

## **SECTION A – CASE QUESTIONS (Total: 50 marks)**

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

### **CASE**

A Ltd. is a leading manufacturer of electronic products in Hong Kong. In 1971, A Ltd. acquired a plot of land in Yuen Long, New Territories [“the Land”] and erected thereon a factory for production. Due to the relocation of its manufacturing process to the Mainland of China [“the Mainland”], the factory in Yuen Long had been left vacant since 2006. In 2007, A Ltd. resolved to put the Land in valuable use. It also planned to diversify its business mix by engaging in property investment in both Hong Kong and the Mainland.

B & Co., a tax and business advisory firm, was consulted by A Ltd. for the above business plan. In 2007, following the advice of B & Co., A Ltd. established a wholly-owned subsidiary, C Ltd., in Hong Kong with a view to redeveloping the Land as a residential complex. A Ltd. contracted to sell the Land to C Ltd. at a consideration of \$200 million plus 60% of the net profits realised by C Ltd. from the redevelopment. The fair market value of the Land at that time was \$500 million.

C Ltd. borrowed \$150 million from Bank D to finance the initial land cost of \$200 million. The loan was secured by a fixed deposit of \$100 million in the name of A Ltd., which was placed with a branch of Bank D in the United States. In the year ended 31 December 2008, C Ltd. incurred interest expenses of \$15 million in respect of the loan, whilst A Ltd. earned interest income of \$10 million from the deposit.

In order to oversee the operation of C Ltd., Mr. X, an executive director of A Ltd., was transferred to serve as the Chief Executive Officer of C Ltd. As per the advice from B & Co., Mr. X entered into two employment contracts with C Ltd. in Hong Kong, one of which [“Contract A”] provided that he was responsible for the local property development projects, whilst the other contract [“Contract B”] only governed his duties concerning the property projects in the Mainland. Both contracts commenced on the same date, and their continuance was interdependent with each other. Under both contracts, Mr. X was required to report directly to the Chairman of A Ltd., who was stationed in Hong Kong.

In the year ended 31 December 2008, the redevelopment of the Land was completed, earning C Ltd. net profits of \$1,000 million from the sale of residential units. Pursuant to its contract with A Ltd., C Ltd. paid a further sum of \$600 million as the consideration of the Land. In the same year, C Ltd. also underwrote the sale of a residential building in Guangzhou at a guaranteed sum of RMB 100 million. C Ltd. arranged various sales presentations and promotion functions in Hong Kong in respect of the relevant building and succeeded in selling all the flats for \$250 million. Due to the appreciation of the renminbi, C Ltd. suffered an exchange loss of \$600,000 when remitting the guaranteed sum to the Mainland developer.

During the year of assessment 2008/09, Mr. X was on business trips to the Mainland for 45 days. He was remunerated with an annual salary of \$1 million under each of Contracts A and B, and an option to subscribe to 100,000 shares in A Ltd. at \$0.01 per share under Contract A. Mr. X resigned from C Ltd. on 5 March 2009. He exercised the share option at a gain on 31 March 2009. In his 2008/09 tax return, Mr. X claimed exemption in respect of the salary under Contract B and the share option gain.

**Question 1** (4 marks – approximately 7 minutes)

Determine whether the interest income received by A Ltd. from the fixed deposit with Bank D was chargeable to profits tax.

(4 marks)

**Question 2** (5 marks – approximately 9 minutes)

Discuss C Ltd.'s exposure to stamp duty in relation to its purchase of the Land from A Ltd.

(5 marks)

**Question 3** (17 marks – approximately 31 minutes)

Last week, C Ltd. received an enquiry from the Inland Revenue Department [“IRD”] in respect of its deductions of the land cost of \$800 million and the loan interest of \$15 million for the year of assessment 2008/09. On behalf of C. Ltd., Mr. X engaged E & Co. to handle the enquiry.

Assume that you are the tax manager of E & Co., who is assigned with this enquiry case, draft an advice letter to Mr. X analysing the deductibility of the above land cost and loan interest under the following sections of the Inland Revenue Ordinance [“IRO”]

(a) sections 16 and 17;

(b) section 61A.

(17 marks)

**Question 4** (10 marks – approximately 18 minutes)

Advise C Ltd. as to:

(a) whether the underwriting profits from the residential building in Guangzhou were chargeable to profits tax in Hong Kong;

(5 marks)

(b) if the underwriting profits were chargeable to profits tax, whether the exchange loss of \$600,000 was an allowable deduction.

(5 marks)

**Question 5** (14 marks – approximately 25 minutes)

Analyse the salaries tax position of Mr. X in relation to:

- (a) his salaries under Contracts A and B; (11 marks)
- (b) his gain realised from the share option. (3 marks)

\* \* \* \* \*

End of Section A

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

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

### **Question 6** (20 marks – approximately 36 minutes)

Emma Wong is a famous pianist in the Mainland. She has immigrated to Hong Kong and would like to set up her music studio providing music lessons to young talents in Hong Kong. She rented 2 apartments in Kowloon: one as her family accommodation and the other one as her studio. As she is a famous pianist, many students have signed up for her classes.

For the year of assessment 2008/09, her records revealed the following:

	\$
Tuition fees	1,000,000
Rent for apartment	360,000
Rent for studio	600,000
Utilities – studio	10,000
Utilities – apartment	8,000
Travelling – personal	8,000
Domestic helper	3,000
Other personal expenses	200,000
Office expenses – studio	200,000

#### **Required:**

- (a) Explain whether Emma is liable to pay salaries tax or profits tax. (3 marks)
- (b) Assuming Emma is liable in part (a), compute her assessable income / profits for the year of assessment 2008/09. (3 marks)
- (c) State which of the items (if any) are not deductible and explain. (2 marks)
- (d) Give suggestions, if any, for Emma to reduce her tax payable (assume Emma needs to pay tax in part (a)). (2 marks)
- (e) If Emma was invited to perform in London's Albert Hall and received a gratuity for her performance, explain whether such a gratuity would be taxable. Advise whether the cost of travel to the UK, hotel accommodation and miscellaneous expenses would be deductible.

What would be the tax position if Emma recorded her performance in her studio in Hong Kong and the recording was then broadcast in London?

(10 marks)

**Question 7** (12 marks – approximately 22 minutes)

NT Co commenced business on 1 January 2010, the date of its incorporation, with the first set of accounts ending 30 June 2011.

Advise NT Co of the basis period for tax filing purposes and in particular, explain the basis period likely to be adopted by the Inland Revenue Department for the years of assessment 2009/10, 2010/11, 2011/12 and 2012/13.

Also, comment on the tax implications if NT Co is to change its accounting year end date later.

(12 marks)

**Question 8** (18 marks – approximately 32 minutes)

(a) HKCO Ltd. (“HKCO”) commenced business and incurred losses of \$20 million in the first accounting year ending 30 June 2011. Advise HKCO of the relevant tax implications.

(4 marks)

(b) HKCO is a subsidiary of Kowloon Ltd. Kowloon Ltd. has a projected profit of \$100 million for the year ending 30 June 2011.

(i) Can Kowloon Ltd. utilise the losses in HKCO?

(ii) Would your answer be the same if Kowloon Ltd. is a subsidiary of HKCO instead?

(4 marks)

(c) What if HKCO is a partner in HK-Kowloon Partnership? The partnership has derived assessable profits of \$60 million in the year ending 30 June 2011. HKCO has a 50% interest in the partnership.

(2 marks)

(d) Comment on the agreed tax losses in HKCO for each of the following scenarios:

(i) the management decided to close down HKCO in 2012 and leave it dormant;

(ii) the management decided to liquidate HKCO;

(iii) the shareholders decided to sell their investment in HKCO to Paris CO.

(8 marks)

\* \* \* END OF EXAMINATION PAPER \* \* \*