Professional Level – Options Module

# Advanced Taxation (Hong Kong)

Friday 6 June 2014

Paper P6 (HKG)

**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 and 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.**

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 2013/14 tax rates and allowances 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) | 70,000 |
| – additional allowance in the year of birth (each) | 70,000 |
| Dependent parent/grandparent allowance – basic | 19,000/38,000 |
| – additional | 19,000/38,000 |
| Dependent brother/sister allowance | 33,000 |
| Disabled dependant allowance | 66,000 |

**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

| | |
|---|---|
| Share transfers | 0·2% + $5 |
| Conveyances (ignoring marginal reliefs) | |
| Not exceeding $2,000,000 | $100 |
| Not exceeding $3,000,000 | 1·5% |
| Not exceeding $4,000,000 | 2·25% |
| Not exceeding $6,000,000 | 3% |
| Not exceeding $20,000,000 | 3·75% |
| Exceeding $20,000,000 | 4·25% |
| Conveyances chargeable with special stamp duty | |
| Holding period | |
| Not exceeding six months | 15% |
| Between six and 12 months | 10% |
| Between 12 and 24 months | 5% |
| Leases | |
| (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% |
| Not exceeding three years | 0·5% |
| Exceeding three years | 1% |
| (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** Tee-fashion Ltd (T-fashion) is a company incorporated and carrying on business in England, engaged in the manufacture and sale of top-brand fashion. In a recent business strategy meeting, the directors of T-fashion have expressed an interest in developing the Mainland China (PRC) market, and have engaged a business consultant to draft a proposal for review.

The following is the proposed structure of the investment and other details:

(a) T-fashion will incorporate a wholly-owned subsidiary in Hong Kong, HK-Co Ltd (HK-Co), as the investment holding vehicle for the operating company in the PRC, PRC-Co Ltd (PRC-Co).

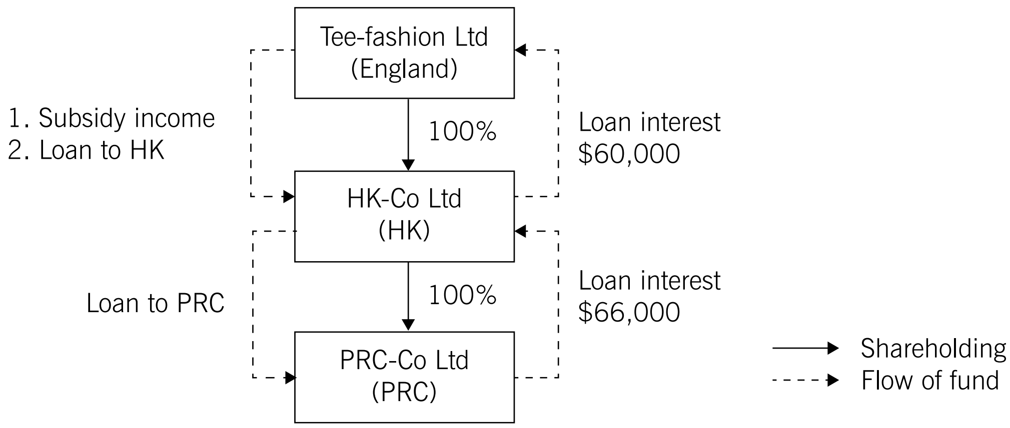
(b) HK-Co will also be the regional support service centre which will hire staff to provide accounting and other support services to the group including PRC-Co.

(c) HK-Co will receive subsidy income from T-fashion to finance its operations. The subsidy will be determined on the basis of 110% of the total annual operating cost before interest and royalty. The 10% premium is intended to be remuneration for HK-Co's services in Hong Kong.

(d) HK-Co will borrow an interest-bearing loan from T-fashion to partly fund its own operation in Hong Kong, and to partly enable HK-Co to extend another loan to PRC-Co to finance the operations within the PRC. Both loans are interest bearing, allowing HK-Co to earn a small interest spread from PRC-Co. The two loan agreements are separate and independent.

(e) HK-Co will pay a royalty of $50,000 to Media-fashion Ltd (Media-fashion), which is another wholly-owned subsidiary of T-fashion in England. Media-fashion produces and owns a series of fashion show videos/films in support of the latest fashion trends promoted by T-fashion. Pursuant to the licence agreement signed with Media-fashion, HK-Co will pay a royalty in return for the right to use and exhibit some of these videos/films in the PRC.

The following structure chart demonstrates the basic mechanism:




(f) The following are the projected management accounts of HK-Co for its first year of operation:

| | $ | $ |
|---|---|---|
| Subsidy income from parent (110% x $2,500,000) | | 2,750,000 |
| Loan interest income from PRC-Co | | 66,000 |
| Depreciation on computer system (cost $100,000) | (30,000) | |
| Incorporation fee | (50,000) | |
| Office rent | (780,000) | |
| Utilities | (250,000) | |
| Staff costs (including mandatory provident fund (MPF) contribution of $30,000) | (930,000) | |
| Auditing and tax filing fee | (160,000) | |
| Consultancy and other professional fees | (200,000) | |
| Sundries | (100,000) | |
| Total operating costs before interest and royalty | | (2,500,000) |
| Loan interest payment to parent | | (60,000) |
| Royalty to Media-fashion | | (50,000) |
| Operating profit for the year | | 206,000 |

The directors of T-fashion have approached a tax consultancy firm in Hong Kong to obtain tax advice on the major Hong Kong tax implications arising from the proposed structure.

**Required:**

**As the tax manager of the consultancy firm approached by the directors of Tee-fashion Ltd (T-fashion), prepare a report for the directors, addressing each of the following issues from a Hong Kong tax perspective:**

**(a) Subsidy income received by HK-Co Ltd (HK-Co) from T-fashion:**

**(i) Discuss the Hong Kong tax implications of the subsidy income received by HK-Co from T-fashion.** (3 marks)

**(ii) Based on the prevailing transfer pricing principles and practice, discuss the issues surrounding the determination of the amount of the intra-group service fee, and comment on the cost-plus basis used to determine the subsidy income as remuneration for HK-Co's services.** (5 marks)

**(b) Loan from HK-Co to PRC-Co Ltd (PRC-Co); and loan from T-fashion to HK-Co:**

**(i) Discuss the Hong Kong tax implications of the loan interest income received by HK-Co from PRC-Co of $66,000.** (3 marks)

**(ii) Discuss the Hong Kong tax implications of the loan interest payment made by HK-Co to T-fashion of $60,000. Based on your analysis, briefly comment on whether you consider that the proposed funding arrangements are tax effective.** (3 marks)

**(c) Royalty income received by Media-fashion Ltd (Media-fashion):**

**Assuming that Media-fashion is not carrying on a business in Hong Kong, discuss whether the royalty income of $50,000 received from HK-Co will be subject to Hong Kong profits tax and if so, why.** (5 marks)

**(d) Based on the projected management accounts of HK-Co for its first year of operation:**

**Explain the Hong Kong tax treatment of the following items, including the relevant tax principles underlying their tax treatment:**

**(i) Depreciation of the computer system of $30,000;** (3 marks)

**(ii) Incorporation fee of $50,000;** (2 marks)

**(iii) Mandatory provident fund (MPF) contribution of $30,000.** (3 marks)

**(iv) Give an estimated calculation of HK Co's Hong Kong profits tax liability, if any, stating any assumptions which you have made.** (4 marks)

Note: You should ignore overseas tax and any double-taxation arrangements throughout this question.

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

**(35 marks)**

**2 You should assume that today's date is 1 January 2014.**

Mr Lee is a Hong Kong permanent resident earning salary income under a Hong Kong employment. In planning for his marriage in March 2014, Mr Lee is in the course of negotiating with a potential seller in respect of a property which he intends to acquire as the home for himself and his wife.

The property will be the first property Mr Lee has acquired in Hong Kong. The offered price is $21 million including a car parking space which is worth around $1·5 million. The seller is a company incorporated in Hong Kong which wholly owns the property (including the car parking space), and Mr Lee is only interested in acquiring the property and the car parking space, not the company. It has been proposed to Mr Lee that he could enter into two separate conveyances, one for the property and the other one for the car parking space, as this would minimise his total stamp duty costs.

In order to finance the acquisition, Mr Lee is considering the following proposals:

(1) Obtaining a mortgage loan from a local bank of up to 50% of the property value. The approximate annual interest cost of this loan is $400,000. Mr Lee has not yet determined whether the property and the bank loan would be held solely in his name or jointly with his wife.

(2) Selling shares in Mr Lee's employer company. Mr Lee currently holds 100,000 shares in his employer company and an option to acquire another 200,000 shares. The 100,000 shares were awarded to him directly by his employer in 2010/11 as part of his performance bonus. These shares were registered in the name of Mr Lee at the time when the shares were awarded to him. The option for 200,000 shares was granted to him in 2012/13. By exercising the option, Mr Lee will have a total of 300,000 shares on hand. By selling them all on the market, he will be able to realise an amount which can finance up to 30% of the property value.

(3) Borrowing from his parents up to 40% of the property value. This loan represents the idle funds which his parents have placed on bank deposit to earn interest income. To compensate for their loss of interest income, Mr Lee would promise to give his parents $10,000 per month. Currently, Mr Lee lives with his parents but they receive no regular contribution from him. After Mr Lee gets married and moves out, his parents will continue living in their own, existing property.

(4) Borrowing from his employer up to 40% of the property value under the employees' low-interest loan scheme. The preferential loan interest rate is much lower than that offered by the bank. The approximate annual interest cost will be $150,000, payable by monthly instalments by way of deduction from Mr Lee's monthly gross salary. Mr Lee estimates that his monthly salary will be reduced to $52,000. The estimated benefit from the saving in interest cost is around $80,000 per annum.

**Required:**

**(a) In respect of the proposed acquisition of property, set out all of the potential Hong Kong stamp duty implications for Mr Lee, including the proposal to minimise the duty payable by splitting the conveyances. If the information provided is not sufficient, state what other information relevant to Mr Lee is required.** (12 marks)

**(b) With reference to proposal (1), advise on all the possible Hong Kong tax implications for Mr Lee in respect of the bank mortgage loan interest payment.** (4 marks)

**(c) With reference to proposal (2), advise on all the possible Hong Kong tax implications for Mr Lee arising from the proposed exercise of the share option, and the sale of all 300,000 shares. Where applicable, you should also discuss in which year(s) of assessment any benefit would be assessed.** (4 marks)

**(d) With reference to proposal (3), advise on all the possible Hong Kong tax implications for Mr Lee arising from the proposed course of action, including the monthly payment of $10,000 to his parents and his eligibility for dependent parent allowance both before and after his marriage.** (3 marks)

**(e) With reference to proposal (4), advise on all the possible Hong Kong tax implications for Mr Lee arising from the proposed course of action, including the loan interest payable to his employer, the reduced monthly salary income and the estimated saving in interest cost.** (2 marks)

**(25 marks)**

**Section B – TWO questions ONLY to be attempted**

**3** AB Co, a company resident only in Hong Kong, has several subsidiaries operating in Asia. AB Co is developing a new financial reporting system and intends to send its IT manager, Paul, to its Malaysian subsidiary for a period of four months to monitor and oversee the implementation of this new system.

Paul is a resident of Hong Kong holding a HKSAR passport. His remuneration will remain the same during his time in Malaysia and it will continue to be paid into his bank account in Hong Kong. All his travel and hotel accommodation costs in Malaysia will be reimbursed by AB Co. AB Co has also agreed to bear any additional personal income tax arising from the assignment. However, AB Co has not yet decided whether it will recharge Paul's remuneration to the Malaysian subsidiary, though the assignment is initiated by AB Co.

**Required:**

**(a) Advise AB Co whether it can claim a tax deduction in respect of Paul's remuneration representing the four-month period of service rendered in Malaysia.** (6 marks)

**(b) Advise Paul whether his remuneration for the four-month period of service rendered in Malaysia and the travel and hotel accommodation costs reimbursed by AB Co will be chargeable to Hong Kong salaries tax.** (7 marks)

**(c) Based on Article 16 of the Double Tax Agreement (DTA) between Hong Kong and Malaysia (as extracted below), explain how the DTA may protect Paul's remuneration from Malaysian personal income tax.**

Hong Kong–Malaysia DTA Article 16 Dependent Personal Services, paragraph 2:

''Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting Party in respect of an employment exercised in the other Contracting Party shall be taxable only in the first-mentioned Party if:

(a) the recipient is present in the other Party for a period or periods not exceeding in the aggregate 183 days in any twelve-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 Party; and
(c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other Party.' (7 marks)

**(20 marks)**

**4** Red Ltd, a furniture manufacturer carrying on business in Hong Kong, makes up accounts to 31 March each year. In May 2005, Red Ltd purchased a two-storey factory building from a property development company at a price of $3,600,000 (including land cost). Details of the costs incurred by the developer of the building are as follows:

| | $ |
|---|---|
| Cost of land | 1,000,000 |
| Construction cost | 2,000,000 |
| | 3,000,000 |

Each floor of the building has an area of 8,000 sq ft. Red Ltd immediately used the ground floor as a factory, and the first floor as a warehouse.

Red Ltd has decided to relocate its production to Dongguan, China in September 2014. It is now considering two alternative proposals for disposing of the two-storey building:

(1) Selling the building for its market value.

(2) Demolishing the building and redeveloping the site by constructing a 20-storey factory building for letting. A bank loan will be obtained to finance the redevelopment.

**Required:**

**(a) Discuss whether Red Ltd is entitled to a depreciation allowance in respect of each floor of the two-storey building; and calculate the allowance for all relevant years of assessment.** (7 marks)

**(b) Advise on the Hong Kong profits tax implications to Red Ltd of:**

**(i) selling the building; and** (4 marks)

**(ii) demolishing the building and redeveloping the site.** (9 marks)

**(20 marks)**

**5 You should assume that today's date is 31 May 2014.**

Derek Chan has been working as the group product director of Joyce Ltd (JL), a company resident in Hong Kong, for over ten years. As a result of a change in product line, Derek has been asked to leave his employment with JL as of 30 June 2014, and to agree not to join any competitor within the next two years.

JL has negotiated and agreed a termination package with Derek, which includes the following amounts:

(1) his last month's salary of $70,000;
(2) accrued vacation pay of $105,000 (including some leave days brought forward from 2013); and
(3) a lump sum gratuity of $840,000.

Derek plans to move to Canada to live with his family on 15 July 2014. At Derek's request, JL will pay the termination payment after his cessation of employment on 30 June 2014 but before he leaves Hong Kong on 15 July 2014. JL will also give Derek a letter stating that, 'A lump sum amount of $1,015,000 is being paid to you in consideration of your agreeing to release the company from all claims you may have against the company arising from the termination of your employment.' By doing so, Derek has been advised by a friend that he may have a good chance to avoid paying any tax on the payment because it will be treated as a tax-free capital receipt; and/or it is received after cessation of employment.

**Required:**

**(a) Advise Derek Chan on the taxability of the termination payment under salaries tax. Where appropriate, suggest any tax planning ideas which may help minimise his salaries tax liability.** (14 marks)

**(b) Advise Joyce Ltd of its compliance obligations under the Inland Revenue Ordinance in respect of the termination of Derek Chan's employment.** (3 marks)

**(c) Explain to Derek Chan the steps the Inland Revenue Department can take without instituting court proceedings, to recover the salaries tax payable by him for 2014/15.** (3 marks)

**(20 marks)**

**End of Question Paper**