Professional Level – Options Module

Advanced Taxation (Hong Kong)

Thursday 10 December 2015

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

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.
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 (HKG)

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 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 2014/15 tax rates and allowances are to be used in answering the questions.

Tax rates

Salaries tax rates:	
First $40,000	2%
Next $40,000	7%
Next $40,000	12%
On the remainder	17%
Standard rate	15%
Profits tax rate for corporations	16·5%

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	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
Contributions to recognised retirement schemes (maximum)	17,500

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

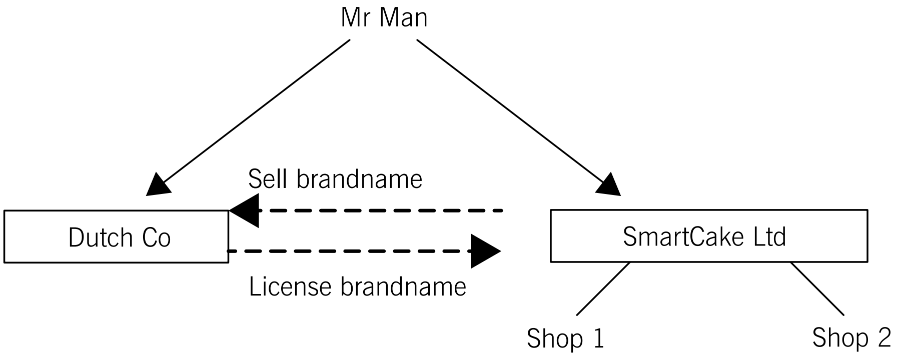
Stamp duty rates

Share transfers		0·2% + $5
Conveyances (ignoring marginal reliefs)		
	Scale 2	**Scale 1**
Not exceeding $2,000,000	$100	1·5%
Not exceeding $3,000,000	1·5%	3%
Not exceeding $4,000,000	2·25%	4·5%
Not exceeding $6,000,000	3%	6%
Not exceeding $20,000,000	3·75%	7·5%
Exceeding $20,000,000	4·25%	8·5%

Conveyances 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
Conveyances chargeable with buyer's stamp duty	15%
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 SmartCake Ltd (SmartCake) is a company incorporated and carrying on business in Hong Kong as a manufacturer and retailer of French macaroons. SmartCake is well known for its award-winning product, 'SmartMac', which contributes 80% of SmartCake's annual turnover. Two years ago when the sole owner of SmartCake, Mr Old, passed away, SmartCake started to suffer severe operating losses due to mis-management by Mr Old's family. Mr Man is interested in taking over the macaroon business by acquiring the shares in SmartCake during the current year. Below is the business plan of Mr Man:



Phase 1: Mr Man will acquire the shares in SmartCake and become the direct sole owner of SmartCake. As part of the acquisition deal, one of SmartCake's current shareholders has agreed to waive the outstanding loan balance due to him by the company. Following the acquisition, Mr Man intends to inject additional funds into SmartCake, either in the form of an interest bearing loan or as equity.

Phase 2: The brandname 'SmartMac' will be revalued, following which the brandname will be sold by SmartCake to a Netherlands company, Dutch Co which is also solely owned by Mr Man. Dutch Co will license the brandname back to SmartCake to enable the latter to continue manufacturing and selling the product. Under the licence agreement, SmartCake will be required to pay an annual licence fee at 2% of the turnover generated from the brandname. Dutch Co does not carry on a business in Hong Kong.

Phase 3: Shop 1 will be closed and the employment of all the staff of Shop 1 will be terminated. Redundancy compensation will be calculated based on the Employment Ordinance and paid to the qualifying staff. In respect of the chef who has declined the offer to continue in service, a special compensation will be paid in exchange for him signing a restrictive covenant not to join any competitor within the next five years.

Phase 4: Shop 2 will continue but at the request of the chef, his employment will also be terminated and SmartCake will enter into a service contract with a company incorporated by him in Hong Kong, Chef Ltd. Chef Ltd will be wholly owned by the chef, who will also be the only employee of Chef Ltd. Under the service contract, the chef will be the designated person to provide the services to SmartCake. An annual fee will be payable to Chef Ltd, at an amount equivalent to 110% of the chef's annual salary under his existing employment contract with Shop 2. This fee will be payable on a bi-annual basis by bank transfer directly to the chef's bank account. The chef will no longer be entitled to any staff benefits except for an annual leave of 20 days in a calendar year. The chef has also requested that he can continue to use his existing business card.

Required:

As the tax consultant engaged by Mr Man, prepare a report for him addressing each of the following issues from a Hong Kong tax perspective.

(a) Acquisition of SmartCake Ltd

(i) The stamp duty implications for Mr Man arising from the acquisition. (3 marks)

(ii) The tax implications for both Mr Man AND SmartCake Ltd in respect of the income or expenditure (as the case may be) under the different forms of additional funding to be provided to SmartCake Ltd (i.e. loan and equity). (5 marks)

(b) Sale and license back of the brandname

Whether the licence fee received by Dutch Co from SmartCake Ltd will be subject to profits tax in Hong Kong and if so, the extent of any tax liability and how the tax will be collected.

Note: You are not required to consider the effect of the Hong Kong – Netherlands double taxation agreement. (5 marks)

(c) Closure of Shop 1

(i) Whether the compensation and gratuity payment made to the terminated staff (including the chef) will be tax deductible to SmartCake Ltd. (6 marks)

(ii) Whether the compensation for the restrictive covenant received by the chef will be chargeable to Hong Kong salaries tax. (2 marks)

(d) The chef of Shop 2

The view that the Inland Revenue Department is likely to take of the relationship between SmartCake Ltd and the chef of Shop 2 under the arrangement requested by the chef, and whether the chef will continue to be subject to Hong Kong salaries tax. (10 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 Peter Chan is a Hong Kong migrant who has lived in Canada for over 20 years. He is currently employed by C Ltd, a Canadian-based company that is listed on the stock exchange in Canada. With effect from January 2016, Peter will be promoted to regional controller in charge of C Ltd's operations in South East Asia. He will be required to travel extensively between Hong Kong and China, but is expected to spend about one-third of his time in Hong Kong. Therefore he will be provided with accommodation in Hong Kong and a work office in C Ltd's Hong Kong subsidiary, HK Ltd.

The following information relates to Peter's plans:

(1) Employment status – When he takes up his new position, Peter has been given a choice of continuing to be employed by C Ltd or being employed by HK Ltd. If he chooses the latter, his employment with C Ltd will be terminated, but he will be appointed as an associate regional director of C Ltd. As associate regional director he will be responsible for reporting the region's performance to C Ltd's board and will be entitled to a nominal director's fee equivalent to HK$100,000 per annum. Irrespective of his employment status, Peter will require his monthly salary to be paid partly into his bank account in Canada (70%) and partly into his bank account in Hong Kong (30%).

(2) Family move – Peter is married with a son and a daughter. His son, aged 20, is currently studying in Canada. His daughter, aged 22, is unemployed and fully maintained by Peter. The family has not yet decided whether or not to move to Hong Kong but, it is likely that only Peter, his wife and daughter will move to Hong Kong. Mrs Chan's parents, who are aged 60, also currently live in Canada, and they are likely to continue to stay in Canada to take care of Peter's son. Peter currently contributes to the maintenance of his parents-in-law and will continue to do so after his move to Hong Kong.

(3) Accommodation in Hong Kong – HK Ltd is prepared to provide Peter and his family with accommodation in a two-room serviced apartment in Hong Kong. Peter will be required to pay a nominal charge equal to 3% of his monthly salary to HK Ltd for this accommodation. Alternatively, Peter can choose to receive a fixed sum housing subsidy each month from HK Ltd in lieu of the accommodation. There is no restriction on the use of the subsidy, so Peter could use it to provide additional funding to finance the acquisition of his own property in Hong Kong.

(4) Asset management in Canada – If Peter and his family move to Hong Kong, their existing property in Canada will be leased out for rental. Also, Peter currently holds a share option granted to him by C Ltd two years ago. Peter intends to exercise this option and sell the shares in May 2016 following the announcement of C Ltd's financial results. Since both these two sources of income will be earned during Peter's time in Hong Kong, he is concerned about any related Hong Kong tax liabilities.

Required:

In respect of the proposed move of Peter Chan, explain and advise on the following:

(a) **Whether, and if so how, his Hong Kong salaries tax position would be affected if he changes his employment from C Ltd to HK Ltd (as in item (1)); and whether or not his family decides to move to Hong Kong (as in item (2)).** (12 marks)

(b) **Assuming Peter will be subject to Hong Kong salaries tax, the allowances he will be able to claim in respect of his family members, including his wife's parents, and whether this would be affected if they move to Hong Kong with him as opposed to staying in Canada.** (4 marks)

(c) **Whether, and if so how, his Hong Kong salaries tax position would be affected if he chooses to live in the accommodation provided by HK Ltd, as opposed to receiving the fixed housing subsidy.** (5 marks)

(d) **Whether, and if so how, the rental income generated from the property in Canada and the gains arising from the exercise of the share option and sale of the shares will be assessed to Hong Kong salaries tax.** (4 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

3 Waterich Ltd (Waterich) operates a retail business through a number of retail shops in Hong Kong. Waterich generates a substantial pool of cash from its daily operations, part of which has been applied in each of the following ways:

(1) To finance loans made to the Waterich's associated companies within the same group, at an interest rate which is benchmarked to the market lending rate. The interest earned or accrued from these loans has been duly recorded as income in Waterich's accounts. Some of the borrowers carry on businesses in Hong Kong and some only outside Hong Kong. The loan moneys were remitted to the respective borrowers' bank accounts in the countries where they operate.

(2) To finance low-interest-rate loans made to Waterich's employees, at an interest rate slightly lower than the general bank lending rate. The loans are provided as a staff benefit to well-performing employees who have the intention of using the funds to buy properties in Hong Kong for either home accommodation or for leasing. The interest earned or accrued from these loans has been duly recorded as income in Waterich's accounts. All of the employees are resident in Hong Kong and all the loan moneys have been applied to acquire Hong Kong properties. During the current year, two employees who left Waterich's employ did not repay their outstanding loan balances. Waterich's management has agreed to waive the right to pursue these debtors further, and the outstanding loan balances were fully written off in Waterich's accounts.

(3) To make a cash deposit with a bank in Hong Kong. The interest earned or accrued from this deposit has been duly recorded as income in Waterich's accounts.

(4) To finance the trading in foreign currencies by Waterich's treasurer. During the year a net gain was realised from this trading and this gain has been duly recorded as a realised gain in Waterich's accounts. At the end of the financial year, the deposit balances in foreign currencies were recorded in Waterich's statement of financial position on a marked-to-market basis. The differences between the fair value and the cost of these balances have been duly recorded as an unrealised gain from foreign currency trading in Waterich's accounts.

Required:

(a) Explain the tax principles and rules which are relevant to ascertaining the taxability of the interest income generated by Waterich Ltd from each of the above-mentioned sources. (10 marks)

(b) Explain the tax principles and rules which are relevant to ascertaining the deductibility of the write-off of the outstanding loan balances due from the two leaving employees as described in item (2). (2 marks)

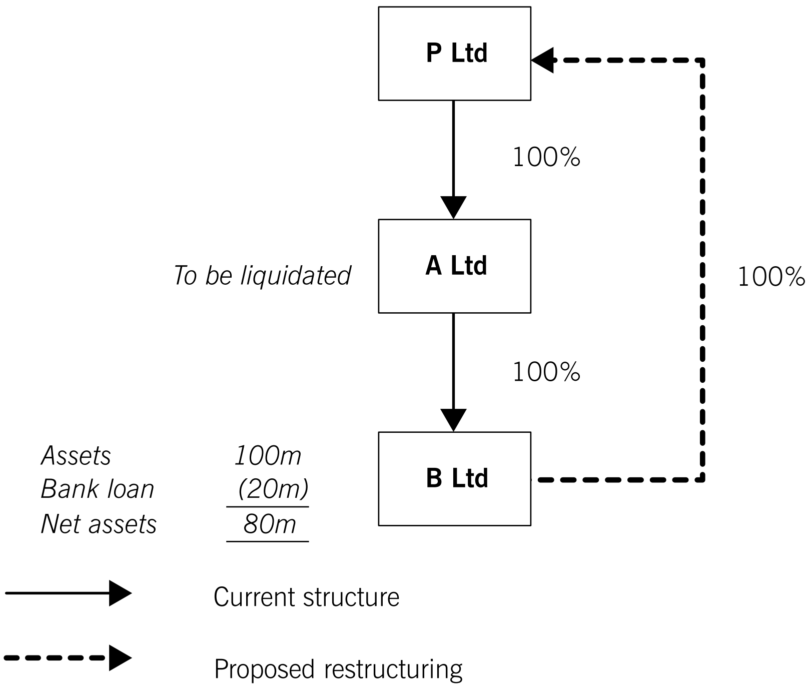
(c) From the perspective of the employees who received the low-interest-rate loans from Waterich Ltd, explain the tax principles and rules which are relevant to ascertaining:

(i) whether the saving in interest expense as compared with the general bank lending rate will be taxable income subject to Hong Kong salaries tax; and (3 marks)

(ii) whether the interest expense paid on the loans will be deductible against the employee's assessable income under Hong Kong salaries tax. (5 marks)

(20 marks)

4 Below is the group structure of P Ltd and its subsidiaries:



Under the current structure:

– P Ltd owns all of the shares in A Ltd; and
– A Ltd owns all of the shares in B Ltd and has done so since B Ltd's incorporation in 2001.

P Ltd is incorporated in Bermuda. A Ltd and B Ltd are incorporated in Hong Kong. A Ltd trades in Hong Kong properties while B Ltd trades in Hong Kong listed securities.

It is proposed to restructure the group in February 2016 as follows:

Step 1: A Ltd will sell all the shares in B Ltd to P Ltd. The consideration will be $80 million payable to A Ltd plus a further $20 million payable directly to the bank on behalf of B Ltd, to fully repay the outstanding bank loan of the same amount. The sale will give rise to a profit of $1 million to A Ltd.

Step 2: A Ltd will be liquidated. Upon liquidation, all the properties held as trading stock by A Ltd will be distributed to P Ltd.

Required:

(a) Discuss whether the profit arising from the sale of the shares in B Ltd (Step 1) would be subject to profits tax. (7 marks)

(b) Explain how the properties held by A Ltd as trading stock should be accounted for on A Ltd's liquidation. (2 marks)

(c) Explain the stamp duty implications arising from the sale of the shares in B Ltd (Step 1) and the liquidation of A Ltd (Step 2). (11 marks)

(20 marks)

5 Kings Ltd, a Hong Kong resident company, is organising a pop music concert to be staged in Hong Kong in January 2016. Kings Ltd has appointed another Hong Kong resident company, Queens Ltd, to procure the performance of an overseas artist at the concert, for which Kings Ltd will pay Queens Ltd $11 million.

Ms Princess, a famous international star singer from the US, has been approached by Queens Ltd to undertake this performance. The remuneration for her performance in Hong Kong has been agreed as $10 million, payable to Mr Prince, the US resident manager of Ms Princess. In the performance agreement, there will be a clause providing that when paying the remuneration, Queens Ltd will be entitled to deduct a sum equivalent to 10% of the gross payment, or any other amount which is sufficient to cover the Hong Kong tax applicable. Ms Princess is not convinced of the need for this clause and has raised the following challenges:

(1) She deals with Queens Ltd on a principal-to-principal basis and thus, Queens Ltd is not an 'agent' acting on her behalf. Therefore, Queens Ltd has no authority to deduct any tax from the payment.

(2) Should there be any tax liability incurred, an assessment should be made by the Hong Kong Inland Revenue Department and issued to her directly as a demand for tax, given that Hong Kong does not operate a self-assessment system.

(3) Hong Kong profits tax should be based on the net assessable profits which are calculated by reference to gross income and deductible expenses. The 10% or any other deemed notional percentage has no legal basis.

Required:

(a) Explain why Ms Princess will be chargeable to Hong Kong tax. (4 marks)

(b) Explain how the Hong Kong tax payable by Ms Princess will be determined and collected.

Note: with the exception of Mr Prince, none of the parties referred to are agents for any other person. (11 marks)

(c) State, giving reasons, whether there will be any difference in the tax position if Ms Princess incorporates a company in Hong Kong to receive the payment on her behalf. (3 marks)

(d) Advise Ms Princess what can be done if tax is overpaid on her behalf by Queens Ltd. (2 marks)

(20 marks)

End of Question Paper