

Student Notes

Module D (Dec 2011)

Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Student Notes
Workshop 1			
1. Introduction	<ul style="list-style-type: none">• Presentation• Group discussion		Please refer to Workshop 1 Student Notes
2. Profits tax	<ul style="list-style-type: none">• Group exercise	Ch. 3, 8 & 11	
3. Negotiation	<ul style="list-style-type: none">• Role play• Group exercise		
4. Tax for individuals	<ul style="list-style-type: none">• Case study• Group discussion	Ch.5, 6, 8 & 11	
Workshop 2			
5. Reboot	<ul style="list-style-type: none">• Presentation• Group discussion		
6. Tax-avoidance	<ul style="list-style-type: none">• Group discussion	Ch. 4, 8, 9 & 11	Pg. 1 to 3
7. Cross border tax issues	<ul style="list-style-type: none">• Group discussion	Ch. 3, 4, 12 & 13	Pg. 4 to 5
8. Tax planning	<ul style="list-style-type: none">• Case study• Group reflection	Ch.3, 4, 5, 6, 7, 9, 11 & 12	Pg. 6 to 7
9. Conclusion	<ul style="list-style-type: none">• Presentation• Group discussion		

Workshop 2 – Anti-Avoidance Provisions

(Group Discussion Exercise)

Reason for activity

CPAs need to be familiar with anti-avoidance provisions in order to identify and manage the risk of possible challenges by the IRD.

Issue 1: Disguised Employment

Details were provided about Mr. Kwan who used to work for a property agency but subsequently reached an agreement with his employer to terminate his employment and to engage a consultancy company to provide services to the property agency instead. However, the consultancy company is controlled by Mr. Kwan and the services are performed by Mr. Kwan only.

Main observation points

Most students readily identified s.9A as the anti-avoidance provision which the IRD may use to challenge the arrangement as Mr. Kwan continued to provide services to the same company, attended work at the same hours, and was remunerated in the same manner as an employee of the property agency.

Most students were aware that the two general anti-avoidance provisions (s.61 and s. 61A) should also be considered.

Issue 2: Interposed Company

Details were provided on SL which carried on a soft drink distribution business in Hong Kong with customers in the US. ML, a company located in a low tax jurisdiction was interposed between SL and the US customers where SL would sell goods at a 5% mark-up to ML and ML would in turn sell the goods to the US customers at a 40% mark-up.

Main observation points

Most students readily identified s.20(2) as the anti-avoidance provision which the IRD may use to challenge the arrangement as it would appear that SL would pay less than the ordinary profits which might be expected to arise in or derived from Hong Kong. The IRD may also challenge the arrangement under s.61 (the interposition of ML may be construed to be artificial) or s.61A (the sole or dominant purpose of the arrangement was to obtain a tax benefit).

Some of the students considered that ML may be able to justify the higher mark-up due to the amount of functions it performed as well as the credit risk borne by ML by offering a longer credit period to the US customers. However, it was agreed that a transfer pricing study should be carried out to support the transfer prices charged between related parties (i.e., SL and ML).

Issue 3: Stamp Duty

Details were provided on the following transactions in which stamp duty was not paid:

- (1) HL sold an office to BL, its BVI subsidiary (95%), at a consideration which was below market value with part of the acquisition cost being financed by a loan from an individual shareholder
- (2) BL then sold the office to CL, a fellow subsidiary, which was 85% owned by HL
- (3) CL leased the office back to HL at a monthly rent of \$60,000 or 1% of annual turnover
- (4) HL signed an agreement with an unrelated third party in which HL would sell all its shares in CL to BL. Subsequently, HL would sell all its shares in BL to the unrelated third party.

Main observation points

- (1) S.45 group relief should be applicable since the company held more than 90% of the subsidiary. However, as the funding was provided by an individual shareholder, who is not a corporate within the associated relationship, pursuant to s.45(4)(a), the group relief under s.45(1) will not apply. As the transaction was below market value, it will be deemed under s.27 to be a voluntary disposition inter vivos and stamp duty will be charged on the market value.
- (2) HL held less than 90% of the shares in CL, therefore BL and CL are not associated companies. As such, s.45 group relief will not apply.
- (3) There is no s.45 group relief for leases. Based on the contingency principle, as the 1% annual turnover is not certain at the time the agreement was signed, it will not be taken into account in calculating the stamp duty payable.
- (4) S.45 group relief will not apply on the transfer of shares in CL to BL as the parties entered into an arrangement with the intent to cease the associated relationship by the subsequent selling of the shares (s.45(4)(c)). However, the subsequent transfer of shares in BL to the unrelated third party would not be subject to stamp duty as the transfer of BL shares is not required to be registered in Hong Kong.

Issue 4: Royalty and Management Fee

Details were provided on HL which paid management fee to ZL based on 10% of HL's turnover. Both companies carried on business in Hong Kong and ZL has significant tax losses which were agreed by the IRD. In addition, CL, an overseas company, was set up to acquire all of HL's existing brand names and to develop new brand names. HL would pay royalty based on 5% of HL's turnover for the right to use the brand names.

Main observation points

For the management fee, most students readily identified s.61A as the anti-avoidance provision which the IRD may use to challenge the arrangement as it would appear that the sole or dominant purpose of the arrangement was to obtain a tax benefit. Some students also suggested that the management fee may not be deductible under s.17(1)(b) if it was not incurred in the production of profits. S.61 may also be applied if it was found to be artificial or fictitious.

For the royalty income, most students understood that it would be chargeable to profits tax under s.15(1)(b) and that 100% of the royalty income for the old brand name would be assessable as the brand name was previously owned by a person carrying on a trade, profession or business in Hong Kong. For the royalty income on the new brand names, only 30% is assessable.

Workshop 2 – Cross Border Transactions

(Group Discussion Exercise)

Reason for activity

CPAs should have an awareness of the tax issues arising from cross-border transactions, especially due to the increase in cross-border transactions between Hong Kong and Mainland China.

Case 1: Royalty and PRC Turnover Tax

Details of AC, a Mainland company which produced and distributed cosmetic products, were provided. AC purchased raw materials from local suppliers in the Mainland. It exported 80% of its products to overseas markets and sold the rest to local markets. In addition, AC set up a subsidiary in Hong Kong, AHK, to sell its products through its retail shops in Hong Kong. AHK would pay AC a royalty fee for using its trademark in selling the products.

Main observation points

For the production and sale of the cosmetic products, most students recognised that AC would be subject to output VAT at 17% on its domestic sales in China and exempt from output VAT on its export sales. In relation to the procurement of raw materials from local PRC suppliers, there would be input VAT of 17%, which would be creditable against output VAT. According to the applicable VAT refund rate and the VAT “Exempt, Credit and Refund” calculation, AC would be eligible for VAT refund.

Consumption tax of 30% should also be levied on the cosmetic products which were manufactured and sold in the Mainland.

For the royalty income received by AC, assuming that AC did not carry on business in Hong Kong, it should be chargeable to Hong Kong profits tax under s.15(1)(b) and the effective rate should be 4.95% (30% x 16.5%).

In addition, AC would be subject to business tax of 5% on the royalty income received as the income was derived from the transfer of right to use intangible assets .

Case 2: eCommerce

Details of NM, a Hong Kong based company engaged in the trading of CDs, VCDs and DVDs via the internet were provided. An automated computer server located in Taiwan was used to accept and process customer orders via the internet. Staff in Hong Kong would follow-up on the delivery of the products and also answer customer enquiries. The director of NM would meet with suppliers to negotiate and conclude the trading terms and also arrange financing with banks in Hong Kong.

Main observation points

Most students were familiar with the IRD's view in DIPN 39 that the location of the server does not, of itself, determine the source of profits. Instead, the IRD would focus more on what and where the underlying physical operations were carried out by the taxpayer to earn the profits in question than on what had been done electronically.

In this case, as most of the underlying physical operations were carried out by NM staff in Hong Kong, it is likely that the profits from selling the CDs, VCDs and DVDs would be sourced in Hong Kong and therefore chargeable to profits tax.

It was further concluded that the characterisation of the income or profits will not be affected even if the customers downloaded the products in digital form for personal consumption.

Workshop 2 – Tax Planning for Individuals

(Group Discussion Exercise)

Reason for activity

CPAs should be able to apply up-to-date tax knowledge together with innovative and critical thinking to minimise the tax exposure of an individual in a legal and commercially realistic manner.

Case Study: Mr Chan

Details of a remuneration package being offered to Mr Chan for joining a private investment company in Hong Kong were provided. The employer is flexible on the make-up of the remuneration package and is happy for the remuneration package to be restructured as long as the total cost to the employer does not exceed the original budgeted amount and the proposed structure will not be challenged by the IRD.

Main observation points

Most students performed well in this exercise. They were actively involved in the group discussions and produced realistic proposals which would provide tax-savings for the client. The proposed remuneration packages mainly involved the acceptance of a share award plan with a two-year lock-up period, and the joining of a company medical insurance scheme. More aggressive proposals included the recommendation for the employer to rent Mr Chan's property and to provide the property to Mr Chan as a housing benefit. Mr Chan would be chargeable to property tax on the rental income but will benefit from the deduction of the mortgage loan interest (up to the net assessable value) by electing for personal assessment. The students agreed that this arrangement may be challenged by the IRD.

Workshop 2 – Tax Planning for Corporations

(Group Discussion Exercise)

Reason for activity

CPAs should be able to apply up-to-date tax knowledge together with innovative and critical thinking to minimise the tax exposure of a company or a group of companies in a legal and commercially realistic manner.

Case Study: New Restaurant Business

Details of a business proposal for the establishment of a new Japanese restaurant chain were provided and students were required to propose a tax plan to minimise the tax liabilities in the following business areas:

1. Material sourcing
2. Brand name management
3. Decoration costs

Main observation points

Students discussed different alternatives which include setting up an offshore company to carry out the sourcing and brand management functions outside Hong Kong. For the decoration costs, it was suggested that the items in the decoration work be reviewed in detail to identify which part of the costs can be classified as plant and machinery and can therefore claim more depreciation allowances.

Apart from the Hong Kong tax implications, students were aware that other jurisdictions' tax implications and commercial considerations should also be considered when providing tax planning ideas.