SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer ALL of the following compulsory questions. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

CASE

A Ltd. was a leading supplier of audio and visual equipment in Hong Kong. In the early nineties, A Ltd. closed its factory in Hong Kong and subcontracted the manufacturing process to four unrelated contractors in mainland China ("the Mainland"). Whilst the company had its own representative office in the Mainland to liaise with the contractors, it did not involve itself in the production work. In Hong Kong, A Ltd. maintained a sales department to solicit orders from customers and a merchandising department to source raw materials and arrange shipments of them as well as the finished products. Most of its directors also stationed themselves in Hong Kong to manage the daily operation of the company.

All along A Ltd. had been assessed as per its profits tax returns without query, until recently when the Inland Revenue Department (IRD) commenced an audit on the tax affairs of A Ltd. for the years of assessment 2008/09 to 2010/11. Upon a review of the relevant documents and records for 2 months, the Assessor revealed the following:

(a) A Ltd. claimed that half of its profits were derived from the manufacturing activities outside Hong Kong. It also claimed depreciation allowance in respect of the plant and machinery which had been provided to the Mainland contractors for production without consideration.

(b) One of the audio and visual products sold by A Ltd. involved a patented technology held by B Inc., a U.S. company which had no relationship with A Ltd. and did not carry on any business in Hong Kong. During the relevant years, A Ltd. paid substantial royalties in respect of the technology and charged the payments in its accounts. It did not, however, report to the IRD the receipt of royalties by B Inc.

(c) An item under the label of "China Tax" was charged in the profit and loss account for the year ended 31 December 2008. A Ltd. asserted that the item represented the business tax paid in respect of the sale of an office unit by its representative office in the Mainland.

(d) In December 2010, A Ltd. purchased a shop for investment at HK$20,000,000 and paid stamp duty accordingly. Notwithstanding the lack of relationship between A Ltd. and the seller, due to the serious cash flow problem of the seller, the sale price of the shop was found to be 20% less than the then market value.

(e) Mr. D was a manager employed by A Ltd. in Hong Kong. During the relevant years, he was seconded to work for the Mainland representative office. Notwithstanding this, he remained under the payroll in Hong Kong and was required to return to Hong Kong two days a week to attend to business matters. Mr. D paid Individual Income Tax ("IIT") in the Mainland and was provided with a 1-room serviced apartment in the Mainland as free residence. As the residence provided was outside Hong Kong, A Ltd. did not report such housing benefit to the IRD.

Question 1 (18 marks – approximately 32 minutes)

Evaluate the following claims of A Ltd.:

(a) **half of its profits were derived outside Hong Kong.** **(8 marks)**

(b) **it was entitled to depreciation allowance in respect of the plant and machinery used by the Mainland entities.**

(4 marks)

(c) **(i)** **it was required to pay business tax in respect of its sale of an office unit in the Mainland; and**

(ii) **the business tax so paid was deductible under profits tax in Hong Kong.**

(6 marks)

Question 2 (11 marks – approximately 20 minutes)

Discuss whether A Ltd. has acted properly under the Inland Revenue Ordinance (IRO) in respect of:

(a) **the royalty payments to B Inc.** **(8 marks)**

(b) **the place of residence provided to Mr. D in the Mainland.** **(3 marks)**

Question 3 (5 marks – approximately 9 minutes)

Explain the stamp duty implication in respect of the undervalued purchase of the shop by A Ltd.

(5 marks)

Question 4 (16 marks – approximately 29 minutes)

Advise Mr. D:

(a) **whether and if so, how he is exempt from salaries tax for the relevant years.**

(11 marks)

(b) **whether and if so, how the place of residence provided to him in the Mainland is assessable to salaries tax.**

(5 marks)

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End of Section A

SECTION B – ESSAY / SHORT QUESTIONS (Total: 50 marks)

Answer ALL of the following questions. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

Question 5 **(12 marks – approximately 22 minutes)**

World Corp. is a large international company incorporated in Country X. It has many subsidiaries in Europe and in the United States. The group would like to carry out the following restructuring plans:

Required:

(a) **World Corp. would like to set up a new subsidiary New Ltd. in Hong Kong to strengthen their market position in Asia. New Ltd. will be responsible for the marketing and sale of group products in Asia. Please comment on any Hong Kong tax implications on New Ltd's operations in Hong Kong.**

(10 marks)

(b) **New Ltd. will also set up a branch in Country Y to market and sell group products in Country Y. Would the branch profits be subject to tax in Hong Kong? If tax is payable in Country Y on the branch profits, comment on the deductibility under profits tax in Hong Kong.**

(2 marks)

Question 6 **(10 marks – approximately 18 minutes)**

As the tax rate in Country X is very high, Global Inc. would like to transfer the intellectual properties (IP) which it has developed over the years to its subsidiary incorporated in Hong Kong "Star Ltd.". After the transfer, Star Ltd. will be collecting royalties from related companies which are using the IP in their jurisdiction.

Required:

(a) **Explain the tax implications of the following:**

(i) **Would the cost of IP be deductible for Star Ltd.?**

(ii) **If the cost of IP includes the cost of one trade mark, would the trade mark cost be deductible?**

(iii) **Would the royalties be taxable?**

(6 marks)

(b) **Star Ltd. will engage research companies in Country Z to carry out research for the purpose of developing new IP. Comment on the deductibility of the above research and development expenditure.**

(4 marks)

<u>Question 7</u> **(18 marks – approximately 32 minutes)**

Carol Smith is employed by ABC Co. as sales and marketing manager. Her remuneration package consists of a base salary of HK$20,000 per month plus commission. If her sales exceed the quarterly target of HK$1M ("Target Sales"), she will be paid commission computed as follows: 1% x (Sales less Target Sales). Commission is paid on a quarterly basis, namely, on the following dates – 31 March, 30 June, 30 September and 31 December.

Last year, Carol's annual chargeable income was HK$500,000. Provisional salaries tax was computed by reference to the aforementioned amount. For the current year of assessment, her bank statements revealed the following:

Salaries for the months of April to June	HK$60,000
June commission	HK$20,000
Salaries for the months of July to September	HK$60,000

Carol informed you that she failed to meet her sales target for the quarter ending September. However, December is usually a good month and she should be able to exceed her target.

Carol will be taking 8 weeks leave from early January to travel round the world. This is because she is able to utilise her accumulated leave entitlement for the past three years.

She noted that the due date for her provisional salaries tax is 30 January.

<u>Required:</u>

(a) **Carol asked you if there is any way to defer or minimise her tax payment on 30 January so she could have more surplus funds for her round-the-world trip. Please advise Carol (with computation to illustrate if required).**

(11 marks)

(b) **During ABC Co.'s annual party held on 15 December, Carol won a cash prize of HK$10,000. The next day, she also won HK$20,000 at the lucky draw held at her friend's wedding party. In appreciation of her contribution, ABC Co. awarded her a travel allowance of HK$8,000 for her round-the-world trip. Please advise if the above are taxable.**

(3 marks)

(c) **ABC Co. reimbursed Carol for the parking fees and fines incurred during her visits to clients' offices in the past year. Comment on the tax implications for Carol and for ABC Co.**

(4 marks)

Question 8 **(10 marks – approximately 18 minutes)**

John Chan acquired Property A in January 2002 just before his wedding. The funds for financing the purchase were provided by his father as a wedding gift to his son.

John and his wife moved into Property A after they returned from their honeymoon.

John's wife, Mary, gave birth to a baby boy on 10 October 2009. They moved into a larger apartment, Property B. They used the proceeds from the sale of Property A and a mortgage loan obtained from a local bank to finance the purchase of Property B.

Required:

(a) **Is the gain on Property A taxable?** **(3 marks)**

(b) **John is preparing his salaries tax return for the year of assessment 2010/11 and called you to inquire what allowances/deductions are available to him?**

(7 marks)

* * * END OF EXAMINATION PAPER * * *