Friendly Notes on Examination Technique:

1. ***Read the question carefully***
   It is important to identify the issue or issues that he question is referring to. Plan ahead before you start writing. A well structure answer would enable you to capture more relevant issues.

2. ***Be relevant***
   Use your time wisely. You won't score by rote-copying irrelevant materials. In an open book examination like QP, marks would be allocated to theoretical part but there must be more marks on the discussion part. So it is important to explain and apply the theory or rules that is relevant in the scenario given.

3. ***Time management***
   On top of the 1.8 minutes per mark guideline stated in the question, do plan your "productive" and "non-productive" time in advance and MUST attempt all the questions.

4. ***Avoid unnecessary panics***
   Questions in section B are usually independent to each other. A good strategy is to answer the questions in accordance with your confidence level.

5. ***Produce a marker-friendly answer script***
   Markers would not demand for some elegant English and/or handwriting, but something readable would suffice. Start a new page for every question and write in short paragraph with lines between paragraphs would facilitate the markers' marking. It is also good for yourself when you want to add something to your answer.

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Module D –Taxation
(December 2013 Session)

Examination Panelists' Report

Section A – Case Questions

General Comments

The case study covered various issues concerning profits tax, salaries tax, and stamp duty arising from a group restructuring. One of the questions also tested the candidates' writing skills by requiring them to prepare an advisory letter to a client. In general, the performance of the candidates was satisfactory. Most candidates were able to provide good answers to the questions which required the direct application of tax principles. Their major weaknesses were found in handling those analytical questions, such as the determination of the source of employment. Candidates are advised to familiarise themselves with these issues in future.

June 2014 Session

Examination Panelists' Report

Section A – Case Questions

General Comments

The case study covered various issues concerning taxability and deductibility of specific income and expenses from a profits tax perspective, computation of salaries tax liabilities, analysis of PRC Individual Income Tax in accordance to the Double Taxation Agreement ("DTA") between the Mainland of China and Hong Kong SAR, discussion of the field audit process, settlement methodologies, and respective exposure to tax representatives in a field audit exercise from an ethical perspective.

The performance of the candidates was generally satisfactory. Specifically, the majority of the candidates were able to provide good and concise answers to the computation question. This is in line with previous examination sessions. However, the performance on specific topics, especially in relation to the analysis of PRC tax exposures, taxability of income from a profits tax perspective as well as the discussion of the exposure to risk for tax representatives from an ethical perspective was less than satisfactory. Candidates are advised to have better preparation on these topics in future in order to achieve a comprehensive understanding of the different issues.

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Module D –Taxation
(December 2013 Session)

CASE

A Ltd. is a company incorporated and listed in Singapore. It has a wholly-owned subsidiary, B Ltd., which is incorporated in Hong Kong. B Ltd. engaged in two profitable lines of business, namely (a) trading of listed securities in Hong Kong, and (b) management of listed securities in Hong Kong for clients in Hong Kong and the Mainland of China ("the Mainland"). The securities trading was undertaken by B Ltd. on its own, whilst the securities management services were provided through its wholly-owned subsidiary, C Ltd. C Ltd. was incorporated in Hong Kong in 2000 and all its shares had been held by B Ltd. since incorporation. A Ltd., B Ltd. and C Ltd. closed their accounts on 31 December each year.

A Ltd. decided to restructure its business operations in the Greater China region. In this regard, B Ltd. sold all the shares in C Ltd. at a profit to A Ltd. Then, B Ltd. went into voluntary liquidation and the liquidator distributed to A Ltd. all the listed Hong Kong shares, which had been included in the trading stock of B Ltd., upon liquidation. The whole restructuring process was completed on 31 December 2012. For the purpose of liquidation, B Ltd. paid service fees of HK$2 million to the liquidator.

C Ltd. established a representative office in Shanghai to solicit Mainland clients for its securities management services. After concluding the management agreements in the Mainland, the representative office would pass the relevant information to the Hong Kong office for opening accounts and managing the clients' listed securities in Hong Kong. For the service fees received in RMB, the representative office would normally place them on 7-day call deposit in a Mainland bank with the intention of obtaining more favourable exchange rates for remittance to Hong Kong. In the year ended 31 December 2012, there was a remittance which, due to an unexpected fluctuation of the exchange rate, gave rise to an exchange loss of $100,000.

Dennis had been employed by C Ltd. as its Chief Executive Officer in Hong Kong for 10 years. After the above restructuring exercise referred to in the second paragraph, Dennis requested for his old employment contract to be terminated and for A Ltd. to re-employ him for secondment to the same position in C Ltd. immediately thereafter. For the termination, Dennis was neither provided with any written notice nor severance payment pursuant to his old employment contract. The new contract was negotiated and signed in Hong Kong, under which he was required to report to the board of directors of C Ltd. His remuneration package under the new contract was the same as that under the old contract. However, there was also a provision for an award of shares in A Ltd. Dennis was granted the relevant shares and became the registered shareholder of A Ltd. upon the commencement of his new employment contract on 1 January 2013. He was, however, restricted from selling the shares within the next 5 years.

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Question 1 (9 marks – approximately 16 minutes)

Discuss, from the profits tax perspective,

(a) whether B Ltd.'s profits from the sale of shares in C Ltd. to A Ltd. are chargeable to tax.

(5 marks)

(b) how the listed Hong Kong shares, which have been included in the trading stock of B Ltd., should be accounted for upon B Ltd.'s liquidation.

(2 marks)

(c) whether the service fees paid to the liquidator are deductible.

(2 marks)

Identify the Issue:

(a)

(b)

(c)

Points to include:

(a)

(b)

(c)

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Answer 1(a)

The chargeability of the profits in question depends on whether the shares in C Ltd. are the trading stock or the long-term investment of B Ltd. This issue should be determined with reference to the intention of B Ltd. upon the acquisition of the relevant shares: see *Simmons v IRC* [1980] 1 ELR 1196.

According to the facts given in the question,

(a) B Ltd. was the founder shareholder of C Ltd. and has held the shares for more than 10 years;

(b) C Ltd. has carried on a profitable business of securities management, which could have generated income to B Ltd.; and

(c) The sale of the relevant shares was triggered by a commercial reason, i.e. the business restructuring of A Ltd. and its subsidiaries in the Greater China region.

It can be inferred from these facts that B Ltd. might not have a trading intention upon the acquisition of the shares in C Ltd., and the relevant shares were not the trading stock of B Ltd. As such, the profits derived from the sale of such shares should not be chargeable to profits tax.

Examination Panelists' Report

Question 1(a) – 5 Marks

This question required the candidates to evaluate whether the shares in C Ltd. are the trading stock or the long-term investment of B Ltd. It was a simple question and many candidates could provide correct answers supported by the facts in the case.

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Answer 1(b)

Pursuant to s.15C(b) of the Inland Revenue Ordinance ("IRO"), the relevant Hong Kong stocks should be valued for the purpose of computing the chargeable profits of B Ltd. for the year of cessation (i.e. 2012/13).

The value of the stocks should be taken to be the amount which they would have realised if they had been sold in the open market at the date of cessation.

Examination Panelists' Report

Question 1(b) – 2 Marks

This question concerned section 15C(b) of the Inland Revenue Ordinance ("IRO"), which requires the Hong Kong stocks held by B Ltd. for trading to be valued at market value for profit computation in its year of cessation. Regrettably, many candidates misunderstood the question and discussed the nature of the relevant Hong Kong stocks (which were already stated in the question). Only a few candidates were aware of the provisions under section 15C(b) and applied them correctly in their answers.

Answer 1(c)

The service fees paid to the liquidator are not deductible under s.16(1) of the IRO as they were not incurred for the purpose of B Ltd.'s business, but for the purpose of closing the business.

Examination Panelists' Report

Question 1(c) – 2 Marks

This question required the candidates to determine whether the liquidator's fees were deductible in the hand of B Ltd. Most candidates did well in this question and recognised that the expenses were not incurred for the carrying on of B Ltd.'s business, but for the closing of such business.

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Question 2 (13 marks – approximately 23 minutes)

A Ltd. had engaged E & Co. to advise on the stamp duty implications before the implementation of the restructuring exercise. Assuming that you were a tax manager of E & Co., draft an advisory letter to A Ltd. analysing the stamp duty implications in respect of the following transactions:

(a) B Ltd.'s sale of shares in C Ltd. to A Ltd.; and

(b) the distribution of the listed Hong Kong shares to A Ltd. by B Ltd. upon liquidation.

(13 marks)

Identify the Issue:

(a)

(b)

Points to include:

(a)

(b)

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Answer 2

[Draft]

[Date]

A Ltd.
[Address]

[Our Reference]

Dear Sir/Madam,

Stamp duty implications of the intended business restructuring

Introduction

1. We refer to your recent engagement with this firm for advice on the stamp duty implications of certain share transactions between A Ltd. and B Ltd. pursuant to the intended business restructuring ("the Transactions"). In particular, you are concerned about whether the instruments for effecting the Transactions are chargeable with ad valorem stamp duty.

The facts

2. As we understand, the basic facts of the Transactions are as follows:

   (a) B Ltd. is a wholly-owned subsidiary of A Ltd.;

   (b) A Ltd. decided to restructure its business operations in the Greater China region. In this regard, B Ltd. will first sell all its shares in C Ltd., a company incorporated in Hong Kong, to A Ltd. ("Transaction 1");

   (c) Then, B Ltd. will go into a voluntary liquidation;

   (d) Upon the liquidation, the liquidator will distribute all the listed Hong Kong stocks held by B Ltd. in specie to the only shareholder, i.e. A Ltd. ("Transaction 2").

Our analysis

3. Having regard to the relevant legal principles and the provisions of the Stamp Duty Ordinance ("SDO"), we are of the view that the Transactions will not be subject to any ad valorem stamp duty. Our reasons are as follows:

   Transaction 1

   (a) The shares in C Ltd. are Hong Kong stocks as defined under s.2 of the SDO because C Ltd. is a company incorporated in Hong Kong and the transfer of its shares should be required to be registered in Hong Kong. By virtue of s.19(1) of the SDO, A Ltd. and B Ltd. have to make and execute contract notes for Transaction 1 ("the Contract Notes") and cause the Contract Notes to be stamped under head 2(1) in the First Schedule of the SDO.

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(b) However, as A Ltd. holds all the shares in B Ltd., these two companies are associated bodies corporate within the meaning of s.45(2) of the SDO. Hence, the Contract Notes effecting Transaction 1 should be exempted from stamp duty under head 2(1) pursuant to s.45(1) of the SDO.

(c) Although B Ltd. will be liquidated after Transaction 1, this will not lead to the revocation of the stamp duty exemption pursuant to s.45(5A) of the SDO as there is no change in the percentage of the issued share capital of the transferee (i.e. A Ltd.).

Transaction 2

(d) Except for the provision of s.27(5) of the SDO, Transaction 2 will be deemed to be a voluntary disposition inter vivos by virtue of s.27(4) of the SDO because it lacks any valuable consideration. The instrument of transfer effecting such a transaction ("the Instrument") will be chargeable with stamp duty under head 2(3) in the First Schedule of the SDO.

(e) Nevertheless, being a distribution in specie of B Ltd.'s assets to its shareholder, A Ltd., upon liquidation, Transaction 2 did not involve any change of beneficial interest in stocks transferred: see *Wigan Coal & Iron Co. Ltd. v IRC [1945] 1 All ER 392*. As such, s.27(5) will be applicable and the Instrument will not be chargeable with stamp duty under head 2(3).

Conclusion

4. The above only provides our initial assessment on the stamp duty chargeability of the Contract Notes and the Instrument, and it may not reflect the actual determination by the Collector. To play safe and obviate any problem of registering the Hong Kong stocks concerned, you are advised to submit the Instrument for adjudication by the Collector at a fee pursuant to s.13(1) of the SDO. For the Contract Notes, adjudication is compulsory by virtue of s.45(3) of the SDO and no adjudication fee will be payable.

5. Indeed, subject to other considerations, you may consider refining your business restructuring exercise by simply liquidating B Ltd. and arranging both the shares in C Ltd. and the listed Hong Kong stocks held by B Ltd. to be distributed in specie to A Ltd. Such refinement will involve less steps, whilst the stamp duty consequence can remain the same.

6. We hope this advice can be of assistance. Should you have any question, please feel free to contact me at [telephone number] or Mr. / Ms. Y, Tax Manager of this office, at [telephone number].

Yours sincerely,

Tax Manager
E & Co.

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Examination Panelists' Report

Question 2 – 13 Marks

This question required the candidates to discuss the stamp duty implications in respect of two share transactions undertaken by B Ltd., namely (1) the sale of C Ltd.'s shares to its parent company, A Ltd. and (2) the distribution of the listed shares in specie to A Ltd. For transaction (1), most candidates could correctly explain the stamping requirements under section 19 of the Stamp Duty Ordinance ("SDO"), and that the intra-group relief under section 45(1) of the SDO was due because of the associated relationship between A Ltd. and B Ltd. However, quite a number of candidates misunderstood that such an associated relationship would cease due to the liquidation of B Ltd. and thus render the revocation of the relief by virtue of section 45(5A) of the SDO. Indeed, such revocation would not occur as there was no change in the beneficial shareholding of the issued share capital of the transferee (i.e. A Ltd.). As regards transaction (2), many candidates wrongly considered that such a distribution in specie was no different from a normal share transaction and thus subject to stamp duty. Just a few candidates could recognise the exemption under section 27(5) of the SDO and that it did apply to such a transaction because of no change in beneficial interest therein.

Apart from the technical points, this question required the candidates to present their discussion in the manner of an advisory letter. In this regard, most candidates were familiar with the formalities of an advisory letter. They did not have any difficulty in scoring for their writing style.

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Question 3 (7 marks – approximately 13 minutes)

Discuss the following in relation to C Ltd.:

(a) whether the service fees from the Mainland clients are chargeable to profits tax; and

(3 marks)

(b) whether the exchange loss in relation to the remittance of service fees is deductible for profits tax purposes.

(4 marks)

Identify the Issue:

(a)

(b)

Points to include:

(a)

(b)

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Answer 3(a)

The broad guiding principle for determining the source of profits, as laid down by Lord Bridge in *Commissioner of Inland Revenue v Hang Seng Bank Ltd.* [1991] 1 AC 306 and expanded by Lord Jauncey in *Commissioner of Inland Revenue v HK-TVB International Ltd.* [1992] 2 AC 397, is "one looks to see what the taxpayer has done to earn the profit in question and where he has done it".

Here, the service fees were paid for the securities management services rendered by C Ltd. pursuant to the management agreements. Albeit the conclusion of the management agreements in the Mainland, C Ltd. did manage their clients' listed securities in Hong Kong.

Following the above broad guiding principle and the authority of *Commissioner of Inland Revenue v Wardley Investment Services (Hong Kong) Ltd.* (1992) 3 HKTC 703, the service fees should have a source in Hong Kong and are thus chargeable to profits tax.

Examination Panelists' Report

Question 3(a) – 3 Marks

This was quite a simple question on the source of profits. Most candidates could apply the broad guiding principle and determine that the service fees should have a Hong Kong source because the securities management services, which were the profit-producing activity, were undertaken in Hong Kong.

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Answer 3(b)

For an exchange loss to be deductible, it must have arisen from the production of chargeable profits, and it must be of revenue and not capital in nature.

In the given case, the funds from which the exchange loss arose were originally trading funds. However, their nature was altered to that of capital investment when they were accumulated and placed on call deposits in the Mainland with the intention of obtaining more favourable exchange rate.

On the authority of *CIR v Li & Fung Ltd.* 1 HKTC 1193, the exchange loss was of capital nature and therefore not deductible.

Examination Panelists' Report

Question 3(b) – 4 Marks

This question tested the candidates' knowledge about the deductibility of the exchange loss incurred by C Ltd. in relation to the remittance of service fees. Most candidates could state the basic principles governing the deduction of an exchange loss. However, when applying the principles to the situation, just a few could recognise that the nature of the exchange loss had changed from revenue to capital upon the placing of the trading funds on call deposits, and the loss was thus not deductible.

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Question 4 (10 marks – approximately 18 minutes)

Analyse whether and if so, how the service fees derived by the representative office of C Ltd. in Shanghai are subject to the Mainland Corporate Income Tax.

(Note: (1) The analysis should include, among others, a discussion of whether C Ltd. can benefit from the Double Taxation Arrangement between the Mainland and Hong Kong.

(2) No discussion on the regulatory issues in relation to the securities management activities carried on by C Ltd. in the Mainland is required.)

(10 marks)

Identify the Issue:

Points to include:

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Answer 4

C Ltd. is not established under Chinese law, nor has it an effective management in the Mainland. According to Article 2 of the Corporate Income Tax Implementation Rules ("CITIR"), C Ltd. is a non-PRC tax resident and is only chargeable to Corporate Income Tax ("CIT") in respect of its PRC-sourced income.

Since C Ltd. has a representative office in Shanghai, it should be regarded as having an establishment in the Mainland by virtue of Article 5 of the CITIR. Under Article 3 of the CITIR, such a non-resident enterprise has to pay CIT in respect of its PRC-sourced income and income which is effectively connected with the representative office in Shanghai.

As provided under Guoshuifa (2010) 19, C Ltd. should set up accounting books in accordance with the Tax Collection and Administration Law and maintain adequate accounting records so as to calculate the taxable income. If C Ltd. is unable to calculate its taxable income accurately because of incomplete accounting records or a lack of information, the Mainland tax authorities are empowered to assess the taxable income on the basis of the relevant gross revenue, cost and/or expenses.

Although pursuant to Article 7 of the Double Taxation Arrangement between the Mainland and Hong Kong ("the Arrangement"), C Ltd., being a resident in Hong Kong, should only be chargeable to tax in respect of its business profits in Hong Kong, it did carry on business in the Mainland through a permanent establishment (i.e. the representative office in Shanghai). In the circumstances, C Ltd. can be taxed in the Mainland to the extent that its income is attributable to the representative office. Since C Ltd. is liable to tax in respect of its income from the representative office in both Hong Kong and the Mainland, it can be provided with a relief by way of tax credit in accordance with Article 21 of the Arrangement and s.50 of the IRO.

Examination Panelists' Report

Question 4 – 10 Marks

This question required the candidates to analyse whether the service fees derived by the Shanghai office of C Ltd. were subject to Mainland Corporate Income Tax ("CIT") and, if so, whether this office could benefit from the Double Taxation Arrangement between the Mainland and Hong Kong ("DTA"). For the first issue, most candidates could merely state the general charging provisions of CIT but failed to recognise that C Ltd., as a non-PRC tax resident, was only chargeable to CIT in respect of its PRC-sourced income. Only a few mentioned the requirement under Guoshuifa (2010) 19 to maintain adequate accounting records to compute taxable income. As regards the second issue, most candidates correctly answered that as the Shanghai office was a permanent establishment in the Mainland and as the income attributable to that office would be subject to tax in both the Mainland and Hong Kong, relief could be provided to C Ltd. by way of tax credit under the DTA.

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Question 5 (11 marks – approximately 20 minutes)

Evaluate the following from the salaries tax perspective:

(a) whether Dennis' new employment under A Ltd. would be accepted by the Inland Revenue Department and therefore eligible for time apportionment of his employment income commencing from 1 January 2013; and

(7 marks)

(b) whether and if so, when and how Dennis is chargeable to salaries tax in respect of the share award.

(4 marks)

Identify the Issue:

(a)

(b)

Points to include:

(a)

(b)

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Answer 5(a)

Dennis had been employed as the Chief Executive Officer ("CEO") of C Ltd. for 10 years. Despite the alleged "termination" of such employment and the alleged commencement of a "new" employment with A Ltd. on 1 January 2013, he was neither provided with a written notice of termination of employment nor severance payment. Under the "new" employment, he remained as the CEO of the C Ltd. and was still responsible to the board of C Ltd. On these facts, it appears that Dennis had not changed his employer to A Ltd. since 1 January 2013; he had all along held one continuous employment with C Ltd. As Dennis should have entered into his employment with C Ltd. in Hong Kong, whilst C Ltd. is a company incorporated Hong Kong, the employment should have a source in Hong Kong and Dennis is thus not eligible to claim time apportionment of his employment income.

In any event, even if Dennis had succeeded to prove the "termination" of his employment with C Ltd. and the commencement of his "new" employment with A Ltd., the Commissioner would have considered invoking s.61 and alternatively s.61A of the IRO, because the arrangement was artificial and commercially unrealistic and should be disregarded for the purposes of salaries tax assessment.

Examination Panelists' Report

Question 5(a) – 7 Marks

This was not a straightforward question on the source of employment – after the restructuring, Dennis signed a new contract with A Ltd., but he remained to work for C Ltd. So before determining the issue of source, the candidates should have considered which company is the real employer of Dennis. This preliminary issue required a detailed analysis of the facts given in the question which was, unfortunately, overlooked by quite a number of the candidates. For those who recognised it, most could point out the superficial features of the alleged new employment and concluded that C Ltd. should remain as the employer of Dennis after the restructuring. Some good answers even mentioned that the Commissioner might invoke sections 61 and alternatively 61A of the IRO to disregard the alleged change of employment for salaries tax purposes.

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Answer 5(b)

The award of shares in A Ltd. is a perquisite derived by Dennis from his employment. No doubt he is chargeable to salaries tax in respect of the award.

As regards the manner of assessment, Dennis was entitled to all the rights of a registered shareholder upon the grant of the share award, subject to a restriction of sale for 5 years. Following the guidelines in DIPN 38, Dennis should be chargeable to tax in respect of the share award in the year of grant (i.e. 2012/13). The taxable amount of the award should be the market value of the relevant shares as at the date of grant, but since there is sale restriction, a discount in valuation (generally 5% per year) may be allowed.

Examination Panelists' Report

Question 5(b) – 4 Marks

This question tested the candidates' knowledge about share awards. Most candidates pointed out that the award was a perquisite and should be taxed at a discounted value in the year of grant. Just a few mixed up share award with share option and explained the tax treatment incorrectly.

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Module D –Taxation
(June 2014 Session)

Synergy Santa Limited ("Synergy") is a company established in Hong Kong engaging in the investment holding business. The following incomes and expenditures have been credited and charged respectively to its financial statements for the year ended 31 March 2013.

A1. Interest Income

Bank interest income of HK$35,000 has been derived from a Hong Kong dollar fixed deposit placed with a local bank. The deposit was pledged to guarantee an overdraft banking facility provided by the same bank to Synergy. During the year, Synergy did not utilise any of the facility and only incurred a HK$500 bank charge as an overdraft facility renewal expense.

A2. Waiver of loan borrowed from a shareholder

A loan of HK$2,000,000 has been borrowed by Synergy from one of its shareholders in the year 2006. The loan was utilised by Synergy as working capital for its daily business operations, and has been stated in the balance sheet of Synergy in relevant years as a long-term liability. In a recent meeting amongst the shareholders of Synergy, the respective shareholder agreed to waive Synergy from the requirement to repay the loan.

A3. Contributions to Mandatory Provident Fund ("MPF")

Synergy made an ordinary annual contribution of HK$630,000. The amount was calculated based on 18% of each employee's remuneration in line with the company's policy. In addition, Synergy also made a special contribution of HK$390,000 to its MPF scheme on top of the ordinary annual contribution.

In April 2012, Synergy employed Mr. David Fong ("Mr. Fong"), a Hong Kong resident, as General Manager responsible for the company's daily business operations. Information available indicated that Mr. Fong had the following remuneration package for the year ended 31 March 2013.

B1. Annual salary HK$1,500,000

Mr. Fong also paid HK$45,000 in MPF contributions during the year.

B2. Holiday travel warrant HK$85,000

Mr. Fong received a round-trip air ticket with hotel accommodation to Europe in the abovesaid value as recognition of his work performance for the year 2012. Synergy directly purchased the holiday warrant from a travel agency and settled the amount in its company account maintained with the travel agent. The package tour cannot be transferred from Mr. Fong to any other persons.

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B3. Bonus of HK$100,000
The bonus was given by one of the shareholders of Synergy personally. The amount was given in recognition of Mr. Fong's exceptional performance in his position.

B4. Gain from disposal of shares HK$400,000
Mr. Fong disposed of 50,000 shares of a listed company on 31 January 2013 and derived a gain of HK$400,000. The share was exercised by Mr. Fong on 1 September 2012 through a share option scheme granted by his former employer with respect to his former employment in Hong Kong. The exercise price of the share was HK$2 for each share. The market price of the share on 1 September 2012 and 31 January 2013 was HK$7 and HK$10 respectively. Mr. Fong resigned on 31 March 2012 from his former employment immediately prior to joining Synergy.

B5. Provision of quarters
Synergy utilised one of its long term investment properties as staff quarters for Mr. Fong during the whole year. The market rental value of the respective property was HK$288,000 per annum. In accordance with the company's policy, Mr. Fong was required to pay 5% of his basic salary as rental to Synergy.

B6. Cash Coupon of HK$10,000 from annual dinner lucky draw
Mr. Fong received a department store cash coupon of HK$10,000 in Synergy's annual dinner lucky draw.

Mr. Fong occasionally travels to the PRC for either business or vacation purposes. A summary of PRC traveling records for Mr. Fong for the years 2012 and 2013 (up to 31 March) is as follows:

Periods	Number of days staying in the PRC	Purpose
From 1 January 2012 to 30 June 2012	Nil	N/A
From 1 July 2012 to 31 December 2012	130	Partly for business and partly for vacation
From 1 January 2013 to 31 March 2013	40	Wholly for business

In early April 2013, Mr. Fong noticed that he would not be required to travel to the PRC for business purposes until 30 June 2013. He therefore planned to have a vacation trip to the PRC in June 2013 for two to three weeks.

Recently Synergy received a letter from the Inland Revenue Department ("IRD") stating that the company has been selected for a field audit exercise for reviewing its tax position. The directors of Synergy are worried about the exposure resulting from the field audit exercise and therefore appointed a tax consulting firm namely Wilson Lee & Co. as its tax representative for the field audit exercise.

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Question 1 (10 marks – approximately 18 minutes)

Discuss the taxability of the following incomes of Synergy for the year. Put forward your analysis from the views of Synergy and the IRD where applicable.

(a) Interest income

(5 marks)

(b) Waiver of loan borrowed from a shareholder

(5 marks)

Identify the Issue:

(a)

(b)

Points to include:

(a)

(b)

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Answer 1(a)

Synergy may claim the bank interest income as exempt from profits tax under the Exemption from Profits Tax (Interest Income) Order 1998 ("the Order") on the basis that the interest income was derived from a local bank, and there was no interest expenses deductible under s.16(1)a, 16(2)(c), (d) or (e) of the IRO. However, under the Order, the exemption shall not apply in the case of any deposit which is used to secure or guarantee money borrowed referred to in s.16(1)(a) of the IRO where the condition for the application of s.16(1)(a) of the IRO is satisfied under s.16(2)(c), (d) or (e) of the IRO and s.16(2A) of the Ordinance does not apply. In this regard, the exemption claim may be challenged on the grounds that the availability of the overdraft facility and the respective bank charge have satisfied the condition for the application of s.16(1)(a), and accordingly the exemption does not apply to Synergy. Whether interest expense deduction has ever been claimed under s.16(2)(c), (d) or (e) of the IRO is irrelevant to the exemption claim.

Examination Panelists' Report

Question 1(a) – 5 Marks

The performance in this question was not satisfactory. Candidates in general did not have a clear understanding of relevant concepts, and accordingly provided irrelevant answers or analysis. Some candidates could not analyze the issue from different perspectives as stipulated in the question. Only a few candidates could elaborate on the exception of the Exemption Order, and applied the concept to the case.

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Answer 1(b)

Synergy could argue that the income derived from the waiver of loan should not be subject to profits tax under s.14(1) of the IRO on the grounds that (i) the amount is capital in nature as it was derived from a waiver of long-term loan advanced from a shareholder, and (ii) the amount is not derived from any of its recurring business on trading activities. However, the IRD may apply s.15(1)(c) of the IRO to deem the amount as a taxable trading receipt. Specifically the amount would be regarded as a grant, subsidiary or financial assistance to Synergy in connection with the carrying on of its business, as the loan was utilised as working capital for its daily business operations.

Examination Panelists' Report

Question 1(b) – 5 Marks

The performance in this question was fair. Some candidates were able to discuss the issue from different perspectives. However, some candidates only mentioned that the income is not subject to tax under s14(1) of the Inland Revenue Ordinance ("IRO") without providing relevant grounds. Only a few candidates could analyze the issue comprehensively with reference to s15(1)(c) of the IRO.

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Question 2 (4 marks – approximately 7 minutes)

Discuss the deductibility of the MPF contributions made by Synergy for the year and, where applicable, compute the amount of allowable deduction for Synergy.

(4 marks)

Identify the Issue:

Points to include:

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Answer 2

MPF ordinary annual contribution HK$630,000

MPF annual contribution incurred in the production of taxable income is deductible under s.16(1) of the IRO, except that the maximum deductible amount is limited to 15% of the total emoluments of the employer under s.17(1)(h) of the IRO. In this regard, the deductible amount of MPF ordinary annual contribution of Synergy should be HK$525,000 (HK$630,000 ÷ 18% x 15%).

MPF Special Contribution HK$390,000

The special contribution to MPF is capital in nature and therefore non-deductible under s.17(1)(c) of the IRO. However, under s.16A of the IRO, the amount is deductible over five years in equal annual installments. In this regard, the deductible amount is HK$78,000 for the year (HK$390,000 x 1/5).

Examination Panelists' Report

Question 2 – 4 Marks

This question required the candidates to discuss the deductibility of MPF annual and special contributions. The performance in this question was satisfactory. Candidates generally were able to address the respective deductibility with reference to specific provisions in the IRO and to compute the amount of deductible expenses accordingly. However, some candidates wrongly discussed the deductibility of MPF from a salaries tax perspective, and provided irrelevant answers. Some candidates were not able to distinguish the tax treatment for annual and special contributions.

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Question 3 (16 marks – approximately 29 minutes)

Compute the salaries tax liabilities of Mr. Fong for the year of assessment 2012/13 based on the available information. (Ignore provisional salaries tax and reduction of salaries tax for the year.)

(16 marks)

Identify the Issue:

Points to include:

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Answer 3

Mr. David Fong
Salaries tax computation
Year of assessment 2012/13

	HK$	HK$
Annual salaries		1,500,000
Holiday travel warrant		85,000
		1,585,000
Add: Rental value ($1,585,000 x 10%)	158,500	
Less: Rent payment to employer (1,500,000 x 5%)	(75,000)	83,500
		1,668,500
Add: Share option gain (50,000 x ($7-2))	250,000	
Bonus	100,000	
		350,000
Net assessable income		2,018,500
Less: Contribution to MPF		(14,500)
		2,004,000
Less: Personal allowance (assuming no other allowances entitled)		(120,000)
Net chargeable income		1.884,000
Salaries tax payable (at progressive rate)		
$40,000 @ 2%		800
$40,000 @ 7 %		2,800
$40,000 @ 12%		4,800
HK$1,764,000 @ 17%		299,880
		308,280
Salaries tax payable (at standard rate) 2,004,000 x 15%		300,600
Tax payable, at lower one		300,600

Examination Panelists' Report

Question 3 – 16 Marks

The performance in this question was generally satisfactory. The majority of the candidates were able to provide a systematic computation to quantify the salaries tax liabilities. However, some candidates could not correctly compute the rental value assessable to salaries tax, and some candidates used the incorrect amount as the MPF deduction.

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Question 4 (5 marks – approximately 9 minutes)

Discuss the PRC Individual Income Tax exposure of Mr. Fong for the period from 1 January 2012 to 30 June 2013.

(5 marks)

Identify the Issue:

Points to include:

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Answer 4

According to the Double Taxation Arrangement (DTA) and the subsequent Protocols entered into between the Mainland of China and Hong Kong SAR, income derived by a resident of one side in respect of employment exercised in the other side will be exempt from tax in the other side if the taxpayer stays in the other side for a period not exceeding the aggregate 183 days in any 12-month period commencing or ending in the taxable period concerned. In order to qualify for the exemption, the respective income must also be paid by an employer of one side and has not been borne by a permanent establishment in the other side.

Mr. Fong stayed in the PRC for 130 days during the 12 months ended December 2012. In this regard, he should not have any PRC Individual Income Tax ("IIT") exposure for the period.

During the 12 months ended March 2013, Mr. Fong stayed in the PRC for 170 days. Accordingly he should not have any PRC IIT exposure for the period.

If Mr. Fong travels to the PRC during the period from April to June 2013 for more than 13 days regardless of the purposes of the travel, his total number of days staying in the PRC for the 12 months ended June 2013 will be more than 183 days. In this circumstance, Mr. Fong will be subject to PRC IIT on employment income derived during his actual working days in the PRC. Actual working days in the case of Mr. Fong include work days in the Mainland and those public holidays in the period he stayed in the PRC.

Examination Panelists' Report

Question 4 – 5 Marks

This question required the candidates to discuss the PRC Individual Income Tax exposure under the DTA between the mainland China and Hong Kong SAR. The performance in this question was not satisfactory. Only some candidates were able to state the 183 days rule and applied the concept into the case. The majority of the candidates could not analyze the PRC Individual Income Tax exposure along with the 12 months rolling basis with reference to the 18 months ended June 2013.

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Question 5 (15 marks – approximately 27 minutes)

(a) Assuming that you are the tax manager of Wilson Lee & Co., elaborate on:

(i) the possible upcoming field audit exercise process; and

(5 marks)

(ii) the availability of settlement methodologies to Synergy.

(5 marks)

(b) Discuss if there is any exposure to risk for Wilson Lee & Co. in the context of (i) the Inland Revenue Ordinance and (ii) ethical perspective in acting as the tax representative of Synergy for the field audit exercise.

(5 marks)

Identify the Issue:

(a)(i)

(a)(ii)

(b)

Points to include:

(a)(i)

(a)(ii)

(b)

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Answer 5(a)

The upcoming field audit exercise and settlement methodologies applicable to Synergy are as follows:-

Preliminary process

As the tax representatives, Wilson Lee & Co., would assist Synergy to contact the IRD to arrange a mutually convenient time and place for the initial interview. To facilitate a thorough understanding of Synergy's business operations and personal affairs, the initial interview will usually be held in Synergy's office premises and be attended by its management executives together with their tax representative.

In arranging the initial interview, the IRD will request details of the books and records maintained by Synergy for the relevant years to be produced at the initial interview. Prior to the initial interview, Wilson Lee & Co. should have obtained instructions from Synergy to compile relevant comprehensive financial and accounting information from Synergy in order to ascertain its true assessable profits for the respective years.

Initial Interview

The initial interview is a fact finding process. Information about the daily business operations, accounting procedures of Synergy and relevant personal affairs of its directors / shareholders or other relevant persons will be sought during the interview process. Synergy may also be requested to estimate the amount of profit understatement and to place a deposit with the IRD on a voluntary basis to cover the estimated tax liability. After the interview, the IRD will prepare a comprehensive meeting note for Synergy's comment and confirmation.

Book and records examination

After the initial interview, the IRD will carry out basic audit work based on the available information. The IRD may issue notice under s.51(4)(a) of the IRO to Synergy or other third parties for obtaining further information or clarification.

Records and documents will be examined to assess their genuineness and reliability, and if they support the entries in the accounts.

Methodologies for field audit settlement

Where book and records are properly kept and have not been manipulated, transactions not reflected in the financial statements can be identified and reconciled. In this circumstance, Synergy should prepare revised financial statements based on the books and records in order to ascertain its true assessable profits for the IRD's examination.

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When books and records have not been kept properly by Synergy, other indirect methodologies may be used for field audit settlement. Indirect methods in this circumstance include the following methodologies:-

(i) Assets Better Statement (Net Worth) method: Adding the directors / shareholders of Synergy and other relevant person's yearly asset increases (i.e. the excess of net assets in any one year over that of the previous year), all expenditure of a non-allowable nature, and deducting receipts which are capital in nature or otherwise not assessable to arrive betterment profits.

(ii) Bank deposit method: Total bank deposits and unbanked deposits with adjustments for the amount of cash receipts directly used for the payment of business / personal expenses held by Synergy or its nominees will be aggregated to represent the total business receipt of Synergy. An "average" or "representative" gross profit ratio is then applied to the total business receipt to quantify the understatement of gross profits.

(iii) Business economics (percentage computation) method: The method involves the application of percentage or ratios (considered typical of business operations similar to those of Synergy) to particular known amounts, for the purpose of computing figures required to determine the sales, cost of sales, gross profits or even net profits of Synergy.

The IRD's Departmental Interpretation and Practice Notes No.11 (Revised October 2007) outlines the details of the field audit process (para.30 to 51) and settlement methods (para. 56 to 80) for comprehensive elaborations.

Examination Panelists' Report

Question 5(a) – 10 Marks

The performance in this question was below expectations with respect to the provision of a clear process for the field audit exercise. Some candidates for this part provided a very brief answer and therefore could not comprehensively identify the whole process. On the other hand, the performance of candidates in discussing the settlement methodologies for the field audit exercise was generally satisfactory. Some candidates, however, could not point out that indirect methodologies would be used when the books and records of the taxpayers have not been kept properly.

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Answer 5(b)

In Part 14 of the IRO, there are provisions of penalties and offences applicable to both the taxpayer and any other persons assisting the taxpayer to commit an offence and be liable to the same penalty. Specifically under s.80(4) of the IRO, any person who aids, abets or incites another person to commit an offence under s.80 shall be deemed to have committed the same offence and to be liable to the same penalty. In addition, any person who willfully with intent to evade or assist any other person to evade tax shall be guilty of an offence under s.82(1) of the IRO.

In this regard, Wilson Lee & Co. should maintain its professional and ethical standards in advising and assisting Synergy in the process of the field audit exercise in order to avoid the exposure of the penalty or prosecution to itself as the tax representative of Synergy.

Examination Panelists' Report

Question 5(b) – 5 Marks

This question required the candidates to discuss the exposure to risk for tax representatives in the field audit exercises from tax and ethical perspectives. The performance was again below expectations. Only a few candidates could identify that penalty provisions under the IRO are applicable to both taxpayers and tax representatives. Some candidates did not understand the question and accordingly provided irrelevant answers.

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Final Recap

1. ***Read the question carefully***
2. ***Be relevant***
3. ***Time management***
4. ***Avoid unnecessary panics***
5. ***Produce a marker-friendly answer script***

Plan your time from today to 27 December
and
make a good attempt on 28 December!

Good Luck!

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