Strategic Professional – Options

Advanced Taxation – Hong Kong (ATX – HKG)

Tuesday 8 June 2021

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.

Please note that you are not expected to make any reference to Covid 19 or the global economic crisis as a result of this pandemic in your exams. None of the temporary financial or legislative measures implemented as a result of Covid are examinable.

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 2020/21 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 Greenery Fresh Food Ltd (Greenery), a company incorporated and carrying on business in Hong Kong, is engaged in the wholesale and manufacture of fresh food sourced from the US and supplied to Hong Kong restaurants. Greenery has been suffering losses due to the cancellation of orders from customers. In order to ease its financial burden and cash flow, Greenery has taken various measures, including the following transactions during the year ended 31 December 2020:

(1) Staff redundancy – In March 2020, five senior staff members were made redundant. Their redundancy payments were calculated based on the Employment Ordinance and were paid to each leaving staff member.

(2) Consolidation of operations – Prior to consolidation, Greenery owned an office and a two-storey factory block in Hong Kong, both for use in its operations. The office was acquired in 2018 and the factory block was constructed in 2010. The entire factory block has been occupied for Greenery's manufacturing operation since inception. As part of the easing measures and to save costs, Greenery took the following actions to consolidate all its operations into the two-storey factory building:

(i) Downsizing of the manufacturing operations into a smaller scale and it now only occupies two-thirds of the first floor of the factory block.

(ii) Its office was moved into the factory block occupying the remaining one-third of the first floor. $500,000 was spent to refurbish the area to accommodate the office move-in.

(iii) The vacated office building has been listed for sale before the year end at a price of $10,000,000. It is anticipated that a book profit of $2,500,000 may be recorded next year when it is sold.

(iv) The ground floor of the factory block was vacated and leased to a retail group which used the space as a warehouse to store its merchandise before distribution to its retail outlets.

Notes:

(a) Based on Greenery's Hong Kong tax return for year of assessment 2019/20, the qualifying cost for the office building entitled to commercial building allowance is $2,000,000 and the tax written down value carried forward from the year of assessment 2019/20 is $1,840,000.

(b) Records show that the land:building proportion, as agreed by the Inland Revenue Department, for the office building is 70:30.

(c) Greenery has been claiming industrial building allowance on the factory block since inception with a qualifying cost of $50,000,000 and tax written down value carried forward from the year of assessment 2019/20 of $20,000,000.

(d) Greenery reports all its profits as assessable to Hong Kong profits tax.

(e) The transactions at (1) and (2) were reflected in Greenery's statement of profit or loss for the year ended 31 December 2020 except for the anticipated profit from the sale of the office building.

In a recent board meeting, the Hong Kong tax implications arising from the above transactions were tabled, and it was resolved that a special tax report be requested.

Required:

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

(a) The profits tax deductibility of the staff redundancy payments as detailed in point (1) above; (5 marks)

(b) The profits tax implications arising from the consolidation of operations as detailed in point (2) above. Your analysis should address the following issues:

(i) Eligibility to industrial building allowance in respect of the two-storey factory block after consolidation; (8 marks)

(ii) Eligibility to tax deduction or depreciation allowance, if any, in respect of the costs spent on refurbishing the first floor in preparation of the office move-in; and (6 marks)

(iii) Taxability of the potential gain arising from the disposal of the office building, as well as the tax adjustment to the commercial buildings allowance claimed for the office building before disposal. Your answer should include a discussion of whether the disposal would potentially constitute a 'trade' or 'an adventure in the nature of trade'. (12 marks)

Note: Discussions of stamp duty and other selling costs are NOT required for part (b).

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, James Liu and his wife, Jade Lau. On 1 June 2021, you attended the first meeting with them and obtained the following information for the year ended 31 March 2021:

(1) James provided his services to a securities company, incorporated and carries on business in Hong Kong, Boom Securities Ltd (BSL). He received a monthly retainer fee of $10,000, and an annual commission of $600,000. He has taken out a Business Registration Certificate. His business card describes him as an account executive of BSL and he is offered a work partition for work in Hong Kong. He has no fixed working hours and cannot work for other companies without prior consent from BSL. He is entitled to medical benefits and four weeks' paid annual leave provided by BSL.

(2) BSL was the subject of an ICAC investigation during the course of the year. The investigation was fruitless and no charges were pressed. Unfortunately, James was named in a local newspaper as being party to fraud on BSL's customers. He sued the publisher of the newspaper, of whom promptly settled the action by payment of $150,000 to him. He incurred legal fees of $100,000 in connection with this legal action. BSL was delighted with the settlement and reimbursed him half of the legal fees incurred.

(3) James contributed a total of $24,000 to the Mandatory Provident Fund.

(4) Jade wholly owns Unique Boutique Ltd (UBL), which trades in second-hand handbags and accessories in Hong Kong. She also acts as a director of UBL, and received a director's fee of $60,000. UBL was incorporated in Hong Kong on 1 January 2020 and commenced trading on 1 March 2020. Since incorporation, UBL has not finalised any audited accounts, filed a profits tax return, nor exchanged any correspondence with the Inland Revenue Department. Management accounts have been prepared for the period 1 January 2020 to 28 February 2021, which show a net profit of $120,000. Jade has not yet determined the accounting year end date for UBL.

Required:

(a) Advise James whether he is liable to profits tax or salaries tax, and on the couple's respective tax positions, in regard to the taxability of their income and deductibility of expenses mentioned above, for the year of assessment 2020/21. Specify any additional information you would need to determine their positions fully. (17 marks)

(b) Advise Unique Boutique Ltd (UBL) of the compliance obligations imposed under the Inland Revenue Ordinance, and the due dates for compliance purposes, assuming that UBL's first accounts are to be closed on (1) 31 March 2020, and (2) 28 February 2021. (8 marks)

(25 marks)

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Question 3 begins on page 8.

Section B – BOTH questions are compulsory and MUST be attempted

3 Miss Wong owns a four-storey house (the property) in Ma On Shan, Hong Kong, which she leases to long-term tenants on a fully furnished basis. Particulars of her income and expenditure for the year ended 31 March 2021 are as follows:

	Note	$	$
Income			
Rent (excluding outstanding rent)	(1)	1,362,000	
Rent deposit	(2)	64,000	
Premium	(2)	32,000	
Service charges	(3)	72,000	
Management fees	(4)	96,000	1,626,000
Expenditure			
Government rent		(46,000)	
Rates		(76,800)	
Cleaning		(48,000)	
Watchman's wages		(240,000)	
Renovation		(50,000)	
Repairs		(28,000)	
Mortgage loan interest	(5)	(360,000)	(848,800)
Net income			777,200

Notes:

(1) Since 1 February 2021, Miss Wong had not received any rent from the tenant of the first floor. As at 31 March 2021, the tenant owed her two months' rent, totalling $60,000.

(2) On 1 July 2020, the second floor was re-let for a term of four years. On signing the lease agreement, the tenant paid a rent deposit of $64,000 and a premium of $32,000.

(3) Service charges relate to the use of the furniture by the tenants.

(4) The tenants paid a separate management fee for cleaning and provision of facilities.

(5) Miss Wong took out a loan from her brother who resides in Canada to help finance the purchase of the property. The loan is properly documented, and the brother holds a first mortgage over the property.

Recently, Miss Wong has been negotiating the possible sale of the property to Mr Hui for a consideration of $60 million. Mr Hui is a Hong Kong permanent resident, and his wife is a resident of mainland China. He owns one commercial property and no residential property in Hong Kong whilst his wife does not own any property in Hong Kong. Mr Hui is considering the following options to purchase the property:

Option 1: To acquire the property in joint names with his wife.

Option 2: To acquire the property in the name of a company to be incorporated in the UK. Mr Hui believes that if the company is managed and controlled by his daughter in the UK, there is a possibility that no Hong Kong tax would arise since the company is not carrying on business in Hong Kong.

Required:

(a) Advise Miss Wong of her tax position for the year of assessment 2020/21. Support your advice with a computation of Miss Wong's tax liability. You may assume Miss Wong is not chargeable to profits tax in respect of the rental income. (5 marks)

(b) Assuming that Miss Wong can renegotiate the terms of the leases (but not the total consideration paid by the tenants), suggest ways in which she could minimise her tax liability if she continued to own the property for rental income. (3 marks)

(c) Advise Mr Hui on the stamp duty implications, if:

(i) he acquires the property in joint names with his wife (Option 1); or
(ii) he acquires the property in the name of a company (Option 2). (9 marks)

(d) Assuming Mr Hui decides to acquire the property in the name of a company as described in Option 2 above, comment on whether or not Hong Kong tax will arise.

Note: You may assume there is no tax treaty between Hong Kong and the UK. (3 marks)

(20 marks)

4 Mr Chan is a permanent resident in Hong Kong. He incorporates two wholly-owned limited companies, Chan (HK) Ltd (C-HK) and Chan (OS) Ltd (C-OS). C-HK is incorporated and carries on investment business in Hong Kong, and returns all of its income for profits tax in Hong Kong. C-OS is incorporated and carries on investment business in Country X, outside Hong Kong, and is subject to tax in Country X. C-OS is not considered as carrying on business in Hong Kong.

Mr Chan is NOT a director nor an employee of either company. In addition, Mr Chan earns income from employment as well as receiving rental income from the letting of a warehouse in Hong Kong. He is subject to Hong Kong salaries tax on his employment income and Hong Kong property tax on his rental income.

During the year ended 31 December 2020, the following loan transactions were recorded, either in the financial records of the companies or personal statements of Mr Chan:

Loan no.	Borrower	Loan from	Use of loan money	Loan security
1	C-HK	Bank in Hong Kong	For C-HK's operations	Secured by Mr Chan's personal deposit placed with the same bank
2	C-HK	Bank in Hong Kong	To buy an office in Hong Kong for use by C-HK	Secured by Mr Chan's personal guarantee
3	C-HK	Bank in Hong Kong	To buy an apartment in Hong Kong for Mr Chan's use if he requires accommodation on business	Secured by the apartment
4	C-HK	C-OS	To buy C-HK's portfolio of listed shares held as inventory	No security
5	Mr Chan	Bank in Hong Kong	To buy an apartment in Hong Kong for Mr Chan to live in with his parents	Secured by the apartment
6	Mr Chan	Bank in Hong Kong	To buy a warehouse in Hong Kong and to lease for rental income	Secured by the warehouse

Required:

By reference to the Hong Kong Inland Revenue Ordinance, analyse and discuss whether the related loan interest expense for each loan (1 to 6 as referred in the above table) is tax deductible in Hong Kong, under the relevant type of tax. For each loan, you should clearly state the relevant type of tax applicable, explain the deductibility principle, and give a conclusion whether, and to what extent, the interest is deductible. Where appropriate, general principles already included in an earlier discussion should not be repeated in the latter discussion.

Note: The following mark allocation is provided as guidance for this question:

Loan 1 6 marks
Loan 2 2 marks
Loan 3 2 marks
Loan 4 3 marks
Loan 5 3 marks
Loan 6 4 marks

(20 marks)

End of Question Paper