Professional Level – Options Module

Advanced Taxation (Hong Kong)

Friday 15 June 2012

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 2011/12 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	108,000
Married person's allowance	216,000
Single parent allowance	108,000
Child allowance – 1st to 9th child (each)	60,000
– additional allowance in the year of birth (each)	60,000
Dependent parent/grandparent allowance – basic	18,000/36,000
– additional	18,000/36,000
Dependent brother/sister allowance	30,000
Disabled dependant allowance	60,000

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)

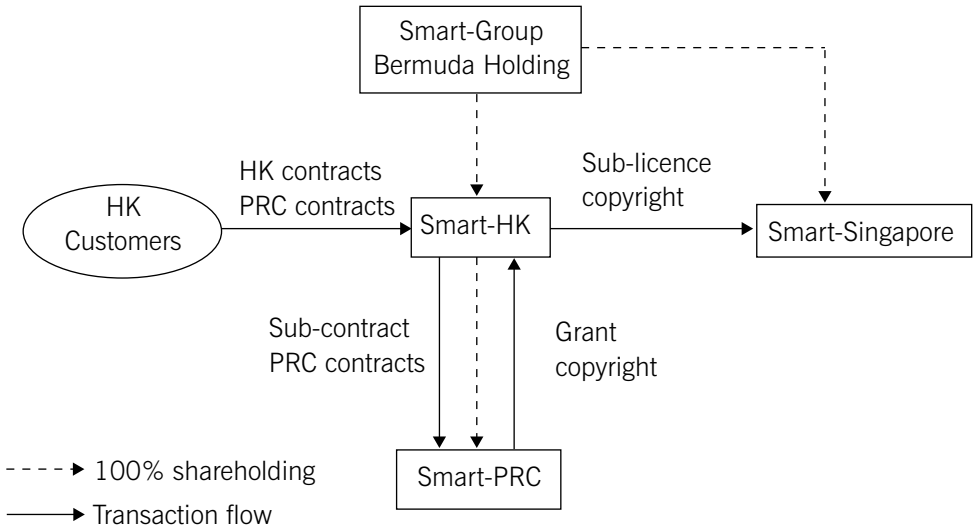
Section A – BOTH questions are compulsory and MUST be attempted

1 Smart HK Ltd ('Smart-HK') is a company incorporated and carrying on business in Hong Kong as a professional training service provider. Smart-HK has a subsidiary in the PRC ('Smart–PRC') and is ultimately owned by a Bermuda company which also owns a subsidiary in Singapore ('Smart-Singapore'). The four companies are collectively known as the 'Smart-Group'.

Recently, the shareholders of the Smart-Group decided to divest the whole group to Acquirer Group ('A-Group'). A full-scale due diligence exercise is to be carried out by the A-Group.

You are the person in-charge of the tax due diligence review of Smart-HK, with the aim to assess the Hong Kong tax position of the company and whether there is any potential tax risk leading to unexpected additional tax liabilities after its acquisition by the A-Group. To facilitate the review, you are provided with the following information:

A simplified chart of the Smart-Group indicating the shareholdings and major transaction flows:



An extract of Smart-HK's management accounts for the preceding year, indicating the Hong Kong tax treatment of each item:

	$000	$000	Treatment in HK tax return
Training fee revenue – HK contracts	300		Taxable
Less: Royalty to Smart-PRC	(9)	291	
Training fee revenue – PRC contracts	1,000		
Less: Sub-contract fee to Smart-PRC	(800)	200	Offshore and non-taxable
Royalty from Smart-Singapore	100		
Less: Royalty to Smart-PRC	(30)	70	Offshore and non-taxable
Dividend from Smart-PRC		220	Offshore and non-taxable
Major income		781	
Staff cost – trainers	(400)		Deductible
Staff cost – support staff	(90)		Deductible
Staff cost – senior management	(210)		Deductible
Other operating expenses	(11)	(711)	Deductible
Net profit		70	

Additional information about Smart-HK's operations:

(1) Smart-HK provides training services to its customers in Hong Kong and the PRC, depending on customers' needs. Separate contracts are signed for training in Hong Kong ('HK Contracts') and the PRC ('PRC Contracts'). Smart-HK sub-contracts all its obligations under the PRC Contracts to Smart-PRC which agrees to fulfil the contract obligations on behalf of Smart-HK and run the training sessions in the PRC for the customers. The

sub-contract fee payable to Smart-PRC is agreed at 80% of the gross service fee under the PRC Contracts. For each training session, experienced trainers are sent from Smart-HK to assist Smart-PRC, but no cost is charged for this by Smart-HK. Other support provided in Hong Kong for the PRC Contracts include liaison with customers, arranging itinerary etc. None of the customers are related to the Smart-Group, and all the service contracts (both HK and PRC Contracts) are negotiated and signed in Hong Kong.

(2) Smart-PRC is responsible for preparing the relevant training materials for use in the training sessions. It has been agreed that the copyright for these materials will remain with Smart-PRC. By virtue of the licence agreement between Smart-PRC and Smart-HK, Smart-HK is granted the right to use the training materials in Hong Kong and Singapore. The royalty payable is based on 3% of the training revenue received. Smart-HK has entered into a sub-licence agreement with Smart-Singapore under which Smart-Singapore is allowed to use the training materials for a royalty at 10% of the training revenue received.

(3) Smart-PRC is the wholly-owned subsidiary of Smart-HK. Each year, Smart-HK has recorded a considerable amount of dividend income from Smart-PRC. Based on the management representation, Smart-PRC has been making a very good return from its investment activities in the PRC, and these investments are mainly funded by the large amount of cash received from Smart-HK by way of sub-contract fees.

Required:

As the tax advisor of Acquirer Group in charge of the tax due diligence review, prepare a report for the directors of Acquirer Group, addressing the Hong Kong tax issues set out below relating to Smart-HK, including supporting calculations where appropriate.

(i) The Hong Kong profits tax implications of the training fee revenue from the PRC Contracts and the sub-contract fee payable to Smart-PRC. Your report should cover the contemporary principles/rules determining the taxability of the net income of $200,000 from the PRC training service, the arguments both for and against the offshore claim made by Smart-HK, the role played by Smart-PRC and whether you agree with the current profits tax treatments by Smart-HK;

Note: For the purpose of this part only, you should assume that all amounts are charged on an arm's length basis. (14 marks)

(ii) Assuming that the training fees from the PRC Contracts are taxable in Hong Kong, the Hong Kong profits tax implications, if any, to Smart-HK of the sub-contract fee paid to Smart-PRC, taking into account the current transfer pricing rules and practices in Hong Kong. Your report should cover the current views of the Inland Revenue Department on charges made between associated enterprises, as set out in Departmental Interpretation and Practice Note (DIPN) 46 'Transfer pricing guidelines – Methodologies and related issues';

Note: You are NOT required to make detailed references to the Double Taxation Arrangement between Hong Kong and the PRC. (10 marks)

(iii) Assuming that Smart-PRC is not carrying on business in Hong Kong, the Hong Kong profits tax implications to Smart-PRC in respect of the royalty received and the Hong Kong tax compliance obligations of Smart-HK in this context; (6 marks)

(iv) Other than the potential technical risks as discussed above, any other information that you would request from Smart-HK in order for you to assess its level of tax compliance in the context of the Hong Kong tax regime, giving brief explanations as to why the information is required. (6 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 its advice is communicated. (4 marks)

(40 marks)

2 Mr Chan, a Malaysian, has been working in Hong Kong for World Ltd, a company resident in Hong Kong (the 'Company') since 1 April 2004, at a monthly salary of $80,000. Due to a failure in an important business project, Mr Chan was asked to resign and he submitted his resignation letter to the Company's director on 31 March 2012, notifying that he would terminate his employment with effect from 1 April 2012. However, his official last day of work in the Company would be 29 March 2012, after deducting two days of entitled annual leave.

Other details of Mr Chan's termination arrangement and payment are as follows:

(I) His total termination payment represented the following:

- (i) his final salary accrued up to 31 March 2012;
- (ii) compensation for the remaining balance of his entitled annual leave days as at 31 March 2012 of 15 days, of $40,000;
- (iii) compensation for loss of office as agreed with the Company's director, representing one month of his salary. It has been the practice of the Company to pay an annual discretionary bonus equivalent to one month's salary;
- (iv) his entitlement payment from the Company's provident fund registered under the Occupational Retirement Scheme Ordinance in the amount of $300,000 (Mr Chan and the Company had contributed equal amounts to the provident fund). The accrued benefit attributable to Mr Chan's service was $120,000; and
- (v) compensation for the loss incurred by him from having to sell his car in Hong Kong as a result of his termination of $10,000.

(II) The Company's director agreed to pay Mr Chan an extra sum of compensation of $200,000 after six months from the date of his termination on the condition that he did not work for the Company's competitors during this period.

Mr Chan is planning to move back to Malaysia. Before he goes back, he is interested in investing in residential properties in Hong Kong. With various ideas in mind, he has approached you for advice on how to plan his investment in a tax effective manner. His plans and ideas are:

(1) He will acquire one or two residential units in Tsimshatsui and lease them out for rental.

(2) The acquisitions will be financed partly by his personal savings (around 50%) and partly by bank mortgage loans. It is expected that the rental income will not be sufficient to cover the mortgage interest.

(3) The residential units need to be renovated before they can be leased out. A substantial amount of renovation costs is expected to be incurred after the acquisition.

(4) In two to five years' time, he may consider disposing of the units if property prices go up to a satisfactory level.

(5) He has no idea as to how the properties should be owned, by an individual or by a special purpose company. However, for the former, he prefers to have the properties owned by his daughter who is single, has always been living in the UK and has no connection with Hong Kong. He believes that this will lead to a tax-free position in respect of the rental received. Alternatively, he is considering setting up a company in an offshore tax haven to hold the properties so that Hong Kong tax can be avoided; with minimal local tax payable in the tax haven country.

Required:

(a) Advise Mr Chan of the general principles used for determining the taxability of each item of the termination payment received upon his cessation of employment.

Note: You are NOT required to calculate his assessable/chargeable income or tax payable. (14 marks)

(b) Compare the tax implications for the rental income received from the residential units if the properties are held by:

(i) an individual; and (3 marks)

(ii) a special purpose company. (4 marks)

(c) Comment on the extent to which the tax planning ideas as described in note 5 above are feasible. (3 marks)

(d) Explain the tax implications arising from the disposal of the residential units in two to five years' time, including how these may be affected by the different ownership structures. (6 marks)

(30 marks)

Section B – TWO questions ONLY to be attempted

3 Mr Hui is working as the Regional IT Manager for GA Ltd ('GAL'), a company incorporated and carrying on general insurance business in Hong Kong. As of 31 August 2012, Mr Hui will have reached the retirement age. He has been requested by his boss to extend his employment services for another two years, but with the following proposed changes in his appointment terms:

(1) The employment contract between Mr Hui and GAL will be terminated with effect from 1 September 2012.

(2) Mr Hui will set up a consulting company which will enter into a service agreement with GAL. Under the service agreement, the consulting company is obliged to provide IT related services to GAL and Mr Hui is designated as the individual to provide the required services.

(3) In return for the services provided by Mr Hui, GAL will pay a monthly fee to the consulting company in an amount equivalent to the monthly salary that Mr Hui currently receives. The payment will be made by direct bank transfer into the consulting company's bank account. Moreover, a profit-sharing bonus will be payable to the consulting company on an annual basis, calculated based on the performance of GAL's business for that year.

(4) Under the same service agreement, Mr Hui will be provided with an office together with secretarial and administrative support by GAL. However, he will not be allowed to take vacation for more than 30 days in a year.

(5) During the period of providing services to GAL, Mr Hui will continue to hold the title of Regional IT Manager, and will remain under the instruction and supervision of GAL's Group IT Director, Mr Hui's current boss.

(6) The service agreement also explicitly mentions that GAL does not act as the employer of Mr Hui and thus is not obliged to comply with any necessary employment regulations and reporting obligations. Mr Hui will undertake to enter into a separate employment contract with his consulting company so as to enable him to provide the required services to GAL. However, GAL will not be involved in, or responsible for, the arrangement between Mr Hui and his consulting company.

Required:

(a) Explain the criteria that the Inland Revenue Department will use to determine whether the proposed changes to Mr Hui's appointment terms will be acceptable as a contract for consultancy services rather than of employment. Clearly identify the extent to which the terms specified in items (1) to (6) do/do not support the contention that GA Ltd no longer acts as Mr Hui's employer. (11 marks)

(b) Assuming that the Inland Revenue Department considers that Mr Hui remains an employee of GA Ltd after 1 September 2012, advise on the tax implications, if any, including any compliance obligations imposed under the Inland Revenue Ordinance for Mr Hui, his consulting company and GA Ltd. (4 marks)

(15 marks)

4 Compass Ltd and David Lo have been in a partnership, carrying on business as a manufacturer of computer games in Hong Kong for many years. For the year ended 31 March 2012 the partnership's income statement contained the following particulars:

	$
Sales	15,000,000
Cost of sales	(10,500,000)
Gross profit	4,500,000
Other income	
Dividends	120,000
Interest income	20,000
Compensation for cancellation of a sales contract	600,000
	5,240,000
Expenses	
Salaries	(2,100,000)
Contributions to mandatory provident fund scheme	(240,000)
Repairs and alterations	(375,000)
Interest expenses	(480,000)
Rent and rates	(420,000)
Legal and professional fees	(45,000)
Research and development	(110,000)
Patent expenses	(135,000)
Sundry expenses	(180,000)
Depreciation	(385,000)
Property tax	(36,000)
Net profit	734,000

Required:

State, with reasons, the additional information that you would require in order to determine the profits tax payable by the partnership business for the year of assessment 2011/12.

(15 marks)

5 **(a)** Take Care Insurance Ltd ('TCIL') commenced its life insurance business in Hong Kong on 1 October 2010. TCIL makes up accounts to 31 March each year and has submitted an actuarial report for the period from 1 October 2010 to 31 March 2012. The following information has been extracted from its accounts and the actuarial report:

Income statement for the period from 1 October 2010 to 31 March 2012

		$	$
Gross premiums received			27,000,000
Re-insurance recoveries received			660,000
Profit from investments			150,000
Profit on disposal of non-current assets			60,000
			27,870,000
Less:	Re-insurance premiums paid	3,000,000	
	Commissions paid	7,320,000	
	Claims paid and payable	2,220,000	
	Management expenses	8,200,000	
	Increase in provision for unexpired risk	4,350,000	
	Allowance for doubtful debts	750,000	
	Depreciation	1,000,000	(26,840,000)
Net profit			1,030,000

Actuarial report for the period from 1 October 2010 to 31 March 2012

			$
1.	Value of life fund at 31 March 2012		19,510,000
	The life fund includes the following items relating to the period 1 October 2010 to 31 March 2012:		
	Additions	– profit on investments comprising the life fund	150,000
		– profit on disposal of non-current assets	60,000
		– transfer from contingency reserve	1,200,000
	Deductions	– transfer to contingency reserve	2,000,000
		– allowance for doubtful debts	750,000
		– commissions paid	7,320,000
2.	Actuarial liabilities on policies comprising the life fund at 31 March 2012		10,200,000
3.	Management expenses:		
	Period from 1 October 2010 to 31 March 2011		2,700,000
	Period from 1 April 2011 to 31 March 2012		5,500,000

Other information:

(i) All insurance contracts were executed in Hong Kong.

(ii) Depreciation allowances have been agreed by the Assessor as follows:

– 1 October 2010 to 31 March 2011	$660,000
– 1 April 2011 to 31 March 2012	$720,000

(iii) Premiums received and receivable (after deduction of re-insurance premiums):

– 1 October 2010 to 31 March 2011	$8,000,000
– 1 April 2011 to 31 March 2012	$16,000,000

The director of TCIL understands that there are two alternative methods for ascertaining the company's assessable profits under the Inland Revenue Ordinance:

(1) the 'per cent premium' method (under s.23(1)(a)); and
(2) the 'adjusted surplus' method (under s.23(1)(b)).

The director has approached you for advice on the two methods.

Required:

(i) Compute the assessable profits of Take Care Insurance Ltd for the years of assessment 2010/11 and 2011/12 under each of the two alternative methods, clearly identifying the basis period; (7 marks)

(ii) Advise Take Care Insurance Ltd, from a tax perspective, on the factors to be considered in choosing between the two methods. (4 marks)

(b) On 1 June 2012, Ms Yan purchased shares in a Hong Kong private company from her relative in Singapore. The contract for the purchase and sale of the shares was executed in Singapore. Neither the contract nor the transfer has yet been submitted to the Stamp Duty Office for stamping.

Required:

Explain Ms Yan's obligations under the Stamp Duty Ordinance, clearly identifying the instruments, if any, that have to be stamped, and if so, how, when and by whom. (4 marks)

(15 marks)

End of Question Paper