Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Examination Technique Seminar (Essay)

for

Module D on Taxation

Speaker
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4 June 2014

HKICPA
QP Module Preparation Seminar
Module D - Taxation

Exam Techniques Seminar on Section B (Essay/ Short Question)

- June 2013 and December 2013

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4 June 2014

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1. Exam Techniques

Before the exam

1. Understand the important and new topics (e.g. new IRO & DIPN)

2. Practise past papers

3. Read the examination panelists' reports

4. Index your notes for examination by topics
   Part A: Tax system and Tax administration
   Part B: Profits tax
   Part C: Salaries tax
   - Computation format
   - Tax rate and allowance table

In the exam

1. Read the requirement carefully
   - ✓ '*Tax exposure*' of certain activities:
     Any person is liable to Property/Salaries/Profits tax/Stamp duty

   - ✓ '*Tax implication*' of certain transactions:
     Any item is taxable/deductible or subject to Stamp duty

2. Draw diagram or timeline to assist your understanding of the question and the relationship between different parties

3. Plan your answer
   i) Law and practice (IRO/SDO, Principle, Tax case, DIPN/SOIPN)
   ii) Analyze the facts
   iii) Draw conclusion
   iv) Alternatives or Recommendation (make reasonable assumption)

4. New page for new question (or part)

5. Time management
   - ☒ Leave question unanswered
   - ☒ Spend too much time on finding reference
   - ☒ Spend too much time on copying the material

6. Only compute what is asked
   E.g. Assessable income, Net assessable income, Net chargeable income or Tax liability?

7. State the applicable tax rate

8. Use correct format required
   E.g. Letter, memo or report

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2. Review Past papers and Examination panelist's report

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Q1 CSH Ltd (Dec 2013 Q7)

CSH Ltd. ("the Company") is a company incorporated in Hong Kong and engaged in the business of manufacturing and sales of precision electroplating machines. It has a subsidiary established in the USA specialised in technology development activities.

In a recent management meeting, the Company considers closing down the USA subsidiary and relocating the technology development activities to Hong Kong which is to be taken up by the Company directly. In this regard, all the tangible assets (i.e. devices, equipment, plant and machinery, etc.) and intangible assets (i.e. patents, trademarks, technical know-how, etc.) currently owned by the USA subsidiary will be sold to the Company with reference to the prevailing market value. All the tangible and intangible assets will then be used by the Company in Hong Kong for the continuation of technology development activities in connection with its existing business.

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Required:

Discuss the deductibility of the expenditures incurred by CSH Ltd. in the contexts of relevant provisions in the Inland Revenue Ordinance with respect to the acquisition, from its USA subsidiary, of the following items:

(a) Tangible assets; and

(6 marks)

(b) Intangible assets.

(6 marks)

Examiner's comment

Question (a)
Performance: Not satisfactory

Common mistake:
- only a few candidates were able to analyse the deductibility of tangible assets comprehensively from different perspectives.
- simply focused on the deduction for prescribed fixed assets under 16G(1) of the IRO and/or depreciation allowances under 39(B)(1) & (2) of the IRO.
- need to take a broader view in the context of IRO when doing the analysis

Question (b)
Performance: Satisfactory
- able to discuss the deductibility of intangible assets based on S16E of the IRO.

Common mistake:
- only a few candidates could discuss the deductibility under 16(1) and 17(1)(c) of the IRO.

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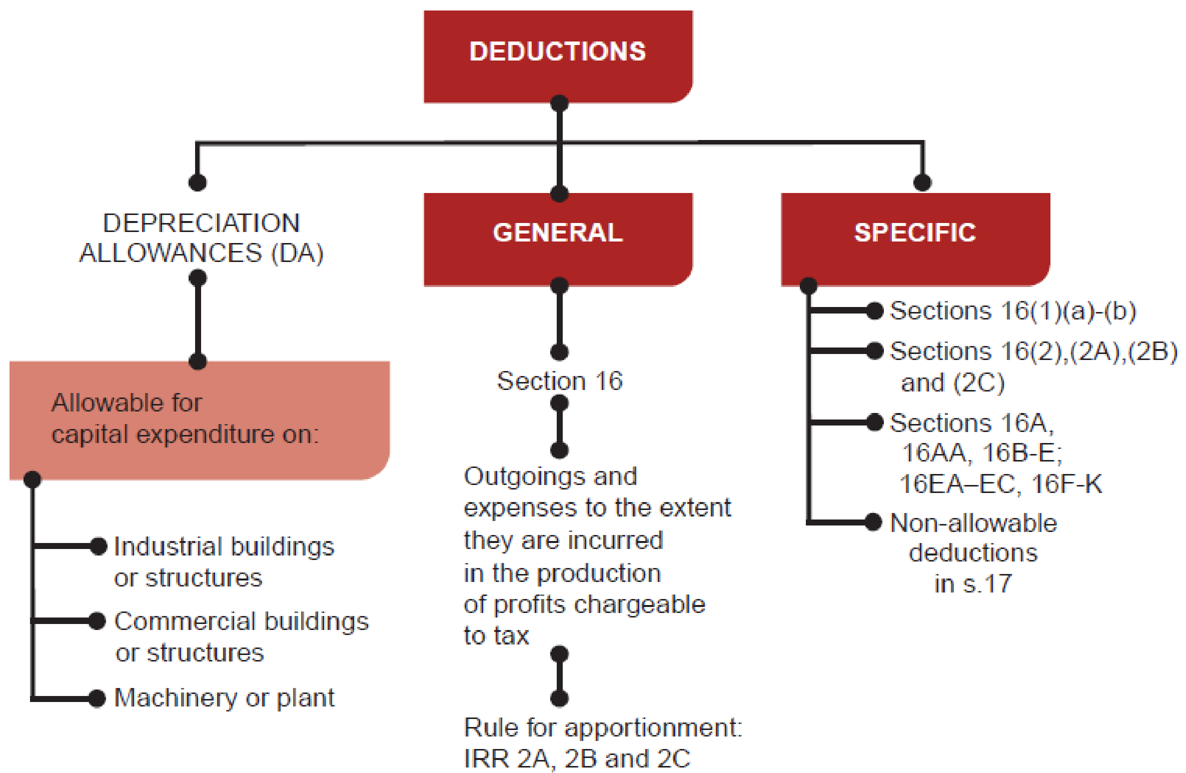
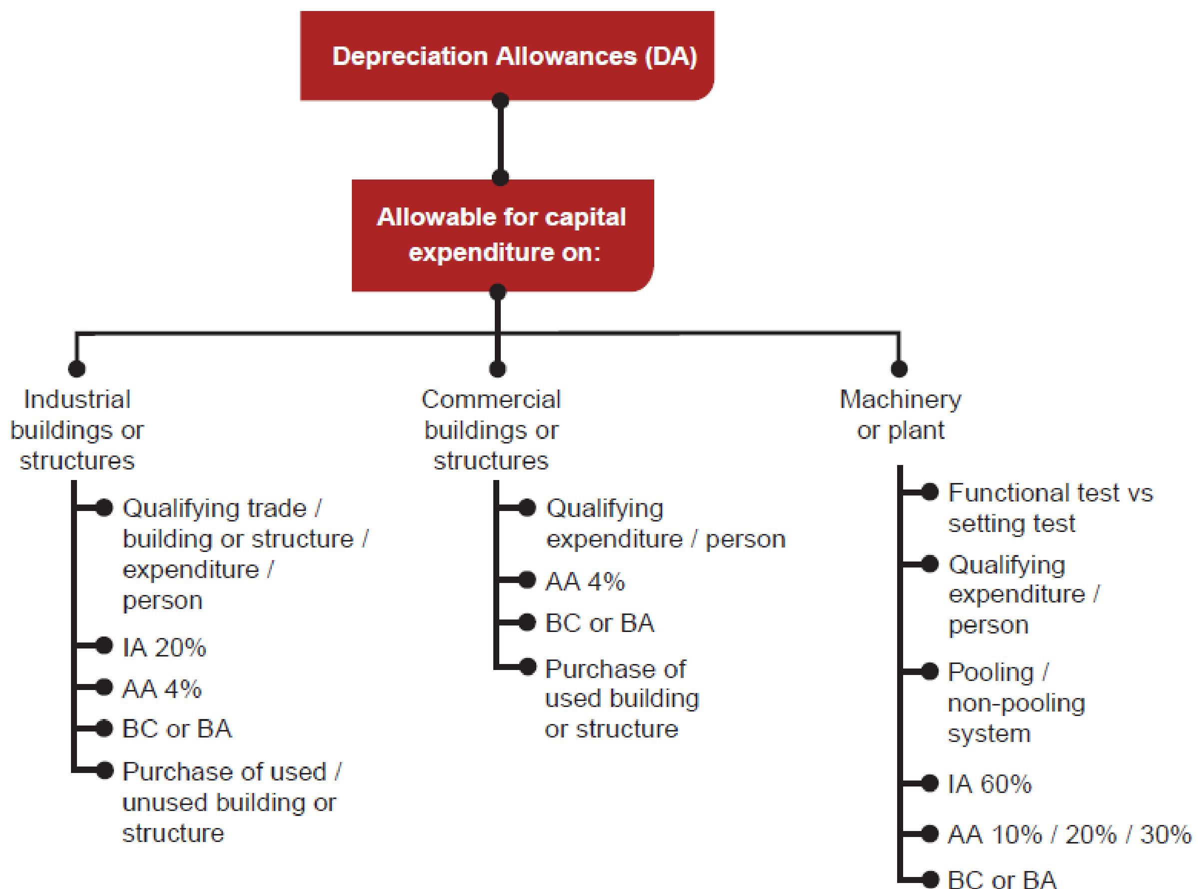
Key concept for Q1 CSH Ltd (Dec 2013 Q7)





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Key concept for Q1 CSH Ltd (Dec 2013 Q7)

Section	Allowable deductions	Conditions
16AA	Mandatory contributions to a MPFS in self-employment cases	• Not otherwise deductible. • Not exceeding $15,000 with effect from 2013/14).
16B	Expenditure on R&D, including expenditure on machinery or plant	• Incurred by the taxpayer or paid to approved research institutions. • The research is related to the taxpayer's trade, profession or business or a class of trade, profession or business in which the taxpayer's trade, profession or business belongs. • Not being expenditures on land or buildings or alternations to buildings. • Apportionment is required if the expenditure is incurred outside Hong Kong and the trade, profession or business is carried out partly outside Hong Kong.
16C	Payments for technical education	• Being payments made to institutions approved by the Commissioner in writing. • Being technical education of a kind specially requisite for persons employed in the class of trade, profession or business to which the taxpayer's trade, profession or business belongs.
16D	ACDs	• Not otherwise deductible. • Not less than $100. • Not exceeding 35% of the assessable profits.
16E	Purchase of patent rights or rights to know-how	• Used in Hong Kong in the production of assessable profits. • Not purchased from an associate. • Apportionment is required if used partly for non-business purpose.
16EA – EC	Purchase of copyright, registered design / trade mark	• Used in Hong Kong in the production of assessable profits. • Not purchased from an associate. • Allowable by five equal instalments (20% per year of assessment). • Apportionment is required if used partly for non-business purpose.

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Key concept for Q1 CSH Ltd (Dec 2013 Q7)

Section	Allowable deductions	Conditions
16F	Expenditure on building refurbishment	• Being expenditures on renovation or refurbishment (not for initial construction or decoration) of a building or structure other than a domestic building or structure. • No depreciation allowance has been claimed. • Allowable by five equal instalments (20% per year of assessment).
16G	Capital expenditure on the provision of a PFA	• Not otherwise deductible. • No depreciation allowance has been claimed. • Not being a leased asset or an asset under a hire-purchase agreement. • Apportionment is required if used partly for non-business purpose.
16H – K	Capital expenditure on the provision of EPM and EFV	• Not otherwise deductible. • No depreciation allowance has been claimed. • Not being a leased assets or an asset under a hire-purchase agreement. • Apportionment is required if used partly for non-business purpose.
16H – K	Capital expenditure on the provision of EPI	• Not otherwise deductible. • No depreciation allowance has been claimed. • Not being a leased assets or an asset under a hire-purchase agreement. • Allowable by five equal instalments (20% per year of assessment). • Apportionment is required if used partly for non-business purpose.

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Key concept for Q1 CSH Ltd (Dec 2013 Q7)

Inland Revenue Rule 2: Rates of depreciation

TABLE

FIRST PART

	Item	Rate of Depreciat
1.	Air-conditioning plant excluding room air-conditioning units	10%
2.	Bank safe deposit boxes, doors and grills	10%
3.	Broadcasting transmitters	10%
4.	Cables (electric)	10%
5.	Lamp standards (street)-gas or electric	10%
6.	Lifts and escalators (electric)	10%
7.	Mains (gas or water)	10%
8.	Oil tanks	10%
9.	Shipping-	
	Ships, junks and sampans	10%
	Lighters	10%
	Tugs	10%
10.	Sprinklers	10%
11.	Domestic appliances	20%
12.	Furniture (excluding soft furnishings)	20%
13.	Room air-conditioning units	20%
14.	Shipping-	
	Launches and ferry vessels	20%
	Hydrofoils	20%
15.	Taxi meters	20%
16.	Type and blocks (if not dealt with on renewals basis)	20%
17.	Aircraft (including engines)	30%
18.	Bar syphon apparatus	30%
19.	Bicycles	30%
20.	Bleaching and finishing machinery and plant	30%
21.	Concrete pipe moulds	30%
22.	Electric cookers and kettles	30%
23.	Electronic data processing equipment	30%
24.	Electronics manufacturing machinery and plant	30%
25.	Motor vehicles	30%
26.	Plastic manufacturing machinery and plant including moulds	30%
27.	Shipping-	
	Outboard motors	30%
28.	Silk manufacturing machinery and plant	30%
29.	Sulphuric and nitric acid plant	30%
30.	Tank lorries	30%
31.	Textile and clothing manufacturing machinery and plant	30%
32.	Tractors-bull dozers and graders	30%
33.	Weaving, spinning, knitting and sewing machinery	30%
34.	Machinery or plant, not specified in items 1 to 33, and used for the purposes of a transport, tunnel, dock, water, gas or electricity undertaking or a public telephone or public telegraphic service	10%
35.	Any other machinery or plant, not specified in items 1 to 34	20%

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Key concept for Q1 CSH Ltd (Dec 2013 Q7)

SECOND PART

Item

1. Belting.
2. Crockery and cutlery.
3. Kitchen utensils.
4. Linen.
5. Loose tools.
6. Soft furnishings (including curtains and carpets).
7. Surgical and dental instruments.
8. Tubes for X-ray and infra-red machines.

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Answer to Q1 CSH Ltd (Dec 2013 Q7)

(a)

The acquisition cost of the tangible assets is capital in nature and cannot be claimed as deductible under s.16(1) & s.17(1)(c) of the IRO.

However, under s.16G(1) of the IRO, CSH Ltd. is eligible to claim for full deduction of specified capital expenditure on the tangible assets if the assets are in the category of prescribed fixed assets (i.e. fixed assets used specifically and directly for any manufacturing purpose or computer software and hardware under s.16G(6) of the IRO).

CSH Ltd. is also eligible to claim for initial and annual allowances on the capital expenditure incurred for "plant and machinery" under s.39(B)(1) & (2) of the IRO. In this regard, CSH Ltd. should ensure that the tangible assets acquired from its USA subsidiary are within the category of "plant and machinery" under this provision. Inland Revenue Rule 2 provides that the "plant and machinery" shall include the items specified in the second column of the First Part of the table annexed to this Rule.

Under s.38(B) of the IRO, if the IRD is of the opinion that the sales price of a tangible asset which qualified for initial or annual allowances and transferred between related companies does not represent its true market value, the IRD can determine such true market value and the amount so determined shall be deemed to be the sale price of such asset for the purpose of calculating the initial and annual allowances.

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(b)

The acquisition cost of the intangible assets is again capital in nature and cannot be claimed for deduction under s.16(1) and s.17(1)(c) of the IRO.

However, under s.16E(1) of the IRO, capital expenditure incurred for the acquisition of patent right or right to any know how for use in trade, profession or business in the production of profits is allowed for full deduction. In addition, capital expenditure incurred by CSH Ltd. for the acquisition of copyright, registered design or registered trade mark is specifically allowed for deduction under s.16EA(2) of the IRO and can be spread over five succeeding years under s.16EA(3) of the IRO.

However, the deductions under s.16E(1) and s.16EA(3) of the IRO are not allowed if the respective intangible assets are purchased wholly or partly from an associate under s.16EC(2) of the IRO; an associate includes an associate corporate.

As CSH Ltd. and its USA subsidiary satisfy the definition of associate corporation, the intangible assets acquired by CSH Ltd. from its USA subsidiary cannot be claimed for deduction.

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Q2 A Ltd, B Ltd & C Ltd (Jun 2013 Q6a,b,d)

A Limited is a toy trading company in Hong Kong. It commenced business in 2000 and closed its accounts annually on 30 June. In early 2011, A Limited took over B Limited, a company incorporated in the Mainland of China ("the Mainland"). After that, A Limited and B Limited reviewed their business processes, under which it was resolved that B Limited would grant A Limited a 10-year licence ("the Licence") to use B Limited's trademark ("the Trademark") for selling toys in Hong Kong at a licence fee of RMB 10 million per year ("the Licence Fee") on 1 July 2011.

B Limited did not have any business presence in Hong Kong. The negotiation for and the decision to grant the Licence to A Limited were made by the directors of B Limited in the Mainland. On 1 December 2011, B Limited sold the Trademark with its right under the Licence at RMB 20 million to C Limited, a Mainland corporation which is wholly-owned by A Limited.

On 1 January 2013, C Limited terminated the Licence and sold the Trademark to A Limited at RMB 50 million with an option for C Limited to purchase back the Trademark after 5 years. The market value of the Trademark as at 1 January 2012 and 1 January 2013 were RMB 100 million and RMB 150 million respectively.

Required:

(a) Discuss whether and, if so, how B Limited is chargeable to profits tax in respect of the Licence Fee.

(4 marks)

(b) Advise whether your answer to item (a) will be different if after the take-over, A Limited and B Limited shared the same group of directors who held all the board meetings in Hong Kong, and negotiated and concluded the agreement for the grant of the Licence in Hong Kong. Cite the relevant case law to support your answer.

(4 marks)

(d) Determine whether A Limited is entitled to the deduction of the purchase cost of the Trademark for profits tax purposes.

(7 marks)

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Examiner's comment

Question (a)
Performance:
- able to identify that B Limited did not carry on business in Hong Kong and sections 15(1)(b), 20B and 21A of the IRO were applicable.

Common mistake:
- wasted time discussing some irrelevant provisions such as sections 15(1)(a) and (ba) of the IRO.
- mistakenly considered that 100% of the licence fees should be chargeable to profits tax by virtue of section 21A(1)(a)

Question (b)
Performance:
- could point out that section 14 of the IRO would apply in the given scenario and the entire licence fees had to be brought into the profits tax charge.

Common mistake:
- overlooked the additional information given in the question
- wrongly concluded that the licence fees would be fully chargeable by virtue of section 21A.

Question (d)
Performance:
- indicate their awareness of the new deduction for intellectual property rights under section 16EA of the IRO
- able to point out the anti-avoidance provisions
- could account for the disallowance because of the association between A Limited and C Limited

Common mistake:
- failed to recognize that the deduction was not applicable because of section 16EC of the IRO.
- did not mentioned the possible challenge on the reasonableness of the transaction because of the premature termination of the previous licence and the consideration below market value.

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Key concept for Q2 A Ltd, B Ltd & C Ltd (Jun 2013 Q6a,b,d)

Section	Sums specifically chargeable to profits tax
15(1)(a)	Sums received by or accrued to a person for the exhibition or use in Hong Kong of cinematograph or television films, tapes, sound recording or any advertising materials connected with any such properties.
15(1)(b)	Sums received by or accrued to a person for the use of or right to use in Hong Kong any patent, design, trademark, copyright material, secret process or formula or other similar property, or for imparting knowledge in connection with the use in Hong Kong of any such properties.
15(1)(ba)	Sums received by or accrued to a person for the use of or right to use outside Hong Kong any intellectual properties listed in s.15(1)(b), or for imparting knowledge in connection with the use outside Hong Kong of any such properties, which are deductible in ascertaining the assessable profits of a person under profits tax. Section 21A provides that the assessable profits of a person's income as described in s.15(1)(a), (b) or (ba) shall be taken as 30% of the sums. Where the relevant sum is derived from an associate, 100% of the sum will be treated as assessable, unless the Commissioner is satisfied that no person carrying on a trade, profession or business in Hong Kong has at any time, wholly or partly, owned the property.

Source: HKICPA Module D Learning Pack p. 295

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Answer to Q2 A Ltd, B Ltd & C Ltd (Jun 2013 Q6a,b,d)

(a)

Whilst B Limited did not carry on any business in Hong Kong, it received the Licence Fee from A Limited in respect of the Trademark used for selling toys in Hong Kong. By virtue of s.15(1)(b) of the IRO, the Licence Fee is deemed to arise in or be derived from Hong Kong from a trade, profession or business carried on by B Limited in Hong Kong.

As it appears that the Trademark had not been previously owned by any person carrying on a trade, profession or business in Hong Kong, the assessable profits deemed to be derived from Hong Kong in respect of the Licence Fee should be computed as 30% of the Licence Fee pursuant to s.21A(1)(b)(ii) of the IRO.

Since B Limited is a non-resident, A Limited is chargeable to profits tax on behalf of B Limited in respect of the Licence Fee (s.20B(2) of the IRO).

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(b)

If the directors of B Limited held all the board meetings in Hong Kong, it is likely that B Limited will be regarded as carrying on a business in Hong Kong: see *De Beers Consolidated Mines Ltd v Howe* (1906) 5 TC 198.

Moreover, as B Limited negotiated and concluded the agreement for the grant of the Licence in Hong Kong, the Licence Fee will also be regarded as having a source in Hong Kong: see *Commissioner of Inland Revenue v HK-TVB International Limited* 3 HKTC 468 and *Lam Soon Trademark Limited v Commissioner of Inland Revenue 6* HKTC 768.

In the circumstances, B Limited will be chargeable to profits tax in respect of the Licence Fee under s.14 instead of s.15(1)(b) of the IRO.

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(d)

S.16EA of the IRO allows the deduction of expenditures incurred in the purchase of intellectual property even though they are capital in nature and should have been disallowed by virtue of s.17(1)(c) of the IRO.

However, A Limited is not entitled to any deduction under s.16EA of the IRO because the relevant purchase cost is prohibited from deduction by virtue of s.16EC(1) and (2) of the IRO, having regard to the following circumstances:

(1) The Trademark had been used by A Limited under the Licence of which the expiry date falls after 16 December 2011. Further, the Licence was terminated before its expiry and the Trademark was purchased by A Limited at a consideration below market value with an option for licensor, C Limited, to purchase back the Trademark after 5 years. In such circumstances, it is likely that the CIR will consider that the consideration for the purchase of the Trademark is not reasonable.

(2) The Trademark was purchased by A Limited from its subsidiary, C Limited.

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Q3 ABC & Co (Dec 2013 Q6)

Mr. Au, Mr. Bill and CKL Ltd. have formed a partnership, namely ABC & Co. ("the Partnership"), for years in Hong Kong carrying on a business of providing consultancy services. According to its partnership agreement, the profit or loss derived by the Partnership is shared equally amongst the partners.

Mr. Au retired from the Partnership on 31 August 2012. Nevertheless, he continued to be employed by the Partnership as a consultant for two years ensuring the seamless transition of the business management to other existing partners. Capital contribution originally made by Mr. Au to the Partnership has also been reclassified as a loan from Mr. Au to the Partnership. After Mr. Au's retirement, the profit or loss sharing ratio between Mr. Bill and CKL Ltd. has changed to 3:2 respectively.

The profit and loss account of the Partnership for the year ended 31 December 2012 is as follows:

	Notes	$
Consultancy income		11,039,960
Less:		
Salary expenses	1	5,480,000
Interest expenses	2	230,000
Rental expenses	3	600,000
Other deductible expenses		1,370,000
		7,680,000
Profit before tax		3,359,960

Notes:

1. Details of salary expenses

Recipients	1 Jan 2012 to 31 Aug 2012	1 Sep 2012 to 31 Dec 2012	Total
	$	$	$
Mr. Au	240,000	80,000	320,000
Mrs. Au (wife of Mr. Au)	80,000	40,000	120,000
Mr. Bill	400,000	200,000	600,000
Mr. Bill Jr. (son of Mr. Bill)	160,000	80,000	240,000
Other employees	2,400,000	1,800,000	4,200,000
	3,280,000	2,200,000	5,480,000

2. Details of interest expenses on capital contribution from the partners and loan from Mr. Au after his retirement

Recipients	1 Jan 2012 to 31 Aug 2012	1 Sep 2012 to 31 Dec 2012	Total
	$	$	$
Mr. Au	100,000	50,000	150,000
CKL Ltd.	60,000	20,000	80,000
	160,000	70,000	230,000

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3. Details of rental expenses

Recipients	1 Jan 2012 to 31 Aug 2012	1 Sep 2012 to 31 Dec 2012	Total
	$	$	$
Independent third party for leasing of head office premises for the Partnership	320,000	160,000	480,000
Mr. Bill for leasing of branch office premises for the Partnership (amount based on market value)	80,000	40,000	120,000
	400,000	200,000	600,000

Required:

(a) Compute the assessable profits of the Partnership for the year of assessment 2012/13.

(5 marks)

(b) Compute the assessable profits allocation amongst the partners of the Partnership and their respective tax payable on the allocated profits for the year of assessment 2012/13. (Assume no election of Personal Assessment by Mr. Au and Mr. Bill. Ignore provisional profits tax and reduction of profits tax for the year.)

(11 marks)

Examiner's comment

Question (a)
Performance: Satisfactory
- able to compute the assessable profits in a partnership context.

Common mistake:
- wrongly adjusted the interest and rental expenses paid to the partners.

Question (b)
Performance: Satisfactory
- could apply their knowledge to the allocation of assessable profits amongst the partners.
- addressed the question with a clear and concise segregation of assessable profits into two periods with the correct adjustment on salaries and interest

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Key concept for Q3 ABC & Co (Dec 2013 Q6)

Section	Provisions and implications
16(1)(b)	The deduction of rent paid by a partnership to any partners or partners' spouses is allowed, but restricted to the assessable value of the relevant property. In practice, this restriction has no operational significance now as the assessable value is often equal to the actual rent consideration.
16AA	Mandatory contributions under the MPFSO which are not otherwise allowable and not exceeding $15,000 (with effect from 2013/14) in respect of a partner of a partnership are deemed to be an expense wholly and exclusively incurred in the production of assessable profits and allowable as a deduction.
17(2)	No deduction is allowed for salaries or other remuneration to any partner or partners' spouses, and interest on capital and/or loan from any partner or their spouses or, subject to s.16AA, contribution made to a MPFS in respect of any partner or partners' spouses. The disallowable payments are regarded as appropriations of profits to the partners which are adjusted in the allocation of profits and loss.
22B	There are restrictions on the share of loss of a limited partner of a partnership which may be set off against the assessable profit of that limited partner, which are outlined in **chapter 9, section 4.16** on 'Limited partner loss relief'.

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Answer to Q3 ABC & Co (Dec 2013 Q6)

(a)

ABC & Co.
Computation of assessable profits
Year of assessment 2012/13

	$	$
Profit before taxation		3,359,960
Add:		
Salary to Mr. Au (from 1 Jan to 31 Aug)	240,000	
Salary to Mrs. Au (from 1 Jan to 31 Aug)	80,000	
Salary to Mr. Bill ($400,000 + $200,000)	600,000	
Interest to Mr. Au (from 1 Jan to 31 Aug)	100,000	
(from 1 Sep to 31 Dec) [s.16(2)(c)]	50,000	
Interest to CKL Ltd. ($60,000 + 20,000)	80,000	
		1,150,000
Assessable profits		4,509,960

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(b)

Allocation of assessable profits for 2012/13
Period from 1 January 2012 to 31 August 2012
$4,509,960 x 8/12 = $3,006,640

	Mr. & Mrs. Au	Mr. Bill	CKL Ltd.	Total
	$	$	$	$
Salaries	320,000	400,000	----	720,000
Interest	100,000	----	60,000	160,000
	420,000	400,000	60,000	880,000
Balance (1:1:1)	708,880	708,880	708,880	2,126,640
Assessable profits	1,128,880	1,108,880	768,880	3,006,640

Period from 1 September 2012 to 31 December 2012
$4,509,960 x 4/12 = $1,503,320

	Mr. Au	Mr. Bill	CKL Ltd.	Total
	$	$	$	$
Salaries	----	200,000	----	200,000
Interest	----	----	20,000	20,000
	----	200,000	20,000	220,000
Balance (3:2)	----	769,992	513,328	1,283,320
Assessable profits	----	969,992	533,328	1,503,320
Total assessable profits for the year	1,128,880	2,078,872	1,302,208	4,509,960
Tax thereon@15%	169,332	311,830		481,162
Tax thereon@16.5%			214,864	214,864
				696,026

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Q4 C Recreation Club (Jun 2013 Q7a, b)

C Recreation Club ("the Club") was incorporated in Hong Kong under the Companies Ordinance as a company limited by guarantee in 2001. A summary of its income and expenditure account for the year ended 31 March 2012 is provided as follows:

Income	$
Members' subscription [Notes (1) and (2)]	600,000
The Rent [Note (3)]	300,000
The Fee [Note (4)]	40,000
Hire charges for sports facilities [Note (5)]	200,000
	1,140,000
Less: Administrative expenses	900,000
Surplus	240,000

Note:

1. All members have voting rights at the Club's general meetings.

2. Members' entrance fees of $250,000 were directly credited to the Club's Accumulated Fund and not included in the income and expenditure account.

3. The Club is the registered owner of Building D in Hong Kong. In May 2011, the Club entered into a lease ("the Lease") with E Limited (which is not a member of the Club) in respect of the ground floor of Building D at a monthly rent of $30,000 ("the Rent") for the period from 1 June 2011 to 31 May 2013. E Limited operated a restaurant on the ground floor to serve both members and non-members of the Club.

4. In January 2012, the Club entered into an agreement ("the Agreement") with F Limited, granting it a non-exclusive right of use of the roof of Building D. Under the Agreement, F Limited was only allowed to use the roof for the installation and operation of certain mobile communication equipment. The term of the Agreement ran from 1 February 2012 to 31 January 2013, and the fee payable thereunder was $20,000 per month ("the Fee"). To protect its rights under the Agreement, F Limited is considering to register the Agreement in the Land Registry.

5. Sports facilities on the first to third floors of Building D were open for use by both members and non-members with fees charged. For the year ended 31 March 2012, the hire charges received from members amounted to $120,000.

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Required:

(a) Determine, <u>with explanations and workings in support</u>, whether the Club is chargeable to profits tax for the year of assessment 2011/12.

(6 marks)

(b) Discuss the Club's property tax exposure for the year of assessment 2011/12 from the following perspectives:

(i) whether the Club is chargeable to property tax in respect of the Rent and the Fee; and

(ii) whether any property tax exemption is available to the Club.

(Note: Computation of property tax, if any, is <u>NOT</u> required.)

(6 marks)

<u>Examiner's comment</u>

<u>Question (a)</u>
Performance: Well

- correctly apply section 24(1) of the IRO
- correctly determine whether the recreation club was chargeable to profits tax by computing the percentage of gross receipts from its members on revenue account.

<u>Question (b)</u>
Performance:

- able to state that the rent and licence fees received by the club should be brought into the charge to property tax.

Common mistake:

- could not explain why the exemption under section 5(2)(a) of the IRO was not applicable.
- misread the question and included a discussion on the property tax "deduction" instead of "exemption" in their answers.

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Key concept for Q4 C Recreation Club (Jun 2013 Q7a, b)

Section 24(1) lays down a test to determine whether the receipts of a club are business receipts and the profits arising therefrom are chargeable to profits tax. The test is as follows:

(a) If not less than half of the club's gross receipts on the revenue account (including entrance fees and subscriptions) are from voting members, the club is deemed not to carry on a business.

(b) Otherwise, the club is deemed to carry on a business. All the club's receipts (including entrance fees) are deemed to be trading receipts chargeable to profits tax.

"Members' means those with voting rights (s.24(3)). Non-members include non-voting members and outsiders.

If a club is not chargeable to profits tax under s.14 because of the compliance with the minimum test laid down under s.24(1), it may still be subject to other taxes. For example, it may be subject to property tax if it has rental income from the letting of property in Hong Kong.

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Answer to Q4 C Recreation Club (Jun 2013 Q7a, b)

(a)

Under s.24(1) of the IRO, a person, who carries on a club or similar institution and receives not less than half of its gross receipts from its members on revenue account, will be deemed not to carry on a business.

For the year of assessment 2011/12, the Club's position is as follows:

	$
Receipts from members	
Entrance fees	250,000
Entrance fees	600,000
Hire charges for sports facilities	120,000
	970,000
Receipts from non-members	
The Rent	300,000
The Fee	40,000
Hire charges for sports facilities ($200,000 - $120,000)	80,000
	420,000
% of members' receipts [$970,000 / ($970,000 + $420,000)]	69.78%

As the Club received not less than half of its gross receipts from its members on revenue account for the year of assessment 2011/12, it is deemed not to carry on a business and is not chargeable to profits tax for that year.

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(b)

The Club is the registered owner of Building D. For the year of assessment 2011/12, the Club received the Rent and the Fee in consideration for the right of use of the ground floor and the roof of the building respectively. Subject to the exemption provided under s.5(2)(a) of the IRO, the Club is chargeable to property tax for the year of assessment 2011/12 in respect of the Rent and the Fee pursuant to s.5(1) and s.5B(2) of the IRO.

Although the Club is a corporation, it is deemed not to be carrying on a business for the year of assessment 2011/12 by virtue of s.24(1) of the IRO. As such, the Rent and the Fee are not chargeable to profits tax. It follows that the exemption provided under s.5(2)(a) does not apply to the Club.

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Q5 Marcus (Jun 2013 Q8)

Marcus commenced his employment with G Limited on 1 April 2011. His remuneration package included, among others, (a) monthly salary of $40,000, (b) rent refund to the maximum of $10,000 per month, (c) an option to acquire 10,000 shares in G Limited at $1.5 per share and (d) benefits from a Mandatory Provident Fund ("MPF") scheme, to which both Marcus and G Limited had to make contributions. On 31 March 2012, Marcus resigned from G Limited. He left Hong Kong and emigrated to Canada at the end of April 2012.

During the year ended 31 March 2012, Marcus rented a flat for residence at a monthly rent of $12,000 for the first 10 months. In the last two months, he moved to a hotel room and incurred rental expenses of $16,000 in total. On his last day of employment, Marcus exercised his share option when the market price of a share in G Limited was $2. He also received his accrued benefits of $80,000 under the MPF scheme ("the MPF Benefits"). Out of the MPF Benefits, $12,000 was attributable to the mandatory contributions made by G Limited, whilst the balance arose from the mandatory and voluntary contributions made by Marcus.

In June 2011, Marcus married Diana, who did not have any income chargeable to tax. The couple are devout Christians. During the year ended 31 March 2012, they made donations of $200,000 to a church, which is an approved charitable institution.

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Required:

(a) Compute, with necessary explanations, the Net Chargeable Income of Marcus for the year of assessment 2011/12.

(9 marks)

(b) Advise whether and, if so, how the computation for item (a) will be different if the MPF Benefits include an amount of $20,000 attributable to the voluntary contributions made by G Limited.

(3 marks)

Examiner's comment

Question (a)
Performance: Good

Common mistake:
- the tax treatments for MPF benefits seemed to be a bit difficult for the candidates

Question (b)
Performance: Good
- correctly apply the proportionate benefit rule and compute the taxable amount of the benefits.

Common mistake:
- due to unsatisfactory time allocation, it was observed that some candidates did not allocate sufficient time to prepare their answers and this affected their performance in this simple question.

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Key concept for Q5 Marcus (Jun 2013 Q8)

A salaries tax computation schedule is as follows:

Assessable income		A
Less:		
Allowable outgoings and expenses [S.12(1)(a)]	B	
Depreciation allowances [S.12(1)(b)]	C	
Losses brought forward [S.12(1)(c)]	D	
Allowable outgoings and expenses/depreciation allowances/losses of a spouse not fully utilised [S.12(1)(d)] *	E	
Self-education expenses [S.12(1)(e)]	F	
		G
Net assessable income		H
Less:		
Concessionary deductions:		
Approved charitable donations [S.26C] **	K	
Elderly residential care expenses [S.26D] ***	L	
Home loan interest [S.26E] ****	M	
Contribution to recognised retirement schemes [S.26G]	N	
	P	
Personal allowances	R	
		S
Net chargeable income		T

Tax thereon:
Lower of:
Standard rate × [H - P]; and
T at progressive tax rates

* Under joint assessment

** Limited to 35% (or 25% for years of assessment 2004/05 to 2007/08; 10% for years of assessment prior to 2003/04) of [A - B - C]

*** Not to be claimed if Dependent Parent Allowance in respect of the same parent has been granted

**** The deduction period for home loan interest is extended from 10 to 15 years starting from the year of assessment 2012/13 (Enacted on 20 July 2012).

Source: HKICPA Module D Learning Pack p. 392

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Key concept for Q5 Marcus (Jun 2013 Q8)

	ORSO		MPF		
	Accrued Benefits Attributable to		Accrued Benefits Attributable to		
	Employee's Contributions	Employer's Contributions	Employee's Contributions (Mandatory and Voluntary)	Employer's Mandatory Contributions	Employer's Voluntary Contributions
Retirement	Exempt	Exempt	Exempt	Exempt	Exempt
Death	Exempt	Exempt	Exempt	Exempt	Exempt
Incapacity	Exempt	Exempt	Exempt	Exempt	Exempt
Termination of service (with or without permanent departure from Hong Kong)	Exempt	Exempt but 'Proportionate Benefit Rule' applies	Exempt	Exempt	Exempt but 'Proportionate Benefit Rule' applies
Permanent departure from Hong Kong without terminating service	Exempt	Assessable	Exempt	Exempt	Assessable
Any circumstances other than listed above	Exempt	Assessable	Exempt	Assessable	Assessable

Source: HKICPA Module D Learning Pack p. 379-380

The proportionate benefit is computed as follows:

$$\frac{\text{Completed months of service of the employee}}{\text{120 months}} \times \text{Accrued benefit of the employee at date of termination of service}$$

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Answer to Q5 Marcus (Jun 2013 Q8)

(a)

	$
Salary ($40,000 x 12)	480,000
Share option gain [($2 - $1.5) x 10,000]	5,000
Value of residence [Note (2)]	23,200
Assessable Income	508,200
Less: Mandatory contributions to MPF scheme [Note (3)]	12,000
Approved charitable donations [Note (4)]	177,870
	318,330
Less: Married person's allowance	216,000
Net Chargeable Income	102,330

Note:

(1) The MPF Benefits attributable to Marcus' contributions are clearly not taxable.

As Marcus left Hong Kong and emigrated to Canada after his resignation, the MPF Benefits attributable to the mandatory contributions by G Limited are exempted from salaries tax by virtue of s.8(2)(cb) of the IRO.

(2) Value of residence for the period from 1 April 2011 to 31 January 2012:
$480,000 x 10/12 x 10% - ($12,000 - $10,000) x 10 = $20,000

Value of residence for the period from 1 February 2012 to 31 March 2012:
$480,000 x 2/12 x 4% = $3,200

Total value of residence = $20,000 + $3,200 = $23,200

(3) Under the MPF scheme, Marcus is required to make a mandatory contribution at 5% of his income, subject to an income ceiling of $20,000 per month (for the year of assessment 2011/12). By virtue of s.26G and Schedule 3B of the IRO, such mandatory contributions (i.e. $20,000 x 5% x 12 = $12,000) are allowable for deduction.

(4) Under s.26C(2)(a)(ii) and (2A) of the IRO, the allowable amount of approved charitable donations is restricted to 35% of Assessable Income (i.e. $508,200 x 35% = $177,870).

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(b)

If the MPF Benefits also include an amount of $20,000 attributable to the voluntary contributions made by G Limited, such amount will only be exempted from salaries tax to the extent of the proportionate benefit (s.8(2)(cc)(ii) and (4) of the IRO), which is computed as $20,000 x 12 months / 120 months = $2,000 (s.8(5) of the IRO). The balance (i.e. $20,000 - $2,000 = $18,000) will be included as part of Assessable Income (s.9(1)(ae) of the IRO).

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Q6 C Recreation Club (Jun 2013 Q7c)

C Recreation Club ("the Club") was incorporated in Hong Kong under the Companies Ordinance as a company limited by guarantee in 2001.

3. The Club is the registered owner of Building D in Hong Kong. In May 2011, the Club entered into a lease ("the Lease") with E Limited (which is not a member of the Club) in respect of the ground floor of Building D at a monthly rent of $30,000 ("the Rent") for the period from 1 June 2011 to 31 May 2013. E Limited operated a restaurant on the ground floor to serve both members and non-members of the Club.

4. In January 2012, the Club entered into an agreement ("the Agreement") with F Limited, granting it a non-exclusive right of use of the roof of Building D. Under the Agreement, F Limited was only allowed to use the roof for the installation and operation of certain mobile communication equipment. The term of the Agreement ran from 1 February 2012 to 31 January 2013, and the fee payable thereunder was $20,000 per month ("the Fee"). To protect its rights under the Agreement, F Limited is considering to register the Agreement in the Land Registry.

Required:

(c) Advise the Club, E Limited and F Limited of the stamp duty implications relating to the Lease and the Agreement. (Note: Computation of stamp duty, if any, is NOT required.)

(6 marks)

Examiner's comment

Question (c)
Performance: Average
- could state that the lease of the ground floor of Building D was chargeable with stamp duty.

Common mistake:
- not able to mention that the licence of the roof of the same building was not chargeable because of the lack of exclusive possession.
- waste time on stamp duty computation which is not required.

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Key concept for Q6 C Recreation Club (Jun 2013 Q7c)

To constitute a lease, the instrument must give the tenant the right to exclusive possession. If the right of the tenant is restricted, e.g. the right of a hotel guest, the instrument is a licence rather than a lease. A licence is not chargeable to stamp duty. Whether an instrument is to be construed as a licence or a lease shall depend on the substance of the transaction rather than its form.

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Answer to Q6 C Recreation Club (Jun 2013 Q7c)

The Lease is chargeable with stamp duty under head 1(2)(b) of the First Schedule of the Stamp Duty Ordinance ("SDO"). The Club and E Limited should present it for stamping within 30 days after the execution of the Lease.

For the Agreement, it does not give F Limited the right to exclusive possession. The rights of F Limited under the Agreement are also restricted. As such, the Agreement is more akin to a licence which is not chargeable with stamp duty.

F Limited is considering to register the Agreement in the Land Registry. However, s.15(2) of the SDO provides, among others, that no instrument chargeable with stamp duty shall be registered by any public officer unless such instrument is duly stamped. In order to avoid any doubt on the stamp duty chargeability of the Agreement which may prevent its registration in the Land Registry, it is advisable that F Limited should submit the Agreement for adjudication under s.13(1) of the SDO.

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Q7. V PM Ltd (Dec 2013 Q8)

VPM Ltd. is a company incorporated in Hong Kong and engaged in the manufacturing and sales of textile products. In order to enlarge its production capacities, VPM Ltd. Considers establishing an overseas subsidiary (Newsub) and setting up a factory in that overseas jurisdiction. Products manufactured by Newsub will be sold to VPM Ltd. for onward sales to its customers.

The management of VPM Ltd. would establish Newsub in either Country X, a country which has a Comprehensive Double Taxation Agreement (CDTA) with Hong Kong, or Country Y, a country which does not have any CDTA with Hong Kong. It is also noted that the production costs and prevailing tax rates of Country X and Country Y are substantially the same.

In view of the complexities of the tax issues involved, VPM Ltd. has approached a leading professional firm, namely DHK & Co., requesting the provision of taxation advisory services, particularly in transfer pricing matters arising from the abovesaid proposal.

Required:

(a) Explain from a transfer pricing perspective (i) why the Inland Revenue Department (IRD) is likely to scrutinise the transactions between VPM Ltd. and its overseas subsidiaries, (ii) the principle that would be used to scrutinise the transactions, and (iii) the relevant provisions in the Inland Revenue Ordinance that may be invoked by the IRD if it decides to tackle the transactions.
(Assume VPM Ltd. has not yet chosen the country to establish Newsub.)
(8 marks)

(b) Identify the transfer pricing methodologies available for the IRD's consideration and applicable to VPM Ltd. for the transactions with Newsub. (3 marks)

(c) From a transfer pricing perspective, discuss the different tax implications for VPM Ltd. with respect to the choice between establishing Newsub in Country X and Country Y. (8 marks)

(d) Discuss the ethical considerations of DHK & Co. before accepting the tax advisory services engagement requested by VPM Ltd. (3 marks)

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Examiner's comment

Question (a)
Performance: Satisfactory
- able to answer the question by explaining the IRD's position and the principle adopted for transfer pricing issues.

Common mistake:
- narrowly focused on a specific aspect in their answers. A broad discussion and analysis were essential for candidates to obtain higher marks.
- failed to draw a conclusion at the end of their analysis.

Question (b)
Performance: Satisfactory
- able to identify the respective methodologies

Common mistake:
- spent excessive time explaining the methodologies in detail, which was not required by the question.

Question (c)
Performance: Not satisfactory

Common mistake:
- only focused on a general discussion with regard to information exchange and/or relief from double taxation.
- could not go into the details and could not substantially differentiate the respective tax implications both in Country X and Country Y.
- Only a few candidates could discuss the Advanced Pricing Arrangement under the Comprehensive Double Taxation Agreement regime.

Question (d)
Performance: Below expectations

Common mistake:
- Only a few candidates could identify the issues of objectivity and competent professional knowledge.
- wrongly discussed the issue of confidentiality and the assurance of the best interest of its clients in the course of providing services. These issues were irrelevant in this question.

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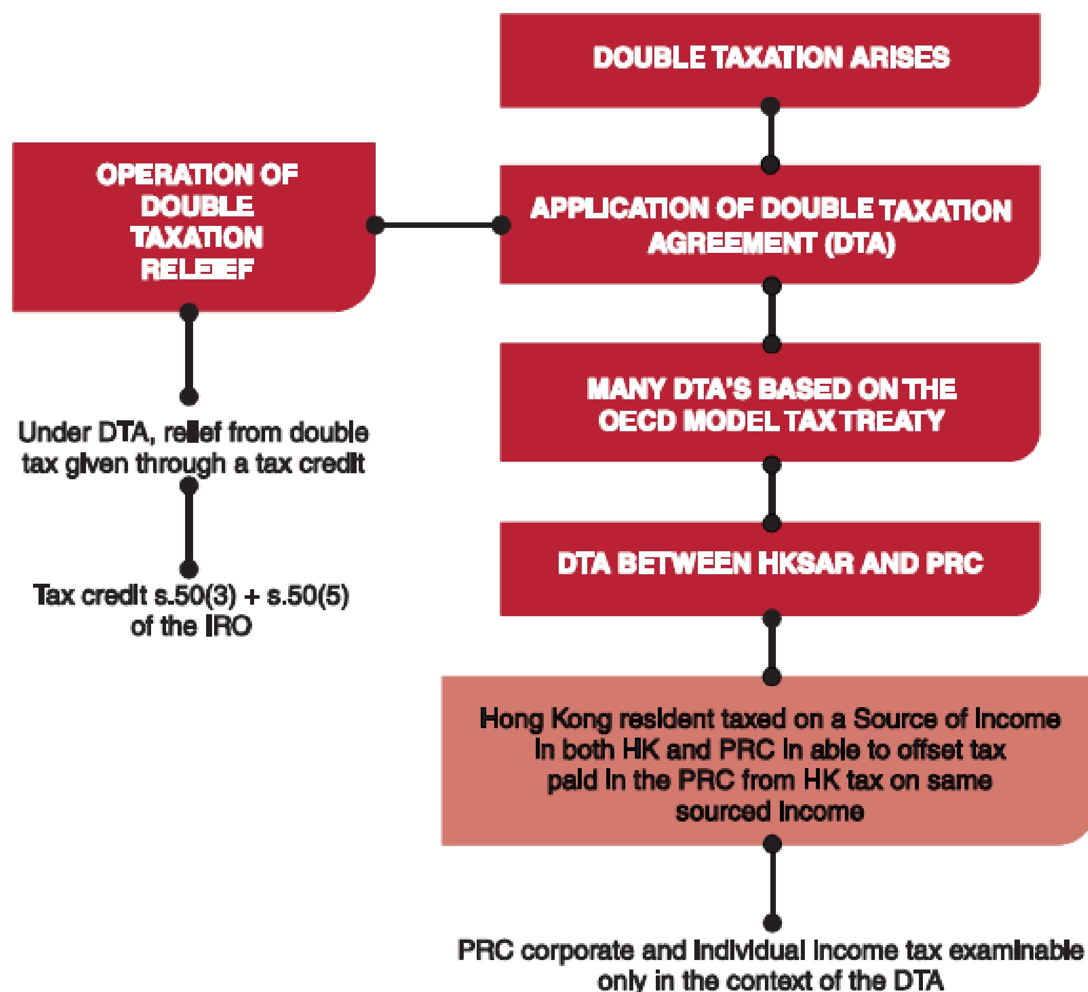
Key concept for Q7 V PM Ltd (Dec 2013 Q8)



Source: HKICPA Module D Learning Pack p. 711

DIPN No. 45, sets out the IRD's views and practices on granting relief from double taxation due to transfer pricing adjustment or profit allocation adjustment under a double taxation agreement/arrangement (DTA).

DIPN 46 provides the basis on which the IRD will assess the arm's length nature of taxpayers' related party transactions, make transfer pricing/profit reallocation adjustments and determine whether a transfer pricing adjustment initiated by a party other than the IRD is correct. DIPN 46 relies on ss.16, 17(1), 20, 61 and 61A as the basis for the Commissioner's powers on making transfer pricing adjustments.

DIPN 47 sets out the practice of the IRD on the processing and exchange of tax information ('**EoI**') upon requests received from treaty partners.

DIPN 48, issued in March 2012, provides guidance for enterprises seeking an Advance Pricing Arrangement (APA) with the IRD.

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Answer to Q7 V PM Ltd (Dec 2013 Q8)

(a)

The proposed sales of products from Newsub to VPM Ltd. are controlled transactions between a Hong Kong resident enterprise (i.e. VPM Ltd.) and an associated non-resident enterprise (i.e. Newsub). In this regard, the respective basis of the pricing policy (i.e. Transfer Pricing Policy) for the abovesaid transactions will affect the Hong Kong Profits tax position and liabilities of VPM Ltd. Therefore the Inland Revenue Department ("IRD") will diligently assess the basis of the transactions under relevant provisions in the IRO.

Endorsed by the Organisation for Economic Co-operation and Development (the OECD) Transfer Pricing Guidelines (TPG), the IRD adopts the arm's length principle for assessing transactions with transfer pricing issues between associated enterprises. The arm's length principle requires associated enterprises to charge the same price, royalty and other fee in relation to a controlled transaction as that which would be charged by independent enterprises in an uncontrolled transaction in comparable circumstances (Para. 36, DIPN No. 46, Dec 2009).

When transactions in this aspect are found without applying the arm's length basis, various provisions in the IRO would be invoked by the IRD in tackling the transfer pricing issues. These provisions include:-

(i) S.16(1) of the IRO – payments made to an associated enterprise on a basis other than arm's length will be disallowed (Para 19, DIPN No. 46, Dec 2009)

(ii) S.17(1)(b) and (c) of the IRO – denying a company a deduction for expenditures not connected with or arising from trade of an associated enterprise, or a capital withdrawn from the enterprise carried on in Hong Kong in order to support that of the foreign associated enterprise (Para 21 & 22, DIPN No. 46, Dec 2009)

(iii) S.61A of the IRO – In abusive profit shifting transactions (Para 23, DIPN No. 46, Dec 2009)

(Discussion of other relevant IRO provision(s) from a transfer pricing perspective (e.g. s.20(2) & s.61 of the IRO))

VPM Ltd. therefore should formulate a transfer pricing policy in accordance with the arm's length principle in order to avoid the possible challenge from the IRD.

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(b)

The IRD seeks to apply the principle in the TPG emphasising the importance of comparability analysis under various transfer pricing methods. The methodologies include comparable uncontrolled price, resale price and cost plus methods under the category of traditional transaction methods. It also includes profit – split and the transactional net margin methods under the category of transactional profit methods. (Para 66, DIPN No. 46, Dec 2009).

All these methods are considered by the IRD to satisfy the arm's length principle, and VPM Ltd. should select the most appropriate transfer pricing method to apply to the transactions conducted with Newsub.

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(c)

If Newsub is established in Country Y and there is a transfer pricing adjustment made by the tax administration of Country Y to increase the taxable income of Newsub with respect to the sales transactions between VPM Ltd. and Newsub, there are no provisions under the IRO permitting the relief from double taxation by way of adjusting the quantum of assessable profits of VPM Ltd. in the absence of a CDTA (Para 9, DIPN No. 45, April 2009). Such relief in the form of revising the assessment of VPM Ltd. can only be possible in accordance with the relief provision in the Associated Enterprises Article of the CDTA and under s.79 of the IRO on the basis that the transfer pricing adjustment is made on the controlled transactions between VPM Ltd. and Newsub, which is to be established in country X (i.e. having a CDTA with Hong Kong). (Para 14, DIPN No. 45, April 2009)

If Newsub is established in Country X, it is possible for VPM Ltd., under the CDTA, to reach a bilateral Advance Pricing Arrangement (APA) with the IRD and the tax administration of Country X for the determination of an appropriate set of criteria on the transfer pricing of the transactions with Newsub over a fixed period of time (Para 6 & 10, DIPN No. 48, March 2012). However, this APA is not applicable to VPM Ltd. if Newsub is established in country Y without any CDTA concluded with Hong Kong.

On the other hand, there is a mechanism on the exchange of information to the tax administration of Country X under the CDTA. In this regard, the IRD could exchange information to Country X or other countries having a CDTA with Hong Kong in relation to the administration and enforcement of taxes covered by the respective CDTA, and the exchange is also restricted only upon request (Para 5 & 16, DIPN No. 47, June 2010). This exchange of information mechanism is not applicable to Country Y or other countries without any CDTA with Hong Kong.

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(d)

Before accepting the tax advisory engagement from VPM Ltd., DHK & Co. should ensure the objectivity of its firm to VPM Ltd. by confirming that there is no conflict of interest between the two entities. Specifically DHK & Co. should not be subject to any undue influence from VPM Ltd. or any other person to override its professional judgments.

In addition, DHK & Co. should also ensure that they have competent professional knowledge on the current developments in practice, legislation and techniques from a transfer pricing perspective.

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Q8 A Ltd, B Ltd & C Ltd (Jun 2013 Q6c)

A Limited is a toy trading company in Hong Kong. It commenced business in 2000 and closed its accounts annually on 30 June. In early 2011, A Limited took over B Limited, a company incorporated in the Mainland of China ("the Mainland").

B Limited did not have any business presence in Hong Kong. On 1 December 2011, B Limited sold the Trademark with its right under the Licence at RMB 20 million to C Limited, a Mainland corporation which is wholly-owned by A Limited. The market value of the Trademark as at 1 January 2012 was RMB 100 million.

Required:

(c) **Evaluate whether and, if so, when and how B Limited is chargeable to the Mainland business tax in respect of the sale of the Trademark to C Limited on 1 December 2011. (Note: Computation of business tax payable is required if chargeable.)**
(5 marks)

Examiner's comment

Question (c)
Performance:
- could identify that the transaction was a taxable activity for the purposes of Mainland business tax

Common mistake:
- not able to state the location of the recipient as the determinant of chargeability.
- not aware that the consideration for the trademark was below its market value and that the Mainland tax authority might impose the business tax charge on the basis of the market value.

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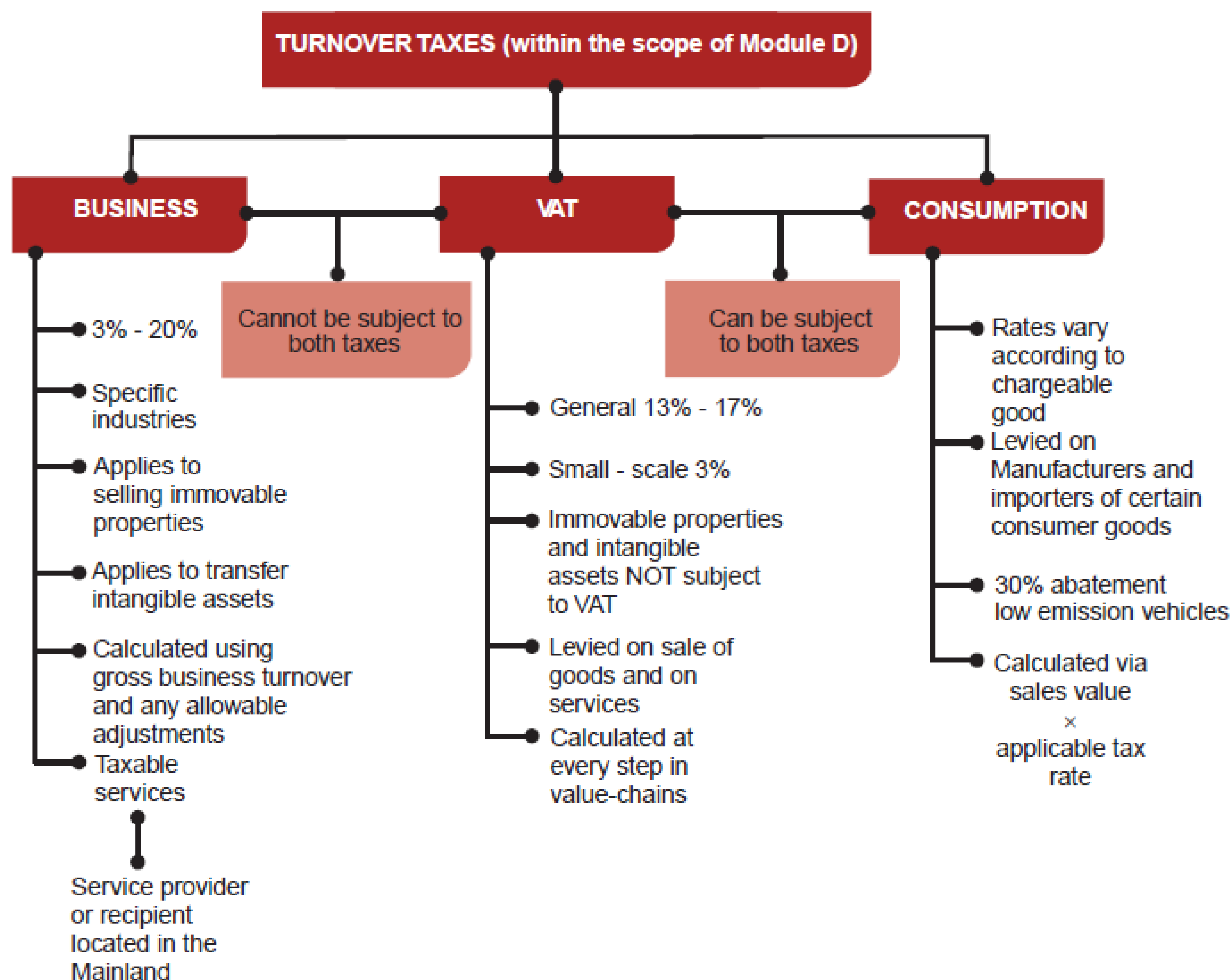
Key concept for Q8 A Ltd, B Ltd & C Ltd (Jun 2013 Q6c)



Source: HKICPA Module D Learning Pack p. 755

Prescribed taxable services	Service recipient or service provider is located in the Mainland
Transfer of intangible assets (excluding land use rights)	Transferee of the intangible assets (or the right to use) is located in the Mainland
Transfer of land use rights	Land is located in the Mainland
Selling or leasing of immovable properties	Immovable property is located in the Mainland

Source: HKICPA Module D Learning Pack p. 725

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Answer to Q8 A Ltd, B Ltd & C Ltd (Jun 2013 Q6c)

(c)

B Limited should be chargeable to business tax in respect of its sale of the Trademark to C Limited because C Limited, being the recipient of the Trademark, is in the Mainland.

The above liability to business tax arises on the date on which B Limited transferred the Trademark to C Limited, i.e. 1 December 2011.

Since the consideration for the Trademark (RMB 20 million) is apparently below its market value (RMB 100 million), by virtue of Article 7 of the PRBT, the Mainland Tax Authority may adopt the market value as the taxable turnover and the applicable tax rate is 5%.

Therefore, the business tax payable = RMB 100 million x 5% = RMB 5 million.

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Practice Makes Perfect!

Good luck!

End of Seminar

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