

Examiner's report

F6 (HKG) Taxation
December 2017

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General Comments

There were two sections to the examination paper and all of the questions were compulsory. Section A consisted of 15 multiple choice questions of two marks each, which covered a broad range of syllabus topics. Section B had four questions worth 10 marks each and two longer questions worth 15 marks, each testing the candidates' understanding and application of taxation in more depth. The following paragraphs report on each section and focus on some of the key learning points.

Specific Comments

Section A

Section A questions aimed to provide a broad coverage of the syllabus. All candidates attempted all of the questions.

The following two questions where most students could not get the correct answer are reviewed with the aim of giving future candidates an indication of the types of questions asked, guidance on dealing with exam questions and to provide a technical debrief on the topics covered by the specific questions selected. Candidates preparing for the next examination of F6 (HKG) should aim to revise all areas of the syllabus, and are advised to work through the pilot paper and the questions discussed here and in the examiner's reports for the past diets; and to carefully review how each of the correct answers were derived.

Question one

A Ltd is resident in Hong Kong and is an associated company of B Ltd which is resident in Country P. On 1 April 2016, A Ltd borrowed a loan of \$8 million from B Ltd at an interest rate of 3% per annum in the ordinary course of its intra-group financing business. On 1 October 2016, \$4 million of this loan was sub-participated to C Ltd, another associated company of B Ltd, which is resident in Country Q. B Ltd was the beneficial owner of the loan interest income and was chargeable to tax on the interest income at the rate of 20% in Country P, but C Ltd was not chargeable to tax in Country Q due to the set-off of losses brought forward.

What is the amount of allowable interest which A Ltd can claim for profits tax purposes for the year ended 31 March 2017?

- A \$0
- B \$240,000
- C \$180,000**
- D \$120,000

This question required candidates to calculate the allowable interest deduction under profits tax. The correct answer was C, whereas the majority of candidates chose A and B.

Under s.16(2)(g), interest on borrowing by a corporation carrying on an intra-group financing business in Hong Kong is deductible if all the following conditions are satisfied:

- (i) Interest is payable on money borrowed from a non-Hong Kong associated corporation in the ordinary course of an intra-group financing business carried on in Hong Kong;
- (ii) The lender is subject to a similar tax on the interest in a territory outside Hong Kong at a rate that is not lower than the reference rate (16.5% or 8.25% if the borrower is a qualifying corporate treasury centre); and
- (iii) The lender's right to use and enjoy that interest is not constrained by a contractual or legal obligation to pass that interest to any other person, unless the obligation arises as a result of a transaction between the lender and a person other than the borrower at arm's length.

Applying s.16(2)(g) to this question, the interest of \$240,000 ($8m \times 3\%$) paid by A Ltd to B Ltd would be allowed. However, the allowable deduction is subject to limitations under ss.16(2CA) and (2CC) – the 'interest diversion' test and 'loss shifting' test. Under s.16(2CA), interest deduction is disallowed where there is an arrangement under which the interest is ultimately paid, directly or through an interposed person, to a person related to the borrower who pays no tax or pays tax at a rate lower than the reference rate.

When \$4 million of this loan was sub-participated to C Ltd which was related to A Ltd and paid no tax, part of the interest in the amount of \$60,000 ($8m \times 3\% \times 4/8 \times 6/12$) would be disallowed. Therefore, the allowable interest was \$180,000 ($240,000 - 60,000$).

Candidates who chose A thought that none of the interest was allowable.

Candidates who chose B ($8m \times 3\% = \$240,000$) thought that all the interest was allowable.

Candidates who chose D ($8m \times 3\% - 8m \times 3\% \times 4/8 = 120,000$) failed to apportion the interest expense correctly.

Question Two

HKCo, a company carrying on a manufacturing business in Hong Kong, obtained the right to use a trade mark registered in Hong Kong from the owner by way of a five-year licence during the year of assessment 2016/17. The consideration included an upfront payment of \$500,000 for the grant of the licence and an annual licence fee of \$50,000. HKCo manufactures goods bearing the trade mark in Hong Kong. These goods are sold by HKCo, half in Hong Kong and half in the United States.

What is the amount of the allowable deduction which HKCo can claim in respect of the trade mark for profits tax purposes in the year of assessment 2016/17?

- A \$150,000
- B \$50,000**
- C \$75,000
- D \$25,000

This question required candidates to calculate the allowable deduction for trade mark under profits tax. The correct answer was B as only the annual licence fee (\$50,000) was deductible, whereas the majority of candidates chose A and C.

Candidates who chose A ($50,000 + 500,000/5 = \$150,000$) thought that the annual licence fee was fully allowed and the upfront payment was allowed over a period of five years.

Candidates who chose C ($(50,000 + 500,000/5) \times 50\% = \$75,000$) had further misunderstood that as half of the goods were sold in Hong Kong and half in the United States, only half of annual licence fee and upfront payment were allowed.

Candidates who chose D ($50,000 \times 50\% = \$25,000$) wrongly allowed half of the annual licence fee.

Specific Comments

Section B

This section had a standard coverage of topics. Questions 1 to 4 were short questions for a total of 40 marks, and questions 5 and 6 were long questions for a total of 30 marks.

It was very pleasing to see that almost all candidates attempted all of the questions.. Where questions were left unanswered by candidates (such as questions 1 and 3a), this appeared to be due to a lack of knowledge on less common topics. Some questions were not answered satisfactorily such as question 3, and questions 4 and 5(a) were answered particularly well. In general, the performance of this paper was very encouraging.

Question One

This 10-mark question was on the topic of tax administration, in particular, the conditions for raising an estimated assessment and applying for hold-over of provisional salaries tax. Very few candidates performed well on this question. Most candidates explained that an estimated assessment was issued when no tax return was filed. However, no other circumstances were given (such as unsatisfactory accounts and records or unacceptable tax return filed).

Regarding part (b), most candidates incorrectly gave answers on objections and section 70A claim instead of holdover. Candidates should take note that objection is valid when the final tax is disagreed, while holdover is applied for both final tax being objected and provisional tax disagreed. Candidates are strongly advised to read the questions carefully.

Question Two

This 10-mark question was on the commonly examined topics of share option and share award schemes. Most candidates got their answers correct for explaining the tax treatment when awards were granted and options were exercised. However, just a few candidates were able to address the 'deemed' exercise of share options at the time of departure from Hong Kong. Most answers only stated that there was no assessment arising when the taxpayer left Hong Kong, and some other answers wrongly applied section 11D to deem the exercise gain to fall on the last day of employment.

As regards part (b) on share award, quite a number of students did not address the fact that the share award was subject to a vesting period.

Question Three

This 10-mark question covered a type of special business – clubs. .

For those who correctly addressed the specific tax treatments for clubs, it was usually found that candidates did not address that the 50% rule applied to ‘voting members’ rather than ‘members’ only. Moreover, most candidates did not specify that entrance fee and subscriptions are included in the 50% rule formula. Last, it was a bit disappointing that most candidates applied 16.5% (instead of 15%) in their tax calculations.

Question Four

This 10-mark question was the best-attempted question which was on property tax. The most common error was that some candidates wrongly claimed irrecoverable debt in the tax computations. Certain rare cases were found to include various expenses (such as management fee, agency fee, mortgage interest, renovation etc.) as deductions.

Question Five

This 15-mark question required candidates to compute the ‘net assessable income’ and then prepare the personal assessment computation. Some candidates did not give the correct ‘net assessable income’, indicating that they were not aware of the definition of the terminology. There were a lot of cases where full computation was given including the Part 5 allowances, while others included concessionary deductions to arrive at the net assessable income. Moreover, some students incorrectly described the ‘ACCA membership fee’ as ‘self-education expenses’.

As regards the personal assessment computation, the performance was generally satisfactory. Common mistakes found in the computation included:

- Wrong calculation of the rental value as 8% of the assessable income or without deduction of allowable professional membership fee.
- Overclaim of mortgage interest deduction beyond the net assessable value.
- Overclaim of home loan interest deduction beyond the statutory limit.
- Granting the wrong amount of dependent parent allowance (\$23,000).
- Not granting the disabled dependant allowance for Mr Shi’s mother.

Question Six

This 15-mark question required preparation of a profits tax computation for a limited company. In general, the performance was good, except for the following common mistakes:

- Wrong calculation of the special Mandatory Provident Fund (MPF) contribution to be added back (80% and not 100%).
- Wrong calculation of special concession for environment-friendly vehicle for 20% instead of 100%.
- Failure to set off the property tax paid against the profits tax liability, or used the wrong property tax figure for set-off.