Strategic Professional – Options

Advanced Taxation – Hong Kong (ATX – HKG)

Tuesday 4 December 2018

ATX HKG ACCA

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 – TWO questions ONLY to 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.

ATX – HKG

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 2017/18 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 $45,000	2%
Next $45,000	7%
Next $45,000	12%
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)	100,000
– additional allowance in the year of birth (each)	100,000
Dependent parent/grandparent allowance – basic	23,000/46,000
– additional	23,000/46,000
Dependent brother/sister allowance	37,500
Disabled dependant allowance	75,000

Deductions

	$
Self-education expenses (maximum)	100,000
Home loan interest (maximum)	100,000
Elderly residential care expenses (maximum)	92,000
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%
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	Scale 2
Up to $2,000,000	1·5%	$100
$2,000,001 to $3,000,000	3·0%	1·50%
$3,000,001 to $4,000,000	4·5%	2·25%
$4,000,001 to $6,000,000	6·0%	3·00%
$6,000,001 to $20,000,000	7·5%	3·75%
$20,000,000 and above	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

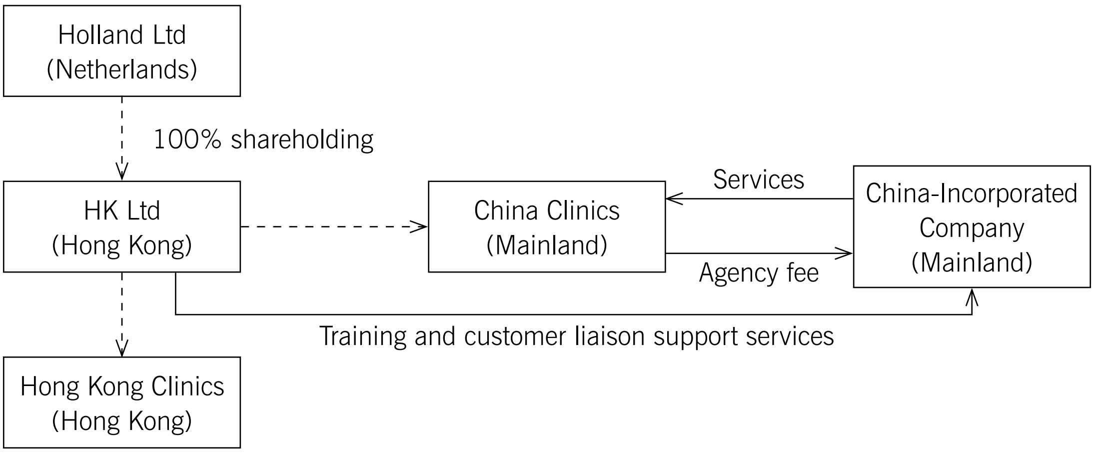
(a)	Key money, construction fee etc only	As for conveyances (above)
(b)	Rent only (as a percentage of the average yearly rent)	
	Undefined term	0·25%
	Not exceeding one year	0·25%
	More than one year but not exceeding three years	0·50%
	Exceeding three years	1·00%
(c)	Key money, construction fee etc and rent	
	Key money, construction fee etc	4·25% of the consideration
	Rent	As for rent-only lease (above)

Section A – BOTH questions are compulsory and MUST be attempted

1 HK Ltd (HK-Co) is a company engaged in providing healthcare services, incorporated and carrying on business in Hong Kong. HK-Co's sole shareholder is Holland Ltd, a company incorporated in the Netherlands and not carrying on business in Hong Kong. HK-Co has healthcare clinics in Hong Kong and in mainland China (Mainland). For the clinics in Hong Kong (Hong Kong Clinics), a team of Hong Kong healthcare specialists is engaged to serve customers in Hong Kong. For the clinics in Mainland (China Clinics), the services are outsourced to a company incorporated in Mainland (China-Incorporated Company) which appoints another team of healthcare specialists.

The healthcare services offered and their prices differ between Hong Kong and Mainland and as a result, some customers of Hong Kong Clinics come from Mainland, and some Hong Kong residents choose to receive services from China Clinics. An agency fee is payable by HK-Co to China-Incorporated Company based on the total sales invoiced by that company. If necessary, training and customer liaison support services are provided by HK-Co to the staff of China-Incorporated Company working in China Clinics.

The diagram below shows the shareholding relationship, together with HK-Co's operational structure:



In 2016, HK-Co's new chief operating officer acquired new healthcare equipment costing $5 million. This was financed by an interest-bearing loan from Holland Ltd. Unfortunately, due to the competitiveness in the industry, HK-Co started to incur operating and tax losses in recent years. In addition, customer complaints are increasing, leading to higher turnover of specialists.

Based on the accounts and tax filing records, HK-Co has included all of its profits as taxable in Hong Kong. The loan interest payable to Holland Ltd has been accrued and claimed as tax deductible for Hong Kong tax purposes on the basis that the loan money was applied to acquire new equipment which was put into use in Hong Kong Clinics.

Holland Ltd is currently considering selling HK-Co to a competitor corporate group (Buyer) at an attractive price which also takes into account the tax benefit from the accumulated tax loss in HK-Co. As part of the deal, Buyer requires Holland Ltd to issue a warranty letter to guarantee the availability of the tax loss of HK-Co for setting off against HK-Co's assessable profits after the transfer of the shareholding in HK-Co from Holland Ltd to Buyer. In exchange, Holland Ltd requests that Buyer takes over the shareholder loan of $5 million due from HK-Co to Holland Ltd, and that this transaction is legally documented in a separate contract. The original sale and purchase contract for the shareholding transfer only records the consideration of $12 million for the value of shares.

Required:

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

(i) Explain the chargeability to tax of the profits earned by HK Ltd (HK-Co) from the clinics in both Hong Kong and mainland China. You should explain the general principles for determining the source of profits in Hong Kong, based on the Departmental Interpretation and Practice Note No. 21 entitled 'Locality of Profits' and other relevant court cases.

Note: You are NOT required to make reference to the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income. (10 marks)

(ii) Explain the tax deductibility of interest charged on the loan from Holland Ltd to HK-Co. (5 marks)

(iii) Based on your answers to (i) and (ii) above, comment on whether HK-Co has been correctly filing Hong Kong tax returns in previous years; and if applicable, what possible actions might be taken by HK-Co. (4 marks)

(iv) Based on the Inland Revenue Ordinance, discuss the eligibility of HK-Co to carry forward the tax losses after the change in shareholding, and your views in respect of Holland Ltd being required to issue the warranty letter. (7 marks)

(v) Based on the Stamp Duty Ordinance, explain the tax implications of the transfer of shares in HK-Co, clearly identifying the instruments, if any, which have to be stamped and if so, how much, when and by whom. You may assume that the contract for the sale and purchase of the shares in HK-Co will be executed outside Hong Kong. (5 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 should assume that today's date is 15 April 2018.**

Ms Carnation, an Australian, has been working for a company (the Company) in Hong Kong since 1 April 2007. One year ago, Ms Carnation lodged a claim with the Labour Department against the Company in respect of alleged mis-treatment. In a meeting on 1 April 2018, Ms Carnation reached a compromise deal with the Company's director to settle the claim and at the same time, Ms Carnation agreed to terminate her contract with immediate effect. The agreement between the Company and Ms Carnation states that a series of payments will be made to her. Ms Carnation has requested that the payments are made to her after three months when her employment with the Company will have officially ceased, on the understanding that the payments will not be treated as income from employment and not taxable.

Details of each payment item as agreed in the compromise deal are as follows:

(i) Payment in-lieu-of notice – Based on Ms Carnation's employment contract, the Company is required to serve three months' notice to Ms Carnation before her employment is terminated, or to make a payment equivalent to three months' salary in lieu of serving the notice. It was agreed that the Company would make the payment to substitute serving the notice so that Ms Carnation would be required to leave the Company immediately.

(ii) Payment in-lieu-of annual leave – The cumulative number of annual leave days up to 31 March 2018 is 13, for which the Company agreed to pay.

(iii) Payment from the Occupational Retirement Scheme Ordinance (ORSO) retirement scheme – The Company established a retirement scheme under the ORSO for its employees. Each month, 15% of each employee's monthly salary is contributed to the fund, representing 5% deducted from the employee's salary and 10% contributed by the Company. Ms Carnation opted to withdraw her entitlement from the retirement fund upon leaving the Company.

(iv) Payment to compensate loss of office – At the request of Ms Carnation, and as part of agreeing to cease employment, a substantial lump sum was agreed to be paid as compensation to Ms Carnation. Due to a loss of trust between herself and the Company, Ms Carnation accepted termination of her employment.

(v) Compensation for withdrawal from legal claim – In addition to the payment for loss of office, the Company offered to make another lump sum in exchange for Ms Carnation agreeing to withdraw from making a legal claim against the Company. Ms Carnation accepted the offer.

(vi) Payment for share option buy-back – Ms Carnation was granted a share option two years ago, which was fully vested but had not yet expired. Given the unpleasant relationship, the Company offered to buy back the share option from Ms Carnation with immediate effect. The price for the buy back is based on a certain percentage of the exercise price pre-determined under the terms of the option. Ms Carnation accepted the offer.

(vii) Staff accommodation extended – Ms Carnation has been living in accommodation provided by the Company. Upon the termination of employment, Ms Carnation is required to move out of this accommodation. However, at the request of Ms Carnation, the Company agreed to grant one month's extension for her to stay in the accommodation at no cost.

(viii) Payment for restrictive covenant – The Company requested that Ms Carnation does not work for any competitor for a certain period. In return, the Company agreed to pay a sum of compensation to Ms Carnation.

Required:

Advise Ms Carnation of the general principles for determining the taxability of each of the above compromise deal items (i) to (viii) as well as the tax implications of Ms Carnation receiving the payments after her employment has ceased.

Note: You are NOT required to calculate her assessable/chargeable income or tax payable.

(25 marks)

Section B – TWO questions ONLY to be attempted

3 Turnip Ltd (Turnip) is a company incorporated in Hong Kong, established to acquire a commercial office in Central for investment purposes with no intention to re-sell it. Prior to the acquisition by Turnip, the office has not been put into use. The total purchase price required by the vendor of the office is $80 million. Based on the vendor's information, 25% of the price is attributable to the construction cost of the building. It is the intention of Turnip to finance the acquisition with a mortgage loan from a bank in Hong Kong, secured fully on the office. Loan interest is charged at market rate.

Upon acquisition by Turnip, the office will be leased for rental income. A property agent will be engaged to take care of the leasing affairs and the property's management, for which a service fee will be payable at a percentage of the monthly rental. Expenditure will be incurred to renovate the office and minimum office furniture will be provided.

Required:

(a) Based on the Inland Revenue Ordinance, discuss the Hong Kong tax implications for Turnip Ltd (Turnip) arising from the leasing of the office building. You should address both the tax chargeability of income, and the tax deductibility of the following expenditure items:

(i) Service fee payable to property agent;
(ii) Interest on bank loan; and
(iii) Cost of acquisition, renovation and provision of furniture. (10 marks)

(b) Explain whether, and if so how, Turnip is eligible for tax depreciation allowance based on the information given. You should include an estimate of the annual allowance if applicable. (5 marks)

(c) Discuss the possible tax depreciation adjustment, if any, in the event of disposal of the building by Turnip five years after acquisition.

Note: You should assume a 50% appreciation of property price in five years' time and you should include an estimate of the tax depreciation adjustment, if applicable, stating any assumptions made regarding the allocation of the sales proceeds. (5 marks)

(20 marks)

4 **(a)** Won Ltd (Won) is incorporated and centrally managed in China. Won is negotiating a consignment agreement with HK Ltd (HKL) in Hong Kong to sell Won's products to customers in Hong Kong. Under the agreement, HKL is responsible for promoting and selling Won's goods in Hong Kong, and receives a commission of 2% of the Hong Kong gross sales proceeds in return for its services. An inventory of goods is shipped from Won to HKL on a regular basis, and HKL is obliged to submit sales reports to Won on a quarterly basis.

In the consignment agreement, there is a clause providing that in remitting the sales proceeds to Won, HKL would be entitled to deduct from the remittance a sum equivalent to 1% of the gross sales proceeds, or any other amount which is sufficient to cover the Hong Kong profits tax applicable. Won is not convinced of the need for this clause and raises the following challenges:

(1) Given that Won is not a Hong Kong company and does not have any operations in Hong Kong, what is the basis for the payment of Hong Kong profits tax?

(2) Hong Kong profits tax should be based on the net assessable profits which are calculated by reference to gross profits and deductible expenses. The 1% or any other deemed notional percentage of the gross sales proceeds has no legal basis.

Required:

(i) Based on the Inland Revenue Ordinance and Rules, explain the circumstances in which a non-resident company can be assessable to profits tax in Hong Kong, and if found to be so assessable, how the chargeable profits will be ascertained. (5 marks)

(ii) Advise Won Ltd (Won) on the Hong Kong profits tax implications arising from the sale of goods in Hong Kong via HK Ltd (HKL), together with the basis of tax assessment, and the justification for the deduction of the tax amount by HKL. (5 marks)

(b) Won is considering expanding into the Hong Kong market by incorporating a wholly-owned subsidiary in Hong Kong. Won will supply goods to the subsidiary for sale in Hong Kong based on the company's pricing strategy, which is yet to be determined.

Required:

Advise on the Hong Kong profits tax position of Won and its Hong Kong subsidiary, and any potential transfer pricing risks to be considered when the pricing strategy is determined.

Note: You are NOT required to make reference to the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income. (10 marks)

(20 marks)

5 Smart Ltd (Smart), a company carrying on business in Hong Kong, has several subsidiaries operating in Asia. Smart is developing a new financial reporting system. In the year ended 31 December 2017, the company sent its IT manager, Joseph, to its Singapore subsidiary for a period of five months to monitor and oversee the implementation of this new system.

Joseph is a resident of Hong Kong. His remuneration remained the same during his time in Singapore and continued to be paid into his bank account in Hong Kong. All his travel and hotel accommodation costs in Singapore were reimbursed by Smart. Smart also agreed to bear any additional personal income tax arising from the assignment.

In reporting its Hong Kong profits tax for the year of assessment 2017/18, Smart has claimed a deduction in respect of Joseph's remuneration including the five-month period of service rendered in Singapore. The Hong Kong profits tax assessment for 2017/18 was issued in September 2018 based on the tax return filed.

In November 2018, Smart received a letter from the Inland Revenue Department seeking justification for the deduction in respect of Joseph's remuneration for the five-month period of service rendered in Singapore.

There is no tax treaty between Hong Kong and Singapore.

Required:

(a) Advise Smart Ltd (Smart):

(i) whether it can claim a tax deduction in respect of Joseph's remuneration for the five-month period of service rendered in Singapore. (5 marks)

(ii) of the purpose of the Inland Revenue Department (IRD) raising the enquiry after issuing the profit tax assessment for 2017/18, and the rights of the IRD to revise the assessment if the deduction is not allowed.

Note: You are NOT required to discuss the IRD's right in making the enquiry. (4 marks)

(iii) on the options available to Smart to protect its rights to continue the dispute with the IRD in the event that an additional assessment is issued which disallows the deduction. (3 marks)

(b) Advise Joseph whether his remuneration for the five-month period of service rendered in Singapore and the travel and hotel accommodation costs reimbursed by Smart is chargeable to Hong Kong salaries tax. (8 marks)

(20 marks)

End of Question Paper