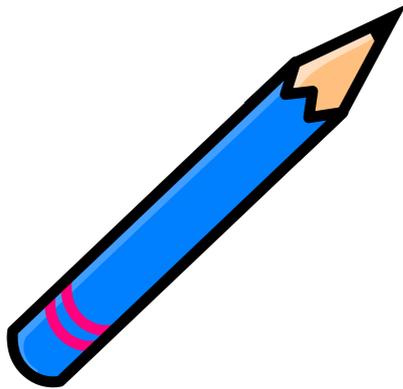


*Taxation
Examination
Q and A*



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Mock Exam Paper for Hong Kong Taxation

Q 1

Facts provided

George Wong, a Macau resident, has an expert knowledge in aromatic oil. He spends more than 330 days every year in Macau. He travels only occasionally to Hong Kong on need basis.

On 1 April 2013, he started a business of buying and selling the product worldwide. A limited company called GW Ltd. was incorporated in Hong Kong of which George and his wife were company directors. In order to minimize the exposure to Hong Kong profits tax, GW Ltd. did not hire any employee in Hong Kong. It rented a virtual office at a business center in Wanchai. Besides, it hired a service firm to handle the company's warehouse, bookkeeping, audit and filing of legal documents in Hong Kong.

To handle purchases and sales, GW Ltd. set up an electronic business platform on internet. The electronic business platform was operated on a computer server installed at a Macau internet service provider. An information technology team consisting of 5 employees was established in Macau to maintain the service of the electronic business platform. All team members were Macau residents and worked in Macau only. All purchases were from suppliers in Europe. Sales were on worldwide basis; of which less than 1% to customers in Hong Kong. Customers' enquiries, after-sale service and negotiation with overseas suppliers were handled by George in Macau through the electronic platform on internet. Goods were delivered to a warehouse in Hong Kong

and then sent to the buyers. The warehouse work and goods delivery were handled by the service firm on behalf of GW Ltd. Payments from customers were remitted by customers via PAYPAL into the company's bank account at HSBC in Hong Kong. Payments to suppliers were made from the bank account by George in Macau through internet banking.

In the profits tax return for 2013/2014, GW applied for offshore exemption.

Requirement

Comment on the possible arguments including legal authorities, case law principles and Inland Revenue Department's policies that may be raised by:

- Inland Revenue Department for rejection of the offshore exemption (7 marks)
- GW Ltd in support of the offshore exemption (8 marks)

Q 2

Facts provided

R Ltd is incorporated, managed and controlled in UK. It is the holding company of Raymond Group in global market in the manufacturing and selling sport cars around the world. R Ltd wants to sell its products to customers in Hong Kong. It is considering 3 options.

Under **option 1**, the sport cars are sold to its distribution agents in Hong Kong who then re-sell the cars to the customers in Hong Kong.

Under **option 2**, a company called RC Ltd is established in mainland China. R Ltd. will first sell the sport cars to RC Ltd. and then RC Ltd will re-sell the cars to the distribution agents in Hong Kong. Then, the distribution agents will sell the cars to the customers in Hong Kong. On receiving the cars from RC Ltd, the distribution agents will send a credit note to RC Ltd. to acknowledge the purchase amount due to RC Ltd with a credit period of 4 months. Interest at 5% per annum is charged on the amount due in the credit period.

Under **option 3**, RC Ltd. maintains a branch in Hong Kong and use the branch to sell the cars directly to customers in Hong Kong.

Requirement

Explain the tax implications, including China tax if any, under

- option 1 (5 marks)
- option 2 (10 marks)
- option 3 (5 marks)

Q 3

Facts provided

X Ltd owns 80% ordinary shares of Y Ltd.

Y Ltd owns 100% ordinary shares of M Ltd.

For the year of assessment 2012/13, M Ltd had an agreed tax loss brought forward of \$1,000,000.

On 1 July 2013, X Ltd sold its office to Y Ltd. for \$20,000,000. The market value of the office on 1 July 2013 was assessed by Rating and Valuation Department at \$30,000,000.

On 1 Aug 2013, by a written lease agreement, Y Ltd leased the office to M Ltd. at a monthly rent \$80,000 for 2 years. On the same day, M Ltd. leased the office to an unrelated company at a monthly rent of \$120,000 for 2 years. M Ltd. will be liquidated after completion of the lease in late 2015.

On 1 Sep 2013, X Ltd. entered into a provisional sale and purchase agreement with an unrelated person to sell a residential flat for \$15,000,000. The formal sale and purchase agreement was executed on 12 Sep 2013 and the then market value of the flat was \$20,000,000. The assignment deed was completed on 15 Oct 2013 and the then market value was \$22,000,000. The flat was purchased by X Ltd. about 10 years ago and was being used as a free accommodation for its employee for many years.

Requirement

Explain the tax implications, including stamp duty, in respect of

- the sale of company office from X Ltd. to Y Ltd. (5 marks)
- the leasing arrangements of Y Ltd. and M Ltd. (10 marks)
- the sale of residential flat by X Ltd. (5 marks)

Q 4

Facts provided

Mr. Chan is an accounting manager of A Ltd. For the year of assessment 2013/14, he received the followings from A Ltd.

- Total salaries for the 12 months ended on 31 March 2014: \$960,000
- Housing allowance per month from 1 Apr 2013 to 31 Mar 2014: \$40,000
- Reimbursement of MBA course fee \$30,000
- Performance bonus of 1 month salary \$80,000
- Incentive bonus in the form of 100,000 company ordinary shares vested on 31 March 2014, subject to a period of 2 years for restriction of sale in stock market.

The market value per share on 31 March 2014 was \$10.

In his employment contract, Chan was entitled to free accommodation provided by A Ltd. in the form of rent refund. Chan was required by A Ltd. to submit the duly executed stamped lease for approval and copy of the monthly rental receipts for record. Throughout the year ended 31 Mar 2014, Chan rented a flat from his brother at a monthly rent of \$30,000. Chan used the flat as his residence up to 28 Feb 2014. The annual rateable value of the flat for 2013/14 was \$360,000. Chan entered into a written

rent agreement with his brother, had the lease duly stamped, and paid the rent monthly to his brother by cheque. He submitted the rent agreement and rent bills to A Ltd. for approval in accordance with the company policy.

Chan paid the following expenses in the period of 1 Apr 2013 to 31 Mar 2014:

- ACCA annual membership fee of 2,000 and HKICPA annual membership fee \$2,500
- MBA course fee \$120,000
- rent of \$360,000 to his brother
- medical expenses of \$100,000 (for his wife giving birth to his first baby)
- living expenses for Mr. and Mrs. Chan \$300,000
- living expenses for his mother-in-law \$20,000

On 1 Dec 2013, Chan bought a residential flat in joint names of Mr. and Mrs. Chan in Taikooshing for \$5,000,000. This was the first time Chan owning a flat. A mortgage loan of \$4,000,000 was borrowed from Hang Seng Bank. The first monthly mortgage installment of \$40,000 was paid on 1 Jan 2014. The interest paid for Jan, Feb and March 2014 were \$11,000, \$10,000 and \$10,000 respectively. Chan moved to live in Taikooshing from 1 March 2014 onward.

Mr. Chan was married in early 2012. He had a child born on 1 Mar 2014. Mr. Chan's mother-in-law, aged over 60, was a Singaporean. On 1 Feb 2014, she came to Hong Kong to live with Mr. and Mrs. Chan. Her living expenses were paid by Mr. Chan.

Mrs. Chan was a freelance writer for a number of newspapers. She earned a net income of \$600,000 in 2013/14.

Both Mr. and Mrs. Chan made contribution to MPF in accordance with law.

Requirement

Advise Mr. and Mrs. Chan the best possible taxation treatments (including whether they should elect for personal assessment) for the year of assessment 2013/14 with computation and explanation of the tax authorities, legal principles and Inland Revenue Department's policies involved. Ignore tax reduction in annual Financial Budget. (25 marks)

Q 5

Facts provided

H Ltd's management accounts for the year ended 31 Mar 2014 shows the following information:

Income	Expenditure
Gross trading profits \$1,000,000	Medical research \$200,000
Shares dealing gain \$100,000	Bank charges and interest \$10,000
Interest \$50,000	Repairs \$100,000
Compensation received \$300,000	Provision for bad debts \$50,000
Sale proceeds of old computers \$100,000	Legal fee \$100,000
Sale proceeds of patent right \$200,000	Donation \$100,000

The shares dealing gain refers to shares listed in UK bought in March 2012 for resale.

Interest income includes \$30,000 earned from a USD time deposit placed at HSBC in Hong Kong and \$20,000 paid by a UK customer in respect of its overdue trading debt.

Compensation \$300,000 refers to the \$200,000 deposit forfeited due to breaching of a trading contract by a customer and \$100,000 payment in lieu of notice received from a resigned employee.

The old computers were bought for \$500,000 in Apr 2012. The net book value before sale is \$200,000.

The patent right was purchased from an unrelated person in 2012 for \$100,000. It had been used by H Ltd. for its trade since 2012. In Oct 2013, it was sold to an unrelated company for \$200,000. No amortization of the cost of the patent has been provided for in the accounts.

Medical research expenditure concerns a payment to Hong Kong University in relation to a medical research project for the benefit of workers working in the trade engaged by H Ltd.

Bank charges and interest include bank charges \$2,000 and interest on loan from its holding company \$8,000. The holding company has been carrying on business in Hong Kong since 2007.

Repairs includes cost of new curtain installed at the company's show room at \$20,000

Provision for bad debts includes 100% specific provision on trade debts unpaid for

more than 6 months at \$20,000. Balance of provision represents a 5% for general provision on all other unpaid trade debts.

Legal fee includes:

- \$80,000 regarding a legal dispute with customer
- \$20,000 for the legal fee and stamp duty in respect of a new lease for the company's office

H Ltd's profit and loss account for the year ended 31 Mar 2013 shows a loss carried forward of \$500,000. No profits tax assessment was issued for 2012/13 because of the loss reported in tax computation. So far, no enquiry letter has been received from Inland Revenue Department concerning the loss.

A truck was bought on 1 April 2013 on hire purchase. The cash price was \$500,000. The hire purchase price was \$1,000,000 payable by 50 equal monthly installments. In the year ended 31 Mar 2014, 12 installments were paid. Annual depreciation is provided at 20% p.a. using straight-line method.

Donation \$100,000 was made during a Tung Wah Hospital charity function. It was used to buy a Chinese tea-set with a open market value of about \$1,000. The tea-set was exhibited at H Ltd's reception.

Requirement

Prepare a profits tax computation for H Ltd for the year of assessment 2013/14 with explanation of the legal authorities, case law principles and Inland Revenue Department's policies involved. (20 marks)

以上只是 qp module d taxation course 的部份筆記，給你作為參考。全部筆記及答題精要，共 122 頁（以 A5 計），會給與參加補習的學生。

這些taxation course notes稅務課程筆記及examination answer key考試答題精要，是基於本人Raymond Yeung 多年的稅務工作，包括稅務教學及評卷經驗，以常考及可能考的題目，按評分準則marking scheme，為了快速取分而編寫：筆記列出稅務考試內可能考的題目及其內容，與及能取分的要點points。

同學請注意，對課題有全面及深入的認識是十分重要，最好是由我講解如何運用這些答題精要，及其餘未列入筆記的稅務知識。課題筆記及答題精要，會在補習有關題目時免費給與學生。

想要齊我的答題筆記，就請你參加由我親自教授的補習班了，或直接購買全套筆記。詳情請到rytc.com.hk。

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Suggested answers

Q 1

IRD's arguments include:

- As GW is a company incorporated in HK and it hires a service firm in HK to do things on his behalf, it can be regarded as carrying on business in HK.
- Under Inland Revenue Rule 5, a permanent establishment includes a branch, management and other place of business. An office can be a place of business. As GW has a virtual office in HK, it can be regarded as having a permanent establishment in HK. GW is therefore carrying on business in HK.
- George, director of GW, traveled to HK on need basis. It is possible that the management and control of GW is in HK. Furthermore, George's activities during his stay in HK can be regarded as the company's operations in HK for earning assessable profits.
- DIPN 39 says that the location of computer server is unimportant for determination of offshore claim. Installation and operation of the server in Macau to handle purchase and sales orders cannot affect the offshore claim. IRD's stance is to consider the location of the human activities and the people carrying out the activities that are responsible for the generation of the profits.
- The transactions are likely trading nature because GW buys goods from Paris and sells them to customers. In DIPN 21, IRD says that for trading transaction, no apportionment of profit is allowed.
- As the goods are sent to HK, warehoused in HK and delivered from a HK warehouse to customers, IRD can regard such HK activities play a significant role or function in earning profits. According to Euro Tech case, profit can arise in HK even though activities in HK are minimal.
- IRD can rely on Kim Eng Securities case to argue that the HK office and HK

activities play a special role or function in earning profit. It was held that no matter how little it did in HK, where the profit derives from what it did in HK, the profit is fully taxable.

- IRD can rely on Magna Industrial case to challenge that GW's profits are taxable. In Magna case, a totality of facts approach is adopted and it was held that regard must be paid to where the contracts for purchase and sales are effected, and other factors including shipment of goods, financing of the transactions, warehousing of goods, processing of documents etc. In GW's case, a warehouse is maintained in HK, a HK bank account is operated, and a service firm is appointed in HK to arrange the delivery of goods. IRD can regard such HK activities as operations for earning the profits and based on a totality of facts, the profits arise in or derived from Hong Kong.
- Under Section 2(1) of IRO, assessable profits include profits earned from business transacted by an agent. The service firm can be regarded as an agent because it acted on behalf of GW. The activities done by the service firm in HK according to GW's instruction can generate assessable profits of GW.
- IRD can rely on TVB International case that since GW has no permanent establishment outside HK to handle the sale and purchase of goods (except an IT team in Macau to take care of the server), it is a rare case that GW can earn offshore profits. As GW has P.E. (a virtual office and an agent) in HK, the HK office or the HK agent can be responsible for earning profits.
- IRD can rely on Kwong Miles Service Ltd. case to argue that the IT function in Macau is only "antecedent or incidental matters" in relation to the earning of profits and therefore such matters should be disregarded when considering the offshore exemption (that is "without being distracted by antecedent or incidental matters"). Besides, IRD can argue that the "effective causes" for earning the profits are the shipment of goods to HK, the operation of the warehouse in HK, and the delivery of goods from HK to customers. As the effective causes are in

Hong Kong or done through Hong Kong, the profits are Hong Kong sourced and therefore they must be assessable.

GW/s arguments include:

- The transactions are trading nature. DIPN 21 states that for trading transaction, the location of the purchases contracts and sales contracts effected are important factors. As both purchases and sales are effected at the electronic business platform located outside Hong Kong, the profits are offshore and not assessable.
- GW has no employee in Hong Kong to issue purchase orders to suppliers or to accept sales contracts from customers. Therefore, the profits cannot be arising in or derived from Hong Kong.
- DIPN is not law. It has no binding force on taxpayers or on law courts. DIPN 39 saying that "the location of server is unimportant in relation to offshore claim" is not binding on GW. Even this saying is valid, the human activities for operating and maintaining the server (responsible for purchases and sales) are in Macau, not in Hong Kong. So, the profits must be offshore.
- GW only appoints a service firm in HK to do the warehouse work, bookkeeping and audit and filing of documents. Such work is administration nature and it should be regarded as "antecedent or incidental matters" and not the "effective causes" for earning profits. Following Kwong Mile Services principle, the administrative work should not affect the offshore claim.
- According to Kwong Mile Services case, we should focus on the "effective causes". In this case, the effective causes are the operations of the electronic business platform in Macau and the services provided by the IT team in Macau. As the effective causes are located outside HK, the profits are offshore.
- The HK service firm has no general authority to negotiate and conclude contracts on behalf of GW. Therefore it should not be regarded as a permanent establishment of GW in Hong Kong. Besides, the service firm does not keep a

stock of merchandise in HK from which it regularly fills orders on behalf of GW. According to Inland Revenue Rule 5, the HK service firm cannot be a permanent establishment for charging profits tax on GW.

- The management and control of GW is outside HK because all directors are based outside HK. In fact, George was the only management personnel of GW. His visits to HK are short and temporary and on need basis. It is likely that the directors' meetings responsible for the management and control of GW and its daily operations were held outside HK. Therefore, GW should not be regarded as carrying on business in HK. As no business is carried on in HK, no profits tax charge should arise under Section 14.
- Even if the directors have some activities in HK, such activities were for administration only and they have no bearing on earning profits.
- GW's business is not just trading. It involves operating a server to place purchase orders with suppliers and to accept sales orders from customers. Its business operations are done by or done through a server in Macau. Following the operation test in Whampoa Dock case, the profits are offshore.
- Hang Seng Bank case states that one should look to see what the taxpayer has done to earn the profits and where he has done it. In GW's case, it is the service of the server in Macau and the activities of the IT team in Macau that are responsible for earning the profits. So, the profits are offshore.
- The IT team in Macau should be regarded as an overseas establishment to earn the profits. As GW has an overseas establishment, the "rare case principle" in TVB International case should not apply in this case.
- Kam Eng Securities case: If a taxpayer employs overseas employees to do things under his instruction, the activities done by the overseas employees are accepted as overseas activities responsible for offshore profits. The Macau IT team is employed by GW and their activities are done under GW's instruction. Therefore, their work in Macau should be accepted as GW's offshore activities.

Q 2

Option 1

- Section 14(1) states the basic conditions for charge of profits tax: (i) A business is carried on in HK and (ii) It has profits arising in HK or derived in HK.
- R Ltd is a non-resident company because it is incorporated outside HK and managed and controlled outside HK. A non-resident company does not carry on a business in HK unless it has a permanent establishment in HK. If R Ltd does not have a permanent establishment in HK, it should not be liable to profits tax.
- A permanent establishment is defined in Inland Revenue Rule 5. It includes an agent who has a general authority to negotiate contracts on behalf of the principal. It also includes an agent who has kept a stock of merchandise from which he regularly fills order.
- Agent is defined in Section 2(1) to include agent, attorney, factor, manager in HK. As the HK distribution agents are part of Raymond Group, it is possible that they are acting on behalf of R Ltd. to do business. If this is the case, they may be regarded as an "agent" of R Ltd. under Section 2(1). More information is needed for consideration of whether the HK distribution agents fall within Section 2(1).
- We should consider whether the distribution "agents" have a general authority to negotiate and conclude contracts (particularly the sales contracts) on behalf of R Ltd. No information about this is given in the question and if we assume this is the case, R Ltd is liable to profits tax in respect of the profits from the sales of the sport cars to HK customers.
- R Ltd. can be liable to profits tax if the distribution agents keep a stock of sport cars in HK from which they regularly fill orders on behalf of R Ltd. No information is given about this and if we assume this is the case, R Ltd is liable to profits tax.
- If R Ltd. is liable to profits tax, the distribution agents are required to pay tax and file tax returns on behalf of R Ltd (who is a non-resident) under Section 20A.

- If R Ltd. does not have a permanent establishment in HK, R Ltd will not be liable to profits tax under Section 14. In that case, the distribution agents themselves will be liable to profits tax in respect of their own profits from their sales of motor vehicles to customers in HK. As such, the following tax implications will arise.
- Because of the close relationship between R Ltd and the distribution agents, IRD can challenge whether the sales from R Ltd to the distribution agents in HK are at open market price on arm-length basis. If the selling prices are unreasonable high causing the profits of HK distribution agents understated, IRD can invoke Section 61A to make an assessment on the distribution agents in order to counteract the tax benefit (that is the tax undercharged) and use case law principle (such as Tai Hing Cotton Mill) to substitute the actual sale price by the open market price.
- Since the transactions between R Ltd and the distribution agents involved related parties in two countries, IRD can adopt the transfer pricing policy as published in DIPN 46 for making assessments on the distribution agents: to use arm-length price for the transactions so that a reasonable allocation of profits between R Ltd and the distribution agents can be achieved. IRD can also consider a functional analysis of the profits allocation between the related parties, taking into account their roles, functions, assets and risk based on the principle in Asia Master case.
- If the sales from R Ltd. (a non-resident company) to HK distribution agents are so arranged that HK distribution agents make no profits or less than their ordinary profits, IRD can invoke Section 20(2) to assess the profits of R Ltd under the name of the HK distribution agents as if they are the agents of R Ltd. under Section 2(1).

Option 2

- Section 14 is the basic charging section of profits tax. It requires a business carried on in HK and profits arising in or derived from HK. R Ltd. does not have any office, branch, management or any place of business in HK. So, it should not

have a permanent establishment in HK. As R Ltd has no permanent establishment in HK, Section 14 should not apply to tax R Ltd..

- R Ltd (a non-resident) only sell goods to RC Ltd. (also a non-resident). No business is done in HK or done through HK. Therefore, R Ltd. is not liable to profits tax under Section 14.
- The HK distribution agents are liable to profits tax under Section 14 in respect of their trading profits in HK because they carry on business of selling sport cars in HK and their sales are effected in HK, according to DIPN 21.
- The HK distribution agents can be "agent" of the RC Ltd. if they act on behalf of RC Ltd. to negotiate contracts or keep a stock of sport cars in HK from which they regularly fill orders on behalf of RC Ltd. If this is the case, the HK distribution agents are required to pay tax for and on behalf of RC Ltd. under Section 20A.
- RC Ltd and the distributing agents are related parties because they belong to Raymond Group. Section 20 may apply if sales from RC Ltd. to distribution agents are so arranged that the distribution agents' profits are lower than their ordinary profits. If this is the case, IRD can invoke Section 20(2) to assess the profits of RC Ltd under the name of the HK distribution agents.
- Section 61A will be applicable if the sales from RC Ltd. to distribution agents are higher than the open market price. Relevant facts for Section 61A are: (a) they are related parties (b) the dealings are not on arm-length basis (c) there are tax benefits on the HK distribution agents if the prices charged by RC Ltd. are excessive. The tax benefit is the reduction of the distribution agents' profits by the high selling prices. In that case, IRD may invoke Tai Hing Cotton Mill case to substitute the actual selling prices by the open market prices.
- IRD may follow DIPN 46 to make assessments on the distribution agents so that a reasonable allocation of profits between RC Ltd and the HK distribution agents can be achieved. IRD can use functional analysis of the profits allocation between the related parties, taking into account their roles, functions, assets and risk

based on the principle in Asia Master case.

- As RC Ltd is an enterprise set up in mainland China, it is liable to Corporate Income Tax in China at 25% in respect of the profits from its sales to the HK distribution agents.
- Sales of cars by a China enterprise in China are liable to Value Added Tax. However, RC Ltd. should be exempt from VAT in respect of the sales of sport cars to HK distribution agents because of export sales. If input VAT or custom duty have been paid on the sport cars exported to HK, RC Ltd. can apply to China tax authority for a refund of VAT or custom duty.
- Sales of cars by a China enterprise in China are also liable to Consumption Tax. However, RC Ltd. should be exempt from Consumption Tax in respect of the sales of sport cars to HK distribution agents because no Consumption Tax are charged for exported goods.
- The interest paid by the HK distribution agents to RC is not deductible under profits tax of the HK distribution agents for the following reasons:
 - ~ As the interest is paid to a person other than a financial institution, the relevant condition under Section 16(2) for considering is Section 162(c): Whether or not the interest received by RC Ltd. is liable to profits tax. Interest received by RC Ltd will be liable to profits tax under Section 15(1)(g) if RC Ltd carries on a business in HK and the interest is sourced in HK. The location of interest is generally determined by provision of credit: that is the place where the money is made available to the borrower.
 - ~ The interest is in relation to the sale of motor vehicles by RC Ltd. to HK distribution agents. According to DIPN 13, interest relating to trading transactions has a HK source if it forms an integral part of a trading transaction carried out in HK, vide BR 20/75. In this case, it is the sales by RC Ltd. that generate the provision of credit, the debt. The credit note issued by the HK distribution agents only acknowledges the payment of interest. As

the sales by RC Ltd. are effected in mainland China, the interest received by RC Ltd. is sourced outside HK and therefore not liable to profits tax.

Furthermore, as RC Ltd. does not carry on a business in HK, Section 15(1)(g) cannot apply to tax the interest. As the interest is not taxable in the hands of the recipient, Section 16(2)(c) condition fails and therefore, no interest deduction is allowable under Section 16(2)(c).

- ~ Section 16(2)(e) should be considered because the interest payment is in relation to purchase of trading stock. However, as the distribution agents and RC Ltd. are part of Raymond Group and they are likely under the control of R Ltd, they will be treated as "associates" under Section 16(3). In that case, Section 16(2)(e) cannot be satisfied and no deduction of interest is allowable under Section 16(2)(e).
- ~ In conclusion, there should be no deduction of interest for the HK distribution agents, whether under Section 16(2)(c) or Section 16(2)(e).

Option 3

- A permanent establishment is defined in Inland Revenue Rule 5. It includes a branch established in HK. Under this option, the branch in HK constitutes a permanent establishment according to IRR 5(1).
- As R Ltd has a permanent establishment in HK, it is regarded as carrying on a business in HK even though R is a non-resident company. The profits earned from the sales of sport cars through the branch are liable to profits tax under Section 14.
- The profits of the branch is determined in accordance with IRR 5(2) which states that:
 - ~ Where the local accounts of the branch reflect the true HK profits, assessment is based on the local accounts.
 - ~ Where the local accounts does not reflect the true HK profits, HK profit is

computed by: $\text{HK Turnover} / \text{World wide turnover} \times \text{Total worldwide profit}$,
with appropriate tax adjustments to worldwide profit.

~ Where these two methods are not practicable, the HK profit is determined by a fair percentage of HK turnover.

Q 3

Sale of company office from X Ltd. to Y Ltd:

- Stamp duty will arise for the sale of office from X Ltd to Y Ltd under Head 1(1) of Stamp Duty.
- The consideration for stamping is treated as voluntary disposition inter vivos according to Section 27 of Stamp Duty Ordinance because the consideration is below market price. The value for stamping is the open market value \$30,000,000, not the actual selling price of \$20,000,000.
- Applicable SD rate is 8.5%. Stamp duty is $30,000,000 \times 8.5\% = 2,550,000$, payable within 30 days of execution of the Sale and Purchase Agreement. A further duty of \$100 is payable within 30 days of the execution of the Assignment Deed. In law, both X Ltd. and Y Ltd are liable to pay the whole stamp duty. It is usual practice that the buyer Y Ltd is liable to pay stamp duty based on the provision made in the Provisional S&P Agreement.
- There is no Section 45 relief for the sale because the controlling shareholding of Y Ltd by X Ltd is only 80%, not meeting the minimum exemption requirement of 90% shareholding.
- The sale of office by X Ltd is capital nature because the office is a permanent structure of X Ltd, according to Fleming case. Profit from sale of capital asset is excluded from assessable profits under Section 14(1).

Leasing arrangements of Y Ltd. and M Ltd:

- Leasing of office from Y Ltd to M Ltd is liable to Stamp Duty under Head 1(2) of Stamp Duty Ordinance if a written agreement of lease is executed.
- Applicable SD rate is 0.5% on yearly rent. Stamp Duty = $80,000 \times 12 \times 0.5\% = \$4,800$. In law, Y Ltd. and M Ltd are both liable to pay the whole stamp duty.
- The monthly rental income of \$80,000 received by Y Ltd is assessable under profits tax of Y Ltd.
- As M Ltd is under the control of Y Ltd, they are associated companies. IRD can therefore challenge the rental income received by Y Ltd. is not on arm-length basis and the purpose of the leasing at the rental income of \$80,000 is to reduce the total tax payable of both companies.
- After leasing of office from Y Ltd, M Ltd leased out the office to an unrelated party at a monthly rent of \$120,000. This is likely a series of preordained transactions to reduce tax of Y Ltd. Following the Furniss v Dawson principle, the IRD can look to the end result of the arrangements, that is to assess Y Ltd. at a monthly rent of \$120,000, instead of \$80,000, for profits tax purpose.
- The monthly rent of \$80,000 payable by M Ltd to Y Ltd is below market rent because M Ltd can lease out the office at a monthly rent of \$120,000. By the leasing arrangements, M Ltd makes a monthly gain of \$40,000. The total gain received by M Ltd. from the 2 year leasing arrangements is $\$40,000 \times 24 = \$960,000$ which is almost set off by its agreed loss brought forward of \$1,000,000. So, a tax benefit of $\$960,000 \times 16.5\% = \$158,400$ is obtained. As tax benefit is obtained after the arrangement, Section 61A may be used by IRD to challenge the tax avoidance scheme.
- M Ltd's tax loss of \$1,000,000 will lapse if M Ltd is liquidated. Therefore, IRD can challenge that the leasing arrangements is to create a monthly profit of \$40,000 for M Ltd which is to absorb the tax loss and to prevent the loss from lapsing. IRD can argue that the loss set off is not commercially based; but is solely or

dominantly for reduction of tax.

- Under Section 61A(1), IRD determines taxpayer's intention of tax avoidance by 7 specified matters, including form and substance, manner of being carried out, result achieved, financial position of all parties, arm-length basis, non-resident party involved. As there is a tax benefit on Y Ltd and the leasing is between two related companies, not on arm-length basis, the monthly rent between Y Ltd and M Ltd is below market rent, such transactions should have a dominant tax avoidance intention. So, Section 61A is likely applicable. In that case, IRD can make an assessment on Y Ltd to counteract the tax benefit and rely on the principle of Tai Hing Cotton Mill case to substitute the monthly rental income of \$80,000 by the open market rental income \$120,000.
- The monthly lease payments by M Ltd of \$80,000 are deductible under Section 16(1) because the leased office is used for production of leasing income chargeable to tax and the monthly lease payment is not excessive as compared to market rent.
- The leasing between Y Ltd and M Ltd can be regarded as artificial under Section 61 because it is not commercially motivated. If this is the case, IRD may invoke Section 61 to disregard the leasing arrangements. However, the disregarding of the leasing between Y Ltd and M Ltd cannot make the monthly leasing income of \$120,000 a taxable income of Y Ltd. Therefore, Section 61 is unlikely to be applicable here.

Sale of residential flat by X Ltd:

- Stamp duty will arise for the sale of flat from X Ltd to an unrelated party under Head 1(1).
- The sale is deemed to be a voluntary disposition inter vivos under Section 27 and the value for stamping is the open market value as at the date of sale and purchase agreement. The market value at the date of sale and purchase

agreement \$20,000,000 is the consideration for computation of stamp duty.

- The market value as at the date of Assignment Deed is ignored for stamp duty purpose.
- New AVD rates apply because the buyer is not a HK permanent resident. Applicable SD rate is 7.5%. Stamp duty is $20,000,000 \times 7.5\% = 1,500,000$, payable within 30 days of execution of the Sale & Purchase Agreement, that is on or before 12 Oct 2013. A further duty of \$100 is payable within 30 days of the execution of Assignment Deed. In law, both X Ltd and the buyer are liable to pay the whole stamp duty. In practice, the buyer will pay the whole Stamp Duty according to the Provisional Sale & Purchase Agreement.
- Buyer Stamp Duty at 15% is levied on top of AVD because it is a residential property purchased not by a Hong Kong permanent resident (the buyer is a Mainland resident). $BSD = 20,000,000 \times 15\% = 3,000,000$. The buyer is liable to pay BSD within 30 days of execution of the Sale & Purchase Agreement.
- As the flat has been used as a free accommodation for employee for many years, it is a capital asset of X Ltd. Profit arising from sale of capital asset is excluded from assessable profits under Section 14(1).

Q 4

- Year of assessment is 2013/14. Basis period is 1.4.2013 to 31.3.2014
- Annual salaries \$960,000 is taxable under S9(1)(a).
- Performance bonus \$80,000 is taxable under S9(1)(a).
- Shares bonus is a perquisite taxable under S9(1)(a). According to DIPN 38, the number of shares vested in the year of assessment is taxable. So, 100,000 shares are taxable in 2013/14. Their assessable value is the market value at the date of vesting. As there is a restriction period of 2 years, a discount $5\% \times 2 = 10\%$

is given according to DIPN 38. Therefore, the assessable value is: $100,000 \times 10 \times 90\% = \$900,000$

- MBA course fee incurred is \$120,000. Amount reimbursed by employer is \$30,000. Net amount incurred by Chan is \$90,000. Chan can claim Self Education Expenses deduction (max \$80,000) for the net amount incurred. The MBA course should be related to Chan's employment because Chan is an accounting manager. Assuming the course provider is an approved education institute, Chan can claim deduction of SEE for \$80,000 (max).
- Total membership fee \$4,500: strictly in law the fee is non-deductible because it is not incurred in the production of income. Nevertheless, according to DIPN 9, IRD allow by concession deduction of one annual membership fee if the membership is a prerequisite for employment and the retention of membership is of regular use to employment. Chan should claim HKICPA annual fee \$2,500 for deduction (which is greater than the ACCA fee).
- Medical expenses for wife are not deductible under S12(1)(a) because they are private expenses and not in the production of income.
- Rent and living expenses of Mr. Chan and his mother-in-law are not deductible under S12(1)(a) because they are private nature and not in the production of income.
- Housing allowance \$40,000 per month is taxable in full amount under S9(1)(a). However, Mr. Chan can claim rental value under S9(1)(b) he can prove that his employer refunded him rent of \$30,000 monthly according to his employment contract and the employer's company policy. He can rely on the facts that A Ltd requires staff to submit stamped tenancy agreement and rent bills as arguments for rent refund case. According to Jesse Robertshaw case, the intention of the employer in relation to the payment is important. According to Peter Leslie Page case, we should look at the substance of the payment, including the employer's control over use of the rent reimbursement. On these facts, Chan's claim for

rental value under S9(1)(b) should succeed.

- Chan renting the flat from his brother should not affect the claim for rental value because the rent agreement is duly stamped; the rent is not excessive as compared to rateable value; the monthly rent payments were effected by cheque payments, and the proportion of rent refund in total remuneration package is not excessive. According to Board of Review D14/00, if a residence is rented from a relative, we should consider whether the employer is under the control of employee. Mr. Chan should have no control over A Ltd because he is only an accounting manger, not the company director.
- Chan should claim rental value computation for April 2013 to Feb 2014. The balance of rent reimbursement less rent payment \$40,000 - \$30,000 = \$10,000 per month is taxable as an allowance under S9(1)(a). As for Mar 2013, since Chan moved to his new home, the monthly housing allowance of \$40,000 is taxable in full amount as an allowance under S9(1)(a).
- Rental value is computed on the assessable income under S9(1)(a) after deduction of expenses under S12(1). It is computed as follows:

Income assessable under S9(1)(a) for Apr 2013 to Feb 2014	
Total salaries 960,000 x 11 /12	880,000
Performance bonus 80,000 x 11 /12	73,333
Shares bonus 900,000 x 11 /12	825,000
Housing allowance 10,000 x 11	<u>110,000</u>
	1,888,333
Less: Subscription fee 2,500 x 11 /12	<u>2,292</u>
	<u>1,886,041</u>
Rental value @10% =	188,604

- Rateable value for Apr 2013 to Feb 2014: $\$360,000 \times 11/12 = \$330,000$ (greater than rental value $\$188,604$) is not applicable for rental value.
- Home loan interest deduction is allowed for mortgage loan interest paid to an approved financial institute for the period in which the flat purchased was used as principal residence. Interest payment for joint property of husband and wife is apportioned between them equally. Chan moved to the purchased home in Mar 2013. So, he can claim HLI for Mar 2011: $10,000/2 = \$5,000$. As Mrs. Chan does not have any assessable income, she can nominate Mr. Chan to get her share of HLI $\$5,000$ under S26F. So, Mr. Chan can get a total HLI deduction of $\$10,000$ under salaries tax.
- Mr. A can claim Married Person Allowance $\$240,000$ because her wife does not have employment income chargeable to Salaries Tax.
- Mr. Chan can claim mandatory MPF contribution $\$15,000$ under salaries tax.
- Mrs. A can claim mandatory MPF deduction $\$15,000$ under profits tax.
- Child Allowance: 1 child $\$70,000$ + 1 new born $\$70,000$: total $\$140,000$
- Chan's mother-in-law cannot qualify DPA because she was not ordinary resident in Hong Kong in 2013/14.
- Mrs. Chan worked as a freelance writer. According to Lam Woo Shang case, anything occupying time, attention and effort can be business. Besides, according to Lee Yee Shing, repetition of facts indicates doing business. Mrs. Chan is self-employed and she is carrying on a business as a writer. She is liable to profits tax in respect of the writer fee $\$600,000$.
- Mr. and Mrs. Chan should consider whether election for Personal Assessment can reduce their total tax liabilities. We should compute Mr. and Mrs. Chan's total tax payable under Personal Assessment and their total tax payable without Personal Assessment and then advise them to make an election or not.

- No election for Personal Assessment

Mr. A's salaries tax liability for 2013/14 (ignoring tax reduction under Budget)

Annual salaries		960,000
Performance bonus		80,000
Shares bonus		900,000
Housing allowance 10,000x11 + 40,000		150,000
Rental value		<u>188,604</u>
Assessable income		2,278,604

Less:

HKICPA annual membership fee	2,500	
Self-Education Expenses	80,000	
MPF contribution	15,000	
Home loan interest	<u>10,000</u>	<u>107,500</u>
Net assessable income		2,171,104

Less:

Married Person Allowance	240,000	
Child Allowance	<u>140,000</u>	<u>380,000</u>
Net chargeable income		<u>1,791,104</u>
Tax at progressive rates		292,487

Tax at standard rate: $2,171,104 \times 15\% = 325,665$ (not applicable)

Mrs. A's profits tax liability for 2013/14 (ignoring tax reduction under Budget)

Net income		600,000
Less: MPF contribution		<u>15,000</u>
Assessable profits		<u>585,000</u>
Tax payable: $585,000 \times 15\% =$		87,750

Therefore, Mr. and Mrs. A's total tax liability = $325,665 + 87,750 = 379,737$

- Tax payable under Personal Assessment (ignoring tax reduction under Budget)

	<u>Mr. A</u>	<u>Mrs. A</u>	<u>Total</u>
Net Assessable income*			
2,278,604 - 2,500 – 80,000	2,196,104		
Assessable profits		585,000	
Less:			
MPF contribution	15,000	0*	
Home loan interest	<u>5,000</u>	<u>5,000</u>	
Total income	2,176,104	580,000	2,756,104
Less:			
Married Person Allowance			240,000
Child Allowance			<u>140,000</u>
Net chargeable income			2,376,104
Tax at progressive rates			391,937
Tax at standard rate: 2,756,104x 15% = 413,415			(not applicable)

- As Mrs. A's assessable profits are after deduction of her MPF contribution, no deduction of MPF contribution is granted under PA computation.
 - Outgoings and expenses under S12(1)(a) and Self Education Expenses under S12(6)(a) are only deductible under Salaries Tax.
- As their total tax payable under Personal Assessment 391,937 is greater than their total tax payable without Personal Assessment \$379,737, they should not elect for Personal Assessment.

Q 5

- The starting point is "Profits before tax" in P&L a/c, computed as follows:

Profit and Loss Account for year ended 31 Mar 2014

Gross trading profits		1,000,000
Add:		
Shares dealing gain		100,000
Interest income		50,000
Compensation receipts		300,000
Profit on disposal of patent 200,000 – 100,000		<u>100,000</u>
		1,550,000
Less:		
Amortization of medical research expenses	200,000	
Loss on disposal of old computers 200,000 –		
100,000	100,000	
Bank charges and interest	10,000	
Repairs	100,000	
Provision for bad debts	50,000	
Legal fee	100,000	
Donation	100,000	
Hire purchase interest of the truck		
$12 \times 20,000 \times 500,000 / 1,000,000$	120,000	
Depreciation on truck		
$500,000 \times 20\%$	<u>100,000</u>	<u>880,000</u>
Net profits (profits before tax)		670,000

- According to Secan case, Generally Accepted Accounting Practice (GAAP)

adopted by taxpayer should be followed for tax computation except a legislation or a case principle saying otherwise. So, the starting point for profits tax computation is the net profits before tax as per Profit and Loss Account.

- Gain on share dealing is offshore and not taxable because the shares are listed in UK. So, the gain \$100,000 should be excluded in tax computation.
- Interest income on USD fixed deposit with HK bank is sourced in HK under provision of credit test. However, the bank interest income is exempt by the 1998 Interest Income Exemption order under S87.
- Interest paid by a US customer is trading nature because it is received in the ordinary course of trade. According to DIPN 13, interest relating to a trading transaction has a HK source if the trading transaction takes place in HK. As the overdue debt is derived from sales contracts concluded in HK, the interest is taxable. No adjustment is made in tax computation.
- Compensation received for cancellation of trading contract is revenue nature and taxable, according to London & Thames Heaven Oil case. No adjustment is made in tax computation.
- Compensation received for payment in lieu of notice from staff is taxable because it is a revenue receipt in the ordinary course of business. So, no adjustment in tax computation.
- The computers purchased in 2012 for \$500,000 are prescribed fixed assets under S16G. They should have been deductible in previous tax computation. In that case, the sales proceeds of \$100,000 (less than the purchase cost \$500,000) is taxable under S16G(3)(b) and added back in tax computation.
- The loss on disposal of computers $\$200,000 - \$100,000 = \$100,000$ is an expense charged to P&L account according to generally accepted accounting practice. However, because the loss is capital nature, it is disallowed under S17(1)(c) and added back in tax computation.

- The profit on disposal of patent \$100,000 is capital nature and therefore not taxable. It should be excluded in tax computation.
- The purchase cost of the patent should have been allowed as a deduction under S16E in previous tax computation. In that case, the sale proceeds as restricted to cost of purchase \$100,000 is a taxable receipt under S16E(3) and added back in tax computation..
- Medical research expenditure \$200,000 is written off as an expense in profit and loss account because the fair value of such expenditure is doubtful. Amortization of medical research expense is capital nature and therefore it is disallowed under S17(1)(c) and added back in tax computation.
- S16B grants full deduction for payment to approved research institute in connection with research and development relating to the trade of taxpayer. According to DIPN 5, medical research for welfare of workers employed in the trade of taxpayer is within the meaning of S16B. Furthermore, HKU is an approved institute. So, the expenditure is deductible under S16B(5)(b)(ii).
- Bank charges are generally deductible under S16(1) because they are incurred in the ordinary course of business. No adjustment in tax computation
- Interest on loan from holding company is allowable under S16(2)(c) only if the following conditions are fully satisfied: the interest expense is not capital nature; the related loan is used for production of chargeable profit; and the interest income is a taxable receipt in the hands of the recipient (the holding company). As the holding company is carrying on a business in HK, its interest income is taxable under S15(1)(g). Assuming the other two conditions are also satisfied, no adjustment is required in tax computation.
- Carpet is a kind of “implement, article, utensil”. Their initial purchase cost is disallowed S17(1)(c) because of capital nature. As the purchase cost of carpet is small, \$20,000, it should be treated as an expense in profit and loss account under GAAP. It must be, however, added back in tax computation.

- Under S16(1)(d), bad debts are deductible if the following conditions are satisfied: (a) it is a trade debt and has been assessed as a trading receipt; and (b) it can be proved to the satisfaction of IRD that the debt has become irrecoverable. General provision for bad debt is disallowed and added back in the tax computation because of failing the (b) condition. In this case, specific provision should also be disallowed because it is only an estimate and there is no proof for how they have become irrecoverable as at the balance sheet date.
- Interest expense on hire purchase of the truck is deductible under S16(1) because the truck is used for the trade. No adjustment in tax computation.
- Depreciation on truck is capital nature. It is disallowed under S17(1)(c) and added back in tax computation.
- Legal fee for trade dispute with customer is deductible under S16(1) because it is revenue nature and incurred in the ordinary course of business. No adjustment in tax computation.
- Stamp duty and legal fee \$20,000 for arranging the new lease is capital nature It is disallowed under S17(1)(c) and added back in tax computation.
- Loss brought forward \$500,000 can set off assessable profits under Section 19C. No information is given on whether such loss has been agreed by IRD. Anyway, make a claim for the loss set off in tax computation because this is in the interest of taxpayer.
- S16D grants exemption for cash donation to approved charitable institution over \$100 subject to a maximum of 35% of assessable profits. Buying tea set is not cash donation, see Sanford Yung Tao Yung case. So, no deduction is allowed under S16D. Besides, the donation cannot qualify for a deduction under S16(1) because it is not in the production of profits. H Ltd. should have no business connection with Tung Wah Hospital and therefore the donation should not be in the ordinary course of business of H Ltd. So, the donation \$100,000 is disallowed and added back in the tax computation.

- Truck on hire purchase is not pooled. It attracts Depreciation Allowance as a separate asset as follows:

	<u>WDV</u>	<u>DA</u>
Cost (cash price)	500,000	
Less: I.A. $12 \times 20,000 \times \frac{1}{2} \times 60\% =$	<u>72,000</u>	72,000
	428,000	
Less: AA at 30%	<u>128,400</u>	<u>128,400</u>
	229,600	200,400

- Suggested profits tax computation for 2013/14
see next page

Suggested profits tax computation for 2013/14

Net profits per profit and loss account		670,000
Add:		
Depreciation	100,000	
Amortization of medical research expenses	200,000	
Loss on disposal of old computers	100,000	
Sales proceeds of old computers	100,000	
Sale proceeds of patent (restricted to cost)	100,000	
Initial purchase cost of carpets	20,000	
Provision for bad debts	50,000	
Donation	100,000	
Stamp duty and legal fee for the new lease	<u>20,000</u>	<u>790,000</u>
		1,460,000
Less:		
Profit on disposal of patent	100,000	
Bank interest	30,000	
Medical research for workers in the trade	200,000	
Gain on disposal of UK listed shares	100,000	
Depreciation allowance	<u>200,400</u>	<u>630,400</u>
Assessable profits for current year		829,600
Less: loss set off under Section 19(c)		<u>500,000</u>
Assessable profits		<u>329,600</u>
Profits tax thereon @16.5%		54,834
Less: Tax reduction under Budget		
at 75%, restricted to \$10,000		<u>10,000</u>
Net tax payable (after tax reduction)		44,384