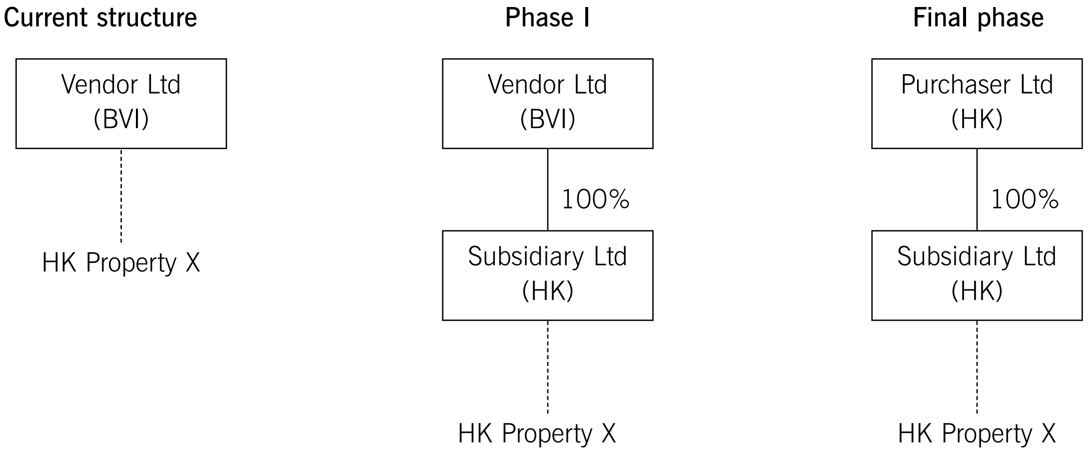
(b) Explain the profits tax implications of the two alternatives for moving HK Ltd's manufacturing operations to Vietnam. (8 marks)

(20 marks)

4 Vendor Ltd (Vendor), a company incorporated in the British Virgin Islands (BVI), is negotiating with another company incorporated in Hong Kong, Purchaser Ltd (Purchaser), to sell one of its Hong Kong properties (Property X) to Purchaser. Property X, a residential property, was purchased by Vendor in April 2014.

Purchaser has suggested some restructuring proposals to save stamp duty on the property transfer, which include the creation of a new company, Subsidiary Ltd (Subsidiary). The proposed steps leading to the ultimate structure at the final phase include:

Step 1 – Vendor to establish a wholly owned subsidiary, Subsidiary.
Step 2 – Vendor to transfer Property X to Subsidiary.
Step 3 – Vendor to transfer its 100% shareholding in Subsidiary to Purchaser.



If carried out, the above proposals will be implemented in January 2017. The estimated market price of Property X in January 2017 is HK$50 million.

Required:

(a) **Advise on the Hong Kong stamp duty cost, if any, of transferring Property X from Vendor Ltd to Purchaser Ltd, as proposed using the newly established Subsidiary Ltd, assuming that all transfers are based on the estimated market value of Property X. You should deal with each step separately and comment on the tax effectiveness of the proposals.** (16 marks)

(b) **Assuming the contract for the sale and purchase of the shares in Subsidiary Ltd will be executed outside Hong Kong, explain the obligations of the relevant parties under the Stamp Duty Ordinance, clearly identifying the instruments, if any, which have to be stamped, and if so, how, when and by whom.** (4 marks)

(20 marks)

5 Takeover Ltd (Takeover) acquired Acquiree Ltd (Acquiree) in October 2015. The tax due diligence report done at the time of the acquisition revealed that Acquiree's tax assessments for all prior years had been properly issued per the tax returns and settled on a timely basis, and no record of any tax query from the Inland Revenue Department (IRD) was found.

On 30 September 2016, Acquiree's management received a letter from the IRD inviting them to a meeting with Acquiree's assessor-in-charge. They did not respond. On 30 November 2016, Acquiree received a notice of additional assessment for 2010/11 dated 28 November 2016, for additional assessable profits of $3 million. The tax is due on 13 January 2017.

Takeover's directors have sought your advice on the following issues:

(a) Why was an additional assessment issued for 2010/11 when the original tax assessment for that year had already been issued as per the return and tax paid without dispute? Why has the original tax assessment not been regarded as final and conclusive?

(b) What could be the basis for the additional profits of $3 million and what actions are available to them if they do not wish to make the tax payment? What will be the consequences if the additional tax is not paid by the due date?

(c) Since Acquiree was only acquired by Takeover in October 2015, the captioned year for the additional assessment 2010/11 was being handled by the previous management of Acquiree. Could this be an acceptable reason for the current management of Acquiree not to respond to the additional assessment?

(d) What are the penalty and prosecution actions (if any) which can be taken against Acquiree by the IRD?

Required:

Advise Takeover Ltd's directors on each of the issues raised, together with any other matters which are relevant and significant to the directors' assessment of the situation. You should make reasonable assumptions in presenting your answer.

Note: The following mark allocation is provided as guidance for this question:

(a) 6 marks
(b) 8 marks
(c) 2 marks
(d) 4 marks

(20 marks)

End of Question Paper