

Professional Level – Options Module

Advanced Taxation (Hong Kong)

Monday 1 June 2009

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)

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

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 2008/09 tax rates and allowances are to be used in answering the questions.

Profits tax rates

Companies	16.5%
Unincorporated business	15%

Salaries tax rates

First \$40,000	2%
Next \$40,000	7%
Next \$40,000	12%
On the remainder	17%
Standard rate	15%

Allowances

	\$
Basic allowance	108,000
Married person's allowance	216,000
Single parent allowance	108,000
Child allowance – 1st to 9th child (each)	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)

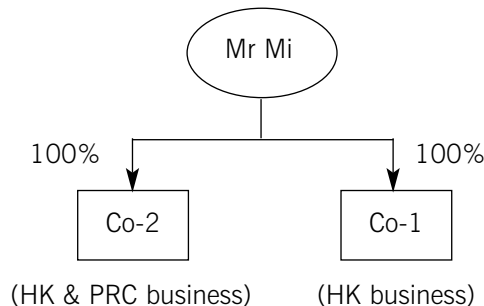
Section A – BOTH questions are compulsory and MUST be attempted

1 Mr Mi is the sole shareholder of Won Co Ltd (Co-1), a company carrying on business in Hong Kong. Co-1 has always been profitable but currently has a liquidity problem. As at 31 March 2009, Co-1’s financial position is as follows:

Extract of Co-1’s Balance Sheet as at 31 March 2009:

Shareholder’s funds	\$	\$
– share capital	1,000	
– retained earnings	5,000,000	
	<hr/>	
Total equity		5,001,000
		<hr/>
Fixed assets		
– two offices (same size and value)	2,500,000	
– computer system	800,000	3,300,000
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Current assets		
– bank balance	200,000	
– amount due from Mr Mi	1,800,000	2,000,000
	<hr/>	
Liabilities		
– trade creditors		(299,000)
		<hr/>
Total net assets		5,001,000
		<hr/>

Mr Mi intends to acquire the shares in another Hong Kong company, Too Co Ltd (Co-2), from an independent seller. Co-2 is currently carrying on business in both Hong Kong and the PRC. The group structure after the acquisition will look like this:



You are the independent tax consultant engaged by Mr Mi, and are presented with the following proposal which has been prepared by Mr Mi’s personal assistant:

From: Personal Assistant
Date: 25 May 2009
Subject: Acquisition of Co-2 and business restructuring

Acquisition of Co-2

- (1) The agreed consideration is \$2,000,000, comprising cash of \$1,500,000 and assignment of a shareholder’s loan of \$500,000. A separate assignment deed will be executed for the assignment of the shareholder’s loan.
- (2) The tax due diligence has been completed, with major findings as follows:
 - (a) All Hong Kong tax returns were filed on time, all Hong Kong tax assessments were issued per the tax returns with no queries, and all Hong Kong tax was paid by the due dates.
 - (b) The seller agreed to warrant and guarantee that all Hong Kong tax assessments prior to the acquisition date are finalised without outstanding tax queries.
 - (c) The seller also agreed that any Hong Kong tax disputes raised in respect of the pre-acquisition period will be handled by him on behalf of Co-2.

Business restructuring

- (3) After the acquisition, Co-2 is expected to rely heavily on resources provided by Co-1, and no profit is budgeted for Co-2 during the initial three years.

- (4) Co-2 will share the computer system currently owned and used by Co-1, at no cost. Starting from 1 April 2012, if Co-2 turns profitable, an annual charge equivalent to 2% of Co-2's annual profits will be payable to Co-1 for this service.
- (5) One of the two office buildings currently owned and occupied by Co-1 will be transferred to Co-2 at a nominal consideration of \$1. Co-2 will occupy the building as its own office.
- (6) Two senior managers of Co-1 will be transferred to Co-2, with identical terms of employment as those under Co-1. One of the managers will be seconded to work in the PRC on a full-time basis.
- (7) To meet the cash requirements of Co-2, the following options are being considered:
 - (A) Co-2 will obtain a bank loan with a guarantee from Mr Mi or Co-1. Before Co-2 starts to make profits, Co-1 will help Co-2 to repay the bank interest.
 - (B) Co-1 will borrow loans from banks and lend the money on to Co-2, interest free.
 - (C) Co-1 will demand repayment from Mr Mi for the amount due of \$1,800,000, and lend it to Co-2, interest free. Mr Mi will fund the repayment by way of a personal loan from a bank.
 - (D) Co-1 will declare a dividend to Mr Mi who will inject the dividend money into Co-2 as additional capital. Because of a lack of cash, Co-1 will have to finance this dividend payment by means of a bank loan.

Required:

Prepare a report for Mr Mi, advising on the personal assistant's proposals concerning the acquisition of Co-2 and the business restructuring. The report should address the Hong Kong tax issues set out below and should, where appropriate, include supporting calculations.

(a) Acquisition of Co-2

- (i) **The Hong Kong stamp duty cost, if any, of acquiring the shares in Co-2;** (3 marks)
- (ii) **The potential risks in the context of Hong Kong tax compliance, if any, that may be faced by Mr Mi in respect of the acquisition of Co-2, including whether the warranties given by the seller are effective or not.** (8 marks)

(b) Business restructuring

- (i) **The Hong Kong tax implications to Co-1 arising from the sharing of its computer system by Co-2, as described under item 4 in the proposal;** (3 marks)
- (ii) **The Hong Kong tax and stamp duty implications to both Co-1 and Co-2 arising from the transfer of the office building from Co-1 to Co-2 at nominal value;** (6 marks)
- (iii) **The Hong Kong tax compliance requirements, if any, that need to be observed by both Co-1 and Co-2 as a result of transferring the two employees from one company to another;** (4 marks)
- (iv) **The tax deductibility of the interest expense, if any, by Mr Mi, Co-1 and Co-2, as the case may be, under each of the funding options described under item 7 (A) to (D) in the proposal.**

Note: marks will be allocated in part (b) (iv) as follows: item 7 (A) – 4 marks; (B) – 2 marks; (C) – 2 marks; (D) – 3 marks. (11 marks)

Note: You should ignore Hong Kong provisional tax and overseas tax.

Professional marks will be awarded in question 1 for the appropriateness of the format and presentation of the report and the effectiveness with which its advice is communicated. (2 marks)

(37 marks)

2 Effective 1 April 2008, Mike Chan has been employed as the project manager of Real Estate Investment Ltd (REIL), a Hong Kong company which conducts a property development business in Hong Kong and China. He has provided you with the following information relating to the year ended 31 March 2009:

- (1) Mike has his office in Hong Kong, but he is mainly responsible for monitoring the progress of the property development projects in China. He negotiated his employment contract with REIL in Shanghai, China. Instead of signing a single employment contract as originally prepared by REIL, at Mike's request, two contracts were signed, Contract 1 covering his services to be rendered in Hong Kong; and Contract 2 covering his services to be rendered in China. His monthly salary under Contract 1 and Contract 2 is \$40,000 and \$60,000 respectively, payable in Hong Kong.
- (2) Mike comes back to Hong Kong every Saturday afternoon to stay with his family and returns to China after reporting his work to his boss at the Hong Kong office on the morning of the following Monday. He also comes back to Hong Kong during his vacations.
- (3) In April 2008, Mike purchased a property in Shatin for \$5,000,000; and used it as his place of residence. He financed the acquisition of this property by way of a loan borrowed from the bank, and paid loan interest of \$60,000 for the year.
- (4) Mike arranged with REIL to rent the Shatin property from him at a monthly rent of \$20,000 starting from 1 May 2008 for a two-year period; and REIL then provided this property rent-free to him. A written tenancy agreement was entered into between Mike and REIL.
- (5) REIL purchased a medical insurance policy for Mike and his family at a cost of \$15,000.
- (6) Mike was provided with a corporate credit card, which he could use for both personal and business expenditure. Although he was the cardholder, REIL was billed by the credit card company directly and paid the amounts. The personal and business expenditure charged during the year was \$36,000 and \$70,000 respectively. The credit card company had a bonus scheme for the cardholder. Under the scheme, the cardholder earned a bonus point for every \$100 spent and these bonus points could be used to redeem merchandise. Mike used his bonus points earned to redeem a mobile phone which could be bought for \$1,800.
- (7) On 15 September 2008, REIL granted Mike a right to subscribe to 8,000 shares in Real Estate Investment Inc, REIL's overseas parent company, at \$20 each. Mike paid \$1,000 for this option. He exercised the option on 10 October 2008 and acquired the full 8,000 shares and on 12 December, he sold all the shares. The market price of the shares on 15 September, 10 October and 12 December 2008 was \$24, \$30 and \$32 respectively.
- (8) In recognition of Mike's outstanding performance, REIL provided him with two round-trip tickets to London for a holiday. The cost of the air tickets to REIL was \$30,000; and Mike could sell them for \$18,000.
- (9) Peggy, Mike's wife, works as a secretary for Apple Ltd, earning a monthly salary of \$10,000.
- (10) Mike divorced his former wife in 2001. He was solely responsible for the maintenance of his daughter (born in 1998) for eight months during the year and his former wife was responsible for the remaining four months. He also paid \$4,000 per month to maintain his 75-year-old father who stays in a nursing home in Shenzhen.
- (11) During the year, Mike and Peggy made cash donations of \$45,000 and \$47,000 respectively to various charities.

Required:

As tax consultant to Mike, write a letter to him giving advice on his and his wife's tax positions for the year of assessment 2008/09. If you need further information to determine the tax position, state what information you need and why you need it.

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

Professional marks will be awarded in question 2 for the appropriateness of the format and presentation of the letter and the effectiveness with which its advice is communicated. (2 marks)

(29 marks)

Section B – TWO questions ONLY to be attempted

3 Zeta Inc (Zeta) is a large US trading corporation. It intends to expand its business and is planning to set up a branch in Hong Kong to sell some of its products in China. The branch will lease an office in Tsuen Wan, consisting of a sales and marketing department, purchasing department, shipping department, accounts department and general administration department. Sales orders from Chinese customers will be solicited by the branch's sales and marketing staff who will travel to China to obtain orders and to promote Zeta's products. All sales orders will be sent to and followed up by the branch in Hong Kong. Confirmation of the orders will then be sent from the branch to the customers, and letters of credit and shipment of products will also be handled by the branch. The products will be purchased by the branch from Zeta's group companies in the US. Some of the products will be transported from the US to Hong Kong for trans-shipment to the customers in China, whereas some will be shipped directly from the US to the customers.

Required:

- (a) Briefly outline the considerations that need to be taken into account by Zeta Inc in deciding whether to set up a branch in Hong Kong. (4 marks)**
- (b) Discuss the potential profits tax liabilities of Zeta Inc in respect of the profits made from the sale of its products by the branch to be set up in Hong Kong. (10 marks)**
- (c) Assuming the Hong Kong branch's profits are chargeable to profits tax, advise Zeta Inc on how the branch's assessable profits would be ascertained. (3 marks)**

(17 marks)

- 4 Li Ping is a Chinese citizen working as an IT manager in a PRC-incorporated company named as ChinaNet Ltd (ChinaNet). Since April 2007, Li Ping has been required to travel to Hong Kong to assist ChinaNet's holding company in Hong Kong, to set up its system in Hong Kong. Li Ping remains an employee of ChinaNet and continues to receive his salary through his bank account in the PRC. ChinaNet does not have the intention to recharge any cost to the Hong Kong company. During his stays in Hong Kong, Li Ping stayed in a hotel and the hotel bill was settled by the Hong Kong company. Li Ping's family did not travel with him.

Li Ping's travelling schedule to Hong Kong since April 2007 has been as follows

		Place of stay	Purpose of stay
2007	10–31 May	Hong Kong	Business
	1–20 September	Hong Kong	Business
	1–18 December	Hong Kong	Business
2008	1–21 April	Hong Kong	Business
	1 May–30 July	Hong Kong	Business
	8–31 August	Hong Kong	Business
2009	15 January–19 February	Hong Kong	Business

Required:

- (a) Advise Li Ping of his Hong Kong salaries tax position in respect of his services performed in Hong Kong during each of the years of assessment 2007/08 and 2008/09.

Note: 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.

(8 marks)

- (b) Based on Article 14 of the double tax agreement (DTA) signed between Hong Kong and the PRC, which is extracted below, explain how the DTA may affect Li Ping'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.'*

(9 marks)

(17 marks)

5 Assume today is 1 December 2008.

Aggressive Co Ltd (the Company) carries on a project consultancy business in Hong Kong, and makes up its accounts to 31 December each year. In reviewing the Company's projected profit and loss account for the year ending 31 December 2008, the Company's financial controller was concerned about the significant profits earned resulting in an increase in both the 2008/09 final profits tax and the 2009/10 provisional profits tax payable. He has the following ideas in mind:

- (a) He has identified two fee invoices that have been issued to customers on 30 November 2008. Corresponding credit notes will be issued to cancel the invoices; and identical invoices will be re-issued to the customers in January 2009.
- (b) An expense voucher will be prepared to claim a whole year's salary payable to an independent project consultant engaged to work for the Company during the year ending 31 December 2008. The named project consultant will be the financial controller's mother, who is a full-time housewife.

Required:

In the context of tax avoidance, discuss the extent of risk to Aggressive Co Ltd arising from the implementation of the financial controller's ideas.

Note: you are not required to discuss any accounting or auditing implications for Aggressive Co Ltd, or the tax positions of the relevant customers or of the independent project consultant under the respective ideas.

(17 marks)

End of Question Paper