Professional Level – Options Module

Advanced Taxation (Hong Kong)

Monday 1 December 2008

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 $. Unless otherwise specified, all amounts are denominated in Hong Kong currency.
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 2007/08 tax rates and allowances are to be used in answering the questions.

Profits tax rates

Companies	17·5%
Unincorporated business	16%

Salaries tax rates

First $35,000	2%
Next $35,000	7%
Next $35,000	12%
On the remainder	17%
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)	50,000
– additional allowance in the year of birth (each)	50,000
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	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%
Exceeding $6,000,000	3·75%

Leases

(a) Premium only	As for conveyances (above)
(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	3·75% of the consideration
Rent	As for rent-only lease (above)

Section A – BOTH questions are compulsory and MUST be attempted

1 Smart Ltd (the Company) is incorporated in Hong Kong and carrying on a general trading business in Hong Kong. Mr Smart is the Company's shareholder and director. In a meeting with Mr Smart, you were given the following information regarding investments in Hong Kong listed securities made by the Company in 2007 and 2008:

	Share A $	Share B $	Share C $
2007			
Cost, bought in May 2007	1,000,000	1,000,000	
Sale proceeds, sold in October 2007		(3,000,000)	
Profit/(loss) from sale – credited to the profit and loss account		2,000,000	
Year-end revaluation gain – credited to equity account	1,500,000		
Market value at 31 December 2007	2,500,000		
2008			
Cost, bought in November 2008			1,800,000
Sale proceeds, sold in August 2008	(400,000)		
Profit/(loss) from sale – debited to the profit and loss account	(2,100,000)		
Transfer from equity account	1,500,000		
Net profit/(loss) from sale	(600,000)		
Estimated year-end revaluation gain/(loss)			(1,600,000)
Estimated market value at 31 December 2008	–	–	200,000

Extract from the profit and loss account:

	Year ended 31 December 2007 $	Year ended 31 December 2008 (estimated) $
Profit/(loss) from sale of Share B	2,000,000	
Profit/(loss) from sale of Share A		
– revaluation gain transferred from equity account		1,500,000
– current year gain/(loss)		(2,100,000)
		(600,000)
Profit/(loss) from trading operations	4,000,000	(3,000,000)
Bank interest expense	(600,000)	(400,000)
Other operating expenses	(1,000,000)	(1,000,000)
Net profit/(loss) for the year	4,400,000	(5,000,000)

(1) In its 2007/08 profits tax return, the Company claimed the $2,000,000 profit from the sale of Share B as non-taxable, on the basis that the share was held for long-term investment purposes. Share A was also disclosed in the Company's 2007 audited accounts as an investment held for long-term purposes. The year-end revaluation gain for Share A was credited to the equity account.

(2) Subsequent to the filing of the 2007/08 tax return, the Company received a notice of assessment showing assessable profits as per tax return filed. Mr Smart is happy that the non-taxable claim for the $2,000,000 profit from the sale of Share B was accepted by the Inland Revenue Department.

(3) During 2008, the global stock market was affected by the US subprime crisis. At the interim audit meeting, Mr Smart advised the auditors that as from 1 July 2008, the investment strategy for holding Hong Kong securities had changed from long term to short term in order to cope with the down-turning market conditions. Records showed that as of 30 June 2008, the market value of Share A was $490,000. The Company subsequently sold Share A in August 2008 and bought Share C in November 2008.

(4) With the year-end audit approaching, Mr Smart wishes to convince the auditors to reflect the short-term investment strategy in the Company's 2008 accounts, and to recognise the disposal loss from Share A, as well as the year-end revaluation loss from Share C, in the profit and loss account. He intends the Company to claim the losses as tax deductible.

(5) After recognising the tax losses in 2008/09, Mr Smart intends to sell the Company at a value representing a share of the tax benefits arising from the tax losses.

(6) The bank loan obtained was wholly used to fund the acquisitions of the shares. Mr Smart confirmed that the bank loan was guaranteed by his personal name. As he is under pressure from the bank to repay part of the bank loan, he is considering obtaining a personal loan from another bank and injecting the additional funds into the Company, in order to allow the Company to repay the existing bank loan.

Required:

Assuming today's date is 1 December 2008, prepare a report for Mr Smart advising him on the Hong Kong tax issues set out below.

(a) Share B

(i) The Hong Kong tax position of Smart Ltd in respect of the profit of $2 million arising from the sale of Share B in 2007; (8 marks)

(ii) Whether the non-taxability position of the profit from the sale of Share B is final and conclusive. (2 marks)

(b) Share A

The Hong Kong tax position of Smart Ltd in respect of:

(i) the $1·5 million revaluation gain in 2007; and (4 marks)

(ii) the net loss of $600,000 from the sale of Share A in 2008. (5 marks)

(c) Share C

The Hong Kong tax position of Smart Ltd in respect of the revaluation gain/loss from Share C in 2008, assuming that the auditors have agreed that Share C is to be disclosed in the accounts as held for short-term trading purposes and the related year-end revaluation gain/loss will be taken to the profit and loss account. (2 marks)

(d) Tax losses

Whether Smart Ltd's tax losses of $5 million for the year 2008 can be carried forward and whether there will be any impact if the shares in the company are sold. (5 marks)

(e) Funding cost deduction

(i) The Hong Kong tax position of Smart Ltd in respect of the existing bank loan interest incurred; (5 marks)

(ii) The Hong Kong tax implications for both Smart Ltd and Mr Smart if the additional funds are injected into the company by way of equity or by way of a loan, interest-bearing or not; (5 marks)

(iii) Whether from a tax viewpoint a better funding solution is available. (2 marks)

Marks are awarded for the appropriateness of the format and presentation of the report and the effectiveness with which the information is communicated. (2 marks)

Notes:

(1) You are not required to discuss any accounting standards or principles relevant to the accounting treatments adopted in this case.

(2) You should ignore Hong Kong provisional tax and overseas tax throughout this question.

(40 marks)

2 You are the tax advisor in charge of two new clients, Jimmy Chiu and his wife Diana Chiu. On 1 December 2008, you attended the first meeting with them and obtained the following information:

(1) Jimmy is employed by Champion Ltd (Champion), a Hong Kong company, as production manager in charge of Champion's manufacturing operation in She Kou, China. His basic salary is $70,000 per month.

(2) Jimmy comes back to Hong Kong every Saturday afternoon and returns to China on the following day. He also comes back to Hong Kong during his vacations. During the year ended 31 March 2008, he was in Hong Kong for a total of 115 days. Because of the nature of his duties, he is rarely required to perform any duties in Hong Kong. However, in August 2007, when he returned to Hong Kong, he was asked to look for and purchase a spare part in Hong Kong which was used for a repair at the factory.

(3) Jimmy is provided with a flat in She Kou, and meals are provided for him at the factory. The flat is leased by Champion at a monthly rental of $10,000. The cost of his travelling expenses between Hong Kong and She Kou of $2,000 per month are paid directly by Champion. In addition, Champion pays him $20,000 each year so that he can travel overseas during his holidays. In August 2007, Jimmy spent $15,000 on a trip to Japan.

(4) In September 2007, Jimmy was hurt in an accident while working in the factory. Champion reimbursed the medical expenses of $24,000 that he paid for his stay in the hospital in She Kou. In addition, he was paid $50,000 by Champion for the loss of the little finger on his left hand.

(5) Diana wholly owns Diana Ltd (the Company), which is engaged in the trading of second-hand handbags and accessories. She also acts as a director of the Company at a director's fee of $60,000 per annum. The Company was incorporated in Hong Kong on 1 October 2007 and commenced business on 1 January 2008. Since incorporation, the Company has not finalised any audited accounts, filed a profits tax return, nor exchanged any correspondence with the Inland Revenue Department. Management accounts have been prepared for the period 1 October 2007 to 30 November 2008, which show a net profit of $100,000. Diana advised you that she has not yet determined the accounting year end date for the Company.

(6) Diana and Jimmy, when he is in Hong Kong, live with Jimmy's parents in a flat in Shatin. The flat is leased for four years, from a relative, at a monthly rental of $15,000, but no tenancy agreement has been prepared. Jimmy also contributes $3,000 per month to support his parents-in-law, who live in China. Both of his parents and parents-in-law were aged over 60 during the year ended 31 March 2008.

Required:

As tax consultant to Jimmy and Diana, write a letter to them giving advice on the following:

(a) Their respective tax positions for the year of assessment 2007/08. If you need further information to determine the tax position, state what information you need and why you need it. (19 marks)

(b) All of the compliance obligations under the Inland Revenue Ordinance in respect of Diana Ltd; and the due dates for compliance purposes, assuming that the company's first accounts are to be closed on (1) 30 November 2008, and (2) 31 March 2008. (7 marks)

Note: your letter should include such supporting calculations of the couple's assessable/chargeable income as you consider relevant, but you are not required to calculate the tax payable.

Marks are awarded for the appropriateness of the format and presentation of the letter and the effectiveness with which the information is communicated. (2 marks)

(28 marks)

Section B – TWO questions ONLY to be attempted

3 Excel Ltd (Excel) commenced business in Hong Kong in 1990, as a manufacturer and exporter of electronic products. In 2007, in order to take advantage of the low labour and other costs on the Mainland, Excel started to arrange for its products to be manufactured on the Mainland.

Excel was recommended by the provincial government to set up a factory in Dong Guan, in the form of a separate entity for carrying on an assembly business under an import processing arrangement. In an 'import processing' arrangement, the Hong Kong manufacturing business sells the unfinished goods or raw materials to the Mainland entity for processing. The Mainland entity owns the inventory and the work in progress, and sells the finished goods back to the Hong Kong manufacturing business.

The establishment of Sino Co (Sino), Excel's wholly owned subsidiary and a wholly foreign-owned enterprise, was approved in March 2007. An import processing agreement was entered into by Sino and Excel on 1 April 2007. Under the import processing agreement, Excel agreed to provide all the machinery, raw materials, design, technical know-how, product specifications and quality control standards, and the training and supervision of local staff on the Mainland.

Excel has performed the obligations on its part under the import processing agreement as follows:

(1) Plant and machinery owned by Excel was transferred to Sino for Sino's use.

(2) Four employees of Excel have been seconded to Sino to supervise and monitor the processing works. These employees remain under the payroll of Excel but they spend their full-time at Sino and are not required to attend Excel's office in Hong Kong.

(3) The design and technical know-how development are carried out in Hong Kong and such design and technical know-how is supplied by Excel to Sino for the processing works carried out by it for Excel.

(4) The supply of raw materials from Excel to Sino is in the form of the sale of the raw materials at cost by Excel to Sino and the finished goods supplied by Sino to Excel are in the form of a purchase by Excel from Sino. The price of the finished goods paid for by Excel represents more or less the expenses incurred by Sino, after offsetting the price of the raw materials supplied by Excel to Sino.

Required:

(a) Based on the Departmental Interpretation and Practice Note No. 21 entitled 'Locality of Profits', explain the general principles applied by the Inland Revenue Department in determining the source of manufacturing profits. (6 marks)

(b) On the basis of the above facts, discuss whether Excel Ltd's profits should be subject to, or exempt from, profits tax. In the course of your answer, you should advise on the likely position the Commissioner of Inland Revenue would take in this case. (10 marks)

(16 marks)

4 Swallow Ltd (Swallow) commenced business in 1993. Its holding company is Parrot Ltd (Parrot), a company incorporated in Japan. Parrot and Swallow have both previously made up their accounts to 31 December annually. In 2008, for administrative reasons, Parrot decided to change its accounting date to 30 June. To give effect to this change, accounts for 18 months will be drawn up for the period 1 January 2008 to 30 June 2009.

In order to conform to the accounting date of Parrot, Swallow will change its accounting date from 31 December to 30 June in 2008. The first set of accounts drawn up after the change will also be for the 18 months period to 30 June 2009. The 18 month account finalisation will be completed by the end of 2009.

As the normal basis period for a continuous business is 12 months, the management of Swallow is concerned about how the Inland Revenue Department will determine its basis period for the relevant years of assessment.

Required:

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

(b) Advise on the position which will be taken by the Inland Revenue Department in assessing Swallow Ltd and determine the basis period for each of the affected years of assessment. (6 marks)

(c) As it is not certain how the Commissioner will determine the basis period, advise Swallow Ltd on the action it could take to increase the level of certainty. (4 marks)

(d) State, giving reasons, how your answer to (b) above would differ if Swallow Ltd had commenced business in 1973 (instead of 1993). (3 marks)

(16 marks)

5 For the purposes of this question, you should assume that today's date is 1 February 2008.

The Chief Executive Officer (CEO) of your company is going to retire with effect from 1 April 2008 and will be returning back to his home in Singapore for good in May 2008. He has the following concerns:

(a) Under his Hong Kong employment contract, the CEO is entitled to receive an annual discretionary bonus, which is calculated based on the company's profit level for the preceding year. However, the company's annual accounts for the year ended 31 March 2008 will only be finalised in June 2008. His boss has agreed to pay him the bonus based on the company's estimated result if he wishes to receive it before leaving Hong Kong, or alternatively, he will have to wait until July 2008 when the company's accounts are finalised. (4 marks)

(b) Throughout his employment, the CEO has been living in the company's quarters free of charge. Although his last day of employment is 31 March 2008, he will be allowed to continue to live in the quarters, free of charge, until the end of May or the day he departs Hong Kong, if earlier. Alternatively, his boss is offering him a housing allowance of $50,000 in cash if he moves out of the quarters on 1 April 2008. (3 marks)

(c) During his employment, the CEO has been granted two batches of options to acquire the company's shares. All the options are unconditional. Based on the current share price, one batch of the options is profitable if exercised now, but the other batch currently stands at a marginal loss. He is thinking of exercising the first profitable batch after he returns to Singapore so that no Hong Kong tax will be payable; but he may let the loss-making batch lapse unless somebody is interested in buying the option. In the CEO's opinion, the company's share price will remain steady until the end of June 2008. (7 marks)

(d) He understands from the 2008 Financial Budget Speech that each Hong Kong taxpayer will be entitled to a tax reduction of 75% of their 2007/08 tax liability subject to a maximum of $25,000. However, the law may not be enacted by the time his final tax assessment for 2007/08 is issued, before he departs Hong Kong in May 2008. He is concerned that his entitlement to this tax rebate will be forfeited. (2 marks)

Required:

Explain the Hong Kong tax implications relating to each of the above issues (a) to (d), and where alternative courses of action are available, give advice on how the maximum tax saving can be achieved.

Note: the marks allocation is shown against each of the four issues above.

(16 marks)

End of Question Paper