SECTION A – CASE QUESTIONS

Answer 1(a)

The relevant sums are computed as follows:

		HK$
(1)	Carriage of goods and passengers shipped in Hong Kong within Hong Kong waters	6,000,000
(2)	Towage operations undertaken within Hong Kong waters	4,000,000
(3)	Charter hire where the ships navigated within Hong Kong waters	5,000,000
(4)	Charter hire where the ships navigated between Hong Kong and the inland waterways of Guangdong (HK$12,000,000 x 50%)	6,000,000
		21,000,000

Note:-

(a) The sum derived from carriage of goods and passengers shipped in Hong Kong to Japan is an exempt sum because the goods and passengers were shipped aboard registered ships in Hong Kong and proceeding to sea (to Japan) from Hong Kong.

(b) The sum derived from towage operations undertaken from Hong Kong to Taiwan is an exempt sum because the towage operations were undertaken by registered ships proceeding to sea (to Taiwan) from Hong Kong.

Answer 1(b)

B Ltd carried on logistic service business in Hong Kong. Provided that the interest income arose or was derived from Hong Kong, it should be chargeable to profits tax under s.14 or s.15(1)(f) of the IRO.

B Ltd is neither a financial institution nor a money lender. To determine the source of its interest income from the Deposit, the applicable test is the “provision of credit” test.

The provision of credit test provides that the place of derivation of interest is the place where the funds from which the interest is derived were provided to the borrower.

In the present case, the Deposit from which B Ltd derived the interest income was placed with the US branch of Bank C. Applying the “provision of credit” test, the interest income should be regarded as having a source outside Hong Kong and is thus not chargeable to profits tax.

Answer 1(c)

The interest expense in respect of the Loan was incurred for the purpose of producing chargeable profits. Hence, it satisfied the condition set out in s.16(1)(a) of the IRO. Besides, the interest expense also satisfied the conditions set out in s.16(2)(d) or (e) of the IRO as the Loan was borrowed from a financial institution and was used wholly and exclusively to finance the acquisition of plant and machinery. As the interest expense was deductible under s.16(2)(d) or (e), it follows that the deduction will be subject to the conditions set out in s.16(2A) and (2B) of the IRO.

As to the tests in s.16(2A) and (2B), having regard to the change in respect of the Loan from being secured by a deposit placed by B Ltd to the sub-participation scheme entered into by Mr. D on 1 October 2013, respective considerations have to be made as to whether, and the extent to which, the interest expense incurred in the periods from 1 April 2013 to 30 September 2013 ("Period 1") and 1 October 2013 to 31 March 2014 ("Period 2") is deductible.

Period 1

The Loan was secured by the Deposit which was provided by B Ltd.

B Ltd was then the only shareholder and thus an associate of A Ltd within the meaning of s.16(3) of the IRO.

For Period 1, B Ltd derived the following interest income from the Deposit, which is not chargeable to profits tax (see Answer 1(b) above):

HK$60 million x 4% x (183 days / 365 days) = HK$1,203,287

By virtue of s.16(2A) of the IRO and pursuant to the practice of the Inland Revenue Department ("IRD") stipulated in Departmental Interpretation and Practice Notes ("DIPN") No. 13A, the amount of interest expenses allowable for deduction in respect of the Loan will be reduced by the above tax-free interest on the Deposit.

Period 2

An arrangement (i.e. the sub-participation agreement) was in place whereby part of the interest payable on the Loan was paid to Mr. D through Bank C.

Mr. D was then the only shareholder and thus an associate of A Ltd within the meaning of s.16(3) of the IRO.

As Mr. D did not carry on any business on his own account, the interest received by him from Bank C is not chargeable to any tax under the IRO. In other words, Mr. D is not an excepted person within the meaning of s.16(2E)(c) of the IRO.

By virtue of s.16(2B) of the IRO, the amount of allowable interest expenses will be further reduced by the following amount:

HK$100 million x 10% x (HK$70 million / HK$100 million) x (182 days / 365 days)
= HK$3,490,410

Therefore, the amount of interest expenses allowable for deduction in respect of the Loan should be computed as follows:

HK$100 million x 10% - HK$1,203,287 - HK$3,490,410 = HK$5,306,303

Answer 1(d)

The issue of shares by A Ltd to fulfill its obligation under the share option scheme merely involves a movement in its equity reserve account.

Following the authority of *Lowry v Consolidated African Selection Trust Ltd.* [1940] 23 TC 259, the fair value of the new shares charged to the accounts of A Ltd should not be regarded as an outgoing or expense for the purpose of s.16(1) of the IRO.

Thus, the charge is not allowable for deduction.

Answer 1(e)

(1) Total shipping profits

		HK$
Net profits per accounts		30,000,000
Add:	Non-deductible interest expenses in respect of the Loan (HK$1,203,287 + HK$3,490,410) - See Answer 1(c) above	4,963,697
	Fair value of the shares issued for share option scheme - See Answer 1(d) above	1,000,000
		35,693,697
Less:	Net agency receipts (HK$20,000,000 x (1-30%))	14,000,000
		21,693,697

(2) Assessable profits of business as an owner of ships

= HK$21,693,697 x (HK$21,000,000 / HK$42,000,000)

= HK$10,846,848

Answer 2

Under s.19(1)(a) and (b) of the Stamp Duty Ordinance ("SDO"), B Ltd and Mr. D are each required to (i) make and execute a contract note in respect of the sale or purchase of the shares in A Ltd, and (ii) cause it to be stamped under head 2(1) in the First Schedule of the SDO.

Under head 2(1) in the First Schedule of the SDO, the stamp duty payable on each contract note is computed at 0.1% of the consideration for the shares.

The consideration provided under the sale and purchase agreement is HK$30 million. However, there was a term under such agreement that Mr. D would enter into a sub-participation agreement with Bank C whereby the repayment of the Loan by A Ltd would, in effect, be secured by Mr. D to the extent of HK$70 million. Thus by virtue of s.24(1) and (3) of the SDO, such part of the Loan will be deemed to be part of the consideration for stamp duty purposes.

Thus, the stamp duty payable on the contract notes executed by B Ltd and Mr. D will be computed as follows:

(HK$30 million + HK$70 million) x 0.1% x 2 = HK$200,000

Normally, in addition to the contract notes, B Ltd and Mr. D will also execute an instrument of transfer to effect the transfer of legal title of the shares. Such instrument will be chargeable with stamp duty of $5 under head 2(4) in the First Schedule of the SDO.

Answer 3(a)

Mr. E is a seafarer. By virtue of s.8(2)(j) of the IRO, he will be exempt from salaries tax for the years of assessment 2012/13 and 2013/14 if he was present in Hong Kong for not more than:

(a) a total of 60 days in each of the relevant years of assessment; and

(b) a total of 120 days falling partly within each of the two consecutive years of assessment, one of which is the relevant year of assessment.

In the year of assessment 2012/13, Mr. E was present in Hong Kong for 40 days. In the two consecutive years of assessment (i) 2011/12 and 2012/13 and (ii) 2012/13 and 2013/14, he was present in Hong Kong for (i) 70 days and (ii) 105 days respectively. Thus, Mr. E should be exempt from salaries tax for the year of assessment 2012/13 pursuant to s.8(2)(j) of the IRO.

As Mr. E was present in Hong Kong for 65 days during the year of assessment 2013/14, the exemption provided under s.8(2)(j) of the IRO is not applicable. Since he had a Hong Kong employment with A Ltd, he will be fully chargeable to salaries tax for the year of assessment 2013/14. Under s.8(2)(j), the criteria for exemption are prescribed in terms of days of presence in Hong Kong. Thus the fact that Mr. E only provided services in Hong Kong for less than 60 days in each of the relevant years is irrelevant in determining his eligibility for the exemption.

Answer 3(b)

Mr. E had a Hong Kong employment as a seafarer with A Ltd during the vesting period of 2 years (i.e. the years of assessment 2012/13 and 2013/14). In accordance with DIPN 38, unless he is exempt from salaries tax by virtue of s.8(2)(j) of the IRO in each of the relevant years during the vesting period, his gain from the share option will be fully chargeable to salaries tax.

As analysed in Answer 3(a), Mr. E is exempt from salaries tax for the year of assessment 2012/13, but he is chargeable to salaries tax for the year of assessment 2013/14. Thus, all his gain from the share option will be chargeable to salaries tax and no apportionment is applicable.

Mr. E exercised the share option on 1 May 2014. Pursuant to s.9(1)(d) of the IRO, his gain from the share option should be charged to salaries tax in the year of assessment 2014/15.

In accordance with s.9(4)(a) of the IRO, the taxable share option gain is computed as follows:

(HK$1.2 - HK$0.8) x 100,000 shares = HK$40,000

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS

Answer 4(a)

For year 2009/10, the IRD has issued Notice of Assessment to FCA. This indicated that FCA should derive assessable profits for the year. As the PYA for this year was derived from the understatement of sales income, taxable profits for the year should therefore be under-assessed. FCA should therefore promptly notify the IRD the details of PYA for the year, the amount of assessable profits understated, and to request the issue of Additional Assessment under s.60 of the IRO.

The IRD has also issued 2010/11 Notice of Assessment to the company. Again, this indicated that FCA should have derived assessable profits for the year. As the understatement of cost of sales deriving the PYA for the year should reduce the assessable profits of the company, FCA should lodge a claim to the IRD under s.70A of the IRO to revise its profits tax position, and request the refund of overpaid profits tax.

The company should have incurred a tax loss for the year of assessment 2011/12 as the IRD has issued Loss Notification to FCA for the year. As the understatement of cost of sales giving rise to the PYA for the year should increase the tax loss of the company, FCA should lodge a disagreement to the IRD elaborating the details of the PYA and request a revision to its tax loss for the year.

The 2012/13 Notice of Assessment issued by the IRD indicated that FCA should have taxable profits for the year. As the amount of tax loss brought forward from prior year should be increased due to the PYA in the prior year, the net assessable profits of the company for the year should be correspondingly reduced. FCA should therefore lodge an objection against the Assessment under s.64(1) of the IRO if the Assessment was issued within one month. If the Assessment was issued more than one month ago, FCA may consider lodging a claim under s.70A of the IRO on the basis that there is an error in computing the assessable profits of the company with respect to the tax loss brought forward from the prior year.

Answer 4(b)

As the PYA was derived from incorrect recognition of sales income and cost of sales, the company may be penalised under s.80(1A) of the IRO on the basis that it failed to comply with the requirements of s.51C of the IRO (i.e. fails to keep proper records of business income and expenditure to enable the assessable profits to be readily ascertained) for relevant years. FCA may then be liable on conviction to a fine at level 6 ($100,000).

For the year of assessment 2009/10, FCA may also be penalised under s.80(2)(a) of the IRO for making an incorrect return by understating the taxable sales income for the year, and be liable on conviction to a fine at level 3 ($10,000) and a fine of treble the amount of tax that has been undercharged or that would have been undercharged if such failure had not been detected.

If no prosecution was made under s.80(1A) or 80(2)(a) of the IRO, the Commissioner of Inland Revenue ("CIR") may compound any offence in this case.

If the understatement of the sales income was a willful intention to evade tax by the use of fraud, false statement, etc., the relevant person(s) committing the offence may be prosecuted under s.82(1) and (1A) of the IRO. The penalty on summary conviction is a fine at level 3 ($10,000), and three times the tax undercharged together with imprisonment for six months. The penalty on indictment is a fine at level 5 ($50,000) and three times the tax undercharged, plus imprisonment for three years.

If no prosecution was made under s.80(2) or 82(1) of the IRO, the company may be liable to be assessed under s.82A of the IRO to additional tax of an amount not exceeding treble the amount of tax that has been undercharged.

Answer 5(a)

There are specific anti-avoidance provisions in the IRO to deal with arrangements to disguise employer / employee relationships (Service Company Type I). In examining the arrangement between ASC and FPL, the IRD would seek to use the operative provisions in s.9A(1) of the IRO together with the principles elaborated in Departmental Interpretation and Practice Notes No. 25 (Revised November 2011)("DIPN No. 25").

In assessing the applicability of s.9A(1) of the IRO to the service fee income received by ASC from FPL, the IRD would examine the prima facie liability of whether there is an arrangement which will come within the scope of the section where (as per para. 8 of DIPN No. 25):

(a) there is an agreement;

(b) services have been carried out under the agreement by a "relevant individual" (i.e. Mr. Lam) for a "relevant person" (i.e. FPL); and

(c) remuneration for the services has been paid or credited to a corporation (i.e. ASC) controlled by the relevant individual as defined in s.9A(1)(a), (b) or (c) of the IRO.

If s.9A(1) of the IRO applies to the arrangement between ASC and FPL, the income derived by ASC from FPL are deemed to be income derived by Mr. Lam from employment and chargeable to salaries tax.

In order to defend against a challenge by the IRD for the application of s.9A(1) of the IRO, ASC must substantiate to the IRD that all the six specific criteria laid down in s.9A(3) of the IRO are satisfied.

Answer 5(b)

S.9A(4) of the IRO provides a practical approach for ASC to ascertain if s.9A(1) of the IRO is not applicable to the arrangement of providing consultancy services to FPL. In this connection, ASC can request for an advance ruling made by the CIR. ASC would then be required to submit further information as per Appendix B of DIPN No. 25 in order to facilitate CIR's consideration if an employment exists by applying the (i) control test, (ii) integration test, (iii) the economic reality test, and (iv) the doctrine of mutuality of obligation. (Para. 41 to 44 of DIPN No. 25). Upon submission of the relevant information, the CIR will exercise his discretion under s.9A(4) of the IRO on whether s.9A(1) of the IRO should apply to the arrangement between ASC and FPL regarding the provision of consultancy services.

Answer 6(a)

Property tax liabilities of Mr. Yip
Year of assessment 2012/13

Property A	HK$	HK$
Rent ($100,000 x 12) 1 April 2012 – 31 March 2013	1,200,000	
Premium ($120,000 x 12/36) 1 April 2012 – 31 March 2013	40,000	
	1,240,000	
Less: Rates ($6,600 x 4)	26,400	
	1,213,600	
Less: 20% statutory deduction	242,720	
Net assessable value	970,880	
Property tax @15%		145,632
Property B		
Rent ($18,000 x 3) 1 April – 30 June 2012	54,000	
Less: Bad debts [($8,000 x 9) *(1 August 2011 to 30 April 2012)* + ($18,000 x 2) *(1 May 2012 – 30 June 2012*)] - $36,000	72,000	
	(18,000)	
Net assessable value (Note)	0	
Property tax @15%		0

Properties C & D

Rent ($20,000 x 6) 1 October 2012 – 31 March 2013	120,000	
Less: Rates ($3,000 x 2)(*Case No. D7/02)*	6,000	
	114,000	
Less: 20% statutory deduction	22,800	
Net assessable value	91,200	
Property Tax @15%		13,680
		159,312

Note:

Under s.7C(3) of the IRO, the excess of irrecoverable rent can only be used to offset the assessable value of the same property in the latest year of assessment in which that assessable value is sufficient, and cannot offset the assessable value of other properties for the same year of assessment

Answer 6(b)

Article 1 of Provisional Regulation on Value-added Tax provides that all units and individuals engaged in the sale of goods, provision of processing, repair and replacement services and importation of goods within the territory of the People's Republic of China are subject to Value-added Tax.

In this regard, sales of furniture by the Mainland manufacturing factory as a general VAT taxpayer is subject to VAT at 17% (RMB100,000 x 17% = RMB17,000).

Since Mr. Yip is only a consumer, he cannot obtain any input VAT credit and cannot apply for export VAT refund.

Article 1 of Provisional Regulations of Business Tax of the People's Republic of China provides that all units and individuals providing prescribed taxable services within the People's Republic of China territory are subject to Business Tax. As transportation service is included in prescribed services, and it was provided by a transportation company and has been specified as a Business Tax taxpayer, the delivery charges is therefore subject to Business Tax at 3% (RMB5,000 x 3% = RMB150).

Answer 7(a)

(i) Deduction of expenses, including entertainment expenses, from a salaries tax perspective is specified in s.12(1)(a) of the IRO. Specifically, all outgoing expenses, other than domestic or private and capital in nature, wholly, exclusively and necessarily incurred in the production of the assessable income are deductible.

Paragraphs 5 to 11 of the Departmental Interpretation and Practice Notes No. 9 (Revised September 2006) ("DIPN No. 9") elaborated the essential principles of deduction claim under s.12(1)(a) of the IRO. For an expenditure to have been incurred it must be an established liability or a definite commitment. For the words "wholly" and "exclusively", expense should be apportioned if it is incurred for more than one purpose. For the word "necessarily", expenditure is vital to the employment to the extent that it would not be possible for the taxpayer to produce the income from the employment without incurring the expenditure. For expenditure incurred "in the production of assessable income", the amount must be incurred in the performance of the duties instead of enabling the duties to be performed.

The IRD adopts the practice that mere social entertaining would be debarred as not being wholly and exclusively incurred (para. 15 of DIPN No. 9). In this regard, the senior insurance agent should ensure that the nature of his entertainment expenses satisfies each and every abovesaid principle in addition to not being expenditures of a domestic, private or capital in nature.

(ii) S.12(1)(e) of the IRO provides for a deduction claim for self-education expenses paid by taxpayers. Expenses of self-education are defined under s.12(6)(b) of the IRO to include fees in connection with a prescribed course of education set by an education provider. Under s.12(6)(c) of the IRD a prescribed course of education must be for gaining or maintaining qualifications for use in any employment. Under s.12(6)(c) of the IRO specified education providers include universities, etc. registered under the Education Ordinance, and any other institutions approved by the IRD. The total amount of self-education expenses that may be deducted in any year of assessment should not exceed the amount specified in relation to that year in Schedule 3A of the IRO (Para 22 to 25 of DIPN No. 9).

In this connection, the finance manager should ensure that the respective overseas university is an institution approved by the IRD, and that the relevant MBA course could enable him to gain or maintain a qualification for use in any of his employment. In addition, the tuition fee has been paid already by the finance manager, and the amount of deduction claim must not exceed the amount specified in Schedule 3A of the IRO for the relevant years.

Answer 7(b)

In providing tax consultancy services, Mr. Hung should consider the following ethical principles in accordance with s.430 “Ethics in Tax Practice” of the Code of Ethics for Professional Accountants (Revised June 2010):

- Mr. Hung is entitled to put forward the best position in favor of his clients provided that he can render the service with professional competence. It does not in any way impair his standard of integrity and objectivity, and is in his opinion consistent with the law.

- Mr. Hung should not hold out to his clients the assurance that his tax advice is beyond challenge. He should ensure that his clients are aware of the limitations attaching to tax advice so that they do not misinterpret an expression of opinion as an assertion of fact.

- Tax advice given to clients should be recorded either in the form of a letter to the clients or in a memorandum for the files.

* * * END OF EXAMINATION PAPER * * *