Professional Level – Options Module

Advanced Taxation (Hong Kong)

Friday 5 June 2015

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 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%

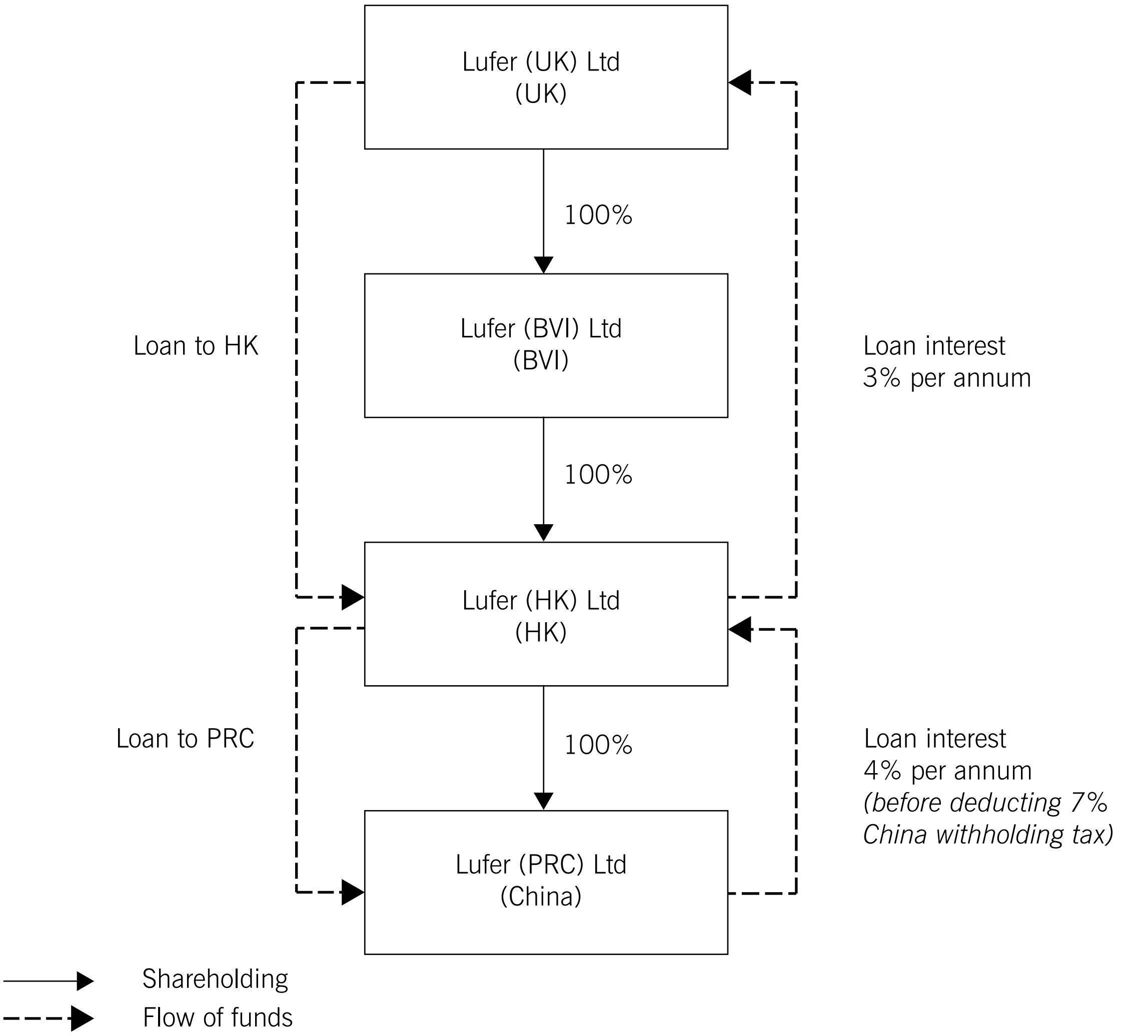
Conveyances chargeable with special stamp duty	
Holding period	
Not exceeding six months	15% or 20% as applicable
Between six and 12 months	10% or 15% as applicable
Between 12 and 24/36 months	5% or 10% as applicable
Conveyances chargeable with buyer's stamp duty	15%

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 Lufer (HK) Ltd (Lufer-HK) carries on a business in Hong Kong as a wholesaler of smart phone accessories. Lufer-HK's major customers are leading retailers in Hong Kong. Lufer-HK procures its products from Lufer (PRC) Ltd (Lufer-China) which is a wholly-owned foreign enterprise established in Mainland China as a subsidiary of Lufer-HK. Lufer-China operates as a manufacturer and is the sole supplier of products to Lufer-HK. Other than Lufer-HK, Lufer-China also supplies related products to other China customers under different specifications.

Lufer-HK is held by Lufer (UK) Ltd through a company incorporated in the British Virgin Islands (BVI), Lufer (BVI) Ltd. The group structure is as follows:



Lufer-HK has signed an import processing contract with Lufer-China, under which the following have been arranged:

(1) Lufer-HK agrees to provide support to Lufer-China for the manufacture of the required products, in terms of product design, technical know-how, training and quality control. Special machinery together with moulds will also be provided for use by Lufer-China for manufacturing the products solely for sale by Lufer-HK. If Lufer-HK is required to send technical staff to support Lufer-China, a service fee will be charged to Lufer-China on a cost-plus-10% basis. However, no charge will be made to Lufer-China for the use of the machinery and moulds.

(2) Lufer-China agrees to be responsible for the provision of workers and a factory including utilities and facilities for the manufacture of the required products. In order to finance the renovation of the factory, Lufer-China received a loan from Lufer-HK at an interest rate of 4% per annum.

(3) Lufer-China will acquire raw materials from Lufer-HK at cost, and sell the finished products to Lufer-HK based on the selling price of similar products in the China market.

In the accounts of Lufer-HK, an interest cost of 3% per annum is recorded as payable to Lufer-UK in respect of a borrowing obtained to finance the loan to Lufer-China. The interest income receivable from Lufer-China at 4% per annum is also recorded as income by Lufer-HK. On the remittance of the interest from China to Hong Kong, China withholding tax at the rate of 7% is deducted by Lufer-China and recorded as an expense in the accounts of Lufer-HK.

Required:

As the tax consultant engaged by Lufer-HK, prepare a report for the company's directors, addressing each of the following issues from a Hong Kong tax perspective.

(a) Profits earned from the sale of smart phone accessories:

(i) Whether the profits earned from the sale of smart phone accessories by Lufer (HK) Ltd to retailers in Hong Kong should be subject to, or exempt from, profits tax. Include an explanation of the general principles for determining the source of manufacturing profits and trading profits in Hong Kong, based on the Departmental Interpretation and Practice Note No. 21 entitled 'Locality of Profits' and other relevant court cases. (14 marks)

(ii) Whether Lufer (HK) Ltd is entitled to any deduction (including depreciation allowance) in respect of the cost of the special machinery and moulds provided to Lufer (PRC) Ltd for use in China. (8 marks)

(b) Funding of the loan made to Lufer (PRC) Ltd:

(i) The profits tax treatment of the 1% margin earned by Lufer (HK) Ltd on the borrowing obtained from Lufer (UK) Ltd at 3% per annum, and the loan extended to Lufer (PRC) Ltd at 4% per annum. Include an explanation of the taxability of the interest income received from Lufer (PRC) Ltd, and the deductibility of the interest expense to Lufer (UK) Ltd and comment on whether the loan arrangement is tax effective. (7 marks)

(ii) Whether the China withholding tax on the interest income earned from Lufer (PRC) Ltd is tax deductible to Lufer (HK) Ltd for Hong Kong profits tax purposes. (2 marks)

Note: You are NOT required to discuss the Arrangement between the Mainland of China and HKSAR for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income.

Professional marks will be awarded in question 1 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 John and Mary are married to each other and are permanent residents of Hong Kong. Each of them currently has full-time employment working for organisations in Hong Kong. Last year, Mary's father passed away, leaving her a boutique business. Also, Mary is pregnant and expecting twin babies in two months' time. John and Mary recently met with a local tax consultant to discuss their future Hong Kong tax positions. A summary of the major points discussed during the meeting is as follows:

(1) Based on the information from her late father's lawyer, the boutique business is currently held through a company incorporated in the British Virgin Islands (BVI). The BVI company is cash-rich without any debt or liability, and does not own any asset other than the boutique business. The boutique is operated at a leased retail shop located in Hong Kong. Mary has been given a choice by the lawyer either to take over the shares in the BVI company or to own the boutique business directly. It is Mary's intention to continue to run the boutique by herself.

(2) Mary has been invited by her brother to participate in an established partnership business following the recent retirement of one of the partners. Mary expects that in addition to her share of profits, she will draw a monthly salary from the partnership. If this is not tax effective, the partnership may engage John as an employee and pay the salary to him instead. On the other hand, Mary's sister has recently graduated and is interested in being engaged as an employee of the partnership.

(3) John has recently signed a new employment contract with an organisation based in Mainland China (China Co). This new employment will commence in three weeks' time. Under the new employment contract, John will be responsible for looking after both China Co's Shenzhen factory and its Hong Kong operations, and thus is expected to travel extensively between China and Hong Kong. The tentative schedule shows that John will stay in Hong Kong for about eight months each year and spend the remaining four months in China. John negotiated his new employment terms during visits to China Co's premises in China, and he also signed the contract there. The major items in the remuneration package include:

(i) A monthly salary of $100,000 (the take-home amount payable to John is $90,000 after withholding 10% for China's individual income tax).

(ii) A lump sum incentive of $80,000 to encourage John to resign from his current employment.

(iii) A housing allowance of $30,000 to compensate for John's mortgage loan repayment for his residence in Hong Kong.

(iv) Reimbursement of any additional China tax liability arising from his employment after adjusting for the 10% amount withheld from the monthly salary.

(v) A holiday package (flight tickets plus hotel) for John's family up to a maximum of $60,000 per annum.

(4) The couple's existing apartment is too small to accommodate themselves and the two babies, and the couple are planning to move into the residence currently owned and occupied by John's parents. John's parents will then move into the couple's existing apartment. The couple jointly owns their current apartment and will continue to pay their mortgage loan instalments after the swap. The residence owned by John's parents is free from any mortgage. John intends to pay a nominal rental to his parents each month for the use of their residence.

(5) The couple are financially independent. Each spouse files their individual tax return each year and pays their salaries tax according to the assessment issued in their own name. Their tax positions in the previous years have been simple and straightforward with their respective employment income as the only item in their tax calculations. After the birth of the twins, each spouse intends to claim one child allowance for Hong Kong tax purposes.

Required:

(a) **Discuss the implications for Mary's Hong Kong tax position in respect of the potential income earned (or losses incurred) by the boutique business in the event that Mary takes over the shares in the BVI company as compared to the alternative that Mary takes over the boutique business directly. You should also address the potential differences in the implications, if any, depending on whether or not Mary elects for personal assessment.** (5 marks)

(b) **Explain how a partnership is assessed for Hong Kong tax purposes, and the Hong Kong tax implications for Mary in respect of the partnership profit or loss shared by her and the salary drawn from the partnership. You should also discuss whether it will make any difference to the tax treatment of the partnership and/or the partners if the salary is received by John or Mary's sister rather than by Mary.** (4 marks)

(c) **Explain whether John is assessable to Hong Kong salaries tax in respect of the income from his new employment, and if so, state on what basis and explain the Hong Kong tax treatment of the major remuneration items specified in the question.**

Note: You are NOT required to discuss the Arrangement between the Mainland of China and HKSAR for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income.
(9 marks)

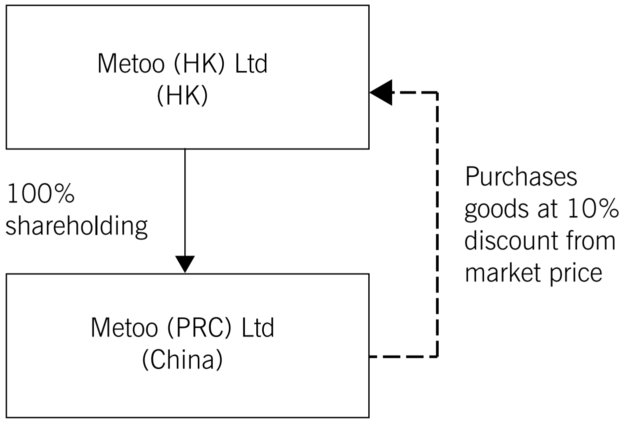
(d) **Analyse the major impact on the couple's Hong Kong tax position arising from the proposed swap of residences between themselves and John's parents. State any assumptions which you deem necessary.**
(3 marks)

(e) **Comment on the proposed action intended to be taken by the couple with regard to their claiming the child allowance in respect of the twins, and advise on the amount of allowance for which they will be eligible.**
(4 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

3 Metoo (HK) Ltd (Metoo-HK) carries on business in Hong Kong as a trader. Metoo-HK purchases its products from its wholly-owned subsidiary in Mainland China, Metoo (PRC) Ltd (Metoo-China), as follows:



Metoo-HK provides management support to Metoo-China and is responsible for promoting the products in Asian markets including Hong Kong. In recognition of Metoo-HK's contribution, Metoo-China grants a 10% discount from the market selling price in respect of the products it sells to Metoo-HK. Metoo-HK files its profits tax returns in Hong Kong reporting all of its profits as assessable in Hong Kong.

During the year ended 31 December 2013, Metoo-China was investigated by the China tax bureau, as a result of which a transfer pricing adjustment was made to adjust the sales made from Metoo-China to Metoo-HK based on the market selling price. The sales income reported in the 2013 accounts of Metoo-China was $900,000. This amount was adjusted to $1,000,000 by the China tax bureau by removing the discount element, which it considered was not at arm's length. Metoo-China was required to pay additional China corporate income tax of $25,000 as a consequence of this adjustment.

The management of Metoo-HK considers that the price adjustment in China is not fair to Metoo-HK and wants to know whether it is possible to revise its Hong Kong profits tax assessment for the year of assessment 2013/14.

Required:

(a) **Based on the facts as stated and making reference to the Arrangement between the Mainland of China and HKSAR for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (the DTA), explain the relationship between Metoo (HK) Ltd and Metoo (PRC) Ltd, and analyse the impact on the whole Metoo group arising from the pricing adjustment made by the China tax bureau to Metoo (PRC) Ltd.** (4 marks)

(b) **Explain the relevant Hong Kong tax law governing the circumstances in which a taxpayer is given the right to revise its tax assessment, and give an opinion as to whether Metoo (HK) Ltd can make a successful revision claim.** (4 marks)

(c) (i) **Making reference to the Departmental Interpretation and Practice Note No. 45 'Relief from double taxation due to transfer pricing or profit reallocation adjustments' and the DTA, explain the different types of double taxation in the context of the DTA, and identify the type of double taxation to which the pricing adjustment made by the China tax bureau belongs.** (7 marks)

(ii) **Advise whether, and if so how, in terms of the DTA, Metoo (HK) Ltd may be able to apply for its Hong Kong profits tax assessment for 2013/14 to be revised.** (5 marks)

(20 marks)

4 Happy Club (the Club) operates as a recreational club in Hong Kong. The Club owns a clubhouse which provides basic catering and spa services to its members. All members are voting members, and all club facilities are restricted to members' use only.

During the year ended 31 March 2015, the Club had the following receipts and payments:

	$
Entrance fees (one-off)	215,000
Subscriptions (annual)	100,000
Catering and bar receipts	150,000
Spa facilities	35,000
Staff costs	(300,000)
Building maintenance	(180,000)
General administration	(120,000)
Deficit	(100,000)

In view of the unfavourable financial position of the Club, the Club's management has made the following proposals:

(1) The catering services will be opened to non-members during lunch and dinner hours.

(2) The Club will acquire the car park adjacent to the clubhouse and lease it out for rental purposes. The acquisition will be financed by a loan from the Club's founders. It is intended that the car park will be used by both Club members and the public.

Required:

(a) Explain the current Hong Kong tax position of Happy Club based on the information given for the year ended 31 March 2015.

Note: Calculations are not required. (3 marks)

(b) Discuss the implications for and potential changes to Happy Club's Hong Kong tax position if both of the proposals are implemented.

Note: Calculations are not required. (10 marks)

(c) Explain the stamp duty implication, if any, to Happy Club arising from proposal 2. (7 marks)

(20 marks)

5 **(a)** Joyce Ltd owns a commercial property (shop) in a major shopping mall. The market rent of the shop is $200,000 per month. On 1 January 2014, Joyce Ltd agreed to lease the shop to Fun Ltd for three years. The lease provides that Fun Ltd will pay to Joyce Ltd $100,000 per month plus 2% of Fun Ltd's gross turnover each month from the business conducted in the shop. In addition, Fun Ltd agreed to pay Joyce Ltd a lump sum of $2,400,000 at the commencement of the lease in consideration for Joyce Ltd agreeing to accept a lower rent. The lump sum is not refundable.

In preparing its financial statements for the year ended 31 December 2014, Joyce Ltd apportioned the upfront payment of $2,400,000 over the term of the lease, and brought only $800,000 into its statement of profit or loss. However, the Inland Revenue Department (IRD) assessed Joyce Ltd on the full upfront payment of $2,400,000 in the year of assessment 2014/15. Joyce Ltd disputes the decision of the IRD.

Required:

(i) Explain the profits tax and stamp duty implications of the lease arrangements for Joyce Ltd. (9 marks)

(ii) State, giving reasons, whether and if so, how your answer to part (a) above would differ if the lease also provided that under no circumstances would the rent payable each month exceed $200,000. (2 marks)

(b) Assuming that Joyce Ltd's tax dispute with the IRD proceeds to litigation, list the advantages of having the case heard before the Board of Review, rather than in the Court of First Instance. (4 marks)

(c) Instead of leasing the property to Fun Ltd for three years, Joyce Ltd decided to grant a licence to Fun Ltd to occupy the premises for ten years. In consideration, Fun Ltd paid Joyce Ltd a lump sum of $20 million. This receipt was recorded in Joyce Ltd's statement of profit or loss as arising from the 'disposal of a fixed asset'.

Required:

Discuss the tax treatment of the $20 million received by Joyce Ltd from Fun Ltd. (5 marks)

(20 marks)

End of Question Paper