Strategic Professional – Options

Advanced Taxation – Hong Kong (ATX – HKG)

Tuesday 2 June 2020

ATX HKG ACCA EN

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.

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 2019/20 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
Contributions to recognised retirement schemes (maximum)	18,000
Qualifying health insurance premiums (maximum)	8,000
Qualifying annuity premiums and tax deductible mandatory provident fund voluntary contributions (maximum)	60,000

Depreciation allowance rates

Initial allowance:	
Plant and machinery	60%
Industrial buildings	20%
Annual allowance:	
Electronic data processing equipment	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	20%
Between six and 12 months	15%
Between 12 and 36 months	10%

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

Lease

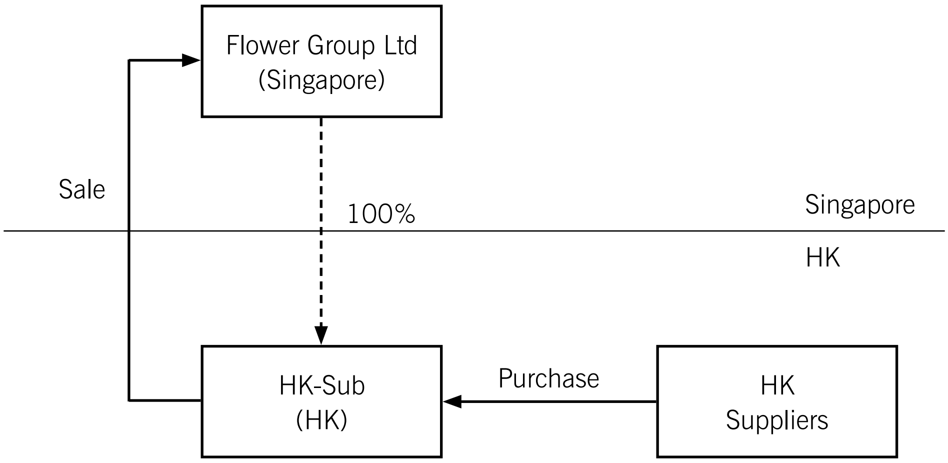
(a) Key money, construction fee etc only	As for conveyances at Scale 2 (above)
(b) Key money, construction fee etc and rent	
Key money, construction fee etc	4·25% of the consideration
Rent	As for rent-only lease (below)
(c) Rent only (as a percentage of the average yearly rent)	
Undefined term	0·25%
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 Flower Group Ltd (Flower) is a company incorporated in Singapore carrying on business in Singapore. Flower currently purchases goods directly from suppliers located in Hong Kong, and sells them to retail customers in Singapore. The purchasing function is currently handled by a team of purchasing staff employed by Flower in Singapore.

At a recent board meeting, the directors of Flower are considering a proposal to set up and incorporate a new subsidiary in Hong Kong (HK-Sub) to look after the purchase operation from the Hong Kong suppliers. HK-Sub will recruit a local purchasing manager in Hong Kong to purchase goods from the suppliers. HK-Sub will then sell the goods to Flower at 10% above market price. All goods will continue to be shipped directly from the suppliers to Flower.

The following diagram illustrates the proposed group and operating structure:



During the same board meeting, the group legal director raised concerns that setting up a subsidiary in Hong Kong might expose Flower to Hong Kong profits tax based on the newly enacted definition of 'permanent establishment' and the commercial director wants more information about the new transfer pricing rules in Hong Kong.

The directors of Flower are considering two alternative options for funding the new HK-Sub:

Option 1: Flower will extend a loan to HK-Sub and charge a market interest rate; or

Option 2: HK-Sub will obtain a loan from a Hong Kong bank, which will be secured by an interest bearing deposit placed by Flower with the same bank.

To address the concerns raised in the board meeting, the directors wish to obtain comprehensive tax advice from a Hong Kong tax adviser.

Required:

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

(a) Making reference to the new definition of 'permanent establishment' under the Inland Revenue Ordinance, evaluate:

(i) Whether HK-Sub would be regarded as a 'permanent establishment' of Flower in Hong Kong. (4 marks)

(ii) Whether the creation of HK-Sub would cause Flower to be deemed to be carrying on business in Hong Kong. (3 marks)

Note 1: For this part only, you are NOT required to address the 'source' principle in Hong Kong.
Note 2: There is no double taxation treaty between Hong Kong and Singapore.

(b) In the context of the newly enacted transfer pricing rules in Hong Kong:

(i) Give brief definitions of 'transfer pricing' and the 'arm's length principle'; (2 marks)

(ii) Explain the circumstances which allow the Inland Revenue Department (IRD) to consider making a transfer pricing adjustment; (4 marks)

(iii) Evaluate whether there is a transfer pricing risk to HK-Sub based on the arrangements proposed by the directors. (3 marks)

(c) Based on the OECD Guidelines, discuss the commonly recognised methodologies used to ascertain the arm's length price during a transfer pricing review. (5 marks)

(d) Advise on the Hong Kong tax implications arising from the alternative funding options. You should address the tax position of Flower in respect of the interest income earned and also the tax position of HK-Sub in respect of the interest expense incurred.

(i) Option 1. (7 marks)
(ii) Option 2. (3 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 Simon was born in Hong Kong, but he has been working for some years in Canada. He is currently a director of Moose Corp (Moose) which is a Canadian company. He was recently asked to return to Hong Kong in order to take on the role of chief executive officer for Panda Ltd (Panda) which is a Hong Kong subsidiary of Moose. The following terms have been agreed:

(i) He has signed a separate employment contract with Panda for an extendable term of three years. The contract was emailed to Simon in Canada for legal review. The original contract was subsequently signed by both parties in Hong Kong.

(ii) He receives a monthly salary of 40,000 Canadian dollars (CAD) for his role at Panda. Moose pays 30% of this salary into Simon's bank account in Canada and the remaining 70% is paid into his bank account in Hong Kong. Moose recharges all of this salary to Panda.

(iii) Simon remains a director of Moose throughout his secondment to Panda and he receives annual director's fees of CAD20,000, less CAD3,000 deducted for annual Canadian payroll taxes.

Simon arrived in Hong Kong with his wife, Annie, and two children on 15 February 2018 and started work for Panda on 1 March 2018. Apart from his immediate family, Simon's parents and other family members also reside in Hong Kong.

During the year ended 31 March 2019, Simon stayed and worked in China (PRC) for a period of 190 days. As a result, he paid PRC income tax of Rmb150,000. During the year ended 31 March 2020, he stayed and worked in Singapore for a total period of 100 days, and paid Singapore income tax of SGD10,000.

For both years ended 31 March 2019 and 31 March 2020, Simon attended Moose board meetings via video link, and he did not return to Canada for any other reason.

Simon's wife, Annie, commenced employment on 1 May 2018 with the Hong Kong Government as a secretary. She is paid a monthly salary of $20,000. On 1 September 2018, Annie resigned from the civil service and joined Dragon Airways, an airline company incorporated in Hong Kong, as a flight attendant at a monthly salary of $25,000. Her flight schedules were as follows:

	In HK	In Asia	In Europe
1 September 2018–31 March 2019	45 days	105 days	62 days
1 April 2019–31 March 2020	70 days	140 days	156 days

In their Hong Kong tax returns, Simon and Annie made the following claims:

(1) Simon claimed he was exempt from Hong Kong salaries tax for the year of assessment 2017/18 because he did not work in Hong Kong for more than 60 days in that year.

(2) For the years of assessment 2018/19 and 2019/20, Simon claimed that the portion of his income attributable to his services rendered in China and Singapore should be exempt from Hong Kong tax. Simon also claimed the China tax, Singapore tax and Canadian tax paid as deductions from his assessable income.

(3) Annie claimed that Hong Kong salaries tax was payable only on her income derived from her services rendered in Hong Kong.

Required:

(a) With reference to the relevant provisions in the Inland Revenue Ordinance and court cases, analyse the issues involved in deciding to what extent Simon's and Annie's income is subject to Hong Kong salaries tax. (9 marks)

(b) Advise Simon whether the claims in his tax returns for 2017/18, 2018/19, and 2019/20 will be successful, and whether he is entitled to any other reliefs. (12 marks)

(c) Advise Annie whether the claims in her tax returns for 2018/19 and 2019/20 will be successful, and whether she is entitled to any other reliefs. (4 marks)

Notes:

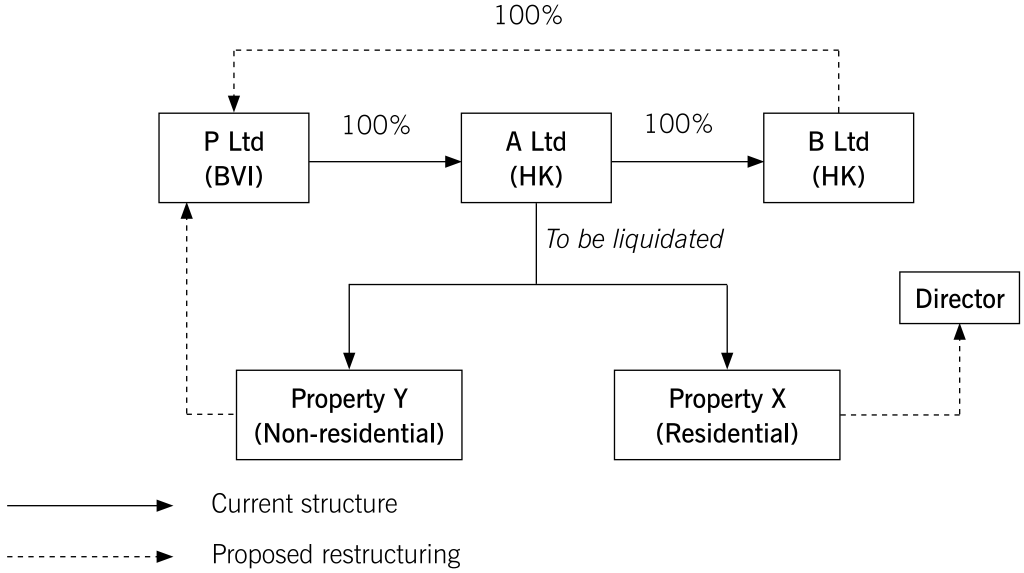
(1) You are NOT required to compute Simon's or Annie's tax liabilities under the Inland Revenue Ordinance.

(2) Hong Kong has entered into double taxation treaties with China and Canada but not Singapore.

(25 marks)

Section B – BOTH questions are compulsory and MUST be attempted

3 Below is the group structure of P Ltd and its subsidiaries:



Under the current structure, P Ltd owns all the shares in A Ltd; and A Ltd owns all the shares in B Ltd since B Ltd's incorporation in 2000. P Ltd was incorporated in the British Virgin Islands. A Ltd and B Ltd were incorporated in Hong Kong. A Ltd has been trading in Hong Kong real estate properties whilst B Ltd trades in securities listed in Hong Kong. The group structure has not changed since incorporation.

It is proposed to restructure the group in July 2020 as follows:

Step 1: A Ltd will sell all the shares in B Ltd to P Ltd. The consideration will be $100 million. The sale will give rise to a profit of $5 million to A Ltd.

Step 2: A Ltd will be liquidated. Upon liquidation, the two properties held as trading stock by A Ltd will be dealt with as follows:

(1) Property X, a residential property bought in February 2018 for $15 million, will be sold to a director for $17 million. The director is the sole shareholder of P Ltd and a permanent resident of Hong Kong. The property has a market value of $18 million. The director carries on personal business in Hong Kong, trading in Hong Kong properties, and he will acquire Property X as trading stock in addition to other residential properties which he owns.

(2) Property Y, a non-residential property bought in August 2017 for $12 million, will be distributed to the shareholder of A Ltd, i.e. P Ltd. The property has a market value of $16 million.

Required:

(a) Discuss whether the profit arising from the sale of the shares in B Ltd (Step 1) would be subject to profits tax. (6 marks)

(b) Explain the profits tax treatment of the two properties held by A Ltd as trading stock upon A Ltd's liquidation. (3 marks)

(c) Explain the stamp duty implications arising from the sale of the shares in B Ltd (Step 1), the sale of Property X and distribution of Property Y by A Ltd (Step 2). (11 marks)

(20 marks)

4 Star (HK) Ltd (Star) was incorporated in Hong Kong, and carries on business in Hong Kong as a manufacturer of smart toy products. All sales have been assessable to Hong Kong profits tax. Star is now exploring ways to develop a new product to sell in Hong Kong, which requires different trademarks and designs to be acquired/licensed as follows:

Galaxy: This is a trademark to be acquired from a Japanese company for use in the manufacturing of the new product in Hong Kong. The estimated cost is $2,000,000.

Nebula: This is a popular design feature which will be incorporated into Star's new product. The permission to use this design is licensed from a company operating solely in Korea. The Korean company charges Star a royalty for the use of the licensed design, calculated at 2% of Star's quarterly sales of all products including the Nebula design. The royalties are paid to the licensor in the second week after each quarter and after deducting the necessary tax which is legally required to be withheld by Star.

In addition to Galaxy and Nebula, Star is planning to develop a new technology specifically for use in the company's smart toy products, named 'Noah'. Star has engaged a licensed research and development (R&D) institution in Hong Kong to develop Noah. The R&D institution has confirmed that Noah is a qualifying R&D activity under 'Type B' as defined under s.10(1)(a) of Schedule 45 of the Inland Revenue Ordinance. The estimated costs payable to the R&D institution in the first year is $2,800,000 which includes a $1,000,000 R&D fee and $1,800,000 for purchasing specialised machinery for use in the R&D activity. It is expected that upon successful development, Noah will be used by Star in its own manufacturing activity.

Required:

(a) Discuss the Hong Kong profits tax implications for Star (HK) Ltd in respect of the costs to be incurred on Galaxy and Nebula, including any related compliance obligations required of Star (HK) Ltd. (14 marks)

(b) Explain, with supporting calculations, the tax deduction available to Star (HK) Ltd in connection with the estimated costs incurred in respect of the development of the Noah technology. (6 marks)

(20 marks)

End of Question Paper