



THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

Specimen Examination Paper

PAPER II

ADVANCED INTERNATIONAL TAXATION

B - HONG KONG

TIME ALLOWED - 3 HOURS

Candidates should answer any **four** out of seven questions.
Each question will carry equal marks.
Start each answer on a fresh sheet.
All workings should be made to the nearest month and dollar unless the question requires otherwise.
Marks are specifically allocated for good presentation.

1. 1) Maggie Co. Ltd (Maggie) was incorporated in Hong Kong and its principal activity was trading of low-value toys. Maggie has about 100 sales agents to organize exhibitions and road-shows for Maggie in overseas. The sales agents sign sales contracts for Maggie with the customers in overseas every six months during the exhibitions and road-shows. At the beginning of every year, Maggie's directors determine the trading term parameters with the ultimate customers and forward the same to the overseas agents. The sale agents are fully authorized to negotiate and conclude the terms with the ultimate customers as long as the terms are within the prescribed trading parameters as set by the Maggie's directors.

Upon receipt of the product requisition note, pursuant to the terms of the sales contracts, from the ultimate customers, Maggie will place a corresponding product requisition note to its related company in Hong Kong, Fullest Co. Ltd. (Fullest). Fullest is the sourcing arm of Maggie and signs supply contracts with the ultimate suppliers in Hong Kong. All suppliers are Hong Kong based companies. Fullest renews the terms of the supply contracts every six months with the ultimate suppliers. Upon receipt of the product requisition note from Maggie, Fullest will place a corresponding note to the ultimate suppliers and arrange the shipment of the goods to the overseas ultimate customers. To reflect the contribution by Fullest, Fullest charges a mark-up on the prices on which it supplies goods to Maggie. This mark-up is determined by the directors of Maggie and is reflected in the requisition note placed by Maggie to Fullest. Maggie maintains an office in Hong Kong with two directors and five sale managers. All procurement managers of the Maggie Group are employed by Fullest.

Maggie's director, Miss Maggie Fung, opines that as Maggie derives its profits from sales to overseas market from operations both done within and outside Hong Kong, only 50% of the profits should be taxable.

You are required to comment on whether only 50% of Maggie's profits should be taxable. (16)

- 2) Susan Inc (Susan) is an U.S. based company and is principally engaged in web trading of software. Customers all over the world can access Susan's website and purchase software there. Upon completion of the purchase procedures, customers can download the software to their own computer for use. For cost control purpose, Susan maintains a server in Hong Kong, which is rented from an internet service provider. Susan's director, Mr. Kennedy, understands that a payment for the use or right to use an intellectual property in Hong Kong is subject to Hong Kong Profits Tax and hence would like to seek your advice in this regard.

You are required to comment on the Hong Kong Profits Tax implications in respect of Susan's sale of software to Hong Kong customers. (9)

Total (25)

2. 1) W Ltd which commenced business in 1971 has been making its accounts up to 31 August. In 2001, the controlling interest of W Ltd was acquired by a local company in the industry. In order to comply with the group's accounting date, W Ltd changed its accounting date to 31 December. The adjusted profits before depreciation allowances for all the relevant accounting years are as follows:

	<u>Adjusted profits before depreciation allowances</u>
	\$
12 months to 31 August 2002	840,000
16 months to 31 December 2003	1,440,000
12 months to 31 December 2004	960,000

The assessor of the Inland Revenue Department has agreed the depreciation allowances for W Ltd as follows:

<u>Year of assessment</u>	<u>Depreciation allowances agreed by the Revenue</u>
2002/03	\$
2003/04	125,000
2004/05	147,000
	113,000

Ascertain the basis periods and assessable profits to be applied to the years of assessment 2002/03, 2003/04 and 2004/05 for W Ltd. (8)

- 2) **Evaluate the deductibility of each of the following items of expenses in the context of Hong Kong Profits Tax:**
- a) **Severance Payment.** HK Textiles Co Ltd has decided to cease business in the near future. The board of directors has announced such an intention and as a result of which, each of the staff is entitled to receive a severance payment which is to be calculated on a basis suggested in the Employment Ordinance. (3)
 - b) **Exchange loss.** Company A placed the sale proceeds it received from a local customer into a three month time deposit account with a bank in Tokyo. The account was in Japanese Yen. However, owing to fluctuation in the exchange rate, it suffered an exchange loss when converting the deposit back to Hong Kong dollars. (3)
 - c) **Bad debt.** In order to maintain a constant source of supply of raw materials, Company C made a large loan to one of its main suppliers which had a serious financial problem. However, the supplier later went into liquidation and the company could not recover this loan which was later written off as bad in its accounts. (3)
 - d) **Interest expenses.** CK Property Development Co. Ltd had incurred interest expenses in financing the development of a housing estate for sale. Before the completion of the construction, the relevant interest expenses were capitalized in the account "property under development". Discuss whether such expenses are deductible during the period of construction. (3)
- 3) **Do you agree that the "provision of credit" is always the guiding principle for determining the locality of interest income? Discuss. (5)**

Total (25)

3. 1) Ms Clever went to an interview with a Mr. Alright of ABC Ltd for a position of 'marketing manager'. Two weeks thereafter, Mr. Alright approached Ms Clever with an offer. Ms Clever did not, however, want to work for the company as an employee. She told Mr. Alright that:

"I own a company incorporated in the Cayman Islands, Evader Ltd, which will undertake to secure my services to work for ABC Ltd. I would be appointed as an independent contractor, not an employee by ABC Ltd. However, I would still expect a monthly payment of my 'salary' to be made by ABC Ltd direct to Evader Ltd subject to 13 months' payment per annum. In addition, there should be specified in the service contract between ABC Ltd and Evader Ltd that I will be entitled to one month's full-paid holiday in each year of service, which is equivalent to the terms currently enjoyed by the employed staff of ABC Ltd. By doing so, I will be better-off from the Hong Kong taxation perspective but at no additional cost to ABC Ltd"

You are required to comment Ms Clever's proposed arrangement in the context of Hong Kong Salaries Tax. (13)

- 2) Mr. Chan wholly owns Star Ltd, a trading company incorporated in Hong Kong. He is also the sole beneficial shareholder of Moon Ltd which is located in a low tax jurisdiction having a standard income tax rate of 10% on all business profits. Moon Ltd has recently suffered heavy losses over the past five years. On the other hand, Moon Ltd has a significant level of cash and is currently looking for new projects.

Mr. Chan now wants to recoup all previous losses of Moon Ltd within the next three years. In order to improve the financial situation of Moon Ltd, the following proposal has been made to Mr. Chan by the financial controller of Star Ltd:

Prices for all goods sold by Star Ltd to Moon Ltd will be set deliberately at a low margin of 5% (the normal margin to other overseas customers is 40%). Moon Ltd will then sell the goods to its customers in the US. Under existing trade terms, Star Ltd makes all the shipping arrangements directly to Moon Ltd's customers in the US and advertises extensively in the US all the brand goods it sells to Moon Ltd. It also allows Moon Ltd favourable trade terms of a longer credit period in respect of all the goods sold.

Please comment the Hong Kong Profits Tax implications of the above proposal. Your answer should include suggestions to improve tax efficiency. (12)

Total (25)

4. 1) Mr. Kwan died intestate on 3 March 2005. The principal value of his estate in Hong Kong exceeds \$8,000,000. The funeral expenses were \$100,000. The surviving spouse, Mrs. Kwan, provides you with the following information:

- Mr. Kwan was the sole owner of a flat in Kowloon which was purchased by him in 1992. Before his death, the flat was occupied by him and his family as their residence. The flat was valued at \$2,500,000 for probate purposes.
- Mr. Kwan owned a fixed deposit of \$500,000 in a branch of the Bank of Banque Nationale de Paris in Hong Kong. Interest accrued to the date of death amounted to \$3,000.
- Mr. Kwan had a half-share partnership business with his sister. The partnership operates its main business in Hong Kong (head office) and in Macau (branch).
- Mr. Kwan gifted a vase made in the Ming Dynasty worth \$750,000 to his son, Donald, in June 2002. Six months before the death of Mr. Kwan, the vase was accidentally broken by the domestic helper and Donald received an insurance compensation of \$500,000.
- Mr. Kwan held 100,000 shares in K Ltd, a company listed in Hong Kong stock market. He gifted the shares to Mrs. Kwan on the occasion of their 30th wedding anniversary in May 2004. In November 2004, K Ltd made a bonus issue at the rate of 1 share for every 20 shares held. The relevant market values of the shares were as follows:

At the date of gift	\$25 per share
At the date of bonus issue	\$26.5 per share
At the date of death	\$28 per share
- In September 2004, a flat in Ma On Shan was gifted to his daughter for her birthday. The market value of the flat at the date of gift and the date of death were \$8 million and \$6.7 million respectively.

You are required to:

- 1) **Explain the Estate Duty implications under the Estate Duty Ordinance arising from the above facts.** (11)
 - 2) **Explain whether, and if so to what extent, the documents executed in the last TWO items attracts Stamp Duty under the Stamp Duty Ordinance.** (4)
- 2) **Briefly explain the methods used to quantify the amount of understatements of profits in a tax investigation.** (10)

Total (25)

5. 1) Wing Fat Ltd failed to lodge profits tax return for the year of assessment 2001/02. As a result of this failure, the assessor raised estimated profits tax assessment on the company for 2001/02 in the amount of \$350,000.

The assessor subsequently discovered that the company's true assessable profits for 2001/02 amounted to \$2,500,000. After raising additional assessment for 2001/02, the Commissioner of Inland Revenue raised an additional tax assessment for 2001/02 in the amount of penalty tax of \$300,000 under section 82A of the Inland Revenue Ordinance.

You are required to discuss the power of the Revenue to raise an additional tax assessment, and the procedures and grounds for Wing Fat Ltd to make a valid appeal against the additional tax assessment.

(10)

- 2) Miss Wong has just noticed from the 2003/04 notice of assessment that the travelling expenses so claimed by her in the return were disallowed and dependent parent allowance in respect of her mother was not granted. The notice of assessment was issued and received by her three months ago. Unfortunately, she was too busy at that moment to examine the notice in details until now.

The travelling expenses were in fact taxi fares from her home to office which cannot be reached by any public transport. She had made the claim for deduction in her 2003/04 tax return together with the facts and grounds. The assessor disallowed the expenses with his note stated in the notice of assessment that travelling expenses from home to office are not deductible.

She then discovered that in the tax return filed, she forgot to put in the particulars of her mother who is 64 years old and living together with her throughout the year.

Miss Wong asked you for advice whether she could object to the assessment now in order to claim for the deduction of travelling expenses as well as the dependent parent allowance.

- 1) **Explain whether or not Miss Wong could object to her 2003/04 tax assessment.** (5)

- 2) **Advise any alternative course of action that can be taken, other than lodging an objection.** (5)

- 3) The management of Hong Kee Ltd is now considering borrowing money from its overseas associate company to finance the acquisition of plant and machinery for its Hong Kong operation. The overseas associated company usually places its surplus cash in time deposit with an overseas bank. The loan will be made at market interest rate.

Comment whether the interest expenses are deductible under Hong Kong Profits Tax. (5)

Total (25)

6. 1) Mr Robinson, a director of a Canadian company, was seconded to the company's subsidiary in Hong Kong as a project manager on the following terms:

- He entered into a 2 year contract with the Hong Kong subsidiary. The contract was enforceable in Canada and covered the period from 1 March 2003 to 28 February 2005.
- He was paid a monthly salary of Can\$10,000. The salary was credited into his bank account in Canada by the Canadian company which recovered the same from the Hong Kong subsidiary.
- He was required to visit China to supervise the joint venture there.

Mr Robinson arrived in Hong Kong on 15 February 2003 and reported duty on 1 March 2003. For each of the years of assessment 2003/04 and 2004/05, he received director's fees of Can\$5,000 from the Canadian company. Because he stayed in China for more than 183 days in the year 2003/04, he had paid PRC income tax of HK\$13,000. On the director's fees, he had paid Canadian tax of Can\$450 each year.

Details of his visits to China and Canada during the 2-year contract were as follows:

<u>Year</u>	<u>Period</u>	<u>Place of visit</u>	<u>Purpose of visit</u>
2003/04	15.8.03-13.9.03	Canada	to attend directors' meeting of the Canadian company
	1.11.03-28.2.04	China	to supervise the joint venture
2004/05	5.6.04-27.6.04	Canada	to attend directors' meeting of the Canadian company
	1.8.04-30.8.04	China	to supervise the joint venture
	30.12.04-23.1.2005	China	to supervise the joint venture

His wife arrived in Hong Kong on 1 April 2003 and commenced employment on 1 May 2003 with the Hong Kong Government as a secretary at a monthly salary of HKS10,000. On 1 September 2003 she resigned from the Civil Service and joined CP Airways, a company incorporated in Hong Kong, as an air hostess at a monthly salary of HK\$15,000.

Mrs Robinson was present in Hong Kong during the following periods:

1.9.2003 - 31.3.2004	40 days
1.4.2004 - 28.2.2005	70 days

Mrs Robinson resigned on 28 February 2005 and returned to Canada with Mr Robinson on 8 April 2005.

Continued

6. *Continuation*

In their Hong Kong Salaries Tax returns, Mr and Mrs Robinson made the following claims:

- Mr Robinson was not required to pay Hong Kong salaries tax for the year of assessment 2002/2003 because he did not work in Hong Kong for more than 60 days.
- For the years of assessment 2003/04 and 2004/05, a portion of his income as attributable to his services rendered in China and Canada should be exempt from tax.
- Mrs Robinson was liable to Hong Kong Salaries Tax to the extent of income derived from her services rendered in Hong Kong only.

Explain in details and cite the relevant statutory provisions whether or not Mr and Mrs Robinson would succeed in their claims. (19)

2) **Explain whether, and if so to what extent, the amount described in each of the following case is subject to Hong Kong Salaries Tax:**

- a) Mr Lee, the finance controller of a Hong Kong company, was paid by his employer an amount of \$5,000 as education incentive upon his successful completion of a certificate course in taxation offered by a local tertiary institute. The employer also reimbursed him the cost of the course which amounted to \$10,000. (3)
- b) Wong (HK) Co. Ltd. was given permission to list its shares on the Hong Kong Stock Exchange. Under the terms of the listing arrangement with the Stock Exchange, each employee of the company was entitled to a certain number of shares upon payment of the offer price of \$15. This was also the amount paid by general members of the public who wish to subscribe for the newly listed shares. A Mr. Wong, an existing employee, applied to subscribe for the shares. Upon receiving the shares, Mr Wong immediately sold them on the market and earned a profit of \$400,000. (3)

Total (25)

7. 1) Boy (HK) Ltd (“BHK”) is incorporated in Hong Kong and was engaged by a Chinese company to provide hotel management services. While BHK rendered majority of the consultancy services in Hong Kong, it did provide some on-site quality control services in the Mainland of China. In this regard, it has sent three senior operation managers to the Mainland. The services rendering period for the quality control work in the Mainland for each of the managers was four months, three months, and two months respectively for the year ended 31 December 2004. The Chinese company paid a consultancy fee to BHK for the services rendered. As most of the services were rendered in Hong Kong, BHK reported all services fee as assessable to Hong Kong Profits Tax.

In the context of the Arrangement of Avoidance of Double Taxation between the Mainland of China and Hong Kong, comment on whether BHK may be subject Income Tax in the Mainland of China, if so how obtain relief from double taxation. (12)

- 2) Whitewall Corporation (“Whitewall”) is a German company, which manufactures and distributes cosmetic products in Germany. The board of directors of the company recently resolved to expand its markets to sell the products to China, Hong Kong and other countries in the Far East. Mr. Hermit, the managing director of Whitewall approaches you to advise him the Hong Kong tax implications of the following proposed schemes of expansion.

- a) Set up a Hong Kong subsidiary and appoint the subsidiary as Whitewall’s regional wholesales agent in the Far East region. In respect of all the sales in Hong Kong, Whitewall will pay the Hong Kong subsidiary a fixed percentage of commission on all the sales in Hong Kong. All the customer orders will be accepted and signed by the subsidiary on its behalf. Alternatively, Whitewall will sell the products on consignment basis to the Hong Kong customers through the Hong Kong subsidiary.
- b) In respect of the sales in China and other countries in the Far East (other than Hong Kong) Whitewall will appoint local agents there to secure orders on its behalf. However, the Company wishes to book the profits for all these overseas sales in the Hong Kong subsidiary.

Comment on the Hong Kong Profits Tax implications of the above proposed schemes a) and b). Your discussion should include the method of ascertaining the assessable profits and the obligations imposed by the Inland Revenue Ordinance on Whitewall and/or its Hong Kong subsidiary. (15)

Total (25)