Strategic Professional – Options

Advanced Taxation – Hong Kong (ATX – HKG)

Tuesday 3 December 2019

ATX HKG ACCA EN

ATX – HKG

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.

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.

Profits tax rates

Assessable profits	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 Assume today is 1 February 2019.

Sugar Ltd is incorporated, and trades as a supplier of medical equipment, in Hong Kong. It has always been wholly owned by Salt Ltd which is a UK company. Salt Ltd does not carry on any business in Hong Kong. A competitor has recently offered to buy all of Sugar Ltd's assets for a total consideration of $38 million ('package sale'). If the offer is accepted, Sugar Ltd will cease trading. Sugar Ltd's assets are as follows:

Asset	Book value	Estimated transfer value
	$	$
Yuen Long office	23,000,000	25,050,000
Solar water heating system	500,000	450,000
Inventory (medical equipment)	1,000,000	1,000,000
Patent (developed in-house)	2,000,000	1,500,000
	26,500,000	28,000,000
Goodwill		10,000,000
Consideration		38,000,000

The directors of Sugar Ltd are concerned about the Hong Kong tax implications of the following:

(1) If the directors accept this offer, Sugar Ltd will realise a book profit in the year ended 31 March 2019 of $11·5 million on the sale of the company's assets. The directors are concerned that this profit will also be taxable at the same rate as the trading profit, leading to a significant amount of profits tax payment for the current year. The directors also raised the concern why the price of $38 million needs to be allocated into different asset items.

(2) The Yuen Long office was acquired from a property developer, as a first-hand buyer and user, in January 2015. Sugar Ltd started to claim commercial building allowance in 2014/15 based on the qualifying expenditure of $13,000,000 which was then agreed by the Inland Revenue Department. The company's accountant estimates that about $18 million of the current sale value is attributable to the building. The directors have heard from friends that they might be able to save tax by reducing the current value attributed to the building.

(3) The solar water heating system was acquired and installed in the Yuen Long office in January 2015, at a cost of $500,000.

(4) All inventory is included in the 'package sale'. The buyer is carrying on a similar medical supply business in Hong Kong, and thus insists that all inventory is transferred at cost. The buyer is currently undertaking a research and development project via a licensed R&D institution in Hong Kong, and some of the inventory acquired from Sugar Ltd may be transferred and capitalised for use in the R&D project.

(5) The patent was developed in-house by Sugar Ltd three years ago.

(6) As part of the sales agreement, some of Sugar Ltd's employees will be transferred to the buyer's business. The remaining employees would be made redundant, including one expatriate who will return back to his home country.

Required:

As the tax adviser for Sugar Ltd, prepare a report for the board of directors addressing the following issues, from a Hong Kong tax perspective:

(a) **The tax implication, including profits tax and stamp duty (if any), arising from the proposed package sale. Your report should deal with the directors' concerns as referred in notes (1) to (5) above;** (18 marks)

(b) **The tax implication, if any, for the buyer on the transfer of some inventory items to its research and development project (note (4));** (3 marks)

(c) **The tax implication, if any, to Sugar Ltd and Salt Ltd, if the buyer acquired the entire shareholding in Sugar Ltd for the same price of $38 million, instead of buying the individual assets directly from Sugar Ltd; and** (6 marks)

(d) **Any compliance obligations which Sugar Ltd must fulfil in respect of the transfer and redundancy of its employees (note (6)).** (4 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 You are the tax adviser in charge of two new clients, Peter and his wife Phoebe, who are permanent residents of Hong Kong. On 1 December 2019, you attended your first meeting with them and obtained the following information:

(1) Peter reported for duty as the production manager for HK Ltd (HKL), a company centrally managed and controlled in Hong Kong, on 1 April 2018. Peter is in charge of HKL's manufacturing operations in Chongqing, China, and is required to travel to Chongqing regularly. He has kept a detailed travelling record of all journeys to allow himself to claim time apportionment for Hong Kong tax purposes.

(2) Peter's basic salary is $90,000 per month. He contributes 5% of his total salary to HKL's mandatory provident fund scheme and HKL contributes 10% to the scheme.

(3) During the year ended 31 March 2019, Peter spent nine months working in China. His gross salary relating to his work in China was $810,000. This is taxable in China. Peter has paid Chinese tax of $150,000 from this amount.

(4) Phoebe has recently inherited her father's boutique business when he died in October 2019. This business is currently operating through a company which was incorporated in the British Virgin Islands (BVI). The BVI company does not own any other assets apart from the boutique business. The boutique operates from a leased retail shop located in Hong Kong. Phoebe has been given the choice, by her late father's lawyer, either to take over the shares in the BVI company or to own the boutique business directly. Phoebe plans to take over running the boutique herself. She thinks it is likely that the business will make a loss in the first year but she is confident that it will soon become profitable.

(5) Phoebe also plans to obtain a mortgage loan to finance the acquisition of another property in Hong Kong in order to create some rental income. Phoebe has no other income.

Required:

(a) Explain the Hong Kong tax treatment of Peter's employment income, including whether or not he will be able to claim time apportionment for tax purposes. (5 marks)

(b) In relation to the income attributable to Peter's services rendered in China, explain the conditions required in order to claim double tax relief and the procedures for claiming this relief according to the provisions made in the Inland Revenue Ordinance. (7 marks)

(c) Calculate Peter's salaries tax liability for the year of assessment 2018/19. (8 marks)

(d) Discuss the Hong Kong tax implications for Phoebe's boutique business, run either through the BVI company, or alternatively as a sole proprietorship. You should also address and compare the potential differences in tax implications, if any, depending on whether or not Phoebe elects for personal assessment. (5 marks)

(25 marks)

Section B – BOTH questions are compulsory and MUST be attempted

3 Mr Lee has been employed for more than ten years by Sour Ltd, a company incorporated in Hong Kong and carrying on business in Hong Kong. On 1 April 2019, Mr Lee met with his supervisor who informed him that Sour Ltd would cease business in two months' time, following which all employees except Mr Lee would be made redundant. Redundancy payments would be calculated based on the Employment Ordinance and paid to all ceasing employees.

Mr Lee, on the other hand, was told he would be given an offer to work in an associate company of Sour Ltd in Hong Kong at a remuneration package which is less attractive than what he currently receives. He has two weeks to consider this offer. If he declines the offer and chooses to leave, he will be asked to sign a restrictive covenant under which he agrees not to join any competitor within the next three years in order to protect Sour Ltd's associated companies' businesses. In return for signing the restrictive covenant, Mr Lee will receive a compensation payment from Sour Ltd.

After two weeks, Mr Lee confirmed he would not accept the offer and terminated his employment. He agreed to sign the restrictive covenant and received the compensation.

A week later, Mr Lee received a counter-proposal that Sour Ltd would appoint him as a consultant at a fee equivalent to 100% of his current salary. If Mr Lee accepted this appointment, Sour Ltd would continue its business. Mr Lee will continue to enjoy most of his staff benefits, including annual leave and annual performance bonus.

In response to this proposal, Mr Lee suggested that he would incorporate a company in Hong Kong wholly owned by him, to sign the consultancy contract with Sour Ltd. His fees would be paid by Sour Ltd on quarterly basis by direct bank transfer into the service company's bank account. Mr Lee confirmed that, as he would be employed by the service company, he would be designated as the person providing the consultancy service and this would be evidenced in the consultancy contract. However, to facilitate him in providing the service to Sour Ltd, he requested to continue using his current business card held by Sour Ltd. Mr Lee would receive a basic salary from his service company equivalent to 60% of the fee received from Sour Ltd, and his housing and daily expenses would be paid for by the service company.

Required:

(a) Discuss and comment on whether the redundancy payments made to the leaving staff, and the compensation for restrictive covenant paid to Mr Lee, would be tax deductible for Sour Ltd. Ignore the later counter-proposal made to Mr Lee. (8 marks)

(b) Discuss and comment on whether the compensation for restrictive covenant received by Mr Lee would be taxable under Hong Kong salaries tax. Ignore the later counter-proposal made to Mr Lee. (2 marks)

(c) From the perspective of the Inland Revenue Department, discuss the tax implications of the relationship between Sour Ltd and Mr Lee via a 'service company' and discuss the Hong Kong tax position of Mr Lee if the proposed arrangement is put in place. You should also address how the arrangement could be changed in order to give Mr Lee a better tax result. (10 marks)

(20 marks)

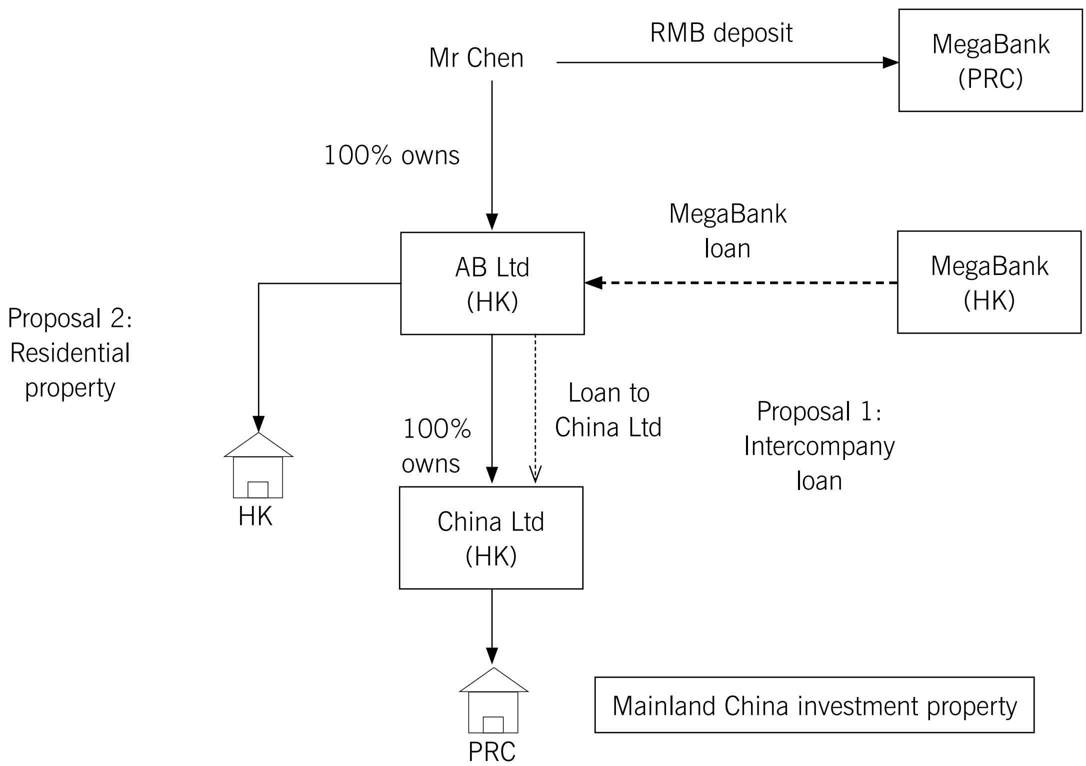
4 Mr Chen, a Hong Kong permanent resident, owns all the issued shares in AB Ltd, a company incorporated in Hong Kong. AB Ltd established a wholly owned subsidiary, China Ltd, in the People's Republic of China (PRC). Apart from the investment in China Ltd, AB Ltd generates assessable profits. During a recent AB Ltd's directors' meeting, the following two proposals were discussed:

Proposal 1:
China Ltd will buy an office block in the PRC as an investment property. This will be funded by an intercompany loan from AB Ltd. This property will be leased by China Ltd to external parties. AB Ltd will need to borrow money to be able to provide the intercompany loan to China Ltd.

Proposal 2:
AB Ltd will buy a residential property in Hong Kong which will be lived in by AB Ltd's sales director, Miss Wang.

In order to fund either of these two proposals, AB Ltd plans to obtain a loan from MegaBank (HK). Mr Chen will consider offering his personal Renminbi (RMB) bank deposit with the PRC branch of MegaBank as security for the bank loan, if MegaBank so requires. Mr Chen earns interest on his personal (RMB) deposit at market rate.

The above transactions are illustrated as follows:



Required:

(a) For this part only, assume NO loan security is put in place for the MegaBank loan.

Discuss the Hong Kong tax implications for AB Ltd arising from the interest paid to MegaBank (HK) on the loan in the following circumstances:

(i) Under proposal 1: whereby the Megabank loan is used to enable an intercompany loan to China Ltd for its acquisition of the PRC property, and interest is charged on the intercompany loan; (7 marks)

(ii) Assuming that proposal 1 is modified such that the Megabank loan is injected into China Ltd as capital instead of as an intercompany loan; (2 marks)

(iii) Under proposal 2: The MegaBank loan is used by AB Ltd to finance the acquisition of Hong Kong residential property for use as living accommodation by the sales director. Assume MegaBank does not require security. (5 marks)

(b) If the MegaBank loan is secured by Mr Chen's RMB deposit in the PRC, discuss whether your answer to (a)(iii) above (that is, proposal 2) would be different, and if so, how. (3 marks)

(c) Assume AB Ltd obtains an interest-bearing loan from Mr Chen (instead of from MegaBank) to finance its acquisition of the residential property for use as living accommodation by the sales director. Analyse whether your answer to (a)(iii) above (that is, proposal 2) would be different, and if so, how. (3 marks)

(20 marks)

End of Question Paper