HKICPA QP
- Module D Taxation
(Case Questions)

June 2012

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## Module D - Taxation

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Case 1 Joseph Chan – QP Dec 2010

Joseph Chan moved to Brazil twenty years ago to work in the family’s restaurant business. The restaurant specialised in Brazilian barbeques. During this time, he invented his own special barbeque sauce. This was used exclusively in his father’s restaurant known as Happy Inn. Last year, his father passed away. He closed down the business and returned to Hong Kong.

On his way back to Hong Kong, Joseph spent a few weeks in London visiting his cousin. His cousin, who is a lawyer, recalled the delicious barbeque sauce at Happy Inn and recommended that Joseph should take necessary legal procedures to register his secret recipe/formula. Joseph accepted his advice and undertook the necessary legal registration procedures and registered his recipe in Country X. The legal owner of this intellectual property is JCo, a company incorporated in Country X, and the shareholders are Joseph and members of the Chan family.

Once Joseph returned to Hong Kong, he set up his own restaurant New Happy Inn. He imported very expensive special ovens and grillers from Brazil. He also engaged a special consultant from Brazil to assist with the installation of the ovens, the consultant also visited Hong Kong on a regular basis to inspect the ovens and conduct regular repairs.

Joseph’s restaurant business was very successful. It became a popular spot for expatriates living in Hong Kong. They found his barbeque sauce unique and tasty. Over time, it was also regarded as one of the tourists’ favorites in Hong Kong.

In order to lure local customers, Joseph modified his recipe and invented a new sauce to cater for the taste of local residents. He also registered his new secret recipe to safeguard his intellectual property rights. Furthermore, he registered the new trade name “New Happy Inn”. These registrations took place in Hong Kong. He incorporated a company “New Happy Inn” in Hong Kong to own the trade name as well as the new recipe.

Some overseas investors learnt about the popularity of New Happy Inn and its famous barbeque sauces. They would like to set up a similar restaurant business in their own jurisdictions and thus they would like to obtain the license to use the trade name New Happy Inn and the old and new recipes.

As his business grew, Joseph travelled to Shanghai and Macau to investigate whether he should set up branches in these cities.
Question 1

(a) Advise Joseph of the tax implications of:

(i) the import of ovens and grillers from Brazil and the engagement of the consultant from Brazil to assist with the installation and regular repairs; and

Answer Plan:

(ii) any other profits tax issues relating to the commencement of business.

Answer Plan:

(12 marks)

(b) Advise Joseph what reporting obligations (both profits tax and salaries tax) that New Happy Inn, as a taxpayer, has to comply with.

Answer Plan:

(7 marks)

Question 2

(a) Joseph noted that he had incurred substantial costs in launching an advertising campaign in Hong Kong. Advise Joseph whether such costs are deductible.

Answer Plan:

(4 marks)

(b) Advise Joseph as to whether the fees incurred in travelling to Shanghai and Macau to explore business opportunities would be deductible.

Answer Plan:

(2 marks)
Question 3

(a) Advise Joseph of the tax implications of the relevant income received by New Happy Inn and JCo when they license the rights to use the trade name and the secret recipes to the overseas investors.

Answer Plan:

(b) What is JCo's tax position if investors in Hong Kong pay JCo for the rights to use the formula in Hong Kong to manufacture and export the sauce to customers in Japan?

Answer Plan:

Question 4

(a) A customer was injured while dining at the restaurant, and took legal actions against New Happy Inn for negligence. The case was settled out of court, and New Happy Inn agreed to pay HK$1 million as compensation. Advise whether such a payment is deductible.

Answer Plan:

(b) Joseph required funds to finance the expansion of his restaurant business in Hong Kong. His uncle in Brazil agreed to lend him US$5 million. He was also able to obtain a loan from a local financial institution. Advise the deductibility of interest payments in respect of the aforementioned loans.

Answer Plan:
Case 1 Answer

(a)

The ovens and grillers are capital assets and the expenditure incurred in acquisition is capital in nature and not deductible under s.17(1)(c) of the Inland Revenue Ordinance (IRO).

However, they could be regarded as “plant and machineries” used in the restaurant business. Hence such ovens and grillers should be entitled to depreciation allowances. (Initial allowance 60%, annual allowance 20%).

The installation cost is not of a recurring nature and is thus a capital expenditure not allowable under s.17(1)(c). Nevertheless, such a cost can be regarded as part of the capital expenditure incurred for the ovens and grillers which are entitled to depreciation allowances. However, annual repair costs are revenue in nature and deductible.

The costs of hiring the consultant to ensure the proper maintenance of the ovens and thus enabling the restaurant business to carry on smoothly and to earn profits should be deductible under s.16(1) of the IRO. However, the portion of consultancy fees attributable to the installation of the equipment may be argued as being part of the installation cost incurred prior to business commencement and thus not deductible under s.17(1)(c).

It is not clear from the facts as to the amount of the costs of expert advice for (1) installation and (2) for regular inspection and repairs. If the terms are clearly set out in the contract between New Happy Inn and the consultant, then the former should not be deductible and the latter deductible. Otherwise, Joseph may need to agree with the Inland Revenue Department (IRD) as to the method for apportioning the costs incurred. Time cost basis may be one acceptable basis to be considered.

Joseph should review all pre-commencement costs such as electricity, lighting, rental, salaries etc. He should distinguish capital expenditure items (such as renovation, chairs, tables and furniture etc) and revenue items. The former would not be deductible under s.17(1)(c). Strictly speaking, revenue expenditures are also not deductible as no revenue was generated during the pre-commencement period. Nevertheless, they may be considered as necessarily incurred to enable New Happy Inn to derive income upon opening. The deductibility of these expenses would be subject to agreement between New Happy Inn and the IRD. In general, it is the IRD’s practice to allow pre-commencement expenses which are revenue in nature in the first basis period.

Comments

Question 1(a) – 12 marks

This question covered the treatment of capital assets and the related installation and repair costs. It also required the candidate to comment on the deductibility of the cost of hiring the consultant. The technical challenge in this question was not only to distinguish the revenue and capital items but also the pre-commencement expenses and comment on the deductibility of the above mentioned items.

Some students performed well but on the whole for this part performance was not satisfactory. It was noted that there were quite a few cases where the candidates misinterpreted the question and wrongly focused on the chargeability to tax of the individual consultant.
(b) S.51(2) of the IRO requires taxpayers to notify the Commissioner if they are chargeable to tax, in writing, no more than four months after the end of the basis period of the relevant year of assessment. Therefore, New Happy Inn should comply with this requirement. New Happy Inn is also required to file profits tax returns within the specified time limit under s.16(1) if the amounts were incurred in the production of chargeable profits.

In support of the profits tax return, New Happy Inn should submit the following:
- signed audited financial statements;
- profits tax computation and supporting schedules; and
- other documents or information as specified in the notes to the return.

As an employer, New Happy Inn is required to furnish the remuneration of its restaurant employees under s.52(2) of the IRO (Forms BIR56A and IR56B). For new employees, it should also notify the Commissioner no later than 3 months after the date of commencement of employment (Form IR56E).

Furthermore, Joseph needs to consider if the contract between New Happy Inn and the consultant is a contract for service or contract of service. Income arising from the former may be subject to profits tax under s.14 as the consulting business/services were carried on/rendered in Hong Kong. If it is the latter, then the consultant is under an employment with New Happy Inn and should be subject to salaries tax.

If the consultant is under a contract of service with New Happy Inn, then the consultant is employed by New Happy Inn. New Happy Inn, being the employer should notify IRD of commencement of employment and chargeability under salaries tax (s.52(2)). New Happy Inn has a duty to inform the Commissioner of the consultant's chargeability to salaries tax.

### Comments

**Question 1(b) – 7 marks**

This question focused on tax administration matters. It also required the candidate to consider if the contract with the consultant was a contract for service or a contract of service and the tax reporting implications thereon. Not many candidates were able to identify these issues. Nevertheless, the overall performance was satisfactory.

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### Question 2(a)

The advertising costs incurred prior to commencement of business would not be deductible as no assessable profits were generated. However, it may be argued that they were incurred to attract customers to the restaurant once it is opened and help the restaurant to generate taxable income and hence deductible under s.16(1). This would be subject to agreement with the IRD.

Advertising costs incurred after commencement of business would be deductible under s.16(1) if the amounts were incurred in the production of chargeable profits.

### Comments

**Question 2(a) – 4 marks**

It was noted that many candidates rightly pointed out that the advertising expense was revenue in nature however they failed to comment on why it is deductible. Showing how the conclusion was arrived at is always more important than just stating the answer.

It was also noted that very few commented on the tax treatment for pre-commencement expenses.
2(b)

Travelling expenses and marketing costs for exploring business opportunities offshore would not be deductible. They are clearly not incurred in the production of assessable profits (s.16(1)) as any income generated will be offshore in nature and not chargeable under s.14.

Comments
Question 2(b) – 2 marks
This question was handled well with satisfactory results. However, many failed to appreciate that expenses incurred for the purpose of looking into offshore business opportunities which generate non-taxable income in the future would not be deductible.

3(a)

The New Trade name “New Happy Inn”

New Happy Inn is chargeable to profits tax under s.14 of the IRO if:
- it carried on a trade, profession or business in Hong Kong;
- the profits to be charged were from such trade, profession or business; &
- the profits were sourced in Hong Kong.

As New Happy Inn carried on business in Hong Kong and the income to be charged was from such business, New Happy Inn would be chargeable to profits tax under s.14 if the income was sourced in Hong Kong.

To determine the source of profits, the broad guiding principle is:

“What the taxpayer has done to earn the profit in question and where he has done it.” (Hang Seng Bank case or HK-TVBI case)

Furthermore, according to Departmental Interpretation and Practice Notes No.21 (Revised), paragraph 45(g), the source of royalty income (other than those deemed chargeable under ss.15(1)(a), (b) and (ba)) should be determined by the place of acquisition and granting of the licence or right to use.

As the trade name was established and developed in Hong Kong through the opening and operation of the New Happy Inn restaurant in Hong Kong, and the licensing agreement granting the right to use the trade name is likely to be negotiated and concluded in Hong Kong, the royalty income should be sourced in Hong Kong and chargeable to profits tax under s.14 of the IRO.

Withholding taxes incurred offshore should be deductible as expenses incurred in the production of assessable profits.

The New Recipe

Similarly, as the recipe was invented in Hong Kong and registered in Hong Kong and the licensing agreement granting the right to use the recipe is likely to be negotiated and concluded in Hong Kong, the royalty income should be sourced in Hong Kong and chargeable to profits tax under s.14 of the IRO. In addition, withholding taxes incurred overseas should also be deductible.
The Old Recipe

JCo is the legal owner of the old recipe. As JCo does not carry on a business in Hong Kong, it should not be subject to Hong Kong profits tax as the first of the 3 conditions under s.14 has not been met.

However, the royalty income received by JCo may be deemed to be chargeable to Hong Kong profits tax under s.15(1)(b) if the use or right to use the intellectual property was in Hong Kong.

In this case, as the old recipe was developed in Brazil and the overseas investors intended to use the old recipe in their own jurisdiction (outside Hong Kong), s.15(1)(b) would not apply and the royalty income on the old recipe should not be chargeable to Hong Kong profits tax.

Comments
Question 3(a) – 15 marks
This question required the candidate to comment on the tax treatment of the income derived from intangible assets such as the New Trade Name, the New Recipe and the Old Recipe.
First of all, this question required the candidate to study the question carefully and to identify the relevant facts. Those who performed well were able to demonstrate an application of the tax rules to the relevant facts and provide comments on the relevant charging section and the tax implications.
This question revealed that many candidates were not able to distinguish the charging sections relating to royalty income earned by a HK resident and that of a non-resident. Similarly, many failed to distinguish the application of s.15(1)(b) and (ba).

3(b)

Pursuant to s.15(1)(b) of the IRO, any sum, not otherwise chargeable to profits tax, received by or accrued to a person for the use of or right to use in Hong Kong a patent, design, trademark, copyright material, secret process or formula or other property of a similar nature, or for imparting or undertaking to impart knowledge directly or indirectly connected with the use in Hong Kong of the aforesaid intellectual properties shall be deemed to be receipts arising in or derived from Hong Kong from a trade, profession or business carried on in Hong Kong.

By virtue of s.15(1)(b) and s.21A of the IRO, JCo will therefore be subject to profits tax on 30% of the royalty income earned during the year under review. The local investors who are carrying on the manufacturing operations in Hong Kong are required to withhold tax and file returns (BIR 54) for JCo.

Comments
Question 3(b) – 5 marks
Candidates were able to demonstrate their knowledge of withholding tax obligations under the IRO. However, many failed to point out that local investors who are carrying on the manufacturing operations in Hong Kong are required to withhold tax and file returns for JCo.
4(a)

One may argue that such payments are deductible for the following reasons:
(1) Incurred in the ordinary course of business.
(2) If not settled out of court, may bring about bad publicity and affect the income earning operation, thus the said sum should be deductible.

It may also be challenged as a once and for all payment which brings about an enduring benefit to New Happy Inn and thus is capital in nature and not deductible. New Happy Inn may need to negotiate with the IRD for this tax deduction claim.

**Comments**

**Question 4(a) – 2 marks**
This question concerned a compensation payment to an injured customer.
This question allowed the candidate to comment on whether this was a capital payment bringing about an enduring benefit and thus capital in nature or whether it was an expense incurred in the ordinary course of business.
It was noted that many candidates did not attempt this question even though it was a relatively simple one.

4(b)

Interest payments to uncle
As Joseph’s uncle is not subject to tax in Hong Kong, the conditions in s.16(2)(c) are not satisfied, therefore the interest payments will not be deductible.

Interest payments to local financial institutions
Interest on a loan used to finance business operations and not to finance capital expenditures should be deductible as conditions in s.16(1)(a) and s.16(2)(d) are satisfied.

However, if the loan is used to finance the expansion overseas, the interest is not deductible irrespective of whether the expenditure is of a capital nature or not as the income derived will not be chargeable to profits tax.

**Comments**

**Question 4(b) – 3 marks**
This was a rather simple case regarding the deductibility of interest payments to (1) a relative overseas and (2) to a local financial institution and required candidates to apply s.16(2)(c) and (d). Those who performed well clearly identified the above as well as pointing out that interest expenses incurred for financing overseas expansion would not be deductible.
Case 2 A Limited – QP Jun 2011

A Ltd. was a leading supplier of audio and visual equipment in Hong Kong. In the early nineties, A Ltd. closed its factory in Hong Kong and subcontracted the manufacturing process to four unrelated contractors in mainland China (“the Mainland”). Whilst the company had its own representative office in the Mainland to liaise with the contractors, it did not involve itself in the production work. In Hong Kong, A Ltd. maintained a sales department to solicit orders from customers and a merchandising department to source raw materials and arrange shipments of them as well as the finished products. Most of its directors also stationed themselves in Hong Kong to manage the daily operation of the company.

All along A Ltd. had been assessed as per its profits tax returns without query, until recently when the Inland Revenue Department (IRD) commenced an audit on the tax affairs of A Ltd. for the years of assessment 2008/09 to 2010/11. Upon a review of the relevant documents and records for 2 months, the Assessor revealed the following:

(a) A Ltd. claimed that half of its profits were derived from the manufacturing activities outside Hong Kong. It also claimed depreciation allowance in respect of the plant and machinery which had been provided to the Mainland contractors for production without consideration.

(b) One of the audio and visual products sold by A Ltd. involved a patented technology held by B Inc., a U.S. company which had no relationship with A Ltd. and did not carry on any business in Hong Kong. During the relevant years, A Ltd. paid substantial royalties in respect of the technology and charged the payments in its accounts. It did not, however, report to the IRD the receipt of royalties by B Inc.

(c) An item under the label of “China Tax” was charged in the profit and loss account for the year ended 31 December 2008. A Ltd. asserted that the item represented the business tax paid in respect of the sale of an office unit by its representative office in the Mainland.

(d) In December 2010, A Ltd. purchased a shop for investment at HK$20,000,000 and paid stamp duty accordingly. Notwithstanding the lack of relationship between A Ltd. and the seller, due to the serious cash flow problem of the seller, the sale price of the shop was found to be 20% less than the then market value.

(e) Mr. D was a manager employed by A Ltd. in Hong Kong. During the relevant years, he was seconded to work for the Mainland representative office. Notwithstanding this, he remained under the payroll in Hong Kong and was required to return to Hong Kong two days a week to attend to business matters. Mr. D paid Individual Income Tax (“IIT”) in the Mainland and was provided with a 1-room serviced apartment in the Mainland as free residence. As the residence provided was outside Hong Kong, A Ltd. did not report such housing benefit to the IRD.
Question 1

Evaluate the following claims of A Ltd.:

(a) half of its profits were derived outside Hong Kong.

Answer Plan:

(b) it was entitled to depreciation allowance in respect of the plant and machinery used by the Mainland entities.

Answer Plan:

(c)

(i) it was required to pay business tax in respect of its sale of an office unit in the Mainland; and

Answer Plan:

(ii) the business tax so paid was deductible under profits tax in Hong Kong.

Answer Plan:

Question 2

Discuss whether A Ltd. has acted properly under the Inland Revenue Ordinance (IRO) in respect of:

(a) the royalty payments to B Inc.

Answer Plan:
(b) the place of residence provided to Mr. D in the Mainland.

Answer Plan:

(3 marks)

Question 3

Explain the stamp duty implication in respect of the undervalued purchase of the shop by A Ltd.

Answer Plan:

(5 marks)

Question 4

Advise Mr. D:

(a) whether and if so, how he is exempt from salaries tax for the relevant years.

Answer Plan:

(11 marks)

(b) whether and if so, how the place of residence provided to him in the Mainland is assessable to salaries tax.

Answer Plan:

(5 marks)
Case 2 Answers

1(a)

The profits of A Ltd. may not be accepted as having a source outside Hong Kong because of the following:

The broad guiding principle for determining the source of profits, as explained in CIR v. Hang Seng Bank Limited [1991] 1 AC 306 and further elaborated in HK-TVB International Limited v. CIR [1992] 2 AC 397, is “what the taxpayer has done to earn the profit in question and where he has done it”. In the present case, A Ltd. was engaged in selling audio and visual equipment. Its profit-producing activities included soliciting sale orders from customers, subcontracting the production to the Mainland entities, sourcing raw materials for production and arranging shipments of them and the finished products. As it performed all these operations in Hong Kong, the source of its profits should be in Hong Kong.

No doubt A Ltd. had a representative office in the Mainland to liaise with the contractors there. However, what it did through the representative office was merely antecedent or incidental work, not the effective cause of its profits. On the authority of Kwong Mile Services Limited v. CIR [2004] 3 HKLRD 168, we should not be distracted by such work when determining the source of A Ltd.’s profits.

In Departmental Interpretation and Practice Notes (“DIPN”) No. 21, the IRD made it clear that profit apportionment would not be appropriate if the Hong Kong company had restricted involvement in the processing arrangement with the Mainland enterprise. Here, A Ltd. was not involved in the manufacturing operations in the Mainland, its profits should thus be fully chargeable to profits tax without any apportionment.

Comments
Question 1(a) – 8 marks

This question required candidates to evaluate the source of profits derived by A Ltd from its sale of audio and visual equipment. Although the company engaged Mainland subcontractors to produce the goods and established a liaison office in the Mainland, it was not involved in the production work. Such circumstances were distinct from the typical cross-border processing trade (i.e. contract processing and import processing), to which many candidates directed their discussion in a lengthy manner. The correct approach to answer this question should be to identify the profit-producing activities that A Ltd. carried out (i.e. sourcing sale orders, subcontracting production, sourcing of raw materials) and where those activities were undertaken (i.e. Hong Kong). They should not be sidetracked by any antecedent or incidental work done by the company in the Mainland.

1(b)

S.39E(1)(b)(i) of the Inland Revenue Ordinance (IRO) denies the granting of a depreciation allowance if the plant and machinery concerned was under a lease and they were wholly or principally used outside Hong Kong by a person other than the taxpayer. S.2 of the IRO defines “lease” to include “any arrangement under which a right to use the machinery or plant is granted by the owner of the machinery or plant to another person”.

In D61/08, (2009-10) 24 IRBRD 184, the Board of Review held that s.2 provides a broader meaning to the term “lease” than either its ordinary meaning or its legal definition in land law. An arrangement, which is not in writing and involves no consideration, suffices.
In the present case, A Ltd. provided the Mainland contractors with certain plant and machinery for production in the Mainland. Such an arrangement fell within the definition of “lease” under s.2. As the plant and machinery under that lease were used wholly outside Hong Kong by the contractors, s.39E(1)(b)(i) should be invoked to deny any depreciation allowance claim from A Ltd.

**Comments**  
**Question 1(b) – 4 marks**  
This question tested the candidates’ knowledge about a hot topic with regard to Hong Kong profits tax, i.e. claim for depreciation allowance in respect of the plant and machinery which were provided to the Mainland entity for use without consideration. Many candidates recognised that such an arrangement should be regarded as a lease and the depreciation allowance claim should be rejected pursuant to S.39E of the IRO. They thus scored well in this question.

1(c)

The claim that A Ltd. has paid business tax in respect of its sale of an office unit in the Mainland is acceptable because selling immovable properties within the Mainland is a taxable service subject to business tax: Article 1 of the Provisional Regulations of Business Tax of the People’s Republic of China. The business tax payable should be 5% of the business turnover.

For sale or transfer of immovable properties, the purchase price of the property or land use right can be deducted from the sale consideration in calculating the business tax payable (*Caishui* (2003) 16; *Guoshuihan* (2005) 83).

For a foreign tax to be deductible for profits tax purposes, it must be: (i) a charge on the earnings (rather than on profits) that must be borne regardless of whether or not a profit is derived; and (ii) the earnings on which the tax is imposed should be chargeable to profits tax: see DIPN No.28.

In the present case, the business tax was imposed on the sale consideration of the office unit only if A Ltd. made a profit. Also, the gain on disposal would not be chargeable to profits tax as it may be of capital and/or offshore nature. Therefore, the business tax should not be deductible.

**Comments**  
**Question 1(c) – 6 marks**  
This question required candidates to discuss whether A Ltd. was liable to business tax in respect of its sale of an office unit and if so, whether the tax payment was deductible under profits tax in Hong Kong. Most candidates had no difficulty in dealing with the first part by quoting the relevant tax regulation of the Mainland. But for the second part, they seemed to lack a thorough understanding of the requirements referred to in DIPN 28, i.e. for a foreign tax to be deductible, it should be a charge on earnings (not profits) and the earnings should be chargeable to profits tax. Many candidates simply provided a general answer that the business tax was not deductible because it was not incurred in the production of A Ltd.’s chargeable profits, without any explanation as to the rationale behind it.
2(a)

Though B Inc. did not carry on any business in Hong Kong, it received royalties from A Ltd. in respect of the patented technology used for the production of audio and visual equipment in the Mainland. Such royalties were deducted in ascertaining the assessable profits of A Ltd. By virtue of s.15(1)(ba) of the IRO, the royalties are deemed to arise in or be derived from Hong Kong from a trade, profession or business carried on by B Inc. in Hong Kong.

Since B Inc. is a non-resident, s.20B(2) of the IRO provides that A Ltd., who paid the royalties to B Inc., is chargeable to tax on behalf of B Inc. in respect of the royalties. As the tax so charged is recoverable from A Ltd., it should deduct from the royalties a sum sufficient to pay the tax due by virtue of s.20B(3) of the IRO. Being the person chargeable to tax on behalf of B Inc., A Ltd. failed to report the royalty payment to the IRD. Such failure is contrary to s.51(2) of the IRO, which requires the taxpayer to inform his chargeability to tax within 4 months after the end of the basis period of the relevant year of assessment.

Comments
Question 2(a) – 8 marks
This question concerned the tax obligations of A Ltd. in respect of its royalty payment to B Inc., a non-resident. Quite a number of candidates did not perform well in this question because they wrongly assumed that the patented technology had been used in Hong Kong and quoted S.15(1)(b) of the IRO as the relevant provision. Indeed, if they had read the case carefully, they would have found that the production had been undertaken in the Mainland and S.15(1)(ba) was engaged as the royalty payment had been charged in A Ltd.’s accounts. In any case, irrespective of whether S.15(1)(b) or (ba) was invoked, most candidates could explain some obligations of A Ltd. as the payer of such a royalty payment. What they usually missed out was A Ltd.’s failure to report the payment, contrary to the provision under S.51(2) of the IRO.

2(b)

A Ltd. provided Mr. D with free residence in the Mainland. It was a fringe benefit to Mr. D. However, A Ltd. failed to return such remuneration to the IRD. S.52(2) of the IRO requires every employer to furnish the remuneration of its employees, whether it is in cash or otherwise. The fact that the residence provided was outside Hong Kong would not relieve A Ltd. from reporting such housing benefit to the IRD under s.52(2).

Comments
Question 2(b) – 3 marks
This question required candidates to evaluate whether A Ltd. had to report the free residence provided to Mr. D in the Mainland. Many candidates correctly answered the question in the affirmative, whilst just a few were able to point out that it was an obligation provided under S.52(2) of the IRO. Some candidates, again, misread the question and discussed at length the reporting obligation of Mr. D, which was simply a waste of time.
3

S.27(1) of the Stamp Duty Ordinance (SDO) provides that any conveyance of immovable property as a voluntary disposition inter vivos shall be chargeable with stamp duty with the substitution of the market value of the property. Under s.27(4) of the SDO, any conveyance of immovable property shall be deemed to be a voluntary disposition inter vivos if the Collector of Stamp Revenue is of the opinion that by reason of the inadequacy of the consideration or other circumstances the conveyance confers a substantial benefit on the person to whom the property is conveyed or transferred.

Here, A Ltd. purchased the shop at 20% less than the market value and such a discount did confer a substantial benefit to the company. The fact that the transaction between A Ltd. and the seller was at arm’s length would not prevent the imposition of stamp duty on the market value of the shop. In *Lap Shun Textiles Industrial Co. Ltd. v Collector of Stamp Revenue* 1 HKTC 880, the Court of Appeal held that the application of ss.27(1) and (4) of the SDO depended on whether the conveyance conferred a substantial benefit upon an objective examination of the factual elements, not the intentions of the parties concerned.

Therefore, by virtue of ss.27(1) and (4) of the SDO, the stamp duty on the relevant conveyance should be calculated at the market value, rather than the sale consideration, of the shop.

The stamp duty payable should be calculated as follows:
Market value of property: HK$20,000,000 / (1-20%) = HK$25,000,000
Stamp duty payable: HK$25,000,000 x 4.25% = HK$1,062,500

**Comments**

**Question 3 – 5 marks**

This question tested the candidates’ basic understanding on the stamp duty implication in the event a property transaction was undertaken at below market value. It was not answered properly as many candidates could only mention that the stamp duty should be computed on the market value rather than the inadequate consideration, but they failed to apply the relevant statutory provisions, S.27(1) and S.27(4) of the SDO, to support their answer.
4(a)

Mr. D’s employment with A Ltd. should have a source in Hong Kong because of the following:

(a) Mr. D was employed by A Ltd. in Hong Kong. His employment contract should have been negotiated, concluded and enforceable in Hong Kong.

(b) A Ltd. was a company managed and controlled in Hong Kong. It should be a resident in Hong Kong.

(c) Mr. D was under the payroll in Hong Kong. Save for the free residence in the Mainland, Mr. D’s other remuneration should have been paid in Hong Kong.

Therefore, unless Mr. D was eligible for the exemptions provided under s.8(1A)(b)(ii), (1A)(c) and (1B) of the IRO, all his remuneration should be chargeable to salaries tax by virtue of s.8(1) of the IRO.

On the facts set out in the question, Mr. D should not be granted full exemption under s.8(1A)(b)(ii) and (1B) for the following reasons:

(a) he attended to business matters in Hong Kong. This means he did not render all the services in connection with his employment in the Mainland.

(b) he returned to Hong Kong for business purposes two days a week, which should have exceeded 60 days during each of the relevant years.

However, pursuant to s.8(1A)(c), he should be exempt from salaries tax to the extent of his income derived and taxed in the Mainland because:

(a) part of his income was derived from his services in the Mainland;

(b) he paid IIT in respect of that income in the Mainland; and

(c) IIT, being a tax assessed on employment income, is of substantially the same nature as salaries tax in Hong Kong.

Alternatively, as Mr. D’s income is subject to tax in both Hong Kong and the Mainland, he may claim for tax credit in accordance with the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income. But in general, the exemption under s.8(1A)(c) will provide greater benefit than that by tax credit.

**Comments**

Question 4(a) – 11 marks

This was a question on the source of employment and salaries tax exemption. For the source issue, many candidates could identify the three-factor test but failed to apply it to the facts of the case. As regards the exemption issue, the candidates had no difficulty in mentioning the relevant exemptions provided under the IRO. Those who performed well could also discuss the application of the double tax arrangement between Hong Kong and the Mainland.
4(b)

S.9(1) of the IRO defines income from employment to include, inter alia, the rental value of any place of residence provided rent-free by the employer. As provided under s.9(2) of the IRO, the rental value of any place of residence shall generally be 10% of the taxpayer’s income from employment. However, if the place of residence is a hotel, hostel or boarding house, the rental value shall be deemed to be 8% of his income where the accommodation consists of not more than 2 rooms, or 4% of his income where the accommodation consists of not more than 1 room.

Here, Mr. D was provided with a serviced apartment for residence in the Mainland. By virtue of s.9(1)(b), the rental value of such residence should be included as his income for salaries tax purposes. The fact that the residence provided was outside Hong Kong would not prevent Mr. D from being assessed with respect to the rental value for salaries tax purposes.

As regards the amount of the rental value, a serviced apartment is not a hotel or boarding house within the meaning of s.9(2): see D91/04, (2005-06) 20 IRBRD 22. Thus, even if Mr. D was only provided with a 1-room serviced apartment, the rental value of such residence should still be calculated at 10% of his income from employment (after the exemption allowed under s.8(1A)(c)).

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<th>Comments</th>
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<tr>
<td><strong>Question 4(b) – 5 marks</strong></td>
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<td>This question concerned the taxation of the housing benefit provided by A Ltd. to Mr. D in the Mainland. Most candidates correctly mentioned that the benefit was taxable irrespective of where it was provided. However, as regards to how the benefit should be assessed, some candidates failed to recognise that the residence which Mr. D was provided with was a serviced apartment, not a room in a hotel, hostel or boarding house within the meaning of S.9(2) of the IRO. Therefore, even though the relevant residence was a 1-room apartment, it should be assessed at 10% instead of 4% of Mr. D’s income from employment.</td>
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Qualification Programme Examination Panelists' Report

Module D – Taxation
(December 2011 Session)

(The main purpose of the following report is to summarise candidates’ common weaknesses and make recommendations to help future candidates improve their performance in the examination.)

(I) Section A – Case Questions

General Comments

The case study required candidates to apply their tax knowledge in a practical business context. This time, the case covered various profits tax, salaries tax, and China tax issues encountered by a property consultancy company. One of the questions also tested the candidates’ knowledge about ethical considerations when handling tax engagements. Regrettably, their overall performance was not satisfactory in this case study. Quite a number of candidates failed to grasp the essence of the case and the questions. Some of them could only state the tax principles in general without applying any of them to the case. As a result, they lost many marks and failed this section as a whole.

Specific Comments

Question 1(a) – 7 marks

This question required the candidates to analyse the facts given in the case and determine whether A Ltd has held its share in B Ltd. as a trading stock and a long-term investment. Whilst analysis of the intention of A Ltd. is of particular importance, many candidates diverted their focus to some irrelevant badges of trade such as subject matter, additional work, etc. Some candidates even misunderstood the question as one on the nature of business receipt and therefore did not score any marks.

Question 1(b) – 6 marks

This question tested the candidates’ knowledge about the source of profits in the context of e-commerce. The performance of candidates was satisfactory. Most could correctly adopt the operation test and identify the profit-producing activity (i.e. the research work in Hong Kong). Some stronger candidates could even mention the Departmental Interpretation and Practice Notes No. 39 to support their answers.
Question 1(c) – 4 marks

This was a question on business tax, of which the taxability depends on the provision of any prescribed taxable service within the territory of the Mainland. In the case outlined, A Ltd. provided services to clients in the Mainland by making use of information about the property market and this constituted taxable services for business tax purposes. However, many candidates did not seem to understand the above and were thus unable to produce the correct answer.

Question 2(a) – 3 marks

This question concerned the deductibility of the stamp duty paid in respect of the Building. Most candidates performed well on this question and could recognise that the relevant stamp duty was capital in nature. However, some candidates misread the question and elaborated on the availability of intra-group relief under s.45 of the Stamp Duty Ordinance. Candidates are advised to read all the questions carefully.

Question 2(b) – 3 marks

This was a straightforward question concerning the deductibility of mortgage interest paid in respect of the Building. Most candidates were able to base their analyses on ss.16(1)(a), (2), (2A) and (2B) of the Inland Revenue Ordinance (“IRO”), and scored well in the question.

Question 3 – 7 marks

This question required the candidates to determine whether B Ltd. is entitled to claim Industrial Building Allowance (“IBA”) in respect of the Building and if so, the amount of such an allowance. Many candidates could point out that IBA was due for the part of the Building which had been used as factory, but only a few were able to recognise that the Building was a new industrial building purchased from property developer and its net price (instead of construction cost) should be adopted in computing IBA pursuant to s.35B(b)(i) of the IRO.

Question 4(a) – 6 marks

This question asked for an evaluation of how Mr. X could save salaries tax by entering into a staff quarters arrangement. A fair performance was observed from most candidates, who were able to recognise the preferential tax treatment on the provision of free quarters. The candidates who scored well could further discuss how the alleged rental income received by Mr. X could be set off by the mortgage interest deduction available under personal assessment, rendering Mr. X tax neutral in this connection.
Question 4(b) – 9 marks

This question required the candidates to discuss how Mr. X would be assessed in respect of the staff quarters arrangement. The discussion should have covered two issues, namely (a) whether the alleged letting of the Property by Mr. X to A Ltd. was acceptable for the purpose of s.9(1); and (b) even if the letting were accepted, whether the Inland Revenue Department ("IRD") would invoke s.61 of the IRO to disregard such an arrangement. Many candidates overlooked issue (a) and merely directed their answers to issue (b). Moreover, while the candidates were aware of the superficial features of the quarters arrangement, they did not refer to the parts of the arrangement which may be considered artificial to support their views on issues (a) and (b). Analytical questions have played a major role in tax examinations and candidates are advised to strengthen their skills in tackling such questions.

Question 5 – 5 marks

This question tested candidates’ understanding of the ethical considerations of tax accountants when revealing irregularities in clients’ tax affairs, and the general principles are provided under s.430 of the Code of Ethics for Professional Accountants. Regrettably, quite a number of candidates did not seem to have good understanding of these principles and simply stated that D & Co. should advise A Ltd. to disclose the irregularities to the IRD. In fact, the preservation of clients’ confidentiality and dissociation from clients who refuse to correct irregularities are also important aspects which the candidates should have considered when facing the given predicament. As prospective accountants, candidates are strongly advised to pay more attention to ethical issues.

(II) Section B – Essay/Short Questions

General Comments

The performance of candidates in Section B was generally satisfactory except for the questions on stamp duty which were below expectations. It appeared that candidates may have focused on profits tax, salaries tax and property tax in their preparation for the examination and may have underestimated the importance of stamp duty, which is actually a significant part of the Hong Kong tax regime.

It also appeared that candidates could handle straightforward questions and obtained promising results, such as for Questions 6(a) and 6(b). However, the mistakes made by candidates in Questions 7(a) in computing property tax liability indicated that many candidates did not read the details of the question carefully, and thereby made errors in the computation. The unsatisfactory performance in questions which require more application of tax knowledge to identify the tax implications indicated that improvements in the practical application of tax knowledge are essential for candidates.
Specific Comments

Question 6(a) – 4 Marks

This question tested the candidates’ understanding of taxpayers’ profits tax obligations when doing business in Hong Kong. Most of the candidates were aware of the filing, notification of chargeability and keeping of business records obligations. However, some candidates incorrectly focused on discussing s.14 and the source of profits which was not required by the question.

Question 6(b) – 5 Marks

This question was straightforward and candidates were generally able to obtain high marks.

Question 6(c) – 4 Marks

This question tested the candidates’ understanding of s.9A of the IRO from the employers’ perspective. However, some candidates could not identify the s.9A issues, or wrongly discussed the implications from the employee’s perspective. As a result, the performance of the candidates was not satisfactory.

Question 6(d) – 3 Marks

The results for this question were also not satisfactory. Most candidates only provided a brief answer and the majority did not discuss the disclosure requirements and the non-disclosure compromise arrangement as stated in DIPN 12.

Question 7(a) – 12 Marks

This question tested the candidates’ knowledge of the computation of property tax. Performance was generally satisfactory. The majority of the candidates were familiar with the layout of the property tax computation and obtained fair marks. However, common mistakes included the incorrect calculation of the number of months in relation to the rental income and the omission of adjusting the deposit received from the tenant for calculating bad debt. The use of a pictorial timeline might be a helpful examination technique for candidates for such purposes.

Some candidates spent time on elaborating the rationale of each tax treatment, which was not required by the question.

Question 7(b) – 5 Marks

Candidates generally were able to identify the eligibility of claiming the mortgage interest deduction for generating rental income under personal assessment, and were able to point out that the taxpayer in the question was not eligible to do so. However, most candidates could not elaborate on the details of the conditions for applying for personal assessment and therefore could not get high marks.
Question 8(a) – 4 Marks

This question tested the candidates’ knowledge of stamp duty on the exchange of immovable properties. Many of them did not appear to understand the requirement in the SDO and therefore applied the sections incorrectly in the stamp duty calculation. Performance was not up to expectations.

Question 8(b) – 5 Marks

This question tested the candidates’ knowledge of group relief on stamp duty under s.45 of the SDO. Candidates were generally able to identify the main focus of the question. However, the majority of them only provided a brief answer which was not sufficient to gain all of the available marks for this question. It appeared that some candidates were confused as to the parties involved for the purpose of the associated corporations in the question in order to meet the relief requirement. Performance in this question was below average.

In order to clearly visualise the group structure for the application of s.45 of the SDO, candidates might consider plotting a visual diagram to enhance their understanding of the overall corporate structure.

Question 8(c) – 5 Marks

This question required the candidates to demonstrate their understanding of the stamp duty implication for the leasing of immovable properties. Many candidates were able to explain some of the relevant concepts. However, some of them used the wrong rates in calculating the stamp duty, such as the rate for annual rent and the premium. In addition, many did not multiply the maximum rent of $1.2million by 12. This indicated that either the candidates did not read the question carefully or did not have a good understanding of the contingency principle.

Question 8(d) – 3 Marks

This question tested the candidates’ knowledge of the stamp duty implication upon the liquidation of a company. Most students were not familiar with the concept of distribution in specie by a liquidator.

(III) Conclusion and Recommendation

Candidates should ensure that they have a good understanding of all the areas of taxes within the syllabus, instead of focusing only on one or two areas. As suggested in previous reports, the quality of the answers is more important than mere rote-copying from the Learning Pack or the IRO. To achieve this, candidates should read the questions carefully, understand what is being asked, before writing the answers, which should be relevant and in response to the question.
Candidates should be aware that questions in this examination do not merely ask candidates to identify the relevant sections from the IRO for respective tax issues. Candidates should develop good analytical skills to understand the tax issues in the questions and apply the relevant sections of the IRO or DIPN in evaluating the tax implication of each question. This is how candidates can demonstrate the application of their tax knowledge in practical circumstances.