

Professional Pilot Paper – Options module

# Advanced Taxation (Hong Kong)

**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

Rates of tax and tables are printed on page 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 (HKKG)

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black square.

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The question paper begins on page 3

The following tax rates and allowances are to be used in answering the questions.

	2006/07
<b>Profits tax rates</b>	
Companies	17.5%
Unincorporated business	16%
<b>Salaries tax rates</b>	
First \$30,000	2%
Next \$30,000	7%
Next \$30,000	13%
On the remainder	19%
Standard rate	16%
<b>Allowances</b>	
	\$
Basic allowance	100,000
Married person's allowance	200,000
Single parent allowance	100,000
Child allowance – 1st to 9th child (each)	40,000
Dependent parent/grandparent allowance – basic	15,000/30,000
– additional	15,000/30,000
Dependent brother/sister allowance	30,000
Disabled dependant allowance	60,000
<b>Depreciation allowance rates</b>	
Initial allowance:	
Plant and machinery	60%
Industrial building	20%
Annual allowance:	
Computers	30%
Motor cars	30%
Furniture and fixtures	20%
Industrial buildings	4% or formula
Commercial buildings (from 1998/99 onwards)	4% or formula
(from 1990/91 to 1997/98)	2%
<b>Stamp duty rates</b>	
Stock transfers	0.2% + \$5
Conveyances (ignoring marginal reliefs)	
Not exceeding \$1,000,000	Nil
Not exceeding \$2,000,000	0.75%
Not exceeding \$3,000,000	1.5%
Not exceeding \$4,000,000	2.25%
Not exceeding \$6,000,000	3%
Exceeding \$6,000,000	3.75%
Leases	
(a) Premium only	Same as conveyances
(b) Rent only (as percentage of average yearly rent)	
Undefined term	0.25%
Not exceeding 1 year	0.25%
Not exceeding 3 years	0.5%
Exceeding 3 years	1%
(c) Premium and rent	
Premium	Same as conveyances
Rent	Same as (b) above

**Section A: BOTH questions are compulsory and MUST be attempted**

1 Target Co Ltd (Target) was incorporated in Hong Kong in July 1990, with principal activities of printing and typesetting under the trademark of “Princess” and of selling and distributing books acquired from international publishers.

Target’s shareholders have been approached by a potential purchaser (the purchaser) which is interested in buying all the shares of the company, and thus, indirectly, those in Target’s wholly owned subsidiary in the British Virgin Island (the offshore subsidiary).

Target has owned a commercial building complex in Aberdeen since April 1990 and is earning rental income from its lease. The building was acquired from a property developer at a net price of \$20 million (land value excluded), and the cost of construction was \$12 million. Since the year of assessment 1990/91, Target has claimed commercial building allowance in each of its profits tax returns at the prevailing rate on \$20 million. The market value of the building complex as at today’s date is estimated to be \$65 million.

Target’s tax records show that it has filed all its prior years’ tax returns, and that these reflect the following tax losses:

1999/2000	– \$30,000 loss
2000/01	– \$50,000 loss
2001/02	– \$15,000 loss
2002/03	– \$55,000 loss
2003/04	– \$200,000 loss
2004/05	– \$33,000 loss
2005/06	– \$10,000 loss

Since 1996/97, the company has made an offshore claim to exclude from Hong Kong tax the income arising from its printing activities in Shenzhen. In 1996/97, Target had appointed a salesman in Shenzhen, who was responsible for promoting and accepting orders from Mainland customers. It has taken Target more than one year to convince the Inland Revenue Department to agree the offshore claim. In July 2005, the salesman left the company and since then, all the orders have been handled by Target’s Hong Kong sales team.

Target’s draft profit and loss account for the year ended 31 March 2007 is as follows:

	\$	\$
Book sales	300,000	
Printing income – HK orders	50,000	
– Mainland orders	80,000	
Lease rental	800,000	1,230,000
Less: Selling expenses	300,000	
Administration expenses	60,000	
Depreciation	530,000	
Auditing and tax filing fees	60,000	
Royalty	80,000	1,030,000
Profit for the year		200,000

The royalty of \$80,000 was paid to the offshore subsidiary which currently owns the trademark “Princess”. The trademark used to be owned and used by Target prior to the year 2000, when it was sold to the offshore subsidiary for \$1. The royalty is fixed each year and Hong Kong profits tax in an amount equal to 5.25% of the royalty has been withheld by Target and paid to the Inland Revenue Department.

An extract of Target’s depreciation allowance schedule from its 2005/06 profits tax return is as follows:

	10%	20%	30%
Plant and machinery:			
– WDV carried forward	\$8,000	\$25,000	\$30,000
Commercial building:			
– Qualifying cost for allowance:	\$20 million		
– Allowance rate		4%	

There were no fixed asset movements during the year ended 31 March 2007.

**Required:**

Prepare a memorandum report for the management of the purchaser concerning the acquisition of Target Co Ltd. The report should address the issues set out below, and should, where appropriate, include supporting calculations.

**(a) The company's tax position for the year of assessment 2006/07**

- (i) Provide a computation of the Hong Kong profits tax payable by Target Co Ltd in respect of the year of assessment 2006/07, showing the tax position before any loss set-off. You should take a conservative approach to any issues that are potentially at risk and provide explanations of all appropriate and reasonable assumptions you have made. (7 marks)**
- (ii) Comment on the correctness of the tax losses available for set-off in 2006/07 and carry forward to future years. If prior years' tax losses are to vary, advise on the possible actions that can be taken by the Inland Revenue Department. (8 marks)**

**(b) The tax liability accrued on the royalty payment**

**Provide an explanation of any Hong Kong profits tax liability of the offshore subsidiary, which is the owner of the trademark in respect of the royalty received from Target Co Ltd. (6 marks)**

**(c) The tax liability accrued on the printing income from the Mainland customers**

**Advise on the Hong Kong tax implications of the printing income received from the Mainland customers; and comment on how the tax positions of the printing income may impact on the Hong Kong tax implications of the royalty payment. (9 marks)**

**(d) Tax indemnity deed**

**Provide a list of any other issues that require the attention of the purchaser in order to help him negotiate the terms of the tax indemnity deed to be included as part of the sale and purchase agreement. Clearly identify any areas where further information or investigation is required. (5 marks)**

**Appropriateness of the format and presentation of the report and the effectiveness with which its advice is communicated. (2 marks)**

You should ignore Hong Kong provisional tax and overseas tax. You may assume that the tax rates and allowances for the financial year to 31 March 2007 and for the assessment year 2006/07 will continue to apply for the foreseeable future.

**(37 marks)**

- 2 Your manager has had a meeting with Jack Wong, a Finance Director of EWA Ltd (EWA) in Hong Kong. The following meeting notes have been forwarded to you:

Meeting with Jack Wong, discussing his personal income tax position for 2006/07

Date: 4 June 2007

- (1) Monthly salary \$50,000, contributes 5% to a mandatory provident fund.
- (2) Received \$5,000 from EWA to reimburse fees for accounting seminars organised by the ACCA. Jack paid \$7,000 in total.
- (3) In June 2006, Jack and his wife went to Europe on vacation as part of a group tour organised and paid for by EWA. The full price of the package tour was \$22,000. EWA paid a discounted price of \$18,000.
- (4) Jack also runs an unincorporated business with his brother, Dennis. Jack takes a monthly salary of \$5,000, Dennis takes a monthly salary of \$25,000. On 1 April 2006, Dennis married May, and since then, May has also taken a monthly salary of \$20,000. Jack and Dennis share profits and losses equally. The partnership closes its accounts on 31 December and it made an accounting profit of \$140,000 for the year ended 31 December 2006. As at 31 December 2005, the partnership had an agreed tax loss of \$260,000, which was allocated to Jack and Dennis in the amounts of \$250,000 and \$10,000 respectively. Neither of the partners elected for personal assessment for 2005/06.
- (5) Jack lent \$150,000 to a friend some years ago. In May 2006, his friend paid him \$4,000 interest. In January 2007, his friend paid him another \$3,000 interest and repaid \$120,000 of the loan. His friend is facing bankruptcy and could not repay the remaining \$30,000. Jack is not optimistic of getting any further money from his friend and would like to claim the loss against his other income.
- (6) Jack and his wife jointly own an apartment in Tai Wai. In 2006/07, they paid mortgage interest of \$120,000, rates of \$12,000 and management fees of \$24,000. Since 2004, the apartment has been rented out for \$20,000 per month, but the tenant has only been able to pay half rent since January 2007 due to financial difficulties. Jack is thinking of selling this apartment and buying another one in Shatin. Property prices in the New Territories have gone up recently and he expects to make a non-taxable gain of \$500,000 on the Tai Wai apartment. He believes that the Shatin market will be even more crazy and hopes to make another non-taxable gain of \$500,000 on the sale of this apartment in two-months' time. He has liaised with his bank to offer an overdraft facility for this purpose.
- (7) Jack's wife works full-time on buying and selling Hong Kong securities from home. She pays close attention to the market through close contact with her broker and friends. Unfortunately, she incurred an overall loss during the year from these "speculations" of \$90,000. Jack has asked whether this loss can be claimed.
- (8) The couple also owns a flat in Tai Po as joint tenants, where they live. During the year, they paid mortgage interest of \$150,000 on this flat to the bank.
- (9) Jack's wife has regularly donated \$1,000 per month to support two children in Thailand under the 'Child Adoption Programme' run by World Vision Hong Kong, an approved charitable organisation in Hong Kong. They often send gifts and necessities to these two children as they treat them like their adopted children.
- (10) During the year, Jack made a donation to The Red Cross, an approved charitable organisation in Hong Kong, of \$120,000.

**Required:**

Your manager has asked you to provide him with information in preparation for his next meeting with Jack Wong, as follows:

- (a) Identify and briefly explain the matters that the manager should draw to Jack Wong's attention with regard to his and his wife's tax positions for the year of assessment 2006/07.

Your answer should be supported with workings on the assessable/chargeable income/value and related tax liabilities as you consider relevant.

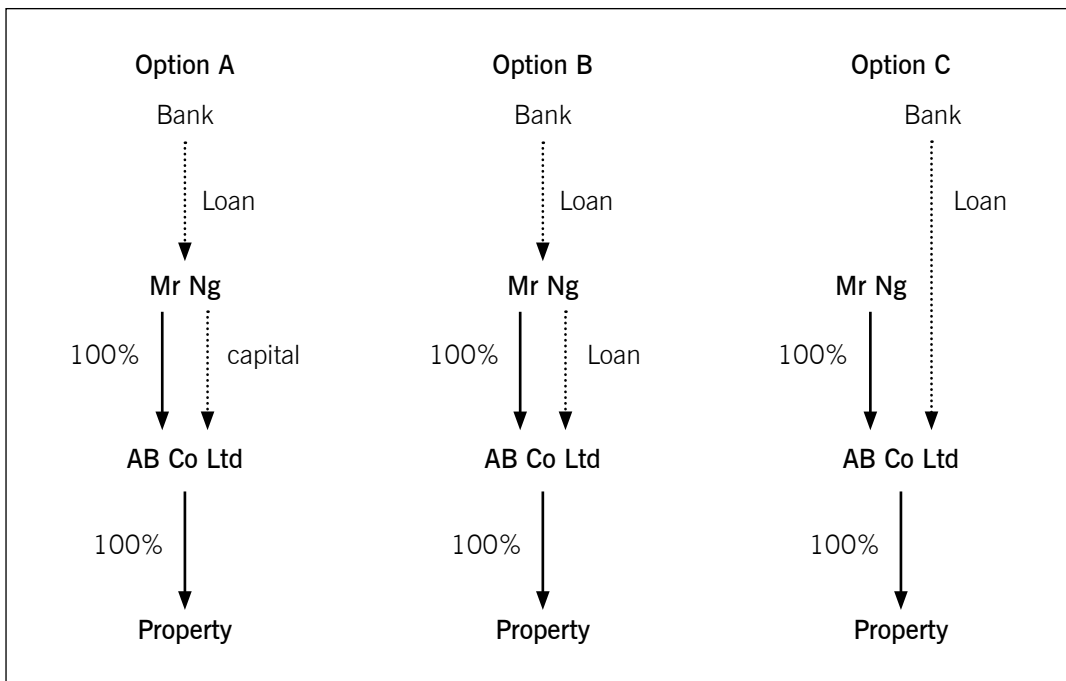
For the purposes of this part of the question only, you should ignore the potential disposal of the Tai Wai apartment and purchase of the Shatin apartment. (19 marks)

- (b) Explain the possible tax implications arising from the sales of the apartments in Tai Wai and Shatin, together with any associated reporting obligations. (10 marks)

**(29 marks)**

**Section B: TWO questions ONLY to be attempted**

**3** Mr Ng is the sole shareholder of AB Co Ltd. He is considering buying a property in Hong Kong and holding it through AB Co Ltd. Funds will be sourced from a bank. The property will be let out for rental. The following structural options are available:



—————> Ownership/shareholding  
 .....> Cashflow

**Required:**

**Evaluate the options available in respect of providing the funding to AB Co Ltd for the property acquisition. Your answer should explain the tax deductibility of the loan interest arising under each of the options, and any possible restrictions that may apply to the interest deduction in the context of extending guarantees to the bank should this be required.**

You may assume that all the loans referred to are interest bearing at the market rate.

(Marks are allocated as follows: Option A – 3 marks; Option B – 10 marks; Option C – 4 marks).

**(17 marks)**

- 4 HK Co which carries on a business in Hong Kong has several subsidiaries operating in Asia. HK Co intends to send Philip, its IT manager, to its Thailand subsidiary for a period of three months. Philip is a resident of Hong Kong holding a HKSAR passport. Philip's remuneration will remain the same throughout the period and continue to be paid in Hong Kong. All travelling and hotel accommodation in Thailand will be borne by HK Co. It is not yet certain whether Philip will be subject to Thailand personal income tax, but if he is, HK Co will bear the tax costs.

**Required:**

- (a) **Advise Philip on how his status for the purposes of Hong Kong salaries tax might be affected, as a result of his short-term assignment to the Thailand subsidiary.** (9 marks)
- (b) **Based on Article 14 of the double tax agreement (DTA) signed between Hong Kong and Thailand, which is extracted below, explain to HK Co how the DTA can protect Philip's remuneration from Thailand personal income tax, clearly identifying the most crucial factor in applying the DTA protection to Philip.**

"Article 14 Employment Income

2. Notwithstanding the provision of paragraph 1, remuneration derived by a resident in a Contracting Party in respect of an employment exercised in the other Contracting Party shall be taxable only in the first-mentioned Party if:
- (a) the recipient is present in the other Party for a period or periods not exceeding in the aggregate 183 days in any 12-month period commencing or ending in the taxable period concerned, and
  - (b) the remuneration is paid by, or on behalf of, an employer who is not a resident in the other Party, and
  - (c) the remuneration is not borne by a permanent establishment which the employer has in the other Party, and
  - (d) the remuneration is taxable in the first mentioned Party according to the laws in force in that Party."

(8 marks)

**(17 marks)**

- 5 SS has been working in Hong Kong since 1990. He is considering buying a residential property in Hong Kong for investment purposes, and is currently negotiating for the purchase of the following property in Yuen Long.

The property is a three-storey house owned by Estates Ltd (Estates). The property is let to three tenants, at a quarterly rent of \$48,000 for each storey payable in advance. Estates provides management services to the tenants for which it receives management fees of \$2,000 per month from each of the three tenants, and pays the wages of a watchman of \$5,000 per month, cleaning costs of \$1,200 per month and rates of \$10,000 per quarter in respect of the whole house.

Apart from letting the Yuen Long property, Estates has no other businesses or assets. Mr EE, who owns all the shares of Estates, has offered

- (1) to sell the property to SS for \$9,000,000, or alternatively:
- (2) to sell all the shares in Estates to SS for \$6,000,000. In addition, SS will also pay EE \$3,000,000 for an assignment of a shareholder's loan that EE has made to Estates. Two separate documents will be prepared to effect the transfer of the shares and the assignment of the shareholder's loan respectively.

In either case, SS will borrow \$7,000,000 from his friend to finance the acquisition of the property, and will pay interest on this loan at the rate of \$40,000 per month. SS will continue to hold the property for rental income.

SS is concerned about the Hong Kong tax implications of the above property investment and approaches you for advice.

**Required:**

**Advise SS on the Hong Kong tax and stamp duty implications if**

- (a) **He acquires the property in his personal name; or** (7 marks)
- (b) **He acquires all the shares in Estates Ltd, together with the shareholder's loan.** (10 marks)

**(17 marks)**

**End of Question Paper**



# Answers

1 Report to the management of the purchaser

To The management of the purchaser  
From Tax adviser  
Date 1 June 2007  
Subject The acquisition of Target Co Ltd and its offshore subsidiary

It is our understanding that the purchaser has the intention to acquire all the shares of Target Co Ltd and its offshore subsidiary incorporated in the British Virgin Islands. Based on the information supplied, we are asked to provide a report on the issues identified below:

(a) (i) Target Co Ltd's tax position for the year of assessment 2006/07

The company's estimated profits tax computation for the year of assessment 2006/07 (based on the year ended 31 March 2007) is as follows:

	\$	\$	
Profit for the year		200,000	
Add: Depreciation		530,000	0.5
		<u>730,000</u>	
Less: Depreciation allowance (800+5,000+9,000)	14,800		
Commercial building allowance	<u>403,200</u>	<u>418,000</u>	0.5
Adjusted profit for the year		<u>312,000</u>	
Estimated profits tax at 17.5%		<u>54,600</u>	0.5

Depreciation allowance schedule

	10%	20%	30%	
	\$	\$	\$	
WDV brought forward	8,000	25,000	30,000	
AA	(800)	(5,000)	(9,000)	1
WDV carried forward	<u>7,200</u>	<u>20,000</u>	<u>21,000</u>	

Commercial building allowance

	\$	\$	
Qualifying cost in 1990/91		12,000,000	0.5
Rebuilding allowance at 2% per annum		<u>240,000</u>	0.5
Total rebuilding allowance from 1990/91 to 1997/98		<u>1,920,000</u>	0.5
Residue of expenditure under s.33A(4)		10,080,000	0.5
AA at 4% from 1998/99 onwards per annum	403,200		0.5
Total AA from 1998/99 to 2005/06		<u>3,225,600</u>	0.5
WDV brought forward		6,854,400	
AA at 4% in 2006/07		403,200	0.5
WDV carried forward		<u>6,451,200</u>	

From the above, the company's estimated profits tax liability for the year of assessment is \$54,600. This estimated computation assumes that the profits arising from all activities including those from Mainland customers are taxed by the IRD.

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- (ii) Moreover, the qualifying cost for commercial building allowance has been adjusted based on the residue of expenditure as at 1997/98, and not on the original qualifying cost of \$12 million. The use of the total price paid for the building of \$20 million as the original qualifying cost for rebuilding allowance was incorrect since the building is a commercial building and s.35B(b)(i) has no application (DIPN 2, para 37). As a result, there has been an overclaim of rebuilding allowance in all the years up to 1997/98. The amount overclaimed per annum was \$160,000 (\$400,000 – \$240,000).

2

Furthermore, since 1998/99, commercial building allowance has also been overclaimed by the company as the qualifying expenditure has not been adjusted under s.33A(4). It is estimated that the allowance overclaimed for each year is \$396,800 (\$800,000 – \$403,200). This has the effect of eliminating the tax losses returned in prior years, leading to a tax-paying position.

2

Had the rebuilding allowance and commercial building allowance been correctly claimed, the tax position in the prior years should have been as follows:

1999/00 – \$366,800 profit (396,800 – 30,000)  
 2000/01 – \$346,800 profit (396,800 – 50,000)  
 2001/02 – \$381,800 profit (396,800 – 15,000)  
 2002/03 – \$341,800 profit (396,800 – 55,000)  
 2003/04 – \$196,800 profit (396,800 – 200,000)  
 2004/05 – \$363,800 profit (396,800 – 33,000)  
 2005/06 – \$386,800 profit (396,800 – 10,000)

There will thus be no tax losses brought forward to set-off against any profit for the year of assessment 2006/07, or for carry forward to future years.

2

Under the IRO, an assessor has the right to issue an additional assessment for any year of assessment within six years after the end of that year of assessment if he is of the opinion that the company has been under-assessed. From the above, the earliest year which is at risk of being re-opened is 2001/02. Additional assessments for all subsequent years are also at risk. It is, therefore necessary to include the profits tax liabilities for these years in the tax indemnity, such that any additional assessments raised by the IRD subsequent to the share transfer would be indemnified by the shareholders of Target Co Ltd.

2

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**(b) Hong Kong profits tax liability of offshore subsidiary**

In the case of the offshore subsidiary, the receipt of royalty income from Target Co Ltd would be deemed under s.15(1)(b) to be a trading receipt subject to Hong Kong profits tax. In general, only 30% of the gross receipts are taxable at the applicable profits tax rate. However, since the offshore subsidiary is an associate of Target Co Ltd, and the trademark has previously been owned by it, 100% of the royalty would be taxed at 17.5%. Target Co Ltd, being the payer of the royalty, is obliged to withhold the relevant tax amount from the royalty payment and remit the tax to the IRD. Annual tax returns will also need to be filed by Target Co Ltd as agent for the offshore subsidiary. The information provided is not sufficient to confirm that appropriate tax returns have been filed. This should be explored further. Moreover, since Target Co Ltd has been withholding only 5.25% of the royalty, the underpayment is subject to challenge by the IRD and additional assessments may be raised. This matter should also be included in the tax indemnity.

5

The tax is computed as follows:

	\$	
Royalty received from Target Co Ltd	80,000	
	<u>80,000</u>	
100% taxable in Hong Kong under s.21A	80,000	
	<u>80,000</u>	
Profits tax at 17.5%, to be withheld from royalty payment and paid to the IRD	14,000	1
	<u>14,000</u>	<u>6</u>

1

6

**(c) Hong Kong profits tax liability on printing income from Mainland orders**

Target Co Ltd has successfully claimed that income arising from the printing orders made by the Mainland customers be excluded from the charge to Hong Kong profits tax. This claim started in 1996/97. However, upon the departure of the salesman, Target Co Ltd continued to accept orders from Mainland customers but the orders were handled by the Hong Kong sales team. The question does not provide enough information about the operation of the sales team in procuring the orders from the Mainland customers. Depending on the factors such as the place of negotiation and conclusion of the contracts; place of the printing activities; and place of decision making, the IRD may refuse to continue allowing the offshore claim on the basis that the mode of operation has changed from that originally agreed. The information provided does not give the amount of offshore claims made in prior years and thus it is not possible to quantify the effect of the claims on the prior years' tax losses. However, the implication is obviously a further reduction of the tax losses or an increase in assessable profits since 2005/06. The matter should also be taken into account when negotiating the tax indemnity.

3

The tax treatment of the printing income arising from the Mainland orders may have an impact on the tax position of the royalty payment for both Target Co Ltd and the offshore subsidiary. As in the prior years, if the income arising from the printing orders from the Mainland customers is not taxable in Hong Kong, any related and relevant expenses should be disallowed. This may include part of the royalty paid for the trademark "Princess" if there is evidence showing that the trademark is being exploited or used both in Hong Kong and in Mainland China. As regards how the part attributable to the Mainland China business is to be ascertained, the IRD may seek an apportionment of the royalty based on the printing income. However, there is no definite rule, and another more reasonable and appropriate basis may be considered. Since it is not clear from the information that any part of the royalty has been disallowed, this remains an area of risk that should be included in the tax indemnity deed.

3

From the perspective of the offshore subsidiary, the total royalty received from Target Co Ltd may strictly be regarded as comprising both Hong Kong source and non-Hong Kong source. In general terms, a royalty is paid for the use of, or right to use, the intellectual property which in this case is the trademark of "Princess". The source of the royalty is generally determined by the place where the right is being exploited or used. In this case, if there is evidence that the trademark is being partly used in the Mainland where the printing activity is carried on, the portion of royalty attributable to the use of the trademark in the Mainland should be regarded as not sourced in Hong Kong. As a result, s.15(1)(b) does not apply to tax that part of the royalty.

2

However, with effect from 25 June 2004, the new s.15(1)(ba) takes effect to deem the royalty which is used outside Hong Kong to be taxable if the royalty is claimed as a deductible expense for Hong Kong profits tax purposes by the payer. In this case, therefore, since the Mainland sourced royalty was claimed as deductible against Target Co Ltd's income chargeable to Hong Kong profits tax, the royalty is therefore deemed under the new provision, s.15(1)(ba) to be sourced in Hong Kong and taxable accordingly.

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**(d) List of other issues to be considered for tax indemnity deed**

The following issues should also be considered in determining the terms of the tax indemnity:

(1) The trademark was previously owned by Target Co Ltd and subsequently sold to its offshore subsidiary for \$1. From the perspective of Target Co Ltd, unless there is evidence showing that the trademark is intended to be a trading asset, it is likely that the trademark would be regarded as a capital asset. As a consequence, the transfer of a capital asset at such a nominal value may not have any significant tax implications since a capital gain is not taxed. However, should it be the case that the trademark was originally acquired at a cost which was included as a deduction in Target Co Ltd's tax computation, any subsequent sale proceeds would then need to be reported as assessable income. (Note: expenditure incurred on the purchase of trademark under contracts entered into before 18 April 1991 was fully deductible under s.16E.) In this event, the IRD may raise the question as to whether the sale proceeds of \$1 is justified and at arm's length. The information provided is not sufficient to enable a conclusion to be drawn. More information is required but for tax indemnity purposes, this potential risk should be taken into account.

3

(2) For all the potential additional assessments mentioned above, there is a risk that Target Co Ltd will be subject to a penalty for filing incorrect tax returns or information. Any tax indemnity should cover any additional costs arising from these events such as penalties, surcharges, additional taxes and probably legal costs.

1

(3) Any tax indemnity should also cover all other possible additional tax liabilities arising out of the pre-acquisition period, and should remain valid for a period of at least six years after the acquisition. This is in line with the statutory time limit within which the IRD has the right to issue any additional assessment.

1

(Marks may also be awarded for a discussion of other valid and appropriate issues.)

5

*Format of report*

2

**37**

**2 (a) Jack Wong and his wife's tax positions for 2006/07**

**1. Personal assessment**

Jack and his wife should be advised to elect for personal assessment for 2006/07 because their aggregate tax liabilities under personal assessment could be reduced. As they are both ordinarily resident in Hong Kong and they derive more than one source of income, they are eligible for personal assessment election. Potential tax savings may be achieved by claiming the bank mortgage interest as deductible against the assessable property income. This treatment is only available if personal assessment is elected. Under personal assessment, income and losses from different sources would be aggregated into one assessment. Details are as follows.

2

**2. Employment with EWA**

Other than the monthly salary, certain benefits received from the employer, EWA, should also be taxable. This includes the price for the package tour provided by the company in the amount of \$18,000. Prior to the year of assessment 2003/04, holiday benefits are specifically exempt from Hong Kong salaries tax; but this has now changed.

1

Jack will be able to claim the excess cost of the accounting seminars of \$2,000 as self-education expenses. The net assessable income of Jack Wong to be aggregated under personal assessment is \$616,000. (\$50,000x12+\$18,000-\$2,000).

2

On the other hand, he will also be able to claim a deduction of \$12,000 (the maximum amount) in respect of his contribution to EWA's mandatory provident fund, and this amount is deducted under the personal assessment calculation.

1

### 3. Partnership

Before aggregating any profit/loss under personal assessment, the assessable profits of the partnership should be allocated to respective partners first. Jack's share of the partnership profits should be offset by his share of prior years' losses, and any excess profits, if any, would be aggregated under personal assessment. However, in Jack's case, his share of partnership profits is fully offset by his prior years' losses (see workings below), leaving an unutilised balance of prior years' losses of \$120,000. Based on the information provided, personal assessment was not elected for the year 2005/06. As a result, any loss unused in the partnership can only be carried forward under the partnership, and cannot be transferred to Jack's personal assessment. In other words, the balance of loss of \$120,000 will be carried forward under the name of the partnership, and can only be used by Jack to offset against his share of future profits from the partnership. In respect of 2006/07, no profit or loss from the partnership would be aggregated under personal assessment.

2

Workings:

Assessable profits of the partnership:  $\$140,000 + (\$5,000 \times 12) + (\$25,000 \times 12) + (\$20,000 \times 9) = \$680,000$   
 Allocation of partnership's profits:

	Jack	Dennis	Total
Salaries	60,000	480,000	540,000
Balance 1:1	70,000	70,000	140,000
Assessable profits	<u>130,000</u>	<u>550,000</u>	<u>680,000</u>
Loss brought forward	<u>(130,000)</u>		
Net profits transferred to personal assessment	<u>0</u>		
Loss carried forward under partnership	120,000		

1

### 4. Property income

For property tax purposes the assessable value is based on the consideration 'payable' under the lease, not the amount actually 'paid'. Therefore, the full twelve months rentals must be included in the 2006/07 assessment. However, should it become evident that the debt due by the tenant is not recoverable, the unrecoverable amount may be deducted from the assessable value in the year in which the debt actually becomes bad. The net assessable value to be aggregated under personal assessment is \$182,400  $[(\$20,000 \times 12 - \$12,000) \times 80\%]$ .

2

As the apartment is owned jointly by Jack and his wife, they will each be assessed on 50% of the net assessable value under personal assessment. Moreover, the mortgage interest incurred on the acquisition of the property is also equally split between the couple, and deducted against their respective share of the net assessable value.

1

### 5. Loan to friend

Jack is hardly in the business of money lending. The loss of \$30,000 is therefore not deductible. The interest income is also not taxable. Although Jack carries on a partnership business in Hong Kong, the interest does not arise in respect of the funds of the business: s.15(1)(g).

1

### 6. Wife's other income

Jack's wife's speculative activities must be ignored. The trend of Board of Review decisions in this area is well summarised in D38/96 where it is stated that although it is not essential that a person carrying on a trade or business must have an office and staff and organisation, where none of these attributes exist, there must be other clear evidence of carrying on a trade or business. A similar decision was reached in D11/97.

1

### 7. Other available deductions

Jack's wife can deduct the monthly donation to World Vision as a concessionary deduction. But this will be limited to \$7,800, being 25% of her assessable income net of the mortgage interest. The excess amount of \$4,200  $(\$12,000 - \$7,800)$  can be transferred back to Jack and claimed as a deduction against Jack's assessable income. In addition, Jack can also claim a deduction for his \$120,000 donation to The Red Cross.

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Jack can claim the maximum deduction of \$100,000 for home loan interest under s.26E. His wife should lodge a nomination under s.26F(1) to allow the full amount to be claimed by her husband.

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However, the couple are not eligible to claim any child allowance in respect of the two children in Thailand on the basis that any 'adopted' child eligible for the deduction must be officially adopted.

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## 8. Jack and his wife's tax positions

Based on the personal assessment calculation, the couple has a net chargeable income of \$234,400 for the year of assessment 2006/07. Salaries tax payable at progressive rates thereon is \$34,036. This tax liability would be split between the couple based on the proportion of their share of net assessable income before personal allowance. Jack will have a share of tax payable of \$32,203 and his wife will have a share of tax payable of \$1,833 (see workings below).

1

	Jack Wong	Wife	
Net assessable value of property	91,200	91,200	
Salaries	616,000	0	
Partnership business	0	0	
Mortgage interest deduction	(60,000)	(60,000)	
Donations	(124,200)	(7,800)	
Home loan interest	(100,000)		
Retirement scheme contributions	(12,000)		
Reduced total income	<u>411,000</u>	<u>23,400</u>	434,400
Married person's allowance			(200,000)
Net chargeable income			<u>234,400</u>
Tax payable at progressive rates			<u>34,036</u>
Share of tax liability	<u>32,203</u>	<u>1,833</u>	

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- (b) Capital gains derived from the realisation of a long-term investment are exempt but profits from the trading of properties are taxable.

0.5

The question of whether a person is carrying on a trade or not is a question of fact. It is always necessary to consider all the relevant circumstances objectively and the person's intentions in carrying out the activities should also be examined.

0.5

The Royal Commission on the Taxation of Profits and Income has identified 'six badges' of trade, which are the factors normally used for determining whether a transaction or a series of transactions constitute a 'trade' or 'an adventure in the nature of trade'. These six badges are briefly, subject matter, length of period of ownership, frequency of similar transaction, supplementary work done, circumstances leading to sale, and motive of sale. Apart from the six badges of trade, other factors to be considered include the method of financing and the destination of the proceeds of sale.

1

Based on the facts given and by applying the so-called badges of trade, Jack may be able to claim the gain arising from the sale of the Tai Wai property as non-taxable, but is very likely to be regarded as carrying on a trade in the case of the Shatin property and thus taxed on the second gain. The areas to be investigated include:

1. The subject matter in this case is property located in Hong Kong. It is true that a property can always give the owner income/personal enjoyment through living in it or letting it out for income earning purpose. However, in the past decade, property in Hong Kong has gradually become an asset that may be acquired for trading or speculative purposes. Involvement in property transactions is now under close scrutiny by the IRD to ascertain whether a trade has been carried on or not. In respect of the Tai Wai property, it has already been let out to a third party, and it is true that Jack has been suffering from the inability of the tenant to honour the full rental payment. These may be favourable arguments for Jack to substantiate that the intention of acquiring and disposing the Tai Wai property has been for capital investment purposes and not trading. The gain can therefore most probably be justified as not taxable.
2. From the facts given, however, there are no other special circumstance leading to the sale of the Shatin property except for the attractive price. In respect of the Tai Wai property, Jack may argue that he has been suffering from the inability of the tenant to honour full rental payment. This may be favourable argument in this context.
3. Part of the finance of the Shatin property is likely to be sourced from short-term money, being the bank overdraft facilities. This indicates that Jack does not have the intention of holding the property as a long-term investment.

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4. In addition, the reason (motive) for the acquisition of the Shatin property was the anticipation of an increase in property price in the short run.

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From the above analysis, Jack would most likely be regarded as carrying on a trade in the Shatin property and thus subject to profits tax under s.14 of the IRO. As for the property in Tai Wai, there are more favourable arguments that would justify otherwise; but these are subject to IRD's agreement.

1

If Jack is subject to profits tax on the gains on the disposal of the property, he will be required to notify the IRD within four months after the end of the basis period if he does not receive a profits tax return for that year (s.51(2)). Under s.80(1), Jack shall be liable to an offence and the penalty thereof if he, without reasonable excuse, fails to notify the IRD of his chargeability to tax.

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### 3 Option A

Under this option, the bank loan is obtained by Mr Ng. However, the bank loan money is injected as capital into AB Co Ltd which will in turn own the property. Interest is payable by Mr Ng on the bank loan. However, the return to Mr Ng out of the capital injection into the limited company would be dividend income should it be distributed by the company. Dividend income is not taxable in the hands of Mr Ng under the Hong Kong tax regime. As a result, Mr Ng would not be able to get any tax deduction on the interest incurred on the bank loan.

2

On the basis that no tax deduction is available for the interest, in the circumstances that guarantee is requested by the bank, it is at the total discretion of Mr Ng to extend any form of guarantee such as the relevant property or shares in the limited company or even deposits. However, other non-tax considerations should not be ignored.

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### Option B

Under this option, the bank loan is also obtained by Mr Ng. However, unlike Option A, the bank loan money is on-lent by Mr Ng to the limited company which in turn uses the loan money to acquire the property. Interest is payable by Mr Ng on the bank loan and interest is also incurred by the limited company on the loan borrowed from Mr Ng. Whether or not the interest is tax deductible by the limited company depends on whether the income arising from the property is taxable, under what tax regime it is taxed and whether all the tax deduction conditions are satisfied.

0.5

As the limited company is the owner of the property situated in Hong Kong, any rental income receivable by the company from letting out the property is subject to property tax under s.5. Loan interest is not eligible for a tax deduction under the property tax regime.

1

On the other hand, the limited company is also regarded as carrying on a business of property letting since the definition of 'business' under s.2 includes 'letting and sub-letting of premises by any corporation'. As a result, the rental income would also be assessable to profits tax under s.14. To avoid double taxation, the limited company should apply for an exemption from property tax under s.5(2)(a); such that only profits tax is payable on the rental income. Apart from s.5(2)(a), the company may also rely on s.25 in the event that both property tax and profits tax are payable. Under s.25, property tax paid could be set off against the profits tax payable.

1.5

Since the rental income is subject to profits tax and the property is acquired with the loan obtained from Mr Ng, the interest incurred by the limited company is incurred in the production of assessable profits. The interest satisfies the basic deduction principle under s.16(1). However, to be deductible, the interest expense also has to satisfy any one of the criteria under s.16(2), as well as s.16(2A) and s.16(2B). In respect of interest incurred on a loan borrowed from a person other than a financial institution, the interest may be deductible if the interest received by the lender is taxable (s.16(2)(c)). Unfortunately, Hong Kong does not tax interest income in the hands of individual taxpayers, unless the lender carries on a business as a money lender (see below). If Mr Ng is not taxed on the interest received from the limited company, this criterion would not be satisfied and the limited company would not get a tax deduction for the interest paid. Further, as the interest income received from the company is not taxable in Mr Ng's hands, Mr Ng will not be able to get a tax deduction for the interest incurred on the bank loan.

3

In the circumstances where Mr Ng is regarded as carrying on a money-lending business in Hong Kong, Mr Ng will be taxed on the interest received from the company and allowed a tax deduction for the interest paid to the bank, subject to the conditions under ss.16(2A) and 16(2B).

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From the perspective of the limited company, the interest expense incurred would satisfy s.16(2)(c) and be deductible if the following conditions under ss.16(2A) and 16(2B) are also satisfied. With effect from 25 June 2004, the interest deduction under ss.16(2)(c), 16(2)(d) or 16(2)(e) is subject to the additional restrictions under ss.16(2A) and 16(2B). Based on Option B, any tax deduction for the interest paid to the bank by Mr Ng, as well as for the interest paid to Mr Ng by the company; would be reduced if (i) the loan is secured or guaranteed by any deposits/loans which generate non-Hong Kong taxable interest income; or if (ii) the interest paid to the bank or Mr Ng, is to be paid or flowed back to the bank or Mr Ng or any associate of the bank or Mr Ng, unless such interest is chargeable to tax by the bank or Mr Ng or any associate of the bank or Mr Ng, as the case may be (ss.16(2A) and 16(2B)).

2

In view of the restrictions under ss.16(2A) and s16(2B), care should be exercised in extending guarantees to the bank if so required. A guarantee or security in the form of deposits or loans which generate interest income not chargeable to tax in Hong Kong or which forms part of the arrangement such as sub-participation under which the interest is paid back to the borrower should be avoided.

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### Option C

Under this option, the bank loan is obtained by the limited company and not by Mr Ng. Whilst Mr Ng is still the shareholder of the limited company, he does not provide any funding for the acquisition of the property by the limited company. The bank provides the loan directly to the company which uses the loan money to acquire the property and pays the loan interest. As analysed above under Option B, the limited company would be assessed under profits tax in respect of the rental income and seek exemption from property tax under s. 5(2)(a). Under the profits tax regime, any bank interest incurred would be deductible against the company's assessable profits if (a) the bank interest is incurred in the production of assessable profits (s.16(1)) and; (b) the bank borrowing is not secured by any deposits or loans which derive non-taxable income in Hong Kong (s.16(2A)(c)); and there is no arrangement in place such that the interest payment is ultimately paid back to the borrower or any connected person (s.16(2B)). In the case of the limited company, if all the above conditions are satisfied, the loan interest payable by the limited company to the bank would be tax deductible against the assessable profits of the limited company.

3

In extending guarantees to the bank, as in Option B, care should be exercised to ensure that the guarantee or security is not in the form of deposits/loans that generate non-Hong Kong taxable interest; or that forms part of the arrangement such as sub-participation under which interest is paid back to the company.

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- 4 (a) Based on the facts given, Philip's employment with HK Co should remain a Hong Kong employment. Moreover, Philip does not appear to be a visitor to Hong Kong but is a resident in Hong Kong. In the circumstances, all of his employment income would be liable to Hong Kong salaries tax unless s.8(1A)(c) applies.

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Under s.8(1A)(c), a portion of Philip's remuneration would be exempt from Hong Kong salaries tax if (i) it was derived by Philip from services rendered in Thailand; (ii) it is chargeable to Thailand personal income tax which is substantially of the same nature as Hong Kong salaries tax; and (iii) the Commissioner is satisfied that Philip has, by deduction or otherwise, paid the tax in Thailand. Therefore, if all three conditions are satisfied, Philip may rely on this section to exclude the three-month period's remuneration from the total assessable income for Hong Kong salaries tax purposes. It is worth noting that for s.8(1A)(c) to apply, Thailand personal income tax must be paid in Thailand. If, however, no Thailand tax is paid, there would be no exemption, and Philip's Hong Kong salaries tax position would remain unchanged.

4

In respect of the travelling and hotel accommodation costs paid by HK Co, the issue of whether they constitute taxable income to Philip depends on various factors. In general, if an employer makes payments to a third party which discharges the liability of the employee, the payments would be taxable income to the employee. However, if the payments only discharge the employer's own liability, it would not be taxable on the employee, unless it is related to a holiday journey or to the employee's child education; or it is convertible into cash. In Philip's case, if the travelling and hotel accommodation are for the account of HK Co, the payments by the company to settle these accounts would not be taxable income to Philip.

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- (b) Pursuant to Article 14 of the double tax agreement (DTA) between Hong Kong and Thailand, Philip's remuneration relating to his services rendered in Thailand would be exempt from Thailand personal income tax if all of the four conditions are fulfilled.

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The first condition is that the aggregate number of days that Philip stays in Thailand in a taxable year does not exceed 183 days. It is not clear from the DTA how a day is counted, but in the case of Philip where his intention is to stay in Thailand for only three months, it is unlikely that this threshold would be exceeded.

1

The second condition is that the payment of Philip's remuneration is made by an employer who is not a resident of Thailand. As it is intended that Philip's remuneration would continue to be paid by HK Co in Hong Kong, and it is assumed that HK Co is not a resident in Thailand, this condition is also fulfilled.

1

The third condition is that the payment of Philip's remuneration is not to be borne by any permanent establishment in Thailand. This condition would be fulfilled only if HK Co does not recharge any of Philip's remuneration to the Thailand subsidiary. If there is a recharge, that portion of Philip's remuneration recharged would be considered as borne by the Thailand subsidiary and thus this condition would not be fulfilled. As a result, Philip's remuneration would not be eligible for the treaty exemption.

2

The last condition is that Philip's remuneration must be taxable in Hong Kong according to Hong Kong tax law. This would mean that if Philip wishes to obtain a treaty exemption from Thailand income tax, he cannot rely on s.8(1)(A)(c) to exempt part of his remuneration from Hong Kong tax.

2

Based on the above, it appears that the issue of recharge or not is critical to ascertaining Philip's personal income tax liability in both Hong Kong and Thailand. Obviously, exemption can only be available in either country but not both.

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**5 (a) Tax and stamp duty implications if SS acquires the property in his personal name**

The first point to note is that if SS acquires the property in his personal name, the rental income will be chargeable to property tax rather than profits tax. Under s.5(1) of the IRO, property tax is levied on any owner of land or buildings or land and buildings situated in Hong Kong, at the standard rate (16%) on the net assessable value of the property.

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'Net assessable value' as defined under s.5B includes any consideration payable in money or money's worth in respect of the right to use the land or/and buildings, as reduced by two types of deductions:

- (1) government rates paid by the owner if it has been so agreed between the owner and the tenant; and
- (2) a statutory allowance of 20% of the assessable value after deducting rates if applicable. The statutory allowance is deemed to cover all related expenses incurred by the owner on the property. Therefore, all other actual expenses incurred by SS, including the wages of the watchman, cleaning costs and interest, will not be deductible for property tax purposes.

2

Property tax can work unfairly where a person incurs expenses greater than the deemed 20% allowance. There would be particular hardship if interest deductions could not be taken into account. The IRO gives relief by providing that, if SS elects for personal assessment, he will be entitled to a deduction for interest incurred by him to acquire the property: s.42(1).

1

Because this is not a profits tax case, the limitations on deductibility of interest as set out in s.16(2) do not apply. SS is therefore entitled to deduct the interest paid to his friend, even though the friend is not subject to Hong Kong tax on the interest he receives. However, the deduction is limited to the 'net assessable value' of the property, ie 80% of the total rental received.

1.5

The final point to consider is stamp duty. The conveyance on the sale in respect of the property is chargeable under Head 1(1) in the First Schedule of the SDO. Stamp duty payable is 3.75% on \$9,000,000, ie \$337,500.

1.5

**(b) Tax and stamp duty implications if SS acquires all the shares in Estates Ltd together with the shareholder's loan**

7

The first point to note is that if SS acquires all the shares in Estates Ltd, the rental income is chargeable to both property tax and profits tax. Section 5(1) is still applicable on the basis that the company will still be considered as 'owner' of the property. Any rental income so received is subject to property tax calculated in the same manner as for an individual as explained above.

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However, according to s.2, 'business' is defined to include letting or sub-letting of property by a corporation. Moreover, under s.14, any person who carries on a trade, profession or business in Hong Kong and derives assessable profits in Hong Kong will be subject to profits tax. Estates Ltd is regarded as carrying on the business of property letting in Hong Kong and subject to profits tax. This double taxation of Estates Ltd can be eliminated by the application of s.5(2)(a). Under this section, any corporation which is subject to profits tax in respect of rental income can apply for an exemption from property tax in relation to the same rental income so that the rental income is only subject to profits tax. Alternatively, Estates Ltd can rely on s.25 to claim the set off of property tax paid against the profits tax payable.

1

Profits tax under s.14 is imposed on the assessable profit which takes into account all relevant expenses and outgoings that are incurred in the production of assessable profits: s.16. Estates Ltd is therefore able to deduct the related expenses such as the wages of the watchman, cleaning costs and rates. In addition, commercial building allowance will be calculated and deductible against the rental income. However, the company will not be entitled to a deduction for the interest paid to SS's friend, because such amount is not subject to Hong Kong tax in the hands of the lender: s.16(2)(c). In a situation where total deductible expenditure exceeds total income, the excess loss can be carried forward to subsequent years and is eligible for deduction against any future taxable income. Currently, the profits tax rate applicable is 17.5%.

2

The final point to consider is stamp duty. The shares of a Hong Kong company are Hong Kong stock: definition in s.2(1) of the SDO. Therefore the parties effecting the sale and purchase thereof must prepare and stamp contract notes for the sale and purchase and an instrument of transfer: s.19(1) and heads 2(1) and 2(4) respectively. Duty on the contract notes under head 2(1) is 0.2% of the amount or value of the consideration; duty under head 2(4) on the transfer is \$5.

2

The issue is whether stamp duty should be paid on only \$6,000,000, or also on the \$3,000,000 for the associated transfer of the shareholder's loan. The answer is the latter. This is a case of a transfer of Hong Kong stock which is subject to the payment of further money (in this case, for the assignment of the shareholder's loan). Such additional money forms part of the total amount on which stamp duty is to be assessed: s.24(1). Therefore, duty on the contract notes under head 2(1) is \$18,000 ( $\$9,000,000 \times 0.2\%$ ). Because the vendor and purchaser are each liable to pay one-half of this amount, it follows that the amount payable by SS is \$9,000, which is much lower than the amount payable (\$337,500) if the property, not the shares, is acquired by SS.

**2**

The final issue relates to the liability for having prepared two separate documents in respect of the same transaction. The SDO stipulates that all the facts and circumstances affecting the liability of any instrument to stamp duty must be fully and truly set forth in the instrument: s.11. This means that the share transfer document should contain a reference to the related assignment of the shareholder's loan, because this would affect the calculation of stamp duty payable. Furthermore, the party preparing the documents would have committed an offence, if, having been employed or concerned in or about the preparation of the instrument, the party has neglected or omitted fully and truly to set forth in that instrument all the relevant facts and circumstances. However, the offence is only committed if the party did so with an intent to defraud the Government and not simply out of inadvertence of the stamp duty consequences.

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