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

2. Review Past papers and Examination panelist's report

Part A: Tax System and Tax Administration

Q1 FC Asia Ltd (Dec 2014 Q4)

(12 marks – approximately 22 minutes)

FC Asia Limited ("FCA") has maintained clear profits tax records. Information indicated that the Inland Revenue Department ("IRD") has issued 2009/10 and 2010/11 Notices of Assessment, and 2011/12 Loss Notification to FCA in accordance with the Profits Tax Returns filed for these years.

FCA recently received its 2012/13 Notice of Assessment indicating that the IRD has also assessed its taxable profits in line with the filed 2012/13 Profits Tax Return. However, upon a detailed review of FCA's audited financial statements for the year ended 31 March 2013, it was noted that there were prior years adjustments ("PYA"). In preparing the 2012/13 Profits Tax Return, the management of FCA considered that the PYA should have no impact on its 2012/13 profits tax position and accordingly FCA did not take into account any of the PYA in preparing the 2012/13 Profits Tax Return. It is further noted that the PYA were attributable to the rectification of incorrect recognition of sales income and cost of sales in prior years. Specifically, sales income was understated in the year ended 31 March 2010, whilst cost of sales in the two years ended 31 March 2011 and 2012 were both understated respectively.

Required:

(a) Discuss the tax implications of FCA, if any, derived from the PYA for the years of assessment 2009/10 to 2012/13 and, where applicable, advise the actions which should be taken by FCA immediately in response to the PYA.

(8 marks)

(b) Discuss the possible penalty exposure, if any, to FCA on the PYA in the context of the IRO.

(4 marks)

Examiner's comment

Question (a)
This question required the candidates to identify the tax implications for a taxpayer derived from prior years adjustments ("PYA") for different years under different tax positions.

Performance: Below satisfactory

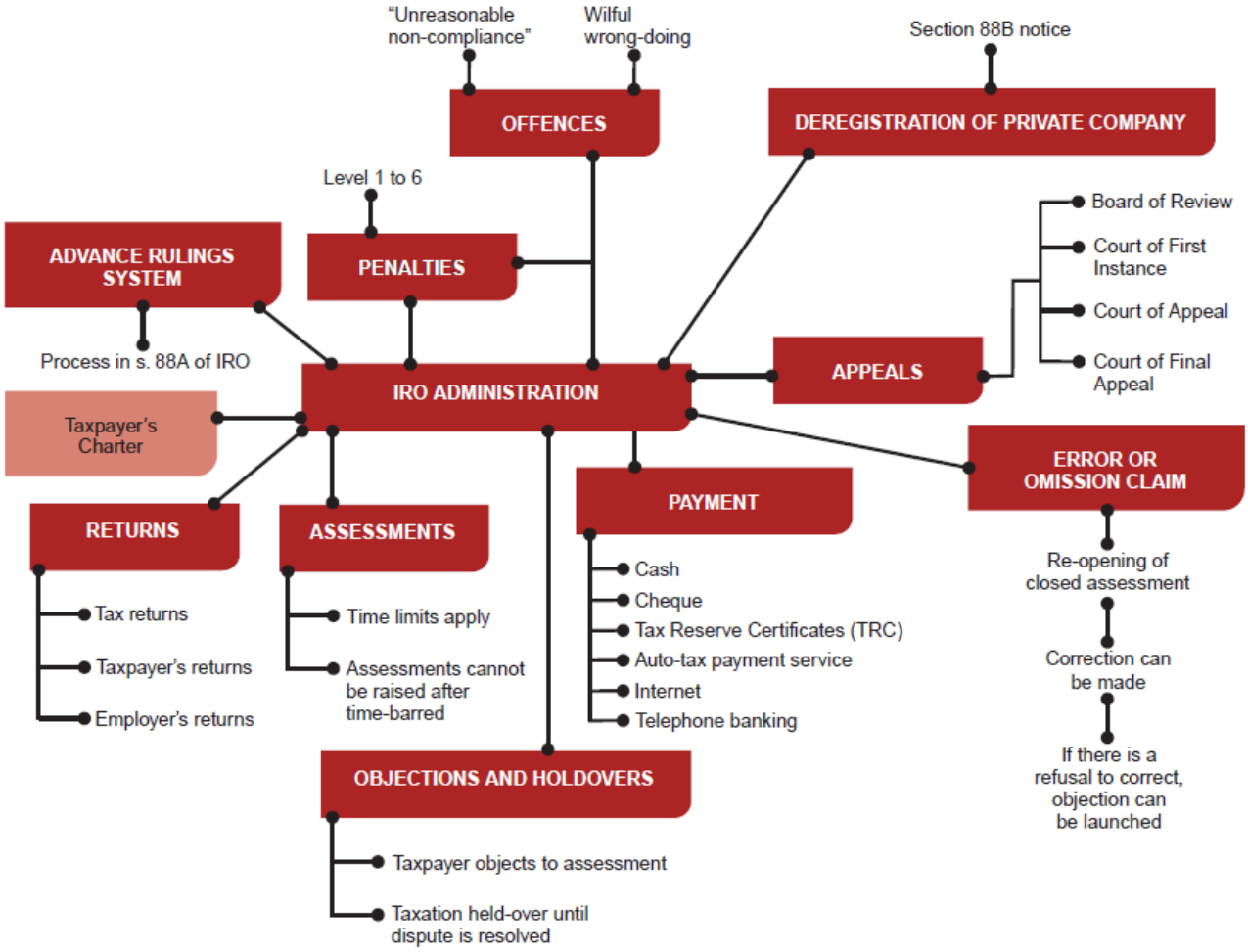
Common mistake:
- generally were not able to identify and analyse the tax implications derived by the PYA in each corresponding year.
- only a few candidates could advise as to the correct actions to be taken by the taxpayer for the respective years.

Question (b)
This question required the candidates to discuss the penalty exposures derived from the PYA.

Performance: Fair
- able to identify various penalty provisions in the context of the IRO.

Common mistake:
- only a few candidates mentioned about the penalty provision under s.51C of the IRO.

Key concept for Q1 FC Asia Ltd (Dec 2014 Q4)



Source: HKICPA Module D Learning Pack p. 79

Key concept for Q1 FC Asia Ltd (Dec 2014 Q4)

Section	Provision
	S.52(6) – employer's return on departure from Hong Kong for more than one month not later than one month before the expected date of departure;
	S. 52(7) – employer to withhold payment due to the employee who is about to leave Hong Kong for a period of one month from the date of servicing a notice to the Commissioner (i.e., the employer's return on departure from Hong Kong) under s.52(6) unless with the consent in writing of the Commissioner;
	S.76(3) – notification to the Commissioner in writing acquainting him with the facts that deduction of tax from payment due to the defaulter is not able to be complied with within fourteen days of the expiration of thirty days from the date of receipt of the Commissioner's notice;
	Commits an offence and is liable on conviction to a fine at level 3 and the Court may order the person convicted within a time specified in the order to perform the act which he has failed to do.
80(1A)	Any person who without reasonable excuse fails to comply with the requirements of s.51C (i.e. fails to keep records of business income and expenditure for a period not less than seven years) commits an offence and is liable on conviction to a fine at level 6 and the Court may order the person convicted within a time specified in the order to perform the act which he has failed to do.
80(2)	Any person who, without reasonable excuse:
	(a) makes an incorrect return by omitting or understating anything in respect of which he is required to make a return;
	(b) makes an incorrect statement in connection with a claim for any deduction or allowance;
	(c) gives any incorrect information in relation to any matter or thing affecting his own liability for tax or the liability of any other person;
	(d) fails to comply with the requirements of a notice given to him under s.51(1) or s.51(2A) (i.e. fails to submit a return by the due date); or
	(e) fails to comply with s.51(2) (i.e. to inform the Commissioner of his chargeability to tax).
	commits an offence and is liable on conviction to a fine at level 3 and a fine of treble the amount of tax that has been undercharged or that would have been undercharged if such failure had not been detected.

Source: HKICPA Module D Learning Pack p. 58

Key concept for Q1 FC Asia Ltd (Dec 2014 Q4)

82(1) & (1A)	Any person who wilfully with intent to evade or to assist any other person to evade tax
	(a) omits from a return any sum which should be included;
	(b) makes any false statement or entry in any return;
	(c) makes any false statement in connection with a claim for any deduction or allowance;
	(d) signs any statement or return furnished without reasonable grounds for believing the same to be true;
	(e) gives any false answer whether verbally or in writing to any question or request for information asked or made;
	(f) prepares, maintains or authorises the preparation or maintenance of any false books of account or other records or falsifies or authorises the falsification of any books of account or records; or
	(g) makes use of or authorises the use of any fraud, art or contrivance, commits an offence.
	Penalty on summary conviction: • a fine at level 3 and • a further fine of three times the tax undercharged or the tax that would have been undercharged and • imprisonment for six months.
	Penalty on indictment: • a fine at level 5 and • a further fine of three times the tax undercharged or the tax that would have been undercharged and • imprisonment for three years

Source: HKICPA Module D Learning Pack p. 59

Key concept for Q1 FC Asia Ltd (Dec 2014 Q4)

82A(1)	Any person who, without reasonable excuse:
	(a) makes an incorrect return by omitting or understating anything in respect of which he is required to make a return;
	(b) makes an incorrect statement in connection with a claim for any deduction or allowance;
	(c) gives any incorrect information in relation to any matter or thing affecting his own liability to tax or the liability of any other person;
	(d) fails to comply with the requirements of a notice given to him under s.51(1) or s.51(2A) (i.e. fails to submit a return by the due date); or
	(e) fails to comply with s.51(2) (i.e. fails to inform the Commissioner of his chargeability for tax).
	provided that no prosecution under s.80(2) or s.82(1) has been instituted in respect of the same facts, shall be liable to be assessed under s.82A to additional tax of an amount not exceeding treble the amount of tax that:
	(i) has been undercharged in consequence of such incorrect return, statement or information, or would have been so undercharged if the return, statement or information had been accepted as correct; or
	(ii) has been undercharged in consequence of the failure to comply with a notice under s.51(1) (i.e. return of property tax, salaries tax, profits tax or Composite Tax Return) or s.51(2A) (i.e. personal assessment return) or failure to comply with s.51(2) (i.e. fails to notify the Commissioner his chargeability for tax), or which would have been undercharged if such failure had not been detected.

Source: HKICPA Module D Learning Pack p. 60

Key concept for Q1 FC Asia Ltd (Dec 2014 Q4)

S.80(1)	S.80(2)	S.82(1)	S.82A
For offences without a reasonable excuse.	For offences without a reasonable excuse.	For wilful evasion cases.	For offences without a reasonable excuse.
Covers most non-compliance offences not involving tax undercharged.	Covers non-compliance offences (no return/late return/incorrect return/failure to inform chargeability for tax) involving tax undercharged.	Covers incorrect return involving tax undercharged.	Covers non-compliance offences (no return/late return/incorrect return/failure to inform chargeability for tax) involving tax undercharged.
Civil proceeding.	Civil proceeding.	Criminal proceeding.	Administrative penalty. No legal proceeding either before or after the additional tax.
Taxpayer to prove, on balance of probability.	Taxpayer to prove, on balance of probability.	Prosecutor to prove, beyond reasonable doubt.	Taxpayer to prove, on balance of probability.
Penalty assessed by Court.	Penalty assessed by Court.	Penalty assessed by Court.	Additional tax raised by the Commissioner or a Deputy Commissioner personally.
S.80(1)	**S.80(2)**	**S.82(1)**	**S.82A**
Penalty: a fine at level 3.	Penalty: a fine at level 3 and ≤ 300% of tax undercharged or would have been undercharged.	Penalty: on summary conviction: a fine at level 3 and ≤ 300% of tax undercharged or would have been undercharged and six months' imprisonment; On indictment: a fine at level 5 and ≤ 300% of tax undercharged or would have been undercharged and three years' imprisonment.	Penalty: additional tax not exceeding 300% of tax undercharged or would have been undercharged.
Appeal to Court.	Appeal to Court.	Appeal to Court.	Appeal to Board of Review.

Source: HKICPA Module D Learning Pack p. 61-62

Answer to Q1 FC Asia Ltd (Dec 2014 Q4)

(a)

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

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

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

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

Answer to Q1 FC Asia Ltd (Dec 2014 Q4)

(b)

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

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

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

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

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

Part B: Profits Tax

Q2 D Ltd (Jun 2014 Q7)

(12 marks – approximately 22 minutes)

D Limited commenced business on 1 October 2010 and closed its accounts on 31 December. The first and second accounts of D Limited were closed on 31 December 2011 and 31 December 2012 respectively.

On 1 January 2011, D Limited entered into a hire purchase agreement to acquire a lorry. The total price of the lorry was HK$640,000, including the cash price of HK$520,000 and interest of HK$120,000. The agreement provided that a down payment of HK$40,000 was payable upon the execution of the agreement and the balance to be paid by 24 instalments of HK$25,000. The first instalment was payable on 31 January 2011 and the remaining 23 instalments were payable on the last day of the following calendar month. Each instalment included capital repayment of HK$20,000 and interest of HK$5,000.

Required:

(a) Determine, with explanation in support, the basis periods of D Limited for the years of assessment 2010/11, 2011/12 and 2012/13.

(7 marks)

(b) Compute the depreciation allowance in respect of the lorry for the years of assessment 2011/12 and 2012/13.

(5 marks)

Examiner's comment

Question (a)
This question required candidates to determine the basis periods for which D Limited would be assessed for profits tax upon its commencement of business.

Performance: Very satisfactory
- could apply s18C(1)(b) of the IRO and apportion the first accounting period of D Limited into the two basis periods for 2010/11 and 2011/12 accordingly.

Question (b)
This question required candidates to compute the depreciation allowance in respect of a lorry purchased on a hire-purchase basis. It was a straightforward question.

Performance:
- could produce correct computations and scored well accordingly.

Common mistake:
- failed to adopt the cash price of the lorry
- miscomputed the capital repayment for each of the relevant years and thus arrived at incorrect calculations.

Key concept for Q2 D Ltd (Jun 2014 Q7)

Commencement of business

There are three possible cases for the first accounting period:

(a) When the first accounting period is less than or equal to 12 months and ended within the year the business commenced, the basis period for the year of commencement is from the date of commencement to the first accounting date (s.18C(1)(a)).

(b) When the first accounting period is less than or equal to 12 months and ended within the following year, there will not be any basis period for the year of commencement, and the assessable profit for the year of commencement is nil (s.18C(2)).

(c) When the first accounting period is more than 12 months, the basis period for the first two years of the business will be determined at the Commissioner's discretion (s.18C(1)(b)). Usually the basis period for the second year of assessment is a period of 12 months counted backwards from the end of the first accounting period while the basis period for the year of commencement is the remaining accounting period counted from the date of commencement.

Source: HKICPA Module D Learning Pack p. 211

Assets acquired under hire purchase: s.37A

Initial allowance is granted at 60% on the capital portion of instalments made during the basis period: s.37A(1A).

Annual allowance is granted at the appropriate rate (10%, 20% or 30%) on the reducing value (cash price minus initial allowance and annual allowance) of the asset in use at the end of the basis period: ss.37A(2) and (3).

For assets not wholly and exclusively used for business purpose, both the initial allowance and annual allowance are limited to the portion for business use.

After the lessee exercised the option to acquire the leased asset, the reducing value will be transferred to the relevant pool in the following year of assessment: s.39C(2).

Source: HKICPA Module D Learning Pack p. 195

Answer to Q2 D Ltd (Jun 2014 Q7)

(a)
Year of assessment 2010/11

Basis period: 1 October 2010 to 31 December 2010

Year of assessment 2011/12

Basis period: 1 January 2011 to 31 December 2011

Year of assessment 2012/13

Basis period: 1 January 2012 to 31 December 2012

Explanation

(1) As the first accounts of D Limited were prepared for a period in excess of 12 months and were closed at 31 December 2011 (i.e. within the second year of assessment), by virtue of s.18C(1)(b) of the Inland Revenue Ordinance ("IRO"), the basis period for the year of commencement will be determined at the Commissioner's discretion. In such circumstances, the Commissioner will usually determine the basis period for the second year of assessment as a period of 12 months counted backwards from the end of the first accounts, whilst the basis period for the first year of assessment will be the remaining period counted from the date of commencement.

(2) The second accounts were prepared for 12 months up to a day other than 31 March (i.e. 31 December 2012). By virtue of s.18B(2) of the IRO, the Commissioner will adopt the same accounting period as the basis period for the year of assessment in which such period ends (i.e. 2012/13).

Answer to Q2 D Ltd (Jun 2014 Q7)

(b)

Year of assessment 2011/12	Lorry (30%) HK$	Allowance HK$
Cash price	520,000	
Less: Initial allowance		
[($40,000 + $20,000 x 12) x 60%]	168,000	168,000
	352,000	
Less: Annual allowance		
($352,000 x 30%)	105,600	105,600
Written down value c/f	246,400	273,600
Year of assessment 2012/13		
Written down value b/f	246,400	
Less: Initial allowance		
($20,000 x 12 x 60%)	144,000	144,000
	102,400	
Less: Annual allowance		
($102,400 x 30%)	30,720	30,720
Written down value c/f	71,680	174,720

Part C: Salaries Tax, Property Tax and Personal Assessment

Q3 Mr. Hung (Dec 2014 Q7)

(14 marks – approximately 25 minutes)

Mr. W.S. Hung is an independent tax consultant running his sole proprietor business namely WS Hung & Co. Recently, Mr. Hung received the following enquiries from his clients:-

(i) A senior insurance agent would like to claim deduction of entertainment expenses incurred exclusively with his clients in the course of discharging his duties for generating commission income.

(ii) A finance manager of a listed company would like to claim deduction of his MBA programme tuition fee organised by an overseas university through online learning.

Required:

(a) Discuss the eligibility of the deduction claims from the salaries tax perspective in the context of the IRO.

(11 marks)

(b) What ethical principles should Mr. Hung consider in the course of providing the tax advisory services?

(3 marks)

Examiner's comment

Question (a)
This question required the candidates to discuss the deductibility of specific expenses in the context of IRO.

Deduction claim for entertainment expenses
Performance: Fair
- could refer to the relevant provision in the IRO when assessing the respective deductibility.
- could comprehensively elaborate on the provision in detail, and apply the principles to assess the issues as identified in the question.

Self-education expenses deduction claim
Performance: Satisfactory
- could correctly cite the provision in the IRO to assess the deduction claim, and were able to elaborate on the specific details which critically qualified for the claim.

Question (b)
This question required the candidates to discuss the ethical principles of a tax representative in providing tax advisory services.

Performance: Fair
- able to identify the respective fundamental principles.

Key concept for Q3 Mr. Hung (Dec 2014 Q7)

Outgoings and expenses

The test for deductibility is much stricter in salaries tax than in profits tax. In order to be qualified for deduction, the expenditure must satisfy each of the following tests in addition to not being expenditure of a domestic, private or capital nature:

- It must have been 'incurred';
- It must have arisen 'wholly and exclusively' in the production of the income; and
- It must have been 'necessary' in the production of the income.

The test of necessity is stringent. In DIPN No. 9 (Revised), the basic test is stated by the IRD as 'whether the expenditure is vital to the employment to the extent that it would not be possible for the taxpayer to produce the income from the employment without incurring that expenditure'.

On the other hand, the IRD has indicated that it would not interpret the words of 'wholly' and 'exclusively' too narrowly. Apportionment could be allowed on an expenditure incurred for dual purposes and the part attributable to the employment would be allowed for deduction, provided the other tests are satisfied.

Source: HKICPA Module D Learning Pack p. 381

Entertainment expenses

The claimant is expected to be able to show that any expenditure claimed was necessarily incurred and that it would not have been possible to have produced the income from the employment without incurring such expenditure. Mere social entertaining would be debarred as not being "wholly and exclusively incurred". Any entertaining must be shown to have been necessarily incurred directly as part of business negotiations and records kept should not only give details of the cost and the names of the persons entertained but the nature of the business in question. It goes without saying that the excess of any round sum entertainment allowance over admissible entertainment expenses incurred is assessable as income from an office or employment.

Source: DIPN 9 (Revised) p. 5

Key concept for Q3 Mr. Hung (Dec 2014 Q7)

Self education expenses

The maximum amount allowable for self-education expenses is $80,000 with effect from the year of assessment 2013/14, as specified in Schedule 3A of the IRO.

Key terms

Expenses of self-education mean expenses paid by the taxpayer as:

(i) fees, including tuition and examination fees, in connection with a prescribed course of education undertaken by the taxpayer; or

(ii) fees in respect of an examination set by education provider, or by a trade, professional or business association for its members, and undertaken by the taxpayer to gain or maintain qualifications for use in any employment,

but does not include:

(i) expenses for which a deduction is allowable or has been allowed to the taxpayer in any year of assessment under any other provision of the IRO; or

(ii) expenses to the extent to which they have been reimbursed or are reimbursable to the taxpayer by his employer or any other person unless the reimbursement has been or will be included in the assessable income of the taxpayer.

Prescribed course of education means a course undertaken to gain or maintain qualifications for use in any employment and being:

(i) a course of education provided by an education provider;

(ii) a training or development course provided by a trade, professional or business association; or

(iii) a training or development course accredited or recognised by an institution specified in Schedule 13 of the IRO (commencing from 1 April 2004).

Education provider means:

(i) a university, university college or technical college;

(ii) a place of education to which the Education Ordinance (Cap. 279) does not apply by virtue of s.2 of that Ordinance;

(iii) a school registered under s.13(a) of the Education Ordinance (Cap. 279);

(iv) a school exempted from registration under s.9(1) of the Education Ordinance (Cap.279);

(v) an institution approved by the Commissioner for the purposes of s.16C; or

(vi) an institution approved by the Commissioner.

Source: HKICPA Module D Learning Pack p. 382

Key concept for Q3 Mr. Hung (Dec 2014 Q7)

s.430 "Ethics in Tax Practice"

430.2 A member rendering professional tax services is entitled to put forward the best position in favour of his client, provided he can render the service with professional competence, it does not in any way impair his standard of integrity and objectivity, and is in his opinion consistent with the law. He may resolve doubt in favour of his client if in his judgment there is reasonable support for his position.

430.3 A member should not hold out to clients the assurance that the tax return he prepares and the tax advice he offers are beyond challenge. Instead, he should ensure that his clients are aware of the limitations attaching to tax advice and services so that they do not misinterpret an expression of opinion as an assertion of fact.

430.4 A member who undertakes or assists in the preparation of a tax return should advise his client that the responsibility for the content of the return rests primarily with the client. The member should take the necessary steps to ensure that the tax return is properly prepared based on the information received from the client.

430.5 Tax advice or opinions of material consequence given to a client should be recorded either in the form of a letter to the client or in a memorandum for the files.

430.6 A member must not associate himself with any return or communication which he has reason to believe:

(a) contains a false or misleading statement;
(b) contains statements or information furnished by the client recklessly or without any real knowledge of whether they are true or false; or
(c) omits or obscures information required to be submitted and such omission or obscurity would mislead the Inland Revenue Department.

If any of the above situations prevails, the member's responsibility is to resign from acting as the client's tax representative. Having resigned the member should:

(a) inform the Inland Revenue Department that he has withdrawn his services.
(b) give no further information to the authorities without the consent of the client, unless required to do so by law.

430.7 A member may prepare tax returns involving the use of estimates if such use is generally acceptable or if it is impractical under the circumstances to obtain exact data. When estimates are used, they should be presented as such in a manner so as to avoid the implication of greater accuracy than exists. The member should be satisfied the estimated amounts are reasonable under the circumstances.

430.8 In preparing a tax return, a member ordinarily may rely on information furnished by his client provided that the information appears reasonable. Although the examination or review of documents or other evidence in support of the client's information is not required, the member should encourage his client to provide such supporting data, where appropriate.

Key concept for Q3 Mr. Hung (Dec 2014 Q7)

In addition, the member:

(a) should make use of his client's returns for prior years whenever feasible.

(b) is required to make reasonable inquiries where the information presented appears to be incorrect or incomplete.

430.9 The member's responsibility when he learns of a material error or omission in a client's tax return of a prior year (with which he may or may not have been associated), or of the failure of a client to file a required tax return, is as follows:

(a) He should promptly advise his client of the error or omission and recommend that the client make disclosure to the Inland Revenue Department. Normally, the member is not obligated to inform the Inland Revenue Department, nor may he do so without his client's permission.

(b) If the client does not correct the error:

(i) the member should inform the client that he cannot act for him in connection with that return or other related information submitted to the authorities;

(ii) the member should consider whether continued association with the client in any capacity is consistent with his professional responsibilities;

(iii) and if the member concludes that he can continue with his professional relationship with the client, he should take all reasonable steps to assure himself that the error is not repeated in subsequent tax returns.

(c) If because of the error or omission, the member ceases to act for the client, in these circumstances, the member should advise the client of the position before informing the authorities of his having ceased to act and should give no further information to the authorities without the consent of the client, unless required to do so by law.

Source: HKICPA Module D Learning Pack p. 638-639

Answer to Q3 Mr. Hung (Dec 2014 Q7)

(a)

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

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

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

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

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

Answer to Q3 Mr. Hung (Dec 2014 Q7)

(b)

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

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

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

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

Part D: Stamp Duty

Q4 E Ltd (Jun 2014 Q8)

(25 marks – approximately 45 minutes)

Discuss the implications of profits tax, salaries tax, property tax, personal assessment and stamp duty (including special stamp duty), where applicable, in each of the following scenarios (Note: No tax computation is required.):

(a) On 1 February 2012, E Limited entered into an agreement to purchase a shop from F Limited. As a confirmor, E Limited entered into an agreement to sell the shop to G Limited at profits on 15 July 2012. By an assignment dated 15 October 2012, the shop was assigned by F Limited to G Limited. E Limited was incorporated on 1 January 2012 and was wholly financed by the contributions of its two shareholders. It became dormant after the completion of the above property transaction.

(7 marks)

(b) Mr. H and his wife, Ms. I, are retirees. The couple entered into an agreement to purchase a residential flat as joint tenants on 1 January 2012. The couple arranged a mortgage loan to finance 30% of the consideration, whilst the remainder was settled by the couple's own savings. The flat was let out after the completion of the transaction. Pursuant to a Compulsory Sale Order granted by the court under the Land (Compulsory Sale for Redevelopment) Ordinance (Cap. 545), Mr. H and Ms. I entered into an agreement to sell the flat at a profit on 1 June 2013.

(11 marks)

(c) Mr. J had a residential flat which was inherited in accordance with the will of his deceased father on 1 April 2012. He subsequently entered into an agreement to sell the flat to Mr. K on 31 December 2012. Upon assignment on 1 April 2013, Mr. K admitted his nephew, Mr. L, as a joint tenant of the flat. Mr. K and Mr. L are both salary earners. They arranged a mortgage loan to finance the acquisition of the flat and used the flat as their residence.

(7marks)

Examiner's comment

Question (a)
This question was set in the context of a confirmor sale of property and candidates were required to analyze the related profits tax and stamp duty implications.

Performance:
Profits tax
- could point out that E Limited would be regarded as having traded in the shop because of the short period of holding.
- mentioned that the company had become dormant after the sale of the shop and that it did not have the financial capability of holding the shop on a long-term basis in their analyses.

Stamp duty
- could correctly state that the assignment of the shop was a chargeable instrument
- state that special stamp duty (SSD) was not applicable to non-residential properties.

Question (b)
This question involved a married couple having sold a residential flat which had been used for letting pursuant to a compulsory sale order. Various stamp duty, profits tax, property tax and stamp duty issues were involved.

Performance: Satisfactory
- could recognize that the agreements for sale were chargeable with stamp duty
- recognize that SSD was not applicable because of the compulsory sale order.
- able to conclude that the sale of the flat was not subject to profits tax.
- not have any difficulty in considering the property tax chargeability and the advantages for personal assessment election.

Common mistake:
- only state the most apparent reason, i.e. involuntary sale, to support their conclusion without considering other factors such as the letting of the flat before sale and the couple's financial capability to hold the property.
- mixed up the deductions of interest payable under personal assessment and home loan interest.
- the flat had been used for letting, the couple were not eligible for any deduction of home loan interest.

Question (c)

This question was based on a scenario where a residential flat was inherited by Mr. J from his father's estate, and was subsequently sold to Mr. K, who in turn added his nephew, Mr. L, as a joint owner upon taking assignment. The stamp duty implications were rather complicated.

Performance: Satisfactory

- mentioned that the agreement for sale of the flat to Mr. K was not chargeable with SSD.
- able to conclude that Mr. J would not be chargeable to profits tax in respect of the sale of the flat as the flat was acquired from an estate,
- able to conclude that Mr. K and Mr. L would be entitled to home loan interest deduction because of their use of the flat for residence.

Common mistake:

- not correctly state how stamp duty would be charged on the assignment to Mr. K and Mr. L,
- not recognize that SSD was also chargeable on this instrument.

Key concept for Q4 E Ltd (Jun 2014 Q8)

Special Stamp Duty

With effect from 20 November 2010, unless the transaction is exempted from Special Stamp Duty (SSD) or SSD is not applicable, any residential property acquired on or after 20 November 2010, either by an individual or a company (regardless of where it is incorporated), and resold within 24 months (the property was acquired on or after 20 November 2010 and before 27 October 2012) or 36 months (the property was acquired on or after 27 October 2012), will be subject to SSD.

Holding period	The property was acquired on or after 20 November 2010 and before 27 October 2012	The property was acquired on or after 27 October 2012
6 month or less	15%	20%
More than 6 months but for 12 months or less	10%	15%
More than 12 months but for 24 months or less	5%	10%
More than 24 months but for 36 months or less	–	10%

Source: HKICPA Module D supplementary note p. 4

Key concept for Q4 E Ltd (Jun 2014 Q8)

Exemption from Special Stamp Duty

(a) Nomination of a close relative (a parent, spouse, child, brother or sister) to take up the assignment of a residential property under an AFS (i.e. the assignment is treated as "in confirmatory with" an AFS). The IRD has indicated that it will accept persons who are blood-related, half-blood related, adopted or step-related (SOIPN 5, para 32(a));

(b) Sale or transfer of a residential property to a close relative;

(c) Addition/deletion of a name to/from a chargeable AFS or a conveyance on sale of a residential property if the person is a parent, spouse, child, brother or sister of the original purchaser;

(d) Sale, transfer or vesting of a residential property made by the courts or pursuant to a court order (including a compulsory sales order made under the Land (Compulsory Sale for Redevelopment) Ordinance, and a foreclosure order made to a mortgagee, irrespective of whether the mortgagee is a FI within the meaning of s.2 of the IRO), and the residential property was sold to/transferred to or vested in the seller by or pursuant to any decree or order of any court;

(e) Sale or transfer of a residential property that relates to the estate of a deceased person, and sale or transfer of a residential property by a person whose property is inherited from a deceased person's estate or is passed to that person under the right of survivorship;

(f) The residential property sold relates solely to a bankrupt's estate or the property of a company which is being wound up by the court by reason of its inability to pay debts;

(g) Sale of mortgaged properties by a mortgagee which is a FI within the meaning of s.2 of the IRO, or by a receiver appointed by such a mortgagee;

(h) Sale or transfer of a residential property to the Government; and

(i) Sale or transfer of a residential property between associated bodies corporate.

It should be noted that under the above circumstances, only the payment of SSD is exempted; the underlying AFS or transfers remain chargeable AFS or transfers under which the purchasers or transferees 'acquired' the immovable properties. When the properties are further disposed of subsequently, any SSD liability will be determined by reference to such 'acquisition' dates (SOIPN 5, para 33).

Source: HKICPA Module D Learning Pack p. 480

Key concept for Q4 E Ltd (Jun 2014 Q8)

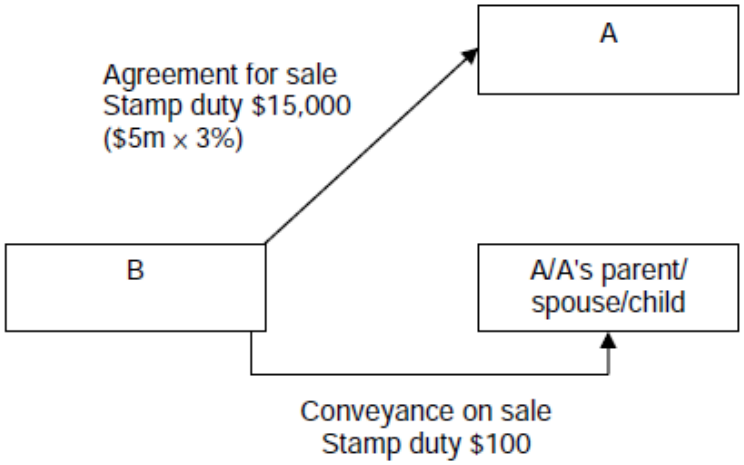
Series of Agreement for sale

In the case of a series of AFS between different parties for the same residential property, stamp duty is chargeable on each of the AFS and the conveyance on sale, resulting in additional costs to the property speculators.

The Stamp Office will pass the information about the speculators to their colleagues in the IRD to consider imposing profits tax on the speculative gains.

Further ad valorem stamp duty is payable if a name is added to or deleted from an AFS. The stamp duty payable is proportional to the share of the ownership change under s.29D(4) and (5). However, a parent, spouse or child of the purchaser will be regarded as the same person as the purchaser (Note 5 to Head 1(1A)); and no further duty is payable.

Example
A signed an AFS to purchase a residential property from B at $5 million, and stamp duty on the AFS was charged at 3% on $5 million. On conveyance, A admitted his parent, spouse and child as joint tenants of the property. In such circumstances, the stamp duty chargeable on conveyance will be $100 as A's parent, spouse and child are deemed to be the same person as A.



If, instead of admitting his parent, spouse and child, A admitted his brother and sister as joint tenants, further ad valorem duty will be payable on the conveyance on sale in the amount of $100,000 ($5 million × 3% × 2/3).

Source: HKICPA Module D supplementary note p. 475-476

Answer to Q4 E Ltd (Jun 2014 Q8)

(a)

Stamp duty

The assignment executed on 15 October 2012 is chargeable with stamp duty under head 1(1) in the First Schedule of the SDO.

Although the shop was sold by E Limited within 24 months after the acquisition, no special stamp duty ("SSD") will be charged as SSD is applicable to residential properties only.

Profits tax

It is likely that E Limited will be regarded as having acquired the shop as trading stock and its profits derived from the sale of the shop will be chargeable to profits tax, having regard to the following circumstances:

(1) E Limited held the shop for a very short period of time. It sold the shop as a confirmor without taking up the assignment.

(2) E Limited is a newly incorporated company and has become dormant since the sale of the shop. It does not appear that the shop was acquired by E Limited for investment or business purposes.

(3) The operation of E Limited was wholly financed by shareholders' contributions. There is no evidence that the company is financially capable of holding the shop on a long-term basis.

In ascertaining the amount of assessable profits, the stamp duty for the purchase of the shop is deductible.

Answer to Q4 E Ltd (Jun 2014 Q8)

(b)

Stamp duty

The agreements for sale executed on 1 January 2012 and 1 June 2013 are chargeable with stamp duty under head 1(1A) in the First Schedule of the SDO.

Although the residential flat was sold by Mr. H and Ms. I within 24 months after the acquisition, no SSD will be charged as the agreement for sale dated 1 June 2013 was made pursuant to a court order: s.29CA(11)(a) of the SDO.

Profits tax

In view of the following circumstances, Mr. H and Ms. I may not be regarded as having acquired the flat as trading stock and thus chargeable to profits tax in respect of the profits derived from the sale of the flat:

(1) Mr. H and Ms. I had used the flat for letting before the sale.
(2) Mr. H and Ms. I should have been financially capable of holding the flat on a long-term basis. The couple could finance 70% of the consideration by their savings. The rental income from the flat should likely provide sufficient means to the couple to repay the mortgage loan.
(3) Mr. H and Ms. I did not sell the flat voluntarily. The sale was made pursuant to the compulsory sale order granted by the court.

Property tax

Mr. H and Ms. I are chargeable to property tax in respect of the rental income from the flat.

In ascertaining the net assessable value of the flat, the stamp duty paid for the purchase of the flat is not deductible.

Personal assessment

Mr. H and Ms. I, being retirees, might not have income other than the rental income from the flat. As such, it is likely that the couple can benefit from the election for personal assessment.

By electing for personal assessment, Mr. H and Ms. I are entitled to married person's allowance. They can also be allowed for deduction of the mortgage loan interest incurred in respect of the flat, limited to the net assessable value of the flat.

Answer to Q4 E Ltd (Jun 2014 Q8)

(c)

Stamp duty

The agreement for sale executed on 31 December 2012 is chargeable with stamp duty under head 1(1A) in the First Schedule of the SDO. Although the residential flat was sold by Mr. J within 24 months after the acquisition, no SSD will be charged as the flat was inherited by Mr. J under the will of his deceased's father: s.29CA(11)(b)(iii) of the SDO.

Provided that the above agreement for sale is duly stamped, the assignment executed on 1 April 2013 will be chargeable with stamp duty under head 1(1) in the First Schedule of the SDO by reference to the consideration less a fraction of the stamp duty representing the proportion of the flat that is vested in Mr. K (i.e. 1/2): s.29D(4) of the SDO. Further, Mr. K will be regarded as having acquired the flat on 31 December 2012 and disposed of 1/2 share of it to Mr. L on 1 April 2013: s.29DA(8) of the SDO. SSD will be charged by reference to the relevant share under head 1(1AA) in the First Schedule of the SDO.

Profits tax

It is unlikely that Mr. J will be chargeable to profits tax in respect of his sale of property as the property concerned has inherited from his father's estate.

Salaries tax

As both Mr. K and Mr. L are salary earners, they will be chargeable to salaries tax in respect of their salary income.

In ascertaining their salaries tax liabilities, Mr. K and Mr. L will each be entitled to deduct 1/2 share of the mortgage interest paid in respect of the flat as home loan interest, subject to the maximum limit in s.26E(2)(a)(ii) and (c) of the IRO.

Part E: Tax planning and Tax investigation

Q5 Mr. Lam (Dec 2014 Q5)

(8 marks – approximately 14 minutes)

Mr. Lam is an experienced accountant who has worked as a Chief Financial Officer in various listed companies in Hong Kong for years. Last month, Mr. Lam resigned from his present employment and established a limited company named AS Consultancy Limited ("ASC") for exploring business opportunities in providing financial consultancy services. Mr. Lam is the sole director and shareholder of ASC.

Recently, Mr. Lam was approached by a Hong Kong company named Full Peak Limited ("FPL") to provide financial consultancy services to its factory located in Thailand. According to the consultancy services agreement recently entered into between ASC and FPL, Mr. Lam is required to travel to Thailand ten to fifteen days per month to provide ad hoc accounting and financial advisory services with respect to the operations of the Thailand factory. Incidental advisory services may also be required when Mr. Lam is in Hong Kong. Consultancy fee income will be received by ASC from FPL on a quarterly basis.

Required:

(a) Discuss the relevant specific anti-avoidance provisions in the IRO and the applicable principles adopted by the IRD in assessing whether the income of ASC is deemed as the employment income of Mr. Lam under the "Service Company Type I" arrangement.

(5 marks)

(b) Discuss the possible pro-active action available to ASC to ascertain if the abovesaid specific anti-avoidance provisions against "Service Company Type I" arrangement in the IRO are not applicable to ASC.

(3 marks)

Examiner's comment

Question (a)
This question required the candidates to identify and apply specific anti-avoidance provisions in the IRO against a Service Company Type I arrangement.

Performance: Satisfactory

- could cite the relevant provision and principles as identified in the respective IRD's Departmental Interpretation and Practice Note in analysing the case and assessing the applicability of the respective provision.

Question (b)
This question required the candidates to discuss the availability of an advance ruling to ascertain the applicability of the specific anti-avoidance provision against a Service Company Type I arrangement.

Performance: Below expectation

Common mistake:

- not able to understand the requirements of the question and accordingly provided irrelevant answers.
- wrongly included the answer in tackling Question 5(a) instead, which for the most part could not be accepted as properly addressing the question.

Key concept for Q5 Mr. Lam (Dec 2014 Q5)

Section 9A – Remuneration under certain agreements treated as income derived from an employment of profit

Section 9A was enacted in 1995 to deter the use of 'Type I' service companies and trusts to disguise the true employer-employee relationship. The use of Type I service company involves an individual providing his services through a company which he (or his associate) controls, a trust of which he (or his associate) is a beneficiary or a company controlled by such trust. The individual obtains tax benefits through being able to structure employment contracts in a more tax efficient manner than was offered by his employer.

With effect from 18 August 1995, s.9A(1) applies when:
(a) there is an agreement (verbal or written);
(b) services have been carried out under the agreement by an individual (the 'relevant individual') for the 'relevant person' or any other person; and
(c) remuneration for the services has been paid or credited to a corporation or trustee controlled by the relevant individual (directly or indirectly through his associate or trustee).

Where s.9A applies:
(a) remuneration for the services are deemed to be income derived by the service provider (the relevant individual) from employment and chargeable to salaries tax;
(b) the relationship between the payer (the relevant person) and the service provider is treated as employer-employee; and
(c) the payer (the relevant person) must comply with the filing obligations as an employer.

To avoid double taxation, where s.9A(1) applies:
(a) payment received by the service company or trust is exempt from profits tax; and
(b) salary paid by the service company or trust to the individual is exempt from salaries tax.

Section 9A(1) shall not apply if:
(a) all the specified criteria laid down in s.9A(3) are satisfied; or
(b) the Commissioner exercises his discretion under s.9A(4) that s.9A should not apply when he is satisfied that at all relevant times the carrying out of the services did not, in substance, amount to the holding of an office or employment of profit by the relevant individual with the relevant person (s.9A(4) clearance). The Commissioner will consider if an employment exists by applying the control test, the integration test, the economic reality test and the doctrine of mutuality of obligation (see chapter 5, section 2.2 on 'Employment' and DIPN 25, para 41 – 44 for a discussion of the tests and the doctrine).

Key concept for Q5 Mr. Lam (Dec 2014 Q5)

The six criteria under s.9A(3) are as follows:

1) the agreement does not provide for employment-type fringe benefits (including money in lieu thereof), e.g. annual leave, sick leave, medical benefits etc.;
2) the relevant individual also provides the same or similar services to other persons;
3) there is no control or supervision of a kind commonly exercised by an employer;
4) the remuneration is not paid or credited periodically or calculated on a basis commonly used in employment contracts;
5) the relevant person has no right to dismiss the relevant individual as if he is an employee; and
6) the relevant individual is not held out to the public to be an officer or employee of the relevant person.

Source: HKICPA Module D Learning Pack p. 532-533

Answer to Q5 Mr. Lam (Dec 2014 Q5)

(a)

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

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

(a) there is an agreement;

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

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

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

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

Answer to Q5 Mr. Lam (Dec 2014 Q5)

(b)

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

Part F: Tax compliance, Tax advisory and Double Taxation

Q6 A Ltd (Jun 2014 Q6)

(13 marks – approximately 23 minutes)

A Limited is a company incorporated and listed in Hong Kong. At all relevant times, A Limited traded actively in listed shares in Hong Kong. To finance the share dealing and investment activities, A Limited placed deposits with the Hong Kong branch of Bank C as security for a back-to-back loan. The deposits were usually rolled over automatically without much management.

For the year ended 31 March 2013, the turnover of A Limited consisted of bank interest income, gains on disposal of and dividend income from the listed shares. A Limited also received dividend from B Limited, a wholly-owned subsidiary incorporated in the Mainland of China ("the Mainland"). A Limited did not have its own establishment in the Mainland.

Recently, the Mainland tax authority has carried out an investigation into the tax affairs of B Limited. In this regard, the Hong Kong Inland Revenue Department ("IRD") has been requested by the Mainland tax authority to provide certain information in relation to the dealings between B Limited and A Limited.

Required:

(a) Discuss whether the placing of deposits by A Limited with Bank C constitutes a carrying on of business in Hong Kong.

(3 marks)

(b) Evaluate whether and if so, how A Limited is chargeable to any tax in the Mainland in respect of the dividend income from B Limited.

(3 marks)

(c) State the factors which the IRD will consider when processing the request for information lodged by the Mainland tax authority.

(7 marks)

Examiner's comment

Question (a)
This question required candidates to analyze whether A Limited had carried on a business by placing deposits to secure a loan for its share dealing activities in Hong Kong.

Performance:
- could identify the relevant authority, CIR v Bartica Investment Limited 4 HKTC 129.

Common mistake:
- not able to anaylze whether the activities of A Limited had gone beyond mere passive acquiescence and were sufficient to constitute carrying on business.
- misunderstood the question and discussed the source of the interest income received by A Limited.

Question (b)
This question tested candidates' knowledge about A Limited's exposure to Mainland tax in respect of its dividend income from B Limited.

Performance:
- As for the tax rate, many candidates could correctly state it as 5%.

Common mistake:
- not discuss the tax residency of A Limited in the Mainland
- merely stated that the dividend income was subject to Mainland Corporate Income Tax on a withholding basis.
- not able to point out that a reduced rate was applicable due to the safe-harbour rule.

Question (c)
This question required candidates to list out the factors which the IRD would consider in processing a request for the exchange of information from another tax authority.

Common mistake:
- Not describe properly the relevant factors which were all listed in DIPN 47
- misread the question and discussed how IRD should gather the requested information, the antitax avoidance provisions or other Hong Kong tax administration matters.

Key concept for Q6 A Ltd (Jun 2014 Q6)

Business

Where trade and profession are normally associated with some active function, the wider term business includes those circumstances where there is a purely passive receipt of income. Whether the passive receipt of interest by a company constitutes the carrying on of a business depends on the facts of each particular case. In DIPN 13 (para 5), the IRD states that:

(a) The mere receipt of interest by a company does not constitute the carrying on of a business;
(b) Actions that go beyond "mere passive acquiescence" may constitute the carrying on of a business;
(c) A period of inactivity does not rebut the fact that a company is still carrying on a business.

In CIR v Bartica Investment Ltd [(1966) 4 HKTC 129], the company placed deposits with financial institutions ('FIs') as security for back-to-back loans, held investments and purchased shares in a listed Hong Kong company. It was held that the company carried on a business in Hong Kong. Its principal on-going activity of placing deposits and furnishing securities was, of itself, sufficient to constitute carrying on a business, i.e. its activities had gone beyond "mere passive acquiescence".

The case turned on its own facts and can be distinguished from situations involving the mere passive receipt of interest.

Source: HKICPA Module D Learning Pack p. 99

Key concept for Q6 A Ltd (Jun 2014 Q6)

Mainland-HKSAR CDTA (Hong Kong Holding Company – Withholding tax)

A Hong Kong company is a preferred choice of special purpose vehicle for foreign investors who would like to make investments into China.

The normal withholding rate (Corporate Income Tax) for dividend, interest and royalty received by foreign enterprises in the Mainland is 10%. However, the withholding tax rate on dividends is reduced from 10% to 5% if the dividends are paid by a Chinese company to its Hong Kong holding company which holds at least 25% of the capital of the Chinese company. 10% rate applies to all other cases.

Under the Mainland – HKSAR CDTA, the withholding tax rate on interest and royalties is reduced from 10% to 7%.

The PRC SAT issued an anti-tax avoidance notice, Guoshuihan [2009] 601, in 2009 setting out guidelines on the interpretation and determination of the term 'Beneficial Owner', which is a prerequisite to enjoying the benefit of a reduced tax rate on passive income such as dividends, interest and royalties under the double tax treaties.

Under Circular 601, an individual, a company or any other organisation can be a beneficial owner if the following requirements are met:

1) The person owns or controls the income, or the assets or rights from which the income is generated;
2) The person is engaged in substantive operational activities, such as manufacturing, distribution, or management; and
3) The person is neither an agent nor a conduit company.

The requirement of substantive operational activities could be a challenge for some offshore holding companies, which have virtually no or very few business activities, other than merely holding and administering lower-tier subsidiaries. These offshore holding companies in current form are unlikely to qualify as beneficial owners under Guoshuihan [2009] 601.

Guoshuihan [2009] 601 expressly lists the following seven factors, which generally lead to unfavorable results, in determining beneficial owners:

1) The applicant is obligated to pay or distribute all or substantially all the income (e.g. more than 60 percent) to a resident of a third jurisdiction within a prescribed time limit (e.g. 12 months following the receipt of the income);

2) The applicant has no or few business activities, other than holding the assets or rights from which the income is generated;

3) Where the applicant is a company or other entity, its size in terms of assets, scale and number of employees is disproportionately small relative to the amount of income;

4) The applicant has no or few rights to control or dispose of the assets or rights from which the income is generated and bears no or few risks;

Key concept for Q6 A Ltd (Jun 2014 Q6)

5) The treaty partner does not tax the income, exempts the income from tax, or imposes tax on the income at a very low effective rate;

6) For a loan contract from which the interest is generated and paid, the creditor and a third party enter into a back-to-back loan or deposit contract with similar principal amount, interest rate and signing date;

7) For a copyright, patent or technology licensing contract from which the royalty is generated and paid, the applicant and a third party enter into a back-to-back copyright, patent, or technology licensing or transfer contract.

On 29 June 2012, the SAT promulgated Public Announcement No. 30 to provide further guidance on the interpretation and determination of beneficial owners under Guoshuihan [2009] 601.

The salient points of Public Announcement No. 30 are as follows:

1) The existence of one negative factor cannot lead to the conclusion that the applicant is not the beneficial owner of the received income.

2) The absence of the intention of tax avoidance/reduction does not mean the applicant is the beneficial owner.

3) In interpreting factors in Guoshuihan [2009] 601, reference can be made to articles of association, financial statements, cash flow records, board meeting records, board resolutions, asset and personnel status, relevant expenditures, function and risk assumptions, loan agreements, royalty or licence agreements, patent registration certificates, copyright ownership certificates and agency agreements or designated recipient contracts etc.

4) There is a safe-harbour rule – if an applicant in a treaty state receives dividend income out of China, and it is listed on the stock exchange of that state or 100% owned directly or indirectly by another company resident and listed in the same state, and the dividend income is derived from the shares held by that listed company, the applicant can be regarded as the beneficial owner of the dividends received. An indirect ownership through a company in a third jurisdiction does not qualify.

5) If an agent receives income on behalf of the applicant, the beneficial ownership of the applicant shall not be affected by the existence of such an agent, no matter whether the agent is a resident of the contracting state or not.

6) Only the provincial-level tax bureau would have the authority to deny beneficial ownership status.

Source: HKICPA Module D Learning Pack p. 687-689

Answer to Q6 A Ltd (Jun 2014 Q6)

(a)

A Limited placed deposits with Bank C in Hong Kong so as to secure a loan for its share dealing and investment activities in Hong Kong. Following *CIR v Bartica Investment Limited* 4 HKTC 129, such on-going activities went beyond the mere passive acquiescence and were sufficient to constitute carrying on a business in Hong Kong.

(b)

A Limited is a non-PRC tax resident as it was incorporated in Hong Kong with no establishment in the Mainland. Its dividend income from B Limited is subject to Corporate Income Tax on a withholding basis.

As B Limited is the wholly-owned subsidiary of A Limited, pursuant to Article 10 of the Double Taxation Arrangement between the Mainland and Hong Kong, the applicable withholding tax rate is reduced from 10% to 5%. Following the safe-harbour rule promulgated in Public Announcement No. 30, A Limited can be regarded as the beneficial owner of its dividend received from B Limited as A Limited is listed in Hong Kong and the dividend income is derived from its shares in B Limited.

Answer to Q6 A Ltd (Jun 2014 Q6)

(c)

In determining whether the request for information lodged by the Mainland tax authority should be acceded to, the IRD will consider the following factors (see Departmental Interpretation and Practice Notes No. 47):

(1) Whether the request is specific, bona fide and justifiable for the purpose of investigating the tax affairs of B Limited, or merely a speculative one that has no apparent nexus to the investigation.

(2) Whether the requested information is "foreseeably relevant" to secure the correct application of the provisions of the Arrangement or the Mainland tax laws.

(3) Whether the requested information is to be used by the Mainland tax authority for the administration and enforcement of taxes covered by the Arrangement. The information obtained pursuant to the Arrangement cannot be used for non-tax purposes.

(4) Whether the requested information is such that the Mainland Tax authority would be unable to obtain it in the normal course of its administration.

(5) Whether the provision of the requested information would be contrary to any public policy.

(6) Whether the requested information constitutes trade or business secrets of B Limited and/or A Limited.

(7) Whether the requested information is protected by legal professional privilege.

(8) Whether the requesting party is the competent authority of a treaty partner.

Please refer to HKICPA Module D Learning Pack p. 695 for details.

Part G: China Tax System

Q7. Mr. Yip (Dec 2014 Q6)

(16 marks – approximately 29 minutes)

Mr. Yip is a property investor currently owning four properties in Hong Kong held for deriving rental income. The details of the property leasing matters for the year ended 31 March 2013 are as follows:-

Property A

This is a shop purchased by Mr. Yip in early 2011. It was let to a tenant carrying on a stationery retail business on 1 July 2011 on the following terms:

- Term of lease : 3 years from 1 July 2011
- Monthly rental : HK$100,000 payable in advance on the first day of each month
- Premium : HK$120,000 payable on 1 July 2011
- Deposit : HK$200,000 payable on 1 July 2011 and refundable upon completion of the lease
- Rates : HK$6,600 per quarter (after the Rates Concession) payable by Mr. Yip

During the year ended 31 March 2013 there was a water leakage in the shop and the tenant had paid HK$25,000 to fix it. Mr. Yip refused to reimburse the amount to the tenant notwithstanding that Mr. Yip as the landlord is responsible for the cost of repairs and maintenance to the property under the tenancy agreement. Eventually the tenant deducted the repair cost from the rental, and only paid HK$75,000 as rental in December 2012.

Property B

This is a residential flat acquired by Mr. Yip more than 10 years ago. Mr. Yip entered into a new lease contract with a tenant on 1 April 2011 on the following terms:

- Term of lease : 2 years from 1 April 2011
- Monthly rental : HK$18,000 payable in advance on the first day of each month
- Deposit : HK$36,000 payable on 1 April 2011 and refundable upon completion of the lease
- Rates : HK$4,500 per quarter (after the Rates Concession) payable by Mr. Yip

Due to financial difficulties, the tenant has only paid HK$10,000 per month as rental since 1 August 2011, and from 1 May 2012 the tenant did not pay any rent to Mr. Yip at all. The tenant finally moved out from the flat on 1 July 2012 and at the same time Mr. Yip re-occupied the flat and set it aside as vacant. Subsequent to the request made by Mr. Yip, the IRD finally agreed to treat the outstanding debt as irrecoverable bad debt on 1 March 2013.

Properties C & D

Properties C and D are two independent residential flats adjacent to each other under separate deeds. These two properties were purchased from a property developer in September 2012 and, upon the acquisition, Mr. Yip immediately leased these two flats to a tenant under a single tenancy agreement. The details are as follows:

- Term of lease : 1 year from 1 October 2012
- Monthly rental : HK$20,000 in total for both properties payable in advance on the first day of each month
- Deposits : HK$40,000 payable upon commencement of lease and refundable upon completion of the lease
- Rates : HK$3,000 for both properties per quarter (after the Rates Concession) payable by Mr. Yip

In April 2013, Mr. Yip purchased a new flat in Hong Kong for his own residential purpose and at the same time he intended to directly purchase some household furniture from a China manufacturing factory for the new flat. The factory was a general Value-added Tax taxpayer in China. Under the arrangement with the China factory, Mr. Yip was required to pick up the furniture from the China factory and arrange the delivery of the furniture to his new flat in Hong Kong. In this regard, he obtained the quotations from the China factory and a China transportation company which was a Business Tax taxpayer as follows:

- Cost of furniture : RMB100,000
- Cost of delivery : RMB5,000

All prices above are exclusive of China taxes.

Required:

(a) Compute the property tax liabilities of Mr. Yip for the year of assessment 2012/13.

(11 marks)

(b) Discuss the China Business Tax and Value-added Tax exposures in connection with the purchase of furniture from the China factory by Mr. Yip.

(5 marks)

Examiner's comment

Question (a)
Performance: Satisfactory
- able to provide a systematic computation to quantify the property tax liabilities

Common mistake:
- could not correctly work out the irrecoverable bad debts as specified in the question.
- wrongly combined all of the four properties into one computation.
- careless errors were also incidentally found in the computations.

Question (b)
This question required the candidates to generally identify the PRC Value-added Tax ("VAT") and Business Tax ("BT") regimes, and to compute the respective tax liabilities.

Performance: Not satisfactory

Common mistake:
- could not comprehensively discuss the PRC VAT and BT regimes with correct computations of the respective tax liabilities.
- not able to identify that a general consumer in the PRC cannot obtain any input VAT credit and cannot apply for an export VAT refund.

Key concept for Q7 Mr. Lip (Dec 2014 Q6)

Property tax computation

S.5(1A)(b)(i) of the IRO provides that rates are a deductible item whereas s.5(1A)(b)(ii) only allows a deduction of a statutory allowance for repairs and outgoings of 20% of the property's assessable value after deduction of any rates paid by the owner.

According to BOR D71/02, strictly speaking the taxpayer cannot claim a deduction of rates paid during the period in which the property was unoccupied. However, in practice, the IRD would normally, by concession, allow the rates, as long as the taxpayer was actively looking for tenants and the property was rented out during the year.

The following is a general format of a property tax computation:
Note: Actual expenses incurred by the property owner are ignored by statute. Only a notional amount (20% on assessable value less rates) of statutory outgoings is allowable

	$
Consideration receivable	A
Premium (related to that year of assessment)	B
Bad debt recovery	C
	D
Less:	
Bad debts	E
Unrelieved bad debts (brought forward from subsequent year(s) of assessment)	F
Assessable value	G
Less:	
Rates paid by the owner	H
	J
Less:	
Statutory outgoings (20% of J)	K
Net assessable value	L
Tax thereon at standard rate (L × tax rate)	M

Source: HKICPA Module D Learning Pack p. 432-433

Key concept for Q7 Mr. Lip (Dec 2014 Q6)

China Value Added Tax

PRVAT Article 1 provides that all units and individuals engaged in the sale of goods, the provision of processing, repair and replacement services and the importation of goods within the territory of the People's Republic of China are subject to VAT

'Goods' include food grains, edible vegetable oils, tap water, heating, air conditioning, hot water, coal gas, liquefied petroleum, natural gas, methane gas, coal/charcoal products for household use; books, newspapers, and magazines, feeds, chemical fertilisers, agricultural chemicals, agricultural machinery and covering plastic film for farming purposes; other goods specified by the State Council. (PRVAT, Article 2)

The current tax rate of VAT is divided into three classifications:
- lower rate of 13%
- basic rate of 17%; and
- zero rate which only applies to export goods.

The basic tax rate of 17% is imposed on sales or imports of goods (except the goods subjected to lower rate and export goods), and on the taxable services of processing, repair or replacement [PRVAT, Article 2 (1)].

VAT payable = Output VAT – Input VAT
Output VAT = applicable VAT rate (generally 17%) × Sales
Input VAT = VAT paid on purchases

Input VAT paid on purchases of raw materials, fuels and powers such as electricity, heat and gas, low-value and non-durable equipment can be claimed and set off with the output VAT.

Source: HKICPA Module D Learning Pack p. 732-733, 736

Key concept for Q7 Mr. Lip (Dec 2014 Q6)

China Business Tax

According to the Provisional Regulations of Business Tax of the People's Republic of China (PRBT), Article 1, all units and individuals providing prescribed taxable services, transferring intangible assets, or selling immovable properties (together called 'taxable services') within the territory of People's Republic of China are subject to business tax.

The prescribed taxable services include transportation service, construction industry, financial and insurance industry, post and telecommunications industry, culture and sports industry, entertainment industry and certain service industries (like hotel, catering, tourism, storing, leasing, advertising etc.)

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

(a) Tax rate of 3% is applicable to the following:
- Transportation industry
- Construction industry
- Post & telecommunications industry
- Culture and sports industry

(b) Tax rate of 5% is applicable to the following:
- Financial and insurance industry
- Service industry
- Transfer of intangible assets
- Sale of immovable properties

(c) Tax rate of 5%-20% is applicable to the entertainment industry

Source: HKICPA Module D Learning Pack p. 724-725, 729

Answer to Q7 Mr. Lip (Dec 2014 Q6)

(a)

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

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

Answer to Q7 Mr. Lip (Dec 2014 Q6)

Properties C & D

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

Note:

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

Answer to Q7 Mr. Lip (Dec 2014 Q6)

(b)

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

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

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

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

Practice Makes Perfect!

Good luck!

End of Seminar