Professional Level – Options Module

Advanced Taxation (Hong Kong)

Monday 2 June 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 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 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)

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Question 1 begins on page 5.

Section A – BOTH questions are compulsory and MUST be attempted

1 You are the Hong Kong tax consultant for Sweetie (HK) Co Ltd (Sweetie-HK). Sweetie-HK operates candy shops in Hong Kong under the tradename of 'Sweetie' licensed from Confectionaries Inc in the US (the US licensor). The US licensor is interested in the PRC market and has been negotiating with Sweetie-HK to extend its licence into the PRC. Sweetie-HK is not related to the US licensor.

You have received the following email from Sweetie-HK's Finance Director:

To: Tax Advisor
From: HL Leung, Finance Director, Sweetie (HK) Co Ltd
Date: 3 February 2008
Subject: Confidential: The PRC franchise

Good news! We have finally obtained the PRC franchise from the US licensor. Time is very tight. Our first shop in Shenzhen must be open by 1 July 2008. We need your tax advice on the whole project, in particular on the following aspects:

1. What is the most tax effective form of business for our operation in the PRC? Should we register as a branch of Sweetie-HK or incorporate a wholly owned subsidiary in the PRC? Note that the PRC business is expected to be loss-making in the first two years. Since Sweetie-HK is making profits, I wonder if we can benefit from these losses by reducing the HK profits tax payable as well as holding over the HK provisional profits tax for the coming assessment year. As you know, cashflow in the forthcoming months is tight.
2. How should we structure the PRC licence? Two options I think:
   (a) license directly from the US licensor to the PRC business; or
   (b) expand the existing HK licence to include the PRC territory and then Sweetie-HK can sub-license it to the PRC business.
3. Should we structure our funding into the PRC business by loan or by capital? Note that we may need to obtain bank borrowings to fund this project.

The inhouse tax director of the US licensor has kindly sent us some information about the PRC tax aspects. Please see the attached email. I am sure you will find them useful in formulating your HK tax advice, but if you have any questions or are in doubt please let me know.

We plan to have the first steering committee meeting next Monday and would appreciate your presentation of the above issues at the meeting. Some projected figures for the new market are provided below. Please use them to illustrate your conclusions wherever possible.

Thanks and regards.

Projected figures for the PRC business (HK$):

	2008 (6 months)	2009 (full year)	2010 (full year)
Number of shops	1	3	4
Projected sales	5,000,000	15,000,000	25,000,000
Royalty charged by the US licensor	2%	2%	2%
Projected profit/(loss)	(500,000)	(400,000)	1,000,000
Funding required from HK	2,000,000	4,000,000	1,000,000
Forecast bank borrowing interest rate	4%	4%	4%

Attachment to the email:

To: HL Leung, Finance Director, Sweetie (HK) Co Ltd
From: Barbara Stuart, Group Tax Director, Confectionaries Inc
Date: 29 January 2008
Subject: Confidential: The PRC licence

Dear Mr Leung,

I was instructed to give you some information about the PRC tax aspects which may hopefully help you to properly structure your future PRC business. Please note that the following information is very general and high-level in nature and you may need to confirm with your PRC tax expert once a structure is formulated.

1. A royalty payable by the PRC business to the US licensor is subject to a 10% withholding tax in the PRC, i.e. for every $100 of royalty paid, the recipient receives $90. However, under the new PRC-HK Double Tax Arrangement, the rate will be reduced to 7% if payable by the PRC business to your company. As agreed, the tax cost will be borne by your company (or the PRC business). Thus, it would be to your advantage if the total tax cost can be minimised. I am not too sure about the HK tax position but would like to remind you that any additional tax cost in HK will still be for your account.
2. If loan funding is required for the PRC operation, any interest payable by the PRC business to your company is subject to a 7% withholding tax in the PRC.

Hope the above are useful. Regards.

Required:

Assuming today's date is 7 February 2008, prepare a report for the management of Sweetie (HK) Co Ltd concerning the structure of the new business in the PRC. The report should address only the Hong Kong tax issues set out below and should, where appropriate, include supporting calculations.

(a) The form of operation in the PRC:

Comment on the Hong Kong tax position of Sweetie (HK) Co Ltd if the PRC business is operated as a branch of Sweetie (HK) Co Ltd as compared to a PRC incorporated subsidiary of Sweetie (HK) Co Ltd. (6 marks)

(b) The structure of the licence from the US licensor:

Note: for the purpose of this part of the question only, you should ignore the gross-up effect of the PRC withholding tax.

Advise on the Hong Kong tax positions of Sweetie (HK) Co Ltd and the US licensor (if applicable) under the following options:

(i) Assuming that Sweetie (HK) Co Ltd sets up a wholly owned subsidiary in the PRC and the PRC licence is directly licensed from the US licensor to the PRC subsidiary; (1 mark)

(ii) Assuming that Sweetie (HK) Co Ltd sets up a wholly owned subsidiary in the PRC and the PRC licence is licensed from the US licensor to Sweetie (HK) Co Ltd which then sub-licenses the PRC licence to the PRC subsidiary; (14 marks)

(iii) Assuming that Sweetie (HK) Co Ltd operates the PRC business as a branch and the existing HK licence from the US licensor is expanded to include the PRC territory. (2 marks)

(c) The funding for the PRC operation:

Note: for the purpose of this part of the question only, you should assume that the PRC business is operated as a subsidiary of Sweetie (HK) Co Ltd.

Comment on the Hong Kong tax position of Sweetie (HK) Co Ltd in respect of the funding cost if:

(i) the funding is injected in the form of equity;
(ii) the funding is injected in the form of an interest bearing loan; or
(iii) the funding is injected in the form of an interest free loan. (8 marks)

(d) The effect of the operating losses:

Note: for the purpose of this part of the question only, you should assume that the PRC business is operated as a branch of Sweetie (HK) Co Ltd.

Discuss the tax implications of the operating losses from the PRC business for Sweetie (HK) Co Ltd and the circumstances under which the Hong Kong provisional profits tax can be held over. (4 marks)

(e) Based on the above analysis, make recommendations regarding the overall structure to be adopted. (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 throughout this question.

(39 marks)

2 Alice Chu has asked your firm to handle all her Hong Kong tax affairs. You have held an initial meeting with Alice, at which you ascertained the following information relating to the year ended 31 March 2008:

(1) Alice has been employed by ATM Inc (ATM), a US company, since January 2002. On 1 April 2007, she was transferred to ATM's Hong Kong buying office to take charge of the sourcing operations.

(2) Alice's basic salary is $90,000 per month. She receives her salary and benefits in Hong Kong dollars. She joined the Hong Kong Mandatory Provident Fund and is covered under the Hong Kong medical scheme.

(3) An air ticket for Alice, to relocate her from the US to Hong Kong, was purchased by ATM at a cost of $16,000.

(4) Alice travels frequently to the Mainland and neighbouring countries in the performance of her duties. During the 2007/08 year, she spent 182 days (including 26 days annual leave) on overseas trips.

(5) Alice receives $30,000 per month as a 'housing allowance' for the purpose of enabling her to afford accommodation in Hong Kong. She spends $20,000 per month on a one room serviced apartment in a hotel and keeps the rest of the housing allowance for herself. ATM does not require the excess amount to be reimbursed to it.

(6) In addition, she receives $50,000 per year as a 'holiday allowance'. The purpose of this allowance is to enable her to return to her home in the US once a year, as well as to fund other occasional holidays. ATM does not monitor how this amount is actually spent. In fact, Alice spent only $40,000 of this amount on holiday travel in the 2007/08 year.

(7) Alice holds a number of different share options in ATM. Under tranche A, granted in January 2004, she was awarded the right to acquire 10,000 shares in ATM if she was still employed by ATM in January 2007. Under tranche B, granted in March 2006, she was awarded the right to acquire 8,000 shares if she was still employed by ATM in March 2008. She exercised both options on 31 March 2008 when the shares were worth $90 each. In addition, on 1 October 2007, under tranche C, she was granted the right to acquire 15,000 shares provided that she remains employed by ATM in October 2010. She believes that she will have left Hong Kong by that date. All the options were awarded for no consideration and the exercise price in each case is $10 per share.

(8) ATM reimburses Alice for her electricity and phone bills, up to a maximum of $12,000 per year. To obtain this reimbursement, she must provide invoices to ATM to prove that she has in fact incurred this amount.

(9) During the year, ATM received and paid the following tax bills in respect of Alice:

PRC individual income tax	$80,000
Other Asian countries' income tax	$30,000

(10) Alice purchased a flat in Kowloon on 1 July 2007. To fund the acquisition of the flat, she borrowed the equivalent of Hong Kong $5 million from her brother in the US to whom she pays interest at 5% per year. On the same day the flat was leased to a friend for a term of four years at a monthly rent of $20,000. No lease agreement was signed.

(11) Alice's husband lives with their 10-year-old daughter in Chicago.

(12) Alice spent $120,000 supporting her aged parents who live with her family in Chicago. Her parents originally came from Hong Kong and hold permanent resident identity cards.

(13) Alice gave $25,000 to charities in Hong Kong and $15,000 to charities in the US during the 2007/08 year.

Required:

Prepare a memorandum for your manager setting out the advice that should be given to Alice Chu on her tax position 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.

Note: your memorandum should include such supporting calculations of Alice's assessable/chargeable income/value as you consider relevant, but you are not required to calculate the tax payable. (27 marks)

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

(29 marks)

Section B – TWO questions ONLY to be attempted

3 The director of Expansion Co Ltd (Expansion Co) recently gave a briefing on the outcome of the due diligence conducted on a company targeted for acquisition (Target Co). The tax related aspects of the briefing are summarised as follows:

(a) Target Co has assessable profits of $12 million for the year of assessment 2006/07. A tax assessment was issued per the tax return and tax payments were made before the due dates.

(b) Copies of profits tax returns for the years of assessment from 2002/03 to 2006/07 have been obtained and found to be in order. All years were tax-paying and assessments were issued per the tax returns lodged.

(c) No record of any tax query from the Inland Revenue Department (IRD) was found.

(d) The shareholder of Target Co has agreed to include the following clauses in the 'Share Sale and Purchase Agreement':

(i) Clause 4.1 – Seller (i.e. Shareholder of Target Co) hereby warrants and guarantees that all tax assessments prior to and including 2006/07 are finalised with no outstanding tax queries.

(ii) Clause 4.2 – Seller has agreed that, in the event of any tax queries or additional assessment raised by the IRD in respect of the years of assessment prior to and including 2006/07, Seller (including the directors of Target Co as named in Appendix A) will be fully responsible for handling the tax queries directly with the IRD, including negotiating with the IRD on behalf of the company.

Required:

Advise the director of Expansion Co Ltd on each of the above points covered at the due diligence briefing. You should address any potential tax risks that may be faced by Expansion Co Ltd in respect of the acquisition of Target Co in terms of tax compliance and whether the suggested clauses 4.1 and 4.2 to be included in the Share Sale and Purchase Agreement are sufficient and would be effective to protect Expansion Co Ltd (and Target Co) in the event of a tax challenge being raised for any prior year.

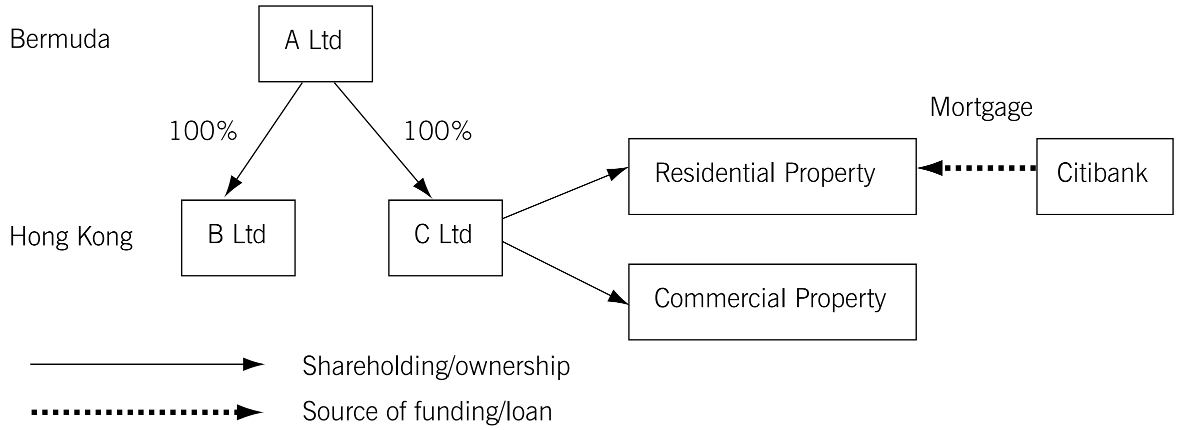
(16 marks)

4 **(a)** Cargo Shipping Ltd is a Liberian company that carries on the business of carrying cargoes on its ships for fees. All its ships are registered in Liberia. The ships sail around the world and collect cargoes at various ports, including Hong Kong, for delivery to various ports, including Hong Kong.

Required:

Explain whether or not Cargo Shipping Ltd will be subject to tax in Hong Kong and if so, how its tax liabilities would be computed. (7 marks)

(b) A Ltd owns all the shares in B Ltd and C Ltd. A Ltd is incorporated in Bermuda. Both B Ltd and C Ltd are incorporated in Hong Kong. C Ltd owns a residential property in Causeway Bay and a commercial property in Central. The residential property is mortgaged in favour of the Citibank for an amount of $10 million. Below is a diagram showing the shareholding/ownership and funding arrangements:



During the year 2007/08, the following transactions were effected:

(i) The residential property was sold by C Ltd to A Ltd for $15 million. As part of the sale, the mortgage to the Citibank was discharged and the property refinanced by way of a mortgage in favour of the Hang Seng Bank.

(ii) The commercial property was leased by C Ltd to B Ltd for a term of four years. Under the lease, B Ltd agreed to pay rent to C Ltd of $50,000 per month plus 10% of B Ltd's gross turnover from business conducted in the property.

(iii) The shares in B Ltd were sold by A Ltd to D Ltd, an unrelated party, for $50 million. The purchase consideration will be settled by way of an issue of shares in D Ltd.

Required:

State, giving reasons, the stamp duty implications arising from the above transactions. (9 marks)

(16 marks)

5 Mr So runs a trading business in Hong Kong through a Hong Kong incorporated company, So Best Co Ltd (the Company). The Company owns a property in Hong Kong funded by a bank mortgage. For certain personal reasons, Mr So is considering liquidating the Company and running the business as a sole proprietor. He will then transfer the property to himself and continue with the bank mortgage under his own name.

The following is a summary of the Company's profit and loss account for the year ended 31 December 2007:

	$	$
Sales		150,000
Property rental income		200,000
Purchases	(120,000)	
Salary to Mr So	(100,000)	
Property management fees	(24,000)	
Property rates	(12,000)	
Other business expenses	(20,000)	
Bank mortgage interest	(160,000)	(436,000)
Profit/(loss)		(86,000)

Mr So is single and has no dependants.

Required:

Advise Mr So on how his tax position would be affected by the proposed change.

Note: you are NOT required to calculate the actual tax liabilities either before or after the change.

(16 marks)

End of Question Paper