Professional Level – Options Module

Advanced Taxation (Hong Kong)

Friday 5 December 2014

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.
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)

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Question 1 begins on page 5.

Section A – BOTH questions are compulsory and MUST be attempted

1 Mr Kam runs a restaurant in Hong Kong under the tradename 'Kam Kee'. During a recent meeting with a tax consultant, Mr Kam presented the following financial results of Kam Kee for the year ended 31 December 2013:

	Notes	$	$
Turnover from restaurant			5,000,000
Cost of goods sold			(2,800,000)
Gross profit			2,200,000
Loan interest income from staff	1		60,000
Loan interest income from sole proprietor	2		20,000
Compensation from cancellation of contract	3		500,000
			2,780,000
Staff costs	4	(600,000)	
Office utilities		(160,000)	
Staff quarters expenses	5	(90,000)	
Legal and professional expenses	6	(180,000)	
Renovation costs	7	(900,000)	
Interest expenses	8	(200,000)	
Other office consumables	9	(50,000)	
Depreciation charge	10	(300,000)	(2,480,000)
Operating income			300,000

The following explanatory notes are provided by Mr Kam in support of his business' results:

(1) Mr Kam treats all employees as valuable assets of the business. When any employee gets married, Mr Kam offers a low interest rate loan to help him/her buy a property to live in. All the staff loans are financed by excess operating cash from the business.

(2) Two years ago, Mr Kam borrowed money from the business in order to assist his sister who is resident in Canada. The loan amount of $1,000,000 was directly transferred from Kam Kee's bank account to his sister's bank account in Canada. Mr Kam is paid interest of 2% per annum by his sister, which is then paid to the business as loan interest.

(3) The compensation was received from a travel agency which terminated its contract with Kam Kee last year. Under the contract, Kam Kee was the exclusive restaurant providing meals to groups of tourists from Mainland China. The amount of compensation represents the estimated loss of revenue suffered by Kam Kee during the remaining period of the contract.

(4) Staff costs comprise:

	$	Remarks
Salary and MPF contributions	300,000	
Medical subsidy to staff	90,000	Reimbursement to staff for medical expenses
Sponsor to staff on courses	10,000	Reimbursement to staff for education courses
Compensation to staff on leaving	50,000	Compensation to an ex-employee for a promise not to join a competitor within five years
Staff loan written off	150,000	Low interest rate loan to one employee who left without repaying the loan
Total per accounts	600,000	

Mr Kam added that he has the intention of joining an employees' group medical insurance scheme so that employees' medical expenses would be covered by the insurance company. However, he is concerned whether the tax deductibility treatment of the insurance premium would be different from the current arrangement, and whether this would be affected by the employees' salaries tax positions.

(5) Staff quarters expenses refer to rates, management fee, and utilities for a residential property which has been occupied as quarters by some employees.

(6) Legal and professional expenses comprise:

	$
Audit and tax filing	30,000
Advice on a tax appeal	70,000
Penalty charged by the IRD for under-reporting income	80,000
Total per accounts	180,000

(7) Renovation costs comprise:

	$
Replacing the old carpets with new ones	400,000
Other refurbishment work	500,000
Total per accounts	900,000

(8) Interest expenses comprise:

	$
Interest on a bank mortgage loan obtained in 2010 to acquire a residential property used as staff quarters	190,000
Interest on the bank overdraft credit line used for daily business operations	10,000
Total per accounts	200,000

The bank mortgage loan is secured by the property.

(9) Other office consumables includes the cost of $8,000 for replacing kitchen utensils, crockery and cutlery (forks and knives, etc) used in the restaurant.

(10) The depreciation charge relates to the following categories of fixed asset:

	$
Property A used as a restaurant	160,000
Property B used as staff quarters	130,000
Truck used for restaurant business	4,000
Furniture and fixtures	6,000
Total per accounts	300,000

There were no additions to fixed assets in the year 2013.

Other information:

(11) The profits tax return for the year of assessment 2012/13 shows a tax loss of $200,000. The tax written down values of the respective plant and machinery pools and commercial buildings allowance are:

Values brought forward	**Plant and machinery – 20% pool**	**Plant and machinery – 30% pool**	**Commercial building allowance**
$	$	$	$
Qualifying cost	–	–	10,000,000
Written down value	100,000	100,000	5,000,000

(12) Mr Kam is interested in acquiring the business of another restaurant, at a consideration of $1,000,000, comprising trading stock ($300,000); furniture and fixtures ($200,000); and the balance ($500,000) for goodwill. The new restaurant will be run under the same business in the name of 'Kam Kee'. Mr Kam has expressed the view that the allocation of the consideration to the individual assets may be adjusted if this could be advantageous to his tax position.

Required:

As Mr Kam's tax consultant, prepare a report addressing each of the following issues from a Hong Kong tax perspective.

(a) Low interest rate loans to employees

(i) For Kam Kee – the tax principles and rules which are relevant to ascertaining the taxability of the interest income derived from the low interest rate loans extended to employees (Note 1), and the deductibility of any subsequent write-off in the event that a borrowing employee defaults in their loan repayment (Note 4). (5 marks)

(ii) For the individual borrowing employee – the tax principles and rules which are relevant to ascertaining whether the loan interest payment will be deductible to them, and whether the benefit of enjoying a lower interest rate is taxable on them. Briefly comment on whether the salaries tax positions of the employees will be relevant to Kam Kee's profits tax position on the interest income received. (4 marks)

(b) The relevant tax principles and rules leading to the tax treatment of the following specific profit or loss items:

(i) Medical subsidy to staff (Note 4)

- **The profits tax deductibility position for Kam Kee, and the salaries tax assessability position for the employees. Also comment on whether Kam Kee's position will be affected by the employees' salaries tax positions.** (2 marks)
- **Whether, and if so, how the profits tax deductibility position for Kam Kee and the salaries tax assessability position for the employees would be different under the new medical scheme arrangement.** (3 marks)

(ii) Compensation to the staff on leaving (Note 4)

- **The profits tax deductibility position for Kam Kee.** (4 marks)

(iii) Interest paid on the bank mortgage loan to acquire the staff quarters property (Note 8)

- **The profits tax deductibility position for Kam Kee.** (4 marks)

(c) Based on the facts given, prepare a BRIEF computation of Kam Kee's profits tax liability for the year of assessment 2013/14.

Note: Marks will NOT be awarded in this part of the question for the treatment of items which have already been discussed in parts (a) and (b) above. (6 marks)

(d) The Hong Kong tax implications for Kam Kee of the acquisition of the business of another restaurant (Note 12), including advice on whether a re-allocation of the consideration to the individual assets would be advantageous. (3 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 Amy, a resident in Malaysia, has recently accepted a new job offer to work in Hong Kong for H Ltd, under a two-year employment contract. H Ltd carries on business in Hong Kong and has its central management and control exercised in Hong Kong. H Ltd is a subsidiary of M Ltd which carries on business in Malaysia. Both H Ltd and M Ltd are listed on the London Stock Exchange.

During a meeting with the personnel manager of H Ltd, Amy discussed her remuneration package, in particular the following items:

(a) Accommodation arrangement in Hong Kong – H Ltd maintains a few apartments in Hong Kong for use as quarters by its regional staff. As Amy is single, she will be entitled to live in a one-room flat, but will be required to pay a nominal rent of 2% of her monthly salary. Amy is also responsible for paying the property management fee during the months of her stay. Alternatively, H Ltd may pay Amy a fixed sum housing subsidy of up to $20,000 per month. Amy has full discretion on how to use the subsidy without any restriction.

(b) Performance incentive scheme – Under the group's performance incentive scheme, Amy will be entitled to receive an option to acquire 10,000 shares in either M Ltd or H Ltd at a favourable exercise price. Alternatively, she may choose to receive the 10,000 shares in either M Ltd or H Ltd. However, both the option and the shares are subject to a vesting period of two years up to the end of her contract.

(c) Tax equalisation compensation – H Ltd has committed that Amy will not suffer a total tax burden more than she would have done if her employment had remained in Malaysia. If Amy can prove that she is subject to tax in both Hong Kong and Malaysia, and the total tax liabilities exceed the Malaysian tax liability calculated as if Amy's employment had been performed in Malaysia, H Ltd will compensate Amy for the excess tax payment.

Required:

(a) In respect of the proposed accommodation arrangement provided by H Ltd to Amy, explain the following issues:

(i) Whether Amy's Hong Kong salaries tax position would be different if Amy enters into the employment contract with M Ltd as opposed to H Ltd. (1 mark)

(ii) How Amy will be assessed to Hong Kong salaries tax if she lives in the staff quarters. (3 marks)

(iii) Whether, and if so how, Amy's Hong Kong salaries tax position would be different if she chooses to receive the housing subsidy of $20,000 per month. (1 mark)

(iv) Assuming that Amy intends to lease an apartment or a hotel room, suggest a tax efficient planning scheme for Amy such that her salaries tax liability could be minimised without any extra cost being incurred by H Ltd. Also explain the key success factors which make such a scheme acceptable by the IRD. (6 marks)

(b) In respect of the performance incentive scheme:

(i) Explain Amy's Hong Kong salaries tax position for each of the following choices:

(1) she chooses to receive the share option; and

(2) she chooses to receive the shares instead of the option.

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

(Choice 1) 6 marks
(Choice 2) 3 marks

(9 marks)

(ii) Whether it will be more advantageous for Amy to exercise the option or to sell the shares received (whichever is the case), after she returns to Malaysia following the expiry of her Hong Kong employment contract. (3 marks)

(c) In respect of the tax equalisation compensation, explain whether, and if so how, the compensation will be subject to salaries tax in Hong Kong. (2 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

3 (a) Roger, a Hong Kong resident, is considering buying a residential property in Hong Kong for investment purposes. He is currently negotiating for the purchase of a property owned by Landlord Ltd. The property is let at a monthly rent of $60,000. Landlord Ltd pays a management fee of $2,000 per month, and rates of $6,000 per quarter.

Apart from letting the property, Landlord Ltd has no other businesses or assets. Richard, who owns all the shares of Landlord Ltd, has offered:

(1) to sell the property to Roger for $30,000,000; or alternatively,

(2) to sell all the shares in Landlord Ltd to Roger for $20,000,000. In addition, Roger will pay Richard $10,000,000 for an assignment of a shareholder's loan which Richard has made to Landlord Ltd. Two separate documents will be prepared to give effect to the transfer of the shares and the assignment of the shareholder's loan respectively.

In either case, Roger will borrow $24,000,000 from a company carrying on business in China to finance the acquisition of the property, and interest will be paid on this loan at the rate of $60,000 per month.

The property will continue to be held for rental income.

Roger is concerned about the Hong Kong tax implications of the above property investment and has approached you for advice.

Required:

Advise Roger on the Hong Kong tax and stamp duty implications if

(i) he acquires the property in his personal name; or (8 marks)

(ii) he acquires all the shares in Landlord Ltd, together with the shareholder's loan. (9 marks)

(b) Roger decides to acquire all the shares in Landlord Ltd from Richard. Roger subsequently discovers in a meeting with Richard that due to an oversight, the rental income reported by Landlord Ltd for the year of assessment 2008/09 was understated by $10,000.

Required:

Advise Roger on the tax implications of this discovery and the course of action he should take.

Note: You are not required to consider any actions which may be taken by the Inland Revenue Department with regard to penalties. (3 marks)

(20 marks)

4 Mr Ma commenced a proprietorship business in Hong Kong on 1 April 2012, making up accounts to 31 March annually. Although requested to do so by the assessor, he did not lodge any profits tax returns for the years of assessment 2012/13 and 2013/14. As a result of his failure to lodge these profits tax returns, on 1 October 2014 the assessor raised estimated profits tax assessments on him for both years under s.59(3) of the Inland Revenue Ordinance, in the amounts of $300,000 and $500,000 respectively.

During the period 16 September to 5 November 2014, Mr Ma was attending a trade fair in France and was not aware of the estimated assessments until he returned from France. Because the one month objection period (as set out in s.64(1)) had expired, Mr Ma took no further action on this matter.

Mr Ma has now received the following two additional (penalty) tax assessments issued by the Commissioner dated 3 December 2014:

Year of assessment	Additional tax under s.82A	Reasons for assessment
2012/13	$22,500	Failure to comply with the notice to lodge profits
2013/14	$75,000	tax return under s.51(1) issued by the Assessor

These assessments are the first communications Mr Ma says he has received from the Inland Revenue Department concerning any penalty tax.

Mr Ma thinks that he has a legitimate reason for failing to comply with his obligations under s.51(1) due to the fact that finalisation of the accounts was affected because his accountant resigned in May 2014 and he has still not been able to recruit a suitable replacement.

Required:

(a) Advise Mr Ma how an objection against an assessment can be made and whether, in this case, a valid objection can be lodged against the estimated assessments. (4 marks)

(b) Explain the meaning of the term 'reasonable excuse' for the purposes of s.82A. Give specific examples to illustrate your answer. (5 marks)

(c) Advise Mr Ma whether it is possible to challenge the additional tax assessments. (11 marks)

(20 marks)

5 Success Ltd (SL) has been trading in Hong Kong since 1970, making up its accounts to 31 December each year. In recent years, its sales revenue and profits have increased rapidly. SL now realises that its peak season has changed to the months of November, December and January, causing much inconvenience in its accounting closing. SL has now decided to close its next accounts on 31 March 2014. Its previous set of accounts were closed on 31 December 2012.

The following figures have been agreed by the Assessor and SL:

Period	**Adjusted profits (before depreciation allowance)**
	$
Year ended 31 December 2012	1,700,000
1 January 2013 to 31 March 2014	2,400,000

The written-down values of SL's business assets as at 31 December 2011 were:

	$
20% pool	88,000
30% pool	161,000

The additions of assets subject to depreciation allowance in the period 1 January 2012 to 31 March 2014 were:

Date	**Pool**	**Additions**
		$
10 January 2012	30%	40,000
15 January 2013	20%	30,000
1 February 2014	30%	20,000

There were no disposals of assets in this period.

Required:

(a) State the general principles to be adopted in ascertaining the basis period for cases involving a change of accounting date. (3 marks)

(b) Advise on the position which will be taken by the Inland Revenue Department when assessing Success Ltd and compute the company's assessable profits for each of the affected years of assessment. (12 marks)

(c) Explain how your answer in (b) would change if the reason for Success Ltd changing its accounting date was because of the large profits it expected in the year ended 31 December 2013 (not because of a change in its business peak season).

Note: You are not required to recompute the assessable profits for the affected years of assessment.

(5 marks)

(20 marks)

End of Question Paper