

Professional Level – Options Module

Advanced Taxation (Hong Kong)

Thursday 7 December 2017



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.

Think Ahead

ACCA

The Association of
Chartered Certified
Accountants

Paper P6 (HKG)

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 2016/17 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 \$40,000	2%
Next \$40,000	7%
Next \$40,000	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	33,000
Disabled dependant allowance	66,000

Deductions

	\$
Self-education expenses (maximum)	80,000
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

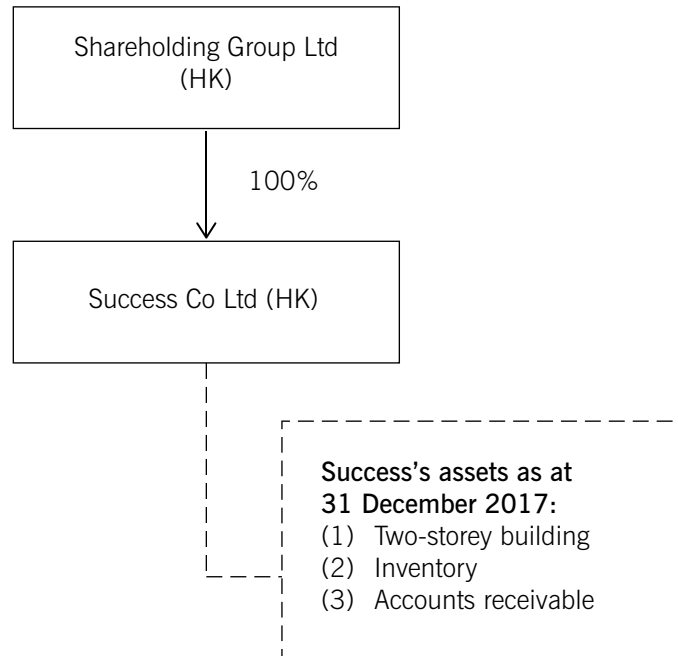
Conveyance on sale and agreement for sale chargeable with buyer's stamp duty 15%

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 Shareholding Group Ltd (SGL) carries on an investment holding business in Hong Kong. One of its subsidiaries, Success Co Ltd (Success), which has been carrying on business in Hong Kong as a manufacturer and trader for several years, is involved in litigation with a substantial potential liability. The diagram below shows the shareholding relationship, together with a summary of Success's assets at 31 December 2017:



The following restructuring of Success's assets is proposed:

- (1) Success will dispose of the two-storey building to a third party buyer at its current market price of \$100,000,000. The building was purchased by Success in November 2016, directly from a property developer, at a price of \$90,000,000. Details of the estimated breakdown of the price and the related costs are as follows:

	Floor area (square feet)	Purchase price \$	Cost \$
Land portion			20,000,000
Building construction			
– Ground floor	10,000) 40,000,000
– First floor	10,000)
Total	<u>20,000</u>	90,000,000	<u>60,000,000</u>

Success used the ground floor as a factory and the first floor as a warehouse. Part of the ground floor, occupying about 10% of the total floor area, was used as an office.

Alternatively, Success is considering demolishing the whole building and then selling the piece of land, if by doing so it would obtain a better price.

- (2) Success will transfer the following assets to its parent, SGL:
- All of its inventory at 30% below its market price. This will enable a reasonable profit to be earned by SGL when the goods are sold.
 - All of its accounts receivable, at cost (i.e. gross of any allowance made for doubtful accounts). A separate calculation of the allowance for doubtful accounts will be made and provided by SGL following the transfer.

Required:

As the tax consultant of the group, prepare a report for the directors of Shareholding Group Ltd (SGL) addressing each of the following issues from a Hong Kong tax perspective:

Two-storey building

- (i) The tax depreciation allowance(s) available to Success Co Ltd (Success) in respect of its use of the building. Provide calculations of the relevant amounts. (10 marks)
- (ii) The profits tax implications for Success arising from the sale of the whole building. (9 marks)
- (iii) The difference, if any, in Success's profits tax position as compared to (ii) above, if the building is demolished and the piece of land is then sold. (2 marks)

Inventory

- (iv) The profits tax implications for both Success and SGL if the inventory is transferred at 30% below its market price. (6 marks)

Accounts receivable

- (v) The profits tax implications, if any, for both Success and SGL if the accounts receivable are transferred at cost (before deducting any allowance for doubtful accounts) and SGL makes its own allowance for doubtful accounts subsequent to the transfer. (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 should assume that today's date is 1 March 2017.

Kelvin was employed as the general manager of Company X (Co X). He has recently been dismissed and Co X has actively negotiated a severance package with Kelvin. The final agreed termination package consists of a total sum of \$1,850,000, comprising the following amounts:

- (1) Salary owing: \$150,000;
- (2) Accrued vacation pay: \$100,000;
- (3) Redundancy payment (due under the Employment Ordinance): \$500,000;
- (4) Payment in lieu of notice (as per his contract of employment): \$450,000;
- (5) Payment for agreeing not to compete with Co X for one year: \$300,000; and
- (6) Payment in recognition of his contribution to the development of Co X's business: \$350,000.

Kelvin has told Co X that it will not be required to report this payment to the Inland Revenue Department because the payment is a tax-free compensation payment for loss of employment.

Kelvin plans to use his termination payment to acquire a residential property in Shatin for rental income purposes. He has the following ideas in mind:

- (i) To hold the property in his own name or in the name of a limited company, which will be incorporated in Hong Kong and wholly owned by him.
- (ii) The cost of acquisition of the property of \$12 million will be financed 30% from the termination payment and Kelvin's existing savings, and 70% by a loan obtained from a bank in Macau. The loan will be secured by the property, and loan interest of 2% per annum will be payable for the first year.
- (iii) To appoint a service company as his agent to handle matters related to the letting of the property.
- (iv) To let the property in a furnished state, as he believes that furnishing the property is more likely to attract long-term tenants.
- (v) He estimates that he will have to spend around \$280,000 on refurbishing the property and providing the necessary furniture, and that the property could then be let for a monthly rental of \$35,000 for a term of two years.

Required:

- (a) Advise Company X on whether it must report the payment made to Kelvin to the Inland Revenue Department, and whether Kelvin will be taxable on any or all of the payment received by him.** (9 marks)
- (b) Advise Kelvin on the tax and stamp duty implications if the property in Shatin is (1) acquired by Kelvin in his own name; or (2) in the name of a limited company. Include an analysis of the deductibility of the expenses incurred in connection with the property as identified in points (ii) to (v) above.** (16 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

3 You should assume that today's date is 6 April 2017.

Mr Chen has been employed for more than ten years by Blessings Ltd, a company incorporated in Hong Kong and carrying on a food and beverage business in Hong Kong. On 1 April 2017, Mr Chen discussed with his supervisor the following issues:

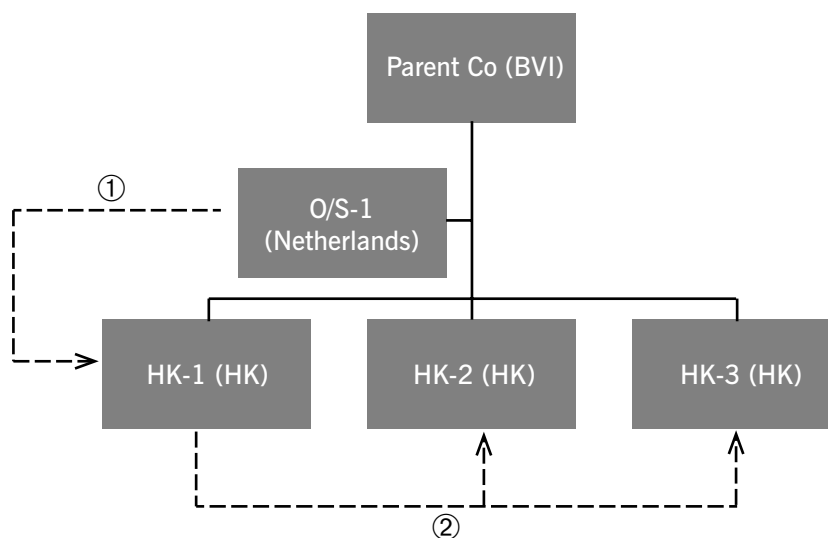
- (1) Due to personal reasons, Mr Chen is considering resigning from his current position with effect from 1 July 2017. Given that he has accumulated substantial annual leave and overtime compensation, he would like to claim all the leave he is entitled to such that his official last day with the company is 15 May 2017. He intends to return to China before the end of May to set up his own business with his wife, and thus has requested his last month's salary and bonus to be remitted to his bank account in China before the end of May.
- (2) Mr Chen's supervisor made a counter offer to Mr Chen that upon Mr Chen's resignation, the company would appoint him as a consultant at a fee equivalent to 120% of Mr Chen's current salary. The fee will be payable on a bi-annual basis by bank transfer. Mr Chen will continue to enjoy 20 days of annual leave per year but will no longer be entitled to any staff benefits or overtime compensation. Mr Chen will be allowed to continue to use his current business card. In response to this offer, Mr Chen indicated that he is interested but he would probably incorporate a company in Hong Kong wholly owned by him to sign the consultancy contract with Blessings Ltd.

Required:

- (a) **Advise Blessings Ltd on its tax reporting obligations in respect of Mr Chen's resignation, and any other possible compliance issues arising therefrom.** (10 marks)
- (b) **From the perspective of the Inland Revenue Department, analyse the relationship between Blessings Ltd and Mr Chen under the counter offer proposed by Mr Chen's supervisor and the Hong Kong tax position of Mr Chen if the proposed arrangement is put in place.** (10 marks)

(20 marks)

- 4 The group chart below illustrates the holding structure of Parent Co, a company incorporated in the British Virgin Islands (BVI), and its subsidiaries (the Group):



The Group carries on various businesses in Hong Kong through its three Hong Kong subsidiaries, i.e. HK-1 (HK), HK-2 (HK) and HK-3 (HK), and substantial profits are being kept at the intermediate holding company in the Netherlands (O/S-1). To utilise the surplus cash effectively within the Group, the following steps are proposed:

Step ①: O/S-1 will extend a loan to HK-1 (Loan-A) upon request at an interest (Int-A) to be determined at the market rate. The interest earned by O/S-1 may be distributed to Parent Co or re-invested for further lending within the Group.

Step ②: HK-1 will on-lend the Loan-A funds to HK-2 (Loan-B) or HK-3 (Loan-C) upon request, at an interest (Int-B or Int-C) to be determined based on 10% above Int-A, i.e. HK-1 will earn a spread of 10%.

HK-1 is newly set up for the purposes of this financing arrangement, but HK-2 and HK-3 have been carrying on trading businesses in Hong Kong for several years.

Required:

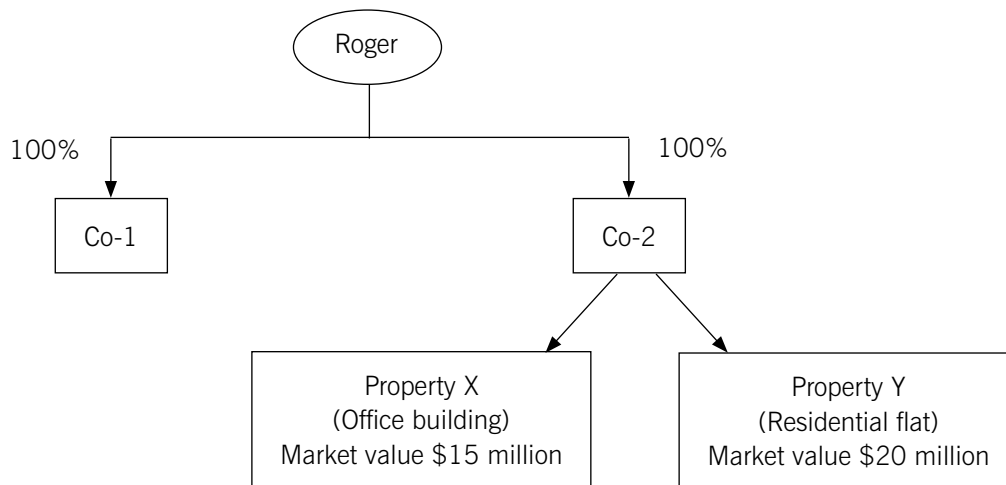
- (a) Discuss the Hong Kong profits tax position of HK-1 under the proposed loan arrangements, in terms of:

- (i) the tax treatment of the interest income arising from the lending transactions; and (11 marks)
- (ii) the tax treatment of the interest expense arising from the borrowing transaction. (6 marks)

- (b) Critically comment on the tax effectiveness of the financing proposal within the Group, and recommend how maximum effectiveness might be achieved. (3 marks)

(20 marks)

- 5 Roger is the sole shareholder of One Co Ltd (Co-1), a company carrying on business in Hong Kong. Roger intends to acquire all of the shares in another Hong Kong company, Two Co Ltd (Co-2), from an independent seller. Co-2 holds two immovable properties in Hong Kong (Property X and Property Y), which are leased out for rental income. The group structure after the acquisition will be as follows:



It has been agreed that the consideration for all the shares in Co-2 will be \$18 million. In addition, Roger will pay the seller \$17 million for an assignment of a shareholder's loan which the seller has made to Co-2. A separate assignment deed will be executed for the assignment of the shareholder's loan.

The tax due diligence for Co-2 has been completed, with major findings as follows:

- (i) All Hong Kong tax returns were filed on time, all Hong Kong tax assessments were issued per the tax returns with no queries, and all Hong Kong tax was paid by the due dates.
- (ii) The seller has agreed to warrant and guarantee that all Hong Kong tax assessments prior to the acquisition date are finalised without outstanding tax queries.
- (iii) The seller has also agreed that any Hong Kong tax disputes raised in respect of the pre-acquisition period will be handled by him on behalf of Co-2.

After the acquisition of Co-2, the following business restructuring will be carried out:

- (1) Property X will be transferred to Co-1 for a nominal consideration of \$1. Co-1 will occupy Property X as its own office.
- (2) On completion of transaction (1) (as above), Co-2 will be put into liquidation by distribution *in specie* of Property Y to Roger.

Required:

- (a) Explain the Hong Kong stamp duty implications arising from the acquisition of the shares in Two Co Ltd (Co-2) by Roger. (4 marks)
- (b) In the context of Hong Kong tax compliance, discuss the potential risks, if any, which may be faced by Roger in respect of the acquisition of Co-2, including whether the warranties given by the seller will or will not be effective. (6 marks)
- (c) Advise on the Hong Kong profits tax and stamp duty implications for both One Co Ltd (Co-1) and Co-2 arising from the transfer of Property X from Co-2 to Co-1 at nominal value. (7 marks)
- (d) Advise on the Hong Kong stamp duty implications to Co-2 arising from the distribution *in specie* of Property Y to Roger. (3 marks)

(20 marks)

End of Question Paper