Professional Level – Options Module

Advanced Taxation (Hong Kong)

Friday 7 June 2013

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.

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.

TAX RATES AND ALLOWANCES

The following 2012/13 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)	63,000
– additional allowance in the year of birth (each)	63,000
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%

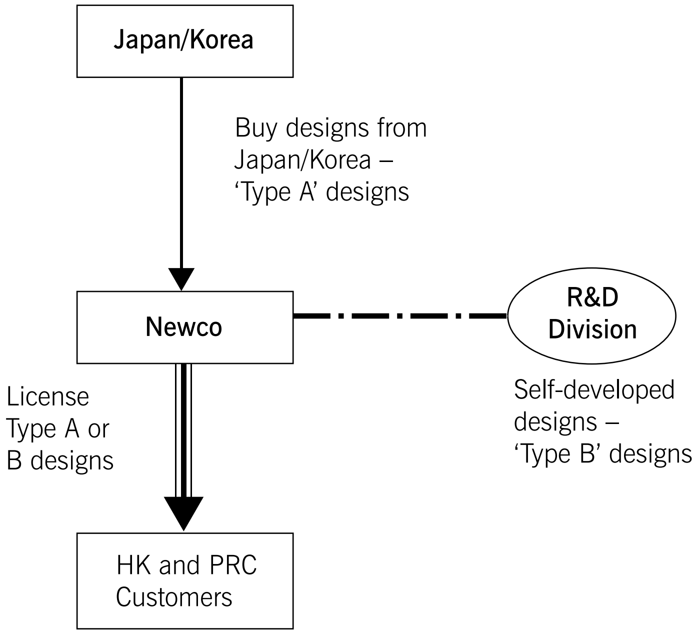
Leases

(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 In a meeting with Mr Man, a new client, you are told that he is interested in incorporating a company in Hong Kong (Newco) to own and license branded cute characters such as 'BB Bug' and 'DD Dog'. Further potential character designs will be sourced from Japan and Korea, and Newco will acquire their ownership and license them for use by customers in Hong Kong and Mainland China. In addition to sourcing designs from third parties, Newco will establish an R&D division with a team of in-house designers to self-develop designs with a local character. The expenditure incurred by the R&D division will include both staff costs and capital expenditure on machinery. Mr Man also believes that significant profits may be earned from the disposing of certain brands after they have become mature in the relevant markets.

The following diagram outlines the operating structure of the two types of designs, Types A and B, targeted by Newco.



The above-mentioned brands 'BB Bug' and 'DD Dog' are currently owned by Mr Man in his own name. He intends to sell 'BB Bug' to Newco at a price of $2 million. He says that this price was determined by reference to the price he has been offered for 'DD Dog' by a third party on an internet sales platform. He is considering accepting this third party offer for 'DD Dog' in the near future.

Mr Man anticipates that, based on the initial purchase costs of $0·5 million for each brand, he will be able to earn a profit of $1·5 million from each brand. He believes that these profits would not be taxed in Hong Kong as he does not have any business registration in Hong Kong and the sale of the brands does not constitute a business. Moreover, he understands that the internet platform used for the sale transaction for 'DD Dog' maintains its server outside Hong Kong.

Required:

(a) Internet sale of 'DD Dog':

(i) Discuss the factors which will be taken into account when determining whether Mr Man is carrying on a trade in respect of the internet sale of 'DD Dog', which may give rise to profits taxable in Hong Kong. Clearly identify what additional information you would require for a full analysis.

Note: You are not required to discuss the rules or principles in relation to the 'source' of profits in this part. (9 marks)

(ii) Assuming the disposal of 'DD Dog' by Mr Man to a third party via the internet is considered to constitute a 'trade', discuss whether the locality of the profit will be outside Hong Kong due to the offshore location of the server. (5 marks)

(b) As the tax manager in charge of Newco's tax affairs, prepare a report for the Board of Directors of Newco, addressing each of the following issues from a Hong Kong tax perspective.

(i) Acquisition of 'BB Bug' by Newco from Mr Man:

Whether the cost incurred in acquiring 'BB Bug' from Mr Man would be tax deductible to Newco for Hong Kong tax purposes. (6 marks)

(ii) 'Type A' designs acquired from Japan/Korea:

(1) The Hong Kong tax implications, if any, to Newco in respect of the costs incurred in acquiring the Type A designs from Japan/Korea.

Note: You need not repeat any principles already established in your answer to (b)(i) above, except to the extent that the effect of their application is different in this case.

(2) The Hong Kong tax implications, if any, to Newco in respect of the income earned from licensing the Type A designs to customers in Hong Kong and Mainland China.

(3) The Hong Kong tax implications, if any, to Newco in respect of the profits arising from a subsequent disposal of the Type A designs.

Note: The total marks will be split equally between each part. (6 marks)

(iii) 'Type B' designs self-developed by Newco:

(1) The Hong Kong tax implications, if any, to Newco in respect of the research and development costs incurred in self-developing the Type B designs by the in-house team.

(2) The Hong Kong tax implications, if any, to Newco in respect of the income earned from licensing the Type B designs to customers in Hong Kong and Mainland China.

(3) The Hong Kong tax implications, if any, to Newco in respect of the profits arising from a subsequent disposal of the Type B designs.

Note: In the case of issues (2) and (3), you need not repeat any principles already established in your answer to part (b)(ii) and (iii) above, except to the extent that the effect of their application is different in this case.

The following mark allocation is provided as guidence for this requirement:

(1) 2 marks
(2) 2 marks
(3) 1 mark

(5 marks)

Professional marks will be awarded in question 1 part (b) 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 Richard, a UK resident, is employed as a marketing manager by a company resident only in the UK (the Company). Starting in December 2011, Richard began to travel around the Asia region visiting the Company's operations and meeting clients. Richard had never been in Hong Kong before 1 December 2011 and all of his remuneration was paid into his bank account in the UK.

Richard's travelling schedule in Asia during the relevant periods has been extracted as follows:

		Place of stay	Purpose of stay
2011	1–14 December	Hong Kong	Business
2012	4–25 January	Hong Kong	Business
	4–18 February	Singapore	Business
	1–24 March	Hong Kong	Business
	6–17 April	Hong Kong	Business
	16 May–23 July	Hong Kong	Business and 5 days of annual leave
	15–30 August	Hong Kong	Business
	5–20 September	Malaysia/Singapore	Business
	7–19 October	Hong Kong	Business
	17 November–2 December	Hong Kong	Business
2013	20 January–2 February	Singapore/Taiwan/China	Business and 10 days of annual leave
	7–31 March	Hong Kong	Business

The following information relates to Richard (all currency amounts are given in Hong Kong dollars):

(1) Basic salary of $100,000 per month.

(2) Lump sum housing allowance of $20,000 per month, paid in cash.

(3) During his time in Hong Kong, Richard stayed in a hotel serviced apartment at a monthly rental of $10,000. This was paid for by the Company directly to the hotel.

(4) For each of the years ended 31 March 2012 and 2013, the Company made a total payment of $120,000 to cover the university fees of Richard's daughter. Richard's daughter is aged 20 and was studying full-time at a university in Manchester, UK in both these years.

(5) Richard holds two share options in the Company.

- Under tranche A, granted on 1 November 2009, he was awarded the right to acquire 10,000 shares in the Company if he was still employed by the Company on 31 October 2011.
- Under tranche B, granted on 1 April 2011, he was awarded the right to acquire 8,000 shares in the Company if he was still employed by the Company on 31 March 2013.

Both options were awarded for no consideration at an exercise price of $10 per share. Richard exercised both options on 31 March 2013 when the shares were worth $90 each.

(6) On 1 May 2012, Richard acquired a flat in Hong Kong at a price of $4 million, and mortgaged it to a bank for $3 million. During the year ended 31 March 2013, he paid interest of $60,000 to the bank.

(7) With effect from 1 July 2012, Richard leased the flat to a friend at a monthly rent of $12,000. Before leasing out the flat, he borrowed the sum of $200,000 to renovate the flat and a further $20,000 to replace the old air-conditioners, refrigerator and washing machine. He paid interest of $3,000 for the money borrowed. A $2,000 monthly management fee for the flat is also payable by Richard.

(8) Richard's wife, Diana, a housewife, lives in Manchester with their daughter.

Required:

Analyse Richard's Hong Kong tax position for each of the years of assessment 2011/12 and 2012/13, clearly explaining the taxability of each item of his income and provide a calculation of his tax liabilities.

Note: You should assume that Richard's letting of property does not amount to the carrying on of a business.

(25 marks)

Section B – TWO questions ONLY to be attempted

3 Expanding Co Ltd (Expanding) carries on a property development and investment business in Hong Kong. The management of Expanding is interested in acquiring all the units in an old residential building which it will pull down and redevelop into a high-end shopping mall. The building is currently owned by Retiring Co Ltd (Retiring) which is also incorporated in Hong Kong. Retiring leases out all of the units in the building and pays profits tax on the rental income.

In the last business meeting with the representatives of Retiring, Expanding offered to acquire the building for $20 billion, which is consistent with its current market value. The representatives of Retiring counter-offered to sell the shares in Retiring for $12·5 billion payable to the company's shareholders, as well as Retiring's outstanding bank mortgage loan of $8 billion being assumed by Expanding. Under this alternative, the total cost to Expanding will be $20·5 billion, but the representatives of Retiring have explained that the small mark-up of $0·5 billion represents Expanding's share of the stamp duty savings resulting from a share transfer, as opposed to the sale of the building.

The directors of Expanding are concerned that the main reason for Retiring's refusal to sell the building directly may be the recently enacted special stamp duty.

Required:

(a) Determine the difference in the stamp duty payable between Expanding Co Ltd's (Expanding) initial offer and Retiring Co Ltd's (Retiring) counter-offer and advise Expanding's directors whether Retiring's claim regarding the $0·5 billion stamp duty benefit is reasonable.

Note: You are not required to consider special stamp duty in your answer to this part. (12 marks)

(b) Explain the effect, if any, of special stamp duty on the proposed transactions and comment on whether the concerns of Expanding's directors are justified. (6 marks)

(c) Identify any potential tax risks to Expanding if it acquires the shares in Retiring, and what course(s) of action are recommended under this option in order to protect the interests of Expanding and its shareholders. (2 marks)

(20 marks)

4 DayOne Co Ltd (DayOne) was incorporated on 1 July 2012 with the intention to carry on a property consultancy business in Hong Kong. DayOne rented an office under a two-year lease which started on 1 November 2012, but with an initial two-month rent free period. The office was renovated during this initial rent-free period and only became available for use on 15 December 2012.

A secretary and a consulting manager were employed by DayOne with effect from 20 December 2012. The consulting manager immediately began to conduct research on the property market and presented his first proposal to a potential customer on 20 February 2013. The first consultancy contract was signed on 1 April 2013, and DayOne received its first consultancy fee on 1 May 2013.

DayOne prepared its first accounts from 1 July 2012 to 31 December 2012. Its first profits tax return for the year of assessment 2012/13 was filed claiming a deduction for all the expenses incurred in 2012 on the basis that the business commenced on 1 July 2012. In June 2013, DayOne received a notice of assessment denying the expense deductions on the basis that it had not commenced business during the year of assessment 2012/13.

Required:

(a) Advise on the course of action available to DayOne Co Ltd (DayOne) if the directors disagree with the notice of assessment and believe that DayOne's original tax filing position and claim for expense deduction was correct. (3 marks)

(b) DayOne's directors have heard about the mechanism of advanced rulings which allows taxpayers to seek interpretation of the statutory provisions under the tax law.

Required:

Briefly explain the PURPOSES of the advanced rulings mechanism and the circumstances under which the Commissioner may decline to issue or is not permitted to issue a ruling. Give your opinion as to the likelihood that a ruling would be issued on the determination of the date of commencement of DayOne's business. (7 marks)

(c) Discuss the general principles and practices in Hong Kong for determining the date of commencement of business for tax purposes. Give your assessment and opinion on the likelihood of each of the following dates being regarded as the date of commencement of DayOne's business, concluding with which date is most likely to be adopted by the IRD:

(i) 1 July 2012;
(ii) 1 November 2012;
(iii) 15 December 2012;
(iv) 20 December 2012;
(v) 1 April 2013; and
(vi) 1 May 2013.

Note: The total marks will be split equally between each part. (7 marks)

(d) Assuming that the IRD has determined a date of commencement of DayOne's business and certain operating expenses and capital expenditure had been incurred prior to this date, advise whether a tax deduction may be claimed for these expenses. (3 marks)

(20 marks)

5 **(a)** Company A is a company incorporated in Hong Kong carrying on business in Hong Kong. Company A is considering extending an interest-bearing loan to its overseas subsidiary. This loan would be financed by Company A's bank overdraft on which an interest cost is payable.

Required:

Discuss the Hong Kong tax position of Company A in respect of the interest received from its overseas subsidiary and the interest paid on its bank overdraft. (8 marks)

(b) Company B is a company incorporated in Hong Kong carrying on business in Hong Kong. Company B has been requested by its group holding company to change its accounting year-end date from 31 December to 30 June, which is in conformity with the group's practice. As a result of this request, Company B will draw up a set of accounts for the 18-month period 1 January 2012 to 30 June 2013.

Required:

Explain the general principles to be adopted in ascertaining the basis period for cases involving a change of accounting date, and advise on ALL the possible basis periods which could be adopted for Company B for each of the years of assessment 2013/14, 2012/13 and 2011/12. (12 marks)

(20 marks)

End of Question Paper