Professional Level – Options Module

Advanced Taxation (Hong Kong)

Friday 6 December 2013

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.

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 You should assume that today's date is 1 March 2013.

Mr Liu wholly owns a company incorporated in Hong Kong, Fortune Ltd (the Company). The Company did not have any transactions before 2012. During the year ended 30 September 2012, the Company acquired two residential properties located in Hong Kong. The properties were renovated and placed for sale with various property agencies. However, due to the stagnant property market, the Company was not able to dispose of the properties at good prices. The properties have remained vacant since then.

Mr Liu is meeting with the auditor to discuss the accounting treatment of the properties and the Company's strategy of holding the properties. Prior to the auditor's meeting, Mr Liu called a meeting to seek views from other members of the Company on the possible strategies to deal with the properties. The following extract of the draft financial statements was presented:

Draft statement of profit or loss for the year ended 30 September 2012

	$	$
Interest income from bank deposits		100
Interest expense on shareholder's loan (Note (a))	(40,000)	
Bank loan interest (Note (b))	(110,000)	
Depreciation on properties (Note (c))	(400,000)	
Other operating expenses	(300,000)	(850,000)
Operating loss for the year		(849,900)

Note (a) – Interest was accrued at 1% p.a. on a loan from the Company's shareholder, Mr Liu, for:

	$
50% of the property acquisition costs	10,000,000
Property renovation costs	800,000
Company's operating fund	500,000
Total shareholder's loan	11,300,000

Note (b) – Bank interest was accrued at 3% p.a. on a mortgage loan of $10,000,000 to finance the property acquisitions. The loan was secured by the properties as well as by Mr Liu's personal guarantee.

Note (c) – The two newly acquired properties were treated by the Company as capital assets in the draft statement of financial position, and depreciation was calculated on the same basis which applied to the tax depreciation allowance on the buildings.

The following meeting notes were extracted:

(1) Mr Liu expressed his concern over the prospects for the Hong Kong property market, and was considering selling the properties at the current market prices which were only slightly above their cost. Although only a small gain would be made, the Company would benefit from the cash inflow which could be used to pay off part of its loans and lessen its interest burden. Mr Liu expected that the Company's current year's operating loss of $849,900 (as shown above) could be carried forward but was not sure whether it could be used to offset the profits earned from the property sales in the following year. He also wondered whether the special stamp duty could be avoided.

(2) The Company's accountant explained that the Company's accounting profit or loss is not necessarily the same as the Company's taxable profit or adjusted tax loss. Moreover, profits earned from the sale of the properties should not be taxable unless the Company traded in properties.

(3) The Company's accountant also suggested that the two properties could be let out on a short-term lease, such as six to twelve months, since better selling prices might be available at a later stage. The lease income could then be used to fund the Company's operations. Mr Liu added that one of his other subsidiaries might be interested in leasing the properties at a market rental. The accountant, however, was not sure whether the auditor would agree to record the properties as 'capital assets' instead of 'trading stock' in the Company's accounts.

(4) Mr Liu also mentioned that if the properties were left vacant, he would consider moving into one of the properties as his residence in his capacity of either the Company's shareholder or director. He was not sure whether the choice would make any difference to the Company's tax position.

Mr Liu has approached a tax consultancy firm to obtain tax advice on the respective options discussed during the meeting.

Required:

As the tax manager of the consultancy firm approached by Mr Liu, prepare a report for Mr Liu, addressing each of the following issues from a Hong Kong tax perspective:

(a) Option to sell the properties for a small gain:

(i) The types of adjustments which are required to be made to an accounting profit/(loss) under the Inland Revenue Ordinance. Provide an estimate of the loss amount to be carried forward for tax purposes based on Fortune Ltd's current year operating loss (as per its draft statement of profit or loss) of $849,900.

Note: You should assume that Fortune Ltd has commenced business. (6 marks)

(ii) Whether, regardless of the accounting treatment, the sale of the properties would constitute a 'trade' such that any profits arising therefrom would be taxable. (8 marks)

(iii) The potential stamp duty liabilities arising from the property sales.

Note: Where appropriate and applicable, the following rates in respect of conveyances chargeable with special stamp duty may be adopted:

Holding period	Rate
Not exceeding six months	15%
Between six and 12 months	10%
Between 12 and 24 months	5%

(7 marks)

(b) Option to lease the properties:

Fortune Ltd's tax position, including any stamp duty implications, in respect of any leasing income earned.

(8 marks)

(c) Option to occupy the properties by Mr Liu:

The Hong Kong tax implications for Fortune Ltd if one of the properties were to be occupied by Mr Liu in his capacity of the company's shareholder, as compared with his capacity of the company's director.

(2 marks)

Professional marks will be awarded 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 Mr and Mrs Ng are planning to retire with effect from 1 April 2014. Their summarised tax computations for 2012/13 are as follows:

Mr Ng – Salaries tax

	$
Salary and other assessable income	1,213,000
Share option (500 shares exercised out of 1,000 shares)	20,000
Less: Mandatory provident fund contributions	(14,500)
Basic allowance	(120,000)
Child allowance	(63,000)
Dependent parent allowance (Mrs Ng's father living with them)	(76,000)
Net chargeable income	959,500
Tax payable	151,115

Mrs Ng – Salaries tax

	$
Salary (part-time job)	10,000
Less: Approved charitable donations (total eligible donations $12,000)	(3,500)
Basic allowance	(120,000)
Net chargeable income	0
Tax payable	0

Mrs Ng – Property tax

	$
Assessable value	120,000
Less: Statutory allowance	(24,000)
Net assessable value	96,000
Property tax payable	14,400

Mr and Mrs Ng have the following plan after Mr Ng retires:

(1) They are currently living in a flat owned by Mrs Ng's father who also lives in the flat. After retirement, the couple will move into the property owned by Mrs Ng, which is currently leased for rental. The leased property was acquired by Mrs Ng under a mortgage loan on which loan interest has been paid. Annual interest is around $150,000.

(2) Mrs Ng's father will sell his flat and move into an elderly home in Hong Kong. The estimated cost of the elderly home is $80,000 per annum, which will be paid by Mr Ng. Alternatively, Mrs Ng's father is considering moving back to live in Mainland China. In either case, Mr Ng will continue to financially support his father-in-law.

(3) Mr Ng has obtained an option to exercise 1,000 shares in his employer company, out of which 500 shares had been exercised during 2012/13. He plans to exercise the balance of the shares **either** before retirement, i.e. during the year 2013/14; **or** after retirement, i.e. after 1 April 2014.

(4) Mr Ng will sign a consultancy agreement with his existing employer and will receive consultancy fees on an ad hoc basis. The estimated fee income per annum from this agreement is $500,000. Mrs Ng will continue with her part-time job.

Required:

(a) With reference to item (1) above, advise Mr and Mrs Ng how to get maximum tax effectiveness from their Hong Kong tax positions if they move into Mrs Ng's property after retirement. (6 marks)

(b) With reference to item (2) above, explain the different tax implications for Mr and/or Mrs Ng's Hong Kong tax positions, if any, if Mrs Ng's father moves into an elderly home in Hong Kong, as compared with his moving back to live in Mainland China. (3 marks)

(c) With reference to item (3) above, explain the different tax implications for Mr Ng's Hong Kong tax position, if any, if he exercises the balance of his share option during 2013/14, as compared with his exercising the option after 1 April 2014. (3 marks)

(d) With reference to item (4) above, advise Mr Ng on his Hong Kong tax position, if any, as a consequence of any consultancy fees received after his retirement. If you consider that the tax position is not tax effective, suggest a way to improve the tax effectiveness. (4 marks)

(e) With reference to Mr and Mrs Ng's tax computations for 2012/13, identify any deficiencies in their tax positions and advise how these deficiencies can be remedied so as to improve the couple's overall tax position. Support your advice with a calculation of the potential tax saving and the action(s) to be taken. (9 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

3 VIP Inc is a company incorporated in the USA, which is not carrying on business in Hong Kong. Currently, VIP Inc manufactures its own handbags in the USA and sells them in the USA, but as its brand has become more popular, it has received an increasing number of online enquiries from customers in Hong Kong seeking to purchase handbags from them. As a result, VIP Inc plans to expand its market into Hong Kong and has proposed the following channels:

(i) To set up a subsidiary in Hong Kong, which will buy the goods from VIP Inc and sell them in Hong Kong via retail outlets.

(ii) To appoint an exclusive agent in Hong Kong, who will be given full authority to handle VIP Inc's sales activities in Hong Kong, including accepting offers for purchases according to a pre-set price policy. Goods will be shipped directly from the USA to the customers.

(iii) To continue to accept online purchase orders from Hong Kong customers in the USA, who will receive the goods from a Hong Kong distribution agent appointed by VIP Inc. An inventory of goods will be shipped from the USA to the agent on a regular basis and delivered to the customers upon confirmation of their orders.

(iv) To continue to accept online purchase orders from Hong Kong customers in the USA, and ship the goods directly from the USA to the customers. No inventory of goods will be retained in Hong Kong but a local customers' service agent will be appointed to handle all after-sales services to the customers.

Required:

(a) **Briefly explain the general principles applied to determine whether or not a company, such as VIP Inc, is considered as carrying on a business in Hong Kong.** (3 marks)

(b) **For each of the four proposed channels described, discuss the Hong Kong profits tax implications for VIP Inc, including whether VIP Inc would be considered as carrying on business in Hong Kong, and, if so, how any tax will be collected. Wherever appropriate, the issue of transfer pricing and its impact should be addressed.**

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

(i) 7 marks
(ii) 6 marks
(iii) 2 marks
(iv) 2 marks

(17 marks)

Note: You are NOT required to address the 'source' issue in any part of this question.

(20 marks)

4 Smart Ltd (Smart) commenced business in Hong Kong in 1990, as a manufacturer and exporter of plastic products. In 2013, in order to take advantage of the low labour and other costs on Mainland China, Smart entered into an arrangement by which its products started to be manufactured on the Mainland.

Smart was recommended by the provincial government to set up a factory in Dong Guan, in the form of a separate entity to carry on a manufacturing business under an import processing arrangement. For this purpose, a wholly owned subsidiary, Wise Co (Wise), was established as a wholly foreign-owned enterprise under the law of the Mainland. An import processing agreement was entered into by Smart and Wise, under which Smart and Wise agreed to perform the following obligations:

(1) Wise is to provide the factory premises and labour for the production of the finished goods.

(2) Smart is to be responsible for the design, technical know-how development and product testing. Such works are carried out by Smart, partly in Hong Kong and partly at Wise's factory premises in Dong Guan, and supplied to Wise in respect of the processing works carried out by it for Smart.

(3) To facilitate the manufacturing process, machinery (acquired under hire purchase) and moulds owned by Smart are to be transferred to Wise for its use at no cost. The machinery and moulds can only be used to manufacture the finished goods to be supplied to Smart.

(4) Quality assurance engineers and production control staff from Smart are to visit Wise to train and update its staff. In addition, a number of senior management staff employed by Smart are to be stationed at Wise's factory to monitor and manage its operation.

(5) Raw materials are to be purchased by Smart in Hong Kong and sold to Wise according to the production schedule set in Hong Kong. Finished goods are to be sold by Wise to Smart. The price of the finished goods to be paid for by Smart will represent more or less the expenses incurred by Wise plus a reasonable mark-up, after offsetting the price of the raw materials which have been supplied by Smart to Wise.

Required:

(a) Based on the Departmental Interpretation and Practice Note No. 21 (DIPN 21) entitled 'Locality of Profits', explain the general principles applied by the Inland Revenue Department in determining the source of manufacturing profits. (5 marks)

(b) On the basis of the facts provided, discuss whether Smart Ltd's profits should be subject to, or exempt from, profits tax. (9 marks)

(c) Explain whether Smart Ltd is entitled to any deduction in respect of the cost of the machinery and moulds transferred to Wise Co. (6 marks)

(20 marks)

5 **(a)** Island Bank is incorporated in Hong Kong and registered under the Banking Ordinance. Island Bank derived gross interest of $3 million on a loan to a joint venture located in Country X. The loan was negotiated and finalised by Island Bank's staff in Country X. Island Bank borrowed money in Hong Kong to finance the provision of the loan and paid interest on this borrowed money. The joint venture deducted Country X withholding tax of $300,000 from the gross interest before it remitted the loan interest to Island Bank.

Required:

Explain whether, and if so to what extent, the interest income derived by Island Bank is chargeable to Hong Kong profits tax; and whether there is any relief for the Country X withholding tax and the interest paid on the money borrowed to finance the provision of the loan. (5 marks)

(b) In February 2013 Chris considered that the Australian dollar would appreciate in value against the Hong Kong dollar. He therefore arranged for his company, HK Co, which is not a financial institution, to borrow $2 million from the Hong Kong Bank, and used the funds to purchase the Australian dollars which were placed on a monthly fixed deposit with the Hong Kong Bank and used as security for the back-to-back loan. HK Co rolled over the deposit for three consecutive months, earning interest of $5,000. At the end of this period, HK Co reconverted the principal sum to Hong Kong dollars in the amount of $2,200,000. During the period, interest of $10,000 was paid on the loan.

Required:

Explain the tax implications of the above transactions for HK Co. (7 marks)

(c) Real Property Development Ltd (RPDL) has a land development project in progress. The whole project will provide 2,000 units for sale, all of which are of the same size. RPDL will sell the first 500 units upon completion in March 2014. In the budget for the project up to March 2014, the following items have, in accordance with generally accepted accounting principles, been included in work in progress:

Interest paid to a bank in Hong Kong	$26 million
Architects' fees	$3 million
Project management fee	$1 million

Required:

Explain the amount which would be deductible as an expense for tax purposes in respect of the above items on the sale of the 500 units. (8 marks)

(20 marks)

End of Question Paper