

Professional Level – Options Module

Advanced Taxation (Hong Kong)

Monday 3 December 2007

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 (HKKG)

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

	2006/07
Profits tax rates	
Companies	17.5%
Unincorporated business	16%
Salaries tax rates	
First \$30,000	2%
Next \$30,000	7%
Next \$30,000	13%
On the remainder	19%
Standard rate	16%
Allowances	
	\$
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
Depreciation allowance rates	
Initial allowance:	
Plant and machinery	60%
Industrial buildings	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%

Stamp duty rates

Share transfers	0·2% + \$5
Conveyances (ignoring marginal reliefs)	
Not exceeding \$1,000,000	\$100
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 a percentage of the 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 You are the in-house tax manager of the Dealing Group which is interested in acquiring the shares of the Losing Group. The Losing Group comprises Losing Ltd and its wholly owned subsidiary, Gain Ltd. Both companies are Hong Kong companies engaged in equipment repairs and maintenance services.

You requested certain information from the Losing Group and the following email has been received from the Losing Group's Finance Director:

From: Andersen, Group Finance Director, Losing Group
Date: 3 November 2007
Subject: Tax due diligence questions

Referring to the questions raised:

1. Attached are the projected profit and loss accounts for the year ending 31 December 2007 and the estimated tax provision calculations for both companies.
2. Gain Ltd is tax-paying each year. Profits tax assessments have been issued per the tax returns. No tax query is outstanding. No profits tax returns have been received for Losing Ltd since 2003/04.
3. Losing Ltd started accumulating tax losses in 2002/03, when the principal operation including all its staff was shifted to Gain Ltd. All new contracts since 2002/03 have been signed under Gain Ltd.
4. Since 2000, Losing Ltd has entered into a management contract with Dogging Management Services Ltd (Dogging), under which Dogging provides management services to the Losing Group. In return for these services, an annual management fee is payable by Losing Ltd based on 10% of the Group's net profits. Since 2002/03, the management fee has been calculated based only on Gain Ltd's profits, although the fee has continued to be payable by Losing Ltd.
5. Summary of the tax position of the Losing Group as requested:

	Gain Ltd's profit/loss per tax return	Losing Ltd's profit/loss per tax return	Management fee deducted by Losing Ltd
2002/03	Profit \$2m	Loss \$0.5m	\$0.2m
2003/04	Profit \$3m	Loss \$0.7m; (c/f \$1.2m)	\$0.6m
2004/05	Profit \$4m	Loss \$0.4m; (c/f \$1.6m)	\$0.8m
2005/06	Profit \$3m	Loss \$0.1m; (c/f \$1.7m)	\$0.6m
2006/07	Profit \$4m	Loss \$1m; (c/f \$2.7m)	\$0.8m

6. Interest income was earned by Gain Ltd in 2006/07 from a company incorporated in Singapore. The relationship of this company to the Losing Group is irrelevant to this project and thus, no further details are provided.

Attachment to the email:

Projected profit and loss accounts for the year ending 31 December 2007

	Gain Ltd \$	Losing Ltd \$
Contract income	8,000,000	–
Profit from securities trading	1,500,000	3,000,000
Interest income from Gain Ltd	–	1,800,000
Interest income from Singapore	2,300,000	–
Directors' fee	–	(3,800,000)
Staff costs	(5,000,000)	–
Management fee	–	(800,000)
Interest expense to bank	–	(1,200,000)
Interest expense to Losing Ltd	(1,800,000)	–
Other operating expenses	(1,000,000)	–
Profit/(loss)	<u>4,000,000</u>	<u>(1,000,000)</u>

Estimated tax provisions:

	Gain Ltd	Losing Ltd
	\$	\$
Profit/(loss)	4,000,000	(1,000,000)
Less: offshore interest income	(2,300,000)	–
Adjusted profit/(loss)	1,700,000	(1,000,000)
Loss brought forward set off	–	(3,300,000)
Net assessable profit/(tax loss carried forward)	1,700,000	(4,300,000)
Tax at 17.5%	297,500	–
Tax provision	300,000	–

Required:

Prepare a report for the management of the Dealing Group concerning the acquisition of Gain Ltd and Losing Ltd. The report should address the Hong Kong tax issues set out below and should, where appropriate, include supporting calculations.

(a) The tax deductibility of the management fee expense by Losing Ltd

- (i) Discuss the tax deductibility of the management fee expense incurred by Losing Ltd since 2002/03;** (10 marks)
- (ii) Advise how the tax losses brought forward from 2002/03 may be affected. If prior years' tax losses will vary from those stated, advise on any action that should be taken by Losing Ltd and any possible actions that can be taken by the Inland Revenue Department;** (4 marks)
- (iii) Assuming that the management contract with Dogging Management Services Ltd has to be continued in its existing form, suggest how the risk of fee disallowance on a going-forward basis might be mitigated.** (3 marks)

(b) The tax deductibility of the interest expense by Gain Ltd and Losing Ltd

- (i) Discuss the tax deductibility of the interest expense incurred by Gain Ltd and Losing Ltd respectively in the year of assessment 2006/07;** (5 marks)
- (ii) Identify the further information that is required to provide a more definitive opinion on the deductibility of the interest expense, stating why it is relevant.** (3 marks)

(c) Taking into account the tax issues in parts (a) and (b), calculate the adjusted estimated tax position of both Gain Ltd and Losing Ltd for the year of assessment 2007/08, before and after any loss set-off. You should take a conservative approach to any issues that are potentially at risk or unclear. (2 marks)

(d) The value of Losing Ltd

From a Hong Kong tax perspective, advise whether or not Losing Ltd is of any value to the Dealing Group. You should cover the following issues:

- (i) The ability of Losing Ltd to carry forward prior years' tax losses, if any, to offset against any assessable profits earned after acquisition;** (5 marks)
- (ii) The benefit, if any, of Losing Ltd in terms of repatriating the after-tax profits out of Gain Ltd.** (2 marks)

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

Notes:

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 will apply for all subsequent years of assessment.

(36 marks)

[P.T.O.]

- 2 Peter Man has asked your firm to handle all his Hong Kong tax affairs. The firm's tax manager has held an initial meeting with Peter, at which he ascertained the following information relating to the year ended 31 March 2007.
- (1) Peter was recruited in Canada by Hong Kong Airways Ltd (HKAL), a Hong Kong based international airline company, as the company's regional manager. He is paid an annual salary of \$1,200,000. His job involves a great deal of travelling around Asia and he only spent six months in Hong Kong in the year ended 31 March 2007. By arrangement with HKAL, his salary was paid direct into a bank account in Canada from which he had money remitted periodically to Hong Kong.
 - (2) Peter rented a flat in Kowloon for \$28,000 per month and received \$25,000 per month from HKAL designated as 'housing assistance' to cover this amount.
 - (3) HKAL paid tuition fees of \$35,000 for the education of his son in Canada. Under an arrangement entered into by the Canadian university with HKAL, Peter was not liable at all for payment of these fees.
 - (4) HKAL operates an employee share scheme. As a result of an administrative oversight, HKAL did not allot certain shares to which Peter was entitled. He was very upset and after long negotiation with HKAL he was paid \$30,000, described as 'compensation for failure to allow you to participate in our employee share scheme for the year ended 31 December 2006'.
 - (5) For many years Peter has had a persistent ear infection which makes him quite ill during plane trips. He cannot fly without taking medication. Since he must travel by plane in order to carry out the duties of his employment, he spent \$30,000 on a minor operation to cure this illness. HKAL reimbursed him half of this amount.
 - (6) As an airline employee Peter is entitled to purchase plane tickets for himself and his family at a 90% discount. He took a holiday during the year and bought four return, business class tickets to Paris for himself, his wife and children for \$16,000. Without the discount he would have had to pay \$160,000.
 - (7) Peter's wife, Mary, runs an unincorporated business with her brother, Paul. Mary takes a monthly salary of \$30,000, Paul takes a monthly salary of \$10,000. They share profits and losses equally. For the year ended 31 March 2007 the partnership made an accounting loss of \$460,000. As of 31 March 2006, the partnership had an agreed tax loss of \$320,000, which was allocated to Mary and Paul in the amounts of \$40,000 and \$280,000 respectively. Neither of the partners elected for personal assessment for 2005/06.
 - (8) Peter and Mary jointly acquired a house in Chueng Chau Island in June 2006 for \$3,000,000. The house was leased out on the following terms:
 - (i) Term of lease: four years from 1 July 2006
 - (ii) Monthly rental: \$20,000
 - (iii) Rent-free period: half month from 1 July 2006
 - (iv) Rent deposit: \$40,000 paid on signing the lease agreement
 - (v) Premium: \$24,000 paid on signing the lease agreement
 - (vi) Management fee: \$1,000, payable by the tenant to the management company
 - (vii) Rates: \$1,500 per quarter, payable by the landlord to the government

Peter and Mary financed the acquisition of the house by way of a loan borrowed from a friend. During the year ended 31 March 2007 they paid loan interest of \$120,000 to the friend.
 - (9) Peter and Mary supported two children, a daughter, aged 16 and a son, aged 21, who is studying part-time at a university, in Canada (see (3) above).
 - (10) Mary gave \$1,000 each month to various charities in Hong Kong.

Required:

Prepare a memorandum for the tax manager setting out the advice that should be given to Peter Man and his wife on their tax positions (Hong Kong tax and stamp duty) for the year of assessment 2006/07. If you need further information to determine the tax position, state what information you need and why you need it.

Note: Your memorandum should include such supporting calculations of their assessable/chargeable income/value as you consider relevant, but you are not required to calculate the salaries tax payable. (28 marks)

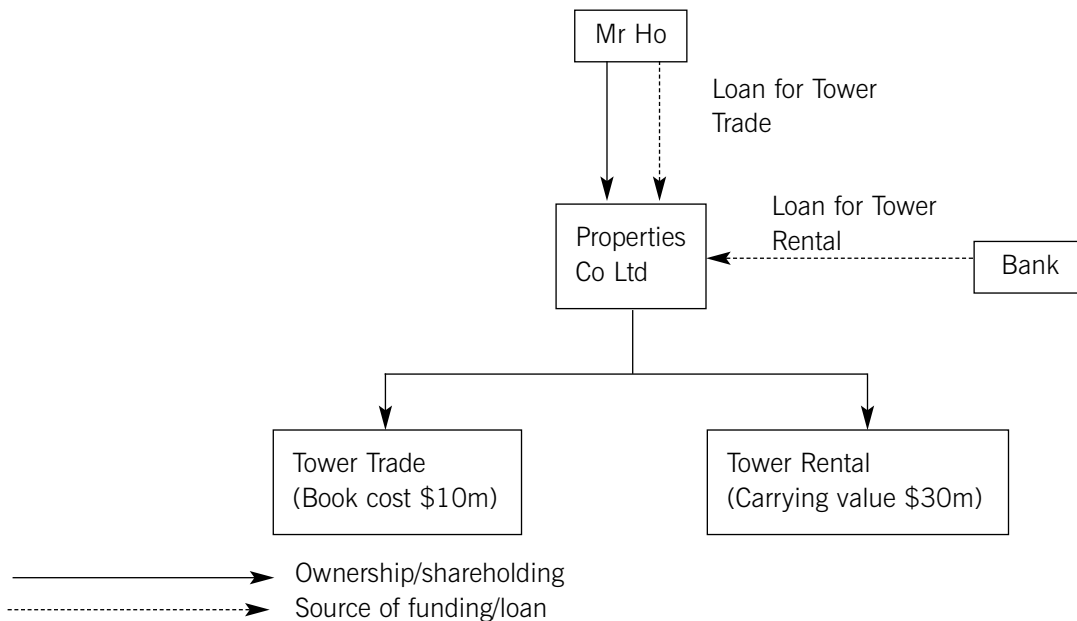
Appropriateness of the format and presentation of the memorandum and the effectiveness with which the information is communicated. (2 marks)

(30 marks)

Section B – TWO questions ONLY to be attempted

3 Mr Ho is the sole shareholder of Properties Co Ltd (the company), a company carrying on business in Hong Kong. As at 31 March 2006 the company owns two Hong Kong properties, Tower Trade and Tower Rental. Tower Trade is funded by a loan from Mr Ho and Tower Rental is funded by a bank loan under Mr Ho’s personal guarantee. Tower Trade is intended to be held for resale purposes and thus, has been booked at cost in the accounts. Tower Rental is being held for investment purposes and has been booked at its revalued amount at each balance sheet date. Tower Rental has been let out ever since its acquisition and the rental income has been returned for profits tax purposes. Exemption from property tax has already been obtained.

Below is a diagram showing the ownership/shareholding and funding arrangements:



Required:

(a) Explain the tax effectiveness of the current funding arrangements for the respective properties based on the information given above.

Note: You may assume that all the loans referred to are interest bearing at the prevailing market rates; and all the interest has been expensed in the company’s profit and loss account. (10 marks)

(b) Mr Ho is considering suspending the selling plan for Tower Trade and to offer the property for rental purposes. He understands from the auditors that if he does this the property will have to be reclassified from ‘assets held for trading’ to ‘assets held for investment’ for accounting purposes and that the property will be revalued to its fair value, giving rise to a revaluation profit of around \$5m, which will be recognised in the company’s current year’s profit and loss account.

Required:

Advise on the Hong Kong profits tax implications, if any, arising from the proposed change of holding purpose of Tower Trade. (7 marks)

(17 marks)

- 4 HK Co and Taisan Co are commonly held by a Hong Kong holding company. HK Co carries on business in Hong Kong and Taisan Co carries on business in Mainland China (PRC). HK Co has sought the help of Taisan Co in setting up a computer system in Hong Kong. Taisan Co has agreed to send Siti, its IT manager, to Hong Kong to provide this help. Siti is a PRC citizen.

During his stay in Hong Kong, Siti will remain as an employee of Taisan Co and be remunerated by Taisan Co. Siti will stay in a hotel and will be responsible for his own spending in Hong Kong. In return for Siti's services, HK Co intends to pay a lump sum amount to Taisan Co upon the completion of the assignment. It has been agreed that, if Siti is subject to tax in Hong Kong, the Hong Kong tax will be borne by HK Co. It is, however, not yet certain how long Siti will be required to stay in Hong Kong.

Required:

- (a) **Advise HK Co on the Hong Kong salaries tax position of Siti in respect of the proposed assignment. For the purpose of this part of the question only, you should answer based on the Hong Kong Inland Revenue Ordinance and ignore the application of the double tax agreement between Hong Kong and the PRC. Where appropriate, you should make reasonable assumptions.** (10 marks)
- (b) **Based on Article 14 of the double tax agreement (DTA) signed between Hong Kong and the PRC, which is extracted below, explain to HK Co how the DTA may affect Siti's Hong Kong salaries tax position, clearly identifying the crucial factors for the DTA exemption to be available.**

'Article 14 Income from Employment

2. *Notwithstanding the provisions of paragraph 1 of this Article, remuneration derived by a resident of One Side in respect of an employment exercised in the Other Side shall be taxable only in the first-mentioned Side if all the following conditions are satisfied:*

- (a) *the recipient is present in the Other Side 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 of the Other Side, and*
(c) *the remuneration is not borne by a permanent establishment which the employer has in the Other Side.'*

(5 marks)

- (c) **Based on your answers to (a) and (b) above, give a brief recommendation to HK Co if the objective is to avoid a Hong Kong salaries tax liability for Siti.** (2 marks)

(17 marks)

- 5** Your client, Ms Lim, is the sole proprietor of a garment business. She has recently received a query from the Inland Revenue Department (IRD) regarding the source of funds she used to purchase two flats in late 2006. The IRD has found that Ms Lim had not reported all the business' sales in her profits tax returns submitted for the years of assessment 1998/99 to 2005/06. The omitted sales represented about one-fifth of the total sales.

Ms Lim told the IRD that she was illiterate and relied on her bookkeeper to handle all the accounting and tax matters. She claimed to have no knowledge of the omission. Although she now wants to disclose her true profits to the department, her accountant has not kept proper books and records from which you could prepare revised accounts.

Required:

(a) Advise Ms Lim on the following matters:

- (i) The obligations that are contained in the Inland Revenue Ordinance in regard to the keeping of business records.** (4 marks)
- (ii) The penalty and prosecution action (if any) that could be taken against her by the Inland Revenue Department.** (9 marks)

- (b) You have decided to prepare an assets betterment statement for submission to the Inland Revenue Department. Make a brief list of the initial information and records you would require Ms Lim to produce to you.** (4 marks)

(17 marks)

End of Question Paper