THE CHARTERED INSTITUTE OF TAXATION

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

May 2006

PAPER II

ADVANCED INTERNATIONAL TAXATION

C – HONG KONG

TIME ALLOWED – 3 HOURS

- You should answer **FOUR** out of seven questions.
- Each question carries equal marks.
- Start each answer on a new sheet of paper.
- All workings should be made to the nearest month and dollar unless the question requires otherwise.
- Marks are specifically allocated for presentation.

Tax Rates and Allowances

Tax Rates	2004/05	2005/06
Standard rate	16%	16%
Corporation profits tax rate	17.5%	17.5%
Progressive rates		
First $30,000	2%	2%
Next $30,000	8%	8%
Next $30,000	14%	14%
Remainder	20%	20%

Personal Allowances		
	$	$
Basic	100,000	100,000
Married person's	200,000	200,000
Child (for each dependant) the 1st and 2nd child	30,000	40,000
the 3rd to 9th child	30,000	40,000
Dependent parent/grandparent (each)		
Basic (aged 60 or above)	30,000	30,000
Additional (aged 60 or above)	30,000	30,000
Basic (aged 55 to 59)	Nil	15,000
Additional (aged 55 to 59)	Nil	15,000
Dependent brother/sister (each)	30,000	30,000
Single parent	100,000	100,000
Disabled dependent (each)	60,000	60,000

Concessionary Deductions		
Self-education expenses (maximum)	40,000	40,000
Home loan interest (maximum)	100,000	100,000
Elderly residential care expenses (maximum)	60,000	60,000
Contributions to Mandatory Provident Fund (maximum)	12,000	12,000

1. Toys Power Ltd ("TPL") is engaged in the business of trading of toys. TPL has two wholly-owned subsidiaries namely Toys Super Ltd ("TSL"), incorporated in Hong Kong and Toys Manufacturing Enterprise ("TME"), incorporated in the Mainland of China. TSL owns over 100 outlets in Hong Kong. TME has been appointed by TPL under a sub-contracting agreement to manufacture products on an independent basis in return for a sub-contracting fee. TPL supplies raw materials and production machines to TME. TPL, acting as a wholesaler, sells products to TSL for retailing.

A draft profit and loss account for TPL for the year ended 31 December 2005 is provided below:

	$'000	$'000
Toys sales	17,500	
Profit from sale of fixed assets	1,200	
Interest income	700	
Dividend	200	19,600
Less:		
Sub-contracting charges	500	
Selling expenses	300	
Administration expenses	1,000	
Salaries and wages	1,100	
Provision for repairs and maintenance	200	
Provision for mandatory provident fund	100	
Bad debts written off	100	
Depreciation	300	
Patent amortization	100	
Legal and professional expenses	600	
Interest expenses	800	
Overstatement of expenses for 2002 - 2004	(1,000)	4,100
Profits before tax		15,500
Tax provision		2,200
Profit after tax		$13,300

The draft tax computation for the year of assessment 2005/06 prepared by TPL's accounting manager is as below:

	$'000	Notes
Profit before taxation	15,500	
Add:		
Depreciation	300	Capital nature
Provision for repairs and maintenance	200	General provision
Patent amortization	100	Capital nature
Legal and profession fees –value added tax	200	Taxation expense, not deductible
	16,300	
Less:		
Depreciation allowance	1,200	See below
Profit from sale of fixed asset	1,200	Capital nature
Bank deposit interest income	500	Exempt by order
Overstatement of expense	1,000	2002 to 2004 expenses
Adjusted profit	12,400	
Tax at 17.5%	2,170	

Continued

1. Continuation

Notes to the tax computation are as follows:

1) The bad debt written off of $100,000 relates to a trade debt of a business which was acquired by TPL in 2003.

2) The legal and professional fees of $600,000 include $200,000 value added tax on importation of raw materials into China for further production. Other legal and professional fees were related to normal business and hence deductible.

3) The interest expense of $800,000 is tax deductible as it was incurred on purchase of trading stock.

4) Tax depreciation allowance is calculated as follows:

	30%
WDV b/f	$400,000
Addition –	
Production machinery used by TME	1,000,000
Delivery lorries	500,000
Initial allowance	(900,000)
Annual allowance	(300,000)
WDV c/f	$700,000

The following additional information has been provided by TPL:

1) During 2003, TPL has acquired a business for a consideration of $3,000,000, comprising equipment of $1,200,000, trade debts of $1,300,000 and patent of $500,000. The patent cost is amortized over five years.

2) TPL has paid a deposit of $500,000 to purchase two lorries, which were put into use from 1 January 2006 onwards.

3) The company made a general provision for repair and maintenance of equipment of $200,000 each year, while all actual repair expenses are charged to the repair provision account.

4) During the audit for 2005, it was found that administration expenses for 2002 to 2004 were overstated by $1,000,000 in total. This was adjusted in the 2005 accounts.

5) TPL has lent its surplus cash to TME. The fund was remitted to TME's bank account in Shenzhen. Interest income so derived during the year is $200,000. TSL was acquired by TPL in 2003 at a consideration of $2,000,000 which was funded by a bank loan.

You are required to comment on the draft tax computation prepared by TPL's accounting manager, as well as on any other relevant items in the draft profit and loss account. If necessary, make assumptions and identify any additional information required. (25)

2. Miss Sarah Chan was born in Hong Kong but has studied in the UK where she has been employed since 2000 by UC plc, a UK company. On 1 April 2004, UC plc established a subsidiary in Hong Kong, and Sarah moved back to Hong Kong to supervise the operation of the Hong Kong subsidiary, HKco Ltd. and report to the finance director of UC. The following information is in relation to Sarah for the year of assessment 2004/05:

1) Before she returned to Hong Kong, she signed a memorandum with UC, in which she was assigned to the position of financial controller for the Pan-Asia region of UC. Her monthly salary was $80,000. Her salary was paid by HKco Ltd into her bank account in Hong Kong.

2) UC plc reimbursed Sarah her cost of removal to Hong Kong of $40,000.

3) Sarah leased her own flat in Hong Kong to HKco Ltd at monthly rent of $30,000. HKco Ltd in turn allow Sarah to reside in the flat free of charge. Sarah paid mortgage interest expense of $360,000 for the flat.

4) She received a holiday allowance of $20,000 and went to Japan. Her husband went with her and shared a hotel room with her, which cost $10,000. Her employer also bought the air ticket for him which cost $20,000.

5) She has paid $150,000 tuition fee during the year for the degree of masters in business administration. Her employer reimbursed 50% of the fee.

6) Before she came to Hong Kong, she received a share option. She has to work in the new position for one year before she can exercise the option. She exercised the option on 4 April 2005.

7) UC plc has entered into a contract with the school in which her son aged seven was studying and UC plc is responsible for the school fee payment.

8) HKco Ltd has allowed Sarah to use the company's car, which was leased by HKco Ltd and Sarah was the guarantor for the lease payment. She was not allowed to lease out the car.

9) Sarah's husband operated a bakery business in Hong Kong, which has sustained a loss of $50,000 during the year, after charging her husband's salary of $80,000 and contribution to mandatory provident fund of $12,000 (mandatory contribution).

10) In addition to the seven-year old son, Sarah has a daughter aged 22 during year of assessment 2004/05 who finished her full-time degree course in the year 2004/05.

11) Sarah's parents, aged 61 and 65 respectively, were living at a nursing home in the UK and Sarah paid accommodation fees of $120,000 for them during the year 2004/05.

12) Sarah contributed $24,000 to a mandatory provident fund scheme.

Explain the tax treatment for each of the above items 1) to 12) for the purpose of Salaries Tax and/or Profits Tax. Advise how Sarah and her husband can reduce their overall tax liability for the year of assessment 2004/05.

(25)

3. Lion Electronics Ltd is incorporated in the Country B and principally engaged in the business of manufacturing and trading of garments. Now, Lion Electronics Ltd is mainly serving the markets in Europe, with annual turnover of about HK$100 million, annual profit of about HK$30 million. Lion Electronics Ltd appointed a manufacturer in Vietnam to manufacture goods for Lion Electronics Ltd. The manufacturer would design products, purchase raw materials and perform quality control on the products.

During a recent executives meeting, Mr Roy Donald, marketing director, stated that he would like to explore the markets in Asia. Miss May Cell, the production director, said that this initiative should be a good chance to leverage on low labour costs in China. The following strategies have been concluded:

1) Hong Kong is the first target market and will be an entrant point for the Greater China.

2) Goods will be sold in Hong Kong on a consignment basis for an initial testing period of one to two years.

3) If the market response is good, Lion Electronics Ltd would set-up its own establishment in Hong Kong. It may either be a full accredited agent or a subsidiary. The agent would lease its warehouse to Lion Electronics Ltd and accept orders from customers according to the operation parameters stipulated in the agency agreement. The subsidiary would operate independently from Lion Electronics Ltd and purchase goods from Lion Electronics Ltd for distribution in Hong Kong.

Based on the above information, you are required to analyse the tax implications of the following options:

1) Consignment sales in Hong Kong; and (4)

2) A fully accredited Hong Kong agent versus a Hong Kong subsidiary. (21)

Total (25)

4. 1) Racer Ltd is a Hong Kong based company and is engaged in the business of manufacturing and trading of furniture. It plans to move its production line into China in order to take the benefit of low labour cost and low land cost. Mr Danny Chan, the production manager of Racer Ltd is considering alternative ways of operation in China, i.e. import processing versus consignment processing. For both arrangements, Racer Ltd would enter into a processing agreement with a PRC Mainland entity. For the consignment processing, Racer Ltd would provide raw materials for further process by the Mainland entity in China. The Mainland entity would provide labour and land. The product design would be carried out by Racer Ltd in Hong Kong. Racer Ltd would send a team of five production supervisors to station in China and to train and supervise the production process there. Racer Ltd would pay a processing fee to the Mainland entity for the production process performed for Racer Ltd. Under the import processing, Racer Ltd would heavily rely on the Mainland entity, which would buy raw materials, design products, operate the production process, perform quality checking and sell completed goods to Racer Ltd.

You are required to explain the Hong Kong tax implications of the above two alternative arrangements. (13)

2) Paul received his notice of assessment for salaries tax for the year of assessment 2004/05 six months ago but he did not open it until, recently, he received another notice from the Inland Revenue Department to remind him to pay the huge amount of outstanding tax in the sum of $1,000,000 within fourteen days.

He then took out the notice of assessment and his completed Composite Tax Return; he discovered that his employer had wrongly stated his total income of $500,000 as $5,000,000 in the employer's return for Paul. He correctly reported the income as $500,000 in his own return. Moreover, the notice assessment mentioned that the assessment was made based on the employer's return, which also reported that Paul had received a sum of $180,000 from the employer, which was in fact a payment in lieu of three months notice Paul received upon his termination of services. Therefore, Paul considers that the tax amount $1,000,000 shown in the tax assessment is incorrect and he is really worried about how this problem can be solved.

You are required to explain the course of action Paul may take in respect of the two errors. (12)

Total (25)

5. 1) Pearl River Ltd ("PRL") is engaged in a property development business in Hong Kong. It acquired certain lots of land in Hong Kong several years ago and constructed a commercial podium and 10 blocks of residential properties on the site. PRL recently disposed of 100 shopping units of the commercial podium, about half of the overall number of units, and earned $20 million from the transactions.

You are required to advise PRL what factors the Inland Revenue Department ("IRD") would consider in determining if the transactions would be subject to tax in Hong Kong, specify what questions the IRD may ask and what evidence the IRD may look at. (17)

2) Cookies Ltd was incorporated in country A and engaged in manufacturing and trading of garments. It plans to sell goods to customers in Hong Kong. Cookies will charge interest on outstanding trade debt owed by customers at 5% per annum. Instead of making direct sales to customers, Cookies Ltd is considering selling goods via either a Belgian company or a Thai company as its director has just noticed that each of these two countries has signed a tax treaty with Hong Kong.

With reference to the relevant tax treaties and Hong Kong tax law, you are required to analyse the tax implications on the interest charged in relation to selling goods:

1) By Cookies Ltd directly to Hong Kong customers.

2) By Cookies Ltd to a Belgian company, which then resells the goods to Hong Kong customers and charges interest on outstanding trade debts.

3) By Cookies Ltd to a Thai company, which then resells the goods to Hong Kong customers and charges interest on outstanding trade debt. (8)

Total (25)

6. 1) HK Faithfulness Ltd, a HK company, holds 100% of the shares in both Apple Ltd and Orange Ltd. Apple Ltd holds 80% of the shares in Grape Ltd. A group restructuring will take place as follows:

(a) Apple Ltd transfers its 80% of the shares in Grape Ltd to Orange Ltd. The consideration is $10m cash payable to Apple Ltd plus another $90m cash payable direct to the bank on behalf of Grape Ltd.

(b) Orange Ltd issues shares equivalent to 10% of its total new shareholdings to an independent third party.

(c) Apple Ltd is liquidated within one month upon completion of steps (a) and (b) above.

Apple Ltd, Orange Ltd and Grape Ltd are all incorporated in Hong Kong with the main business carried on in the People's Republic of China (PRC), and almost all of their assets are located in the PRC.

You are required to discuss the Hong Kong Stamp Duty implications pertaining to the restructuring. (14)

2) Gene Ltd holds 100% of the share capital in Power Ltd, which is incorporated in Hong Kong and is carrying business of property development in Hong Kong. Sunny Ltd is very interested in the projects of Power Ltd and has agreed to pay $100million to Gene Ltd for Gene Ltd's agreement to (a) alter the articles of association of Power Ltd so that Gene Ltd's interest in Power Ltd will be deferred, and after the deferral, in fact, Gene Ltd will have no voting right nor entitlement to the profit of Power Ltd, and (b) to procure Power Ltd to issue two new shares to Sunny Ltd.

You are required to discuss the Hong Kong Stamp Duty implications pertaining to the above information. Suggest one possible tax efficient structure on holding a Hong Kong property development project that in particular can facilitate the subsequent disposal of the interest of the project. (7)

3) **You are required to explain whether the documents used in connection with the following transactions should be stamped under the Stamp Duty Ordinance:**

(a) Mr Tam transfers 10 residential flats he owned in Hong Kong by deed to a trustee of a standard discretionary trust. The discretionary objects of the trust are all Mr Tam's relatives presently living in Hong Kong.

(b) After the trust in (a) was established, the trustee exercised its discretion and transferred one residential flat to Mr. Tam's son.

(c) A grant of probate to the executor under a will. (4)

Total (25)

7. Modest Printing Ltd is principally engaged in the business of printing. It prints newspapers, magazines, books, etc. Mr Clever, finance director of Modest Printing Ltd, is considering a possible financing arrangement for business expansion. He planned to purchase 10 sets of machines for the expansion. As to the financial arrangement, Modest Printing Ltd will sell these machines to a finance company, Wonderful Ltd which will then lease the machines back to Modest Printing Ltd. Mr Clever is wondering whether or not the lease payment by Modest Printing Ltd to Wonderful Ltd would be tax deductible.

You are required to explain the tax implications of the above proposed transaction in the context of:

1) Anti-avoidance provision specifically on sale and lease back transaction; and

2) The general anti-avoidance provision as well as general deduction provision.

Total (25)