

Strategic Professional – Options

# Advanced Taxation – Hong Kong (ATX – HKG)

Tuesday 4 June 2019



**Time allowed:** 3 hours 15 minutes

This question paper is divided into two sections:

Section A – BOTH questions are compulsory and MUST be attempted

Section B – BOTH questions are compulsory and MUST be attempted

**Tax rates and allowances are on pages 2 and 3**

**Do NOT open this question paper until instructed by the supervisor.**

**This question paper must not be removed from the examination hall.**

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Think Ahead

**ACCA**

The Association of  
Chartered Certified  
Accountants

## 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.
5. Ignore provisional tax and statutory tax reductions, unless specified otherwise.

## TAX RATES AND ALLOWANCES

The following 2018/19 tax rates and allowances are to be used in answering the questions.

Assessable profits	Profits tax rates	
	Companies	Unincorporated business
First \$2 million	8.25%	7.5%
Over \$2 million	16.5%	15%

Salaries tax rates	
First \$50,000	2%
Next \$50,000	6%
Next \$50,000	10%
Next \$50,000	14%
Remainder	17%
Standard rate	15%

Allowances		\$
Basic allowance		132,000
Married person's allowance		264,000
Single parent allowance		132,000
Child allowance – 1st to 9th child (each)		120,000
– additional allowance in the year of birth (each)		120,000
Dependent parent/grandparent allowance – basic		25,000/50,000
– additional		25,000/50,000
Dependent brother/sister allowance		37,500
Disabled dependant allowance		75,000
Personal disability allowance		75,000

Deductions		\$
Self-education expenses (maximum)		100,000
Home loan interest (maximum)		100,000
Elderly residential care expenses (maximum)		100,000
Mandatory provident fund contributions (maximum)		18,000

### Depreciation allowance rates

Initial allowance:	
Plant and machinery	60%
Industrial buildings	20%
Annual allowance:	
Computers	30%
Motor cars	30%
Aircraft	30%
Furniture and fixtures	20%
Machines	10–30%
Industrial buildings	4% or formula
Commercial buildings	4% or formula

### Stamp duty rates

**Stock** 0.2% + \$5

#### Immovable property

Conveyance on sale and agreement for sale (ignoring marginal reliefs)

	Scale 1 (Part 1)	Scale 1 (Part 2)	Scale 2
Up to \$2,000,000	15%	1.5%	\$100
\$2,000,001 to \$3,000,000	15%	3.0%	1.50%
\$3,000,001 to \$4,000,000	15%	4.5%	2.25%
\$4,000,001 to \$6,000,000	15%	6.0%	3.00%
\$6,000,001 to \$20,000,000	15%	7.5%	3.75%
\$20,000,000 and above	15%	8.5%	4.25%

Conveyance on sale and agreement for sale chargeable with special stamp duty

Holding period	
Not exceeding six months	15% or 20% as applicable
Between six and 12 months	10% or 15% as applicable
Between 12 and 24/36 months	5% or 10% as applicable

Conveyance on sale and agreement for sale chargeable with buyer's stamp duty 15%

Lease

- |                                                            |                                       |
|------------------------------------------------------------|---------------------------------------|
| (a) Key money, construction fee etc only                   | As for conveyances at Scale 2 (above) |
| (b) Key money, construction fee etc and rent               |                                       |
| Key money, construction fee etc                            | 4.25% of the consideration            |
| Rent                                                       | As for rent-only lease (below)        |
| (c) Rent only (as a percentage of the average yearly rent) |                                       |
| Undefined term                                             | 0.25%                                 |
| Not exceeding one year                                     | 0.25%                                 |
| More than one year but not exceeding three years           | 0.50%                                 |
| Exceeding three years                                      | 1.00%                                 |

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

1 Yellow (HK) Ltd (Yellow) was incorporated in Hong Kong on 1 January 2010 and carries on business in Hong Kong as a retailer. Yellow is the target company in a recent merger and acquisition project. The current shareholder of Yellow, Vendor Co (Vendor), will sell its 100% shareholding in Yellow to an unrelated purchaser, Buyer Co (Buyer). A tax due diligence exercise is being carried out, which includes a review of Yellow’s estimated assessable profit computation for the year of assessment 2018/19 (based on the draft financial statements for the year ended 31 March 2019) and a review of Yellow’s estimated statement of financial position as at 31 March 2019.

A summary of Yellow’s estimated assessable profit computation for 2018/19 is as follows:

	HK\$	Relevant information:
Profit before tax	2,000	
<b>Tax adjustments:</b>		
1. <i>Add</i> Accounting depreciation	40,000	Furniture: \$50,000 (no additions) at 20% per annum; Computers: \$100,000 (including an addition of \$50,000) at 30% per annum; All on a straight-line basis.
Refurbishment	48,000	Refurbishment of the company director’s residence: \$40,000. Refurbishment of the company offices: \$20,000.
Disallowed donation	8,000	Total donation of \$20,000 including \$12,000 cash paid to Community Chest and \$8,000 paid for bottled water which was donated to Hong Kong Red Cross.
2. <i>Less</i> Depreciation allowance	(41,000)	Tax written down values at 1 April 2018: 20% pool: \$10,000; 30% pool: 10,000; Commercial/industrial building allowance: \$0.
Interest income	(5,000)	Interest receivable on staff loans: \$4,000; Interest receivable from overseas customers on overdue accounts: \$1,000.
Assessable profit	52,000	

Below is an extract of income and expenditure items which are included in Yellow’s profit before tax figure but not yet adjusted for in the above tax computation:

Income	\$	Expenditure	\$
General allowance for doubtful debts written back	7,000	Interest expense on a bank loan which is secured on the real estate of a director of the company	3,500
		Royalty paid to an unrelated Japanese licensor for a trademark used in the company’s operations	30,000

Based on the review of Yellow’s statement of financial position, it was found that Yellow has an amount due to Vendor of \$28,000. This represents an accumulated unsettled balance for purchases made by Yellow from Vendor in the past few years. It has been agreed between Vendor and Buyer that this inter-company balance will be waived by Vendor before the share sale.

It is also proposed that 80% of the employees of Yellow will be made redundant. Redundancy payments will be paid by Yellow according to statutory requirements before the share sale.

Based on the proposed sale and purchase agreement, the date of disposal of the shareholding in Yellow by Vendor to Buyer is 1 July 2019. In order to align with the financial reporting period of Buyer, Yellow will change its accounting date to 31 December and will prepare its next financial statements for the period 1 April 2019 to 31 December 2019.

**Required:**

As the tax adviser engaged by Vendor Co (Vendor), prepare a report for its board of directors addressing each of the following issues from a Hong Kong tax perspective:

- (i) Evaluate, for tax purposes, the accuracy of the estimated assessable profit of Yellow (HK) Ltd (Yellow) for the year of assessment 2018/19, in respect of the following items:
- (1) Refurbishment adjustment of \$48,000;
  - (2) Depreciation allowance of \$41,000;
  - (3) Disallowed donation adjustment of \$8,000;
  - (4) Interest income adjustment of \$5,000;
  - (5) General allowance for doubtful debts written back of \$7,000 (not adjusted);
  - (6) Interest expense on bank loan of \$3,500 (not adjusted);
  - (7) Royalty paid to an unrelated Japanese licensor of \$30,000 (not adjusted).

The following mark allocation is provided as guidance for this requirement:

items 1–6    2 marks each  
item 7        4 marks

(16 marks)

- (ii) Discuss the impact for tax purposes on Yellow's estimated assessable profit for 2018/19 in respect of the proposed waiver of the inter-company balance due to Vendor Co. (3 marks)
- (iii) Discuss whether the proposed redundancy payments would be tax deductible for Yellow. (3 marks)
- (iv) Explain the general principles to be adopted in ascertaining the basis period for cases involving a change of accounting date and advise on the possible basis periods which could be adopted by Yellow for its year of change and the preceding year. (9 marks)

Professional marks will be awarded in question 1 for the appropriateness of the format and presentation of the report and the effectiveness with which the advice is communicated. (4 marks)

**(35 marks)**

- 2** Amy graduated with a Bachelor's degree in Social Science in July 2016. On 15 November 2016, Amy was offered the position of a trainee auditor with AB CPA & Co (ABCo) on the condition that, prior to commencing employment, she would successfully complete a six-month accounting programme at the Kowloon University, with the course fee being refunded to Amy by ABCo.

Amy accepted the offer on 1 December 2016. She undertook the six-month accounting programme from January 2017 to June 2017, and the course fee of \$60,000 was refunded to her by ABCo on 3 January 2017. Amy took up employment with ABCo on 1 July 2017, earning a monthly salary of \$14,000.

In the last week of March 2019, Amy went on a two-month holiday in Europe and returned to Hong Kong at the end of May 2019. A notice of assessment to salaries tax for the year of assessment 2017/18 was issued and delivered to her home on 1 April 2019. The assessment included the amount of \$60,000 refunded to her by ABCo for her course fee. Amy believes that, as the \$60,000 was refunded to her before she joined ABCo, it is not income from employment. However, if the course fee is taxable employment income, she should be entitled to a deduction for the course fee expense incurred to produce the employment income.

**Required:**

- (a) Advise Amy on the criteria for making a valid objection against an assessment and whether she is in time to lodge such an objection.**

Note: You are NOT required to analyse the precise grounds of the objection in this part of the answer.

(3 marks)

- (b) Draft a suitable notice of objection.**

(5 marks)

- (c) Discuss whether the course fee paid by Amy and reimbursed by AB CPA & Co (ABCo) is chargeable to salaries tax and if so, the year of assessment in which it is assessed.**

(8 marks)

- (d) Explain the rules governing deductions for outgoings and expenses for salaries tax purposes. Comment, with reasons, on whether Amy can claim a deduction for the course fee paid by her and reimbursed by ABCo and if so, the year of assessment in which it is deductible.**

(9 marks)

**(25 marks)**

**Section B – BOTH questions are compulsory and MUST be attempted**

**3** Edmond earns regular employment income in Hong Kong. During the period from April 2018 to May 2019, he bought and sold two residential properties in Hong Kong. The table below details the events which have occurred in relation to the two properties during the year. He did not own any other properties in Hong Kong.

	<b>Property A</b>	<b>Property B</b>
April 2018	<ul style="list-style-type: none"><li>– Acquired on 5 April for \$5 million and immediately listed for sale by Edmond at the property agency.</li><li>– 90% financed by a loan from the property developer.</li></ul>	<ul style="list-style-type: none"><li>– Acquired on 23 April for \$7 million.</li><li>– 50% financed by a loan from Edmond's employer. Interest was charged at 1% per annum, when the market rate was 3%.</li></ul>
May 2018	<ul style="list-style-type: none"><li>– Renovated.</li></ul>	<ul style="list-style-type: none"><li>– Edmond moved in and used the property as his residence.</li></ul>
June 2018	<ul style="list-style-type: none"><li>– Signed a lease for one year providing monthly rental at \$15,000.</li></ul>	
December 2018	<ul style="list-style-type: none"><li>– Tenant vacated the property and it was re-let to a friend at a monthly rental of \$10,000. No lease was signed.</li></ul>	
April 2019	<ul style="list-style-type: none"><li>– Friend vacated the property.</li></ul>	<ul style="list-style-type: none"><li>– Edmond vacated the property and renovated it to increase its value.</li></ul>
May 2019	<ul style="list-style-type: none"><li>– Sold for \$7 million.</li></ul>	<ul style="list-style-type: none"><li>– Sold for \$9 million.</li></ul>

**Required:**

**Advise Edmond on the tax implications arising in respect of:**

**(a) Property A; and** (12 marks)

**(b) Property B.** (8 marks)

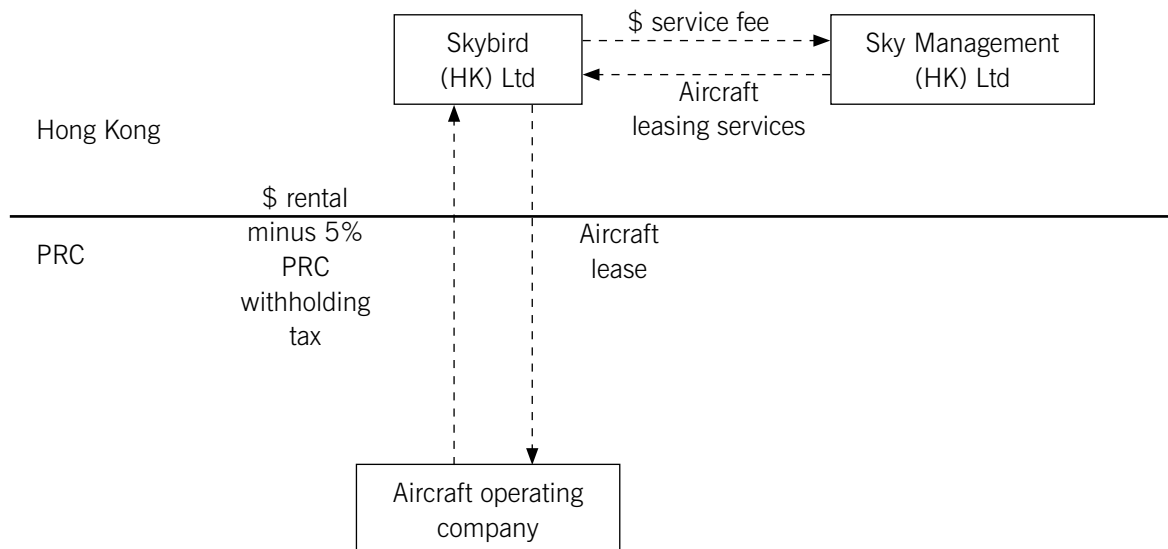
Note: You are NOT required to discuss Edmond's tax compliance obligations.

**(20 marks)**

- 4 Skybird (HK) Ltd (Skybird) was incorporated in Hong Kong in 2018 and carries on business in Hong Kong leasing aircraft to airline companies. Skybird owns a fleet of ten aircraft which are leased to different aircraft operating companies incorporated in the People's Republic of China (PRC). All leases cover three to five years and are renewable upon negotiation. All leases are 'dry leases', without crew, insurance and maintenance, and none of the lease agreements pass the ownership of the aircraft to the lessee at the end of the lease term.

In order to carry out the leasing business more effectively, Skybird outsources the leasing management duties to another Hong Kong-incorporated company, Sky Management (HK) Ltd, the lease manager, for a service fee. All companies are unrelated and all transaction prices are at arm's length.

A sample operation structure for one lease is illustrated as follows:



**Required:**

Assume Skybird (HK) Ltd (Skybird) is a qualifying aircraft lessor company under s.14I of the Inland Revenue Ordinance (IRO). Based on the sample operation structure illustrated above, advise Skybird on the following issues:

- Whether Skybird is chargeable to Hong Kong profits tax in respect of the rental income derived from leasing aircraft to People's Republic of China (PRC) airline operators, and if so, the basis of assessment. (12 marks)
- Whether Skybird is eligible to claim tax depreciation allowance in Hong Kong in respect of the aircraft owned and leased for rental, and if so, the basis of calculation. (5 marks)
- Assuming that Skybird is chargeable to Hong Kong profits tax in respect of the lease rental, discuss whether the related leasing expenses such as the service fee payable to Sky Management (HK) Ltd, the lease manager, and the PRC withholding tax are deductible for tax purposes, and if so, how. (3 marks)

**(20 marks)**

**End of Question Paper**