

SECTION A – CASE QUESTIONS (Total: 50 marks)

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

CASE

Jerry and Lily are the founders, directors and shareholders of Quality One Limited ("Q1"), which is a Hong Kong incorporated private limited company. Jerry and Lily are a married couple (both aged 55) and both are Hong Kong residents, holders of the Hong Kong identity card. Jerry and Lily have spent all of their time running the business of Q1 after they graduated from university. They do not own any other business and have no investment.

Q1 has been engaged in the provision of product testing services for over 20 years. Details of the operation are set out below:

- Q1 has an office cum service centre located in the Hong Kong Science Park. It employs a team of 10 engineers and 5 administrative staff.
- The engineers are responsible for the provision of the core technical services to Hong Kong customers, whilst the administrative staff are responsible for office administrative activities, IT, HR and finance and accounting functions.
- The testing services include testing the products and reporting to the customers whether their products meet international quality standards.

The following is the income statement of Q1 for the year ended 31 December 2020:

	Engineering Department <u>HK\$</u>	Administrative Department <u>HK\$</u>	Total <u>HK\$</u>
Revenue ^{note 1}	24,000,000	-	24,000,000
Expenses:			
Salary	6,900,000	2,400,000	9,300,000
Office rental	600,000	600,000	1,200,000
Office expense	200,000	300,000	500,000
Royalty fee ^{note 2}	1,000,000	-	1,000,000
Total expenses	(8,700,000)	(3,300,000)	(12,000,000)
Profit/ (Loss) before tax	<u>15,300,000</u>	<u>(3,300,000)</u>	<u>12,000,000</u>

Note 1 The product testing services were all performed by the engineers in Hong Kong.

Note 2 Royalty fee is paid to an unrelated non-resident recipient K Limited, which is an international standard setting organization, for the right to replicate the tests conducted when providing the product testing services. Based on the licensing contract, the recipient is a Cayman Islands company having a business address in Country X that has entered into a double tax agreement with Hong Kong. The recipient is responsible for the tax attributable to the royalty income.

In a regular management meeting taken place in early 2020 in Hong Kong, Jerry and Lily were considering the following business restructuring initiatives to be carried out in 2021:

Business sale – engineering department

Jerry, who leads the engineering department, would like to change Q1's business model by selling the engineering department that delivers the product testing services at market value to a BVI company Quality Two Limited ("Q2"). Jerry will be the sole shareholder and director of Q2 based in Hong Kong responsible for daily operations, work coordination and key business decision making.

After the business sale (including the transfer of business assets/ liabilities, novation or assignment of customer contracts, employees' employment, etc.), all engineers will be encouraged to conduct the product testing services entirely at the customer's premises in Hong Kong. Other ancillary business activities like supplies of testing material, team meeting and training will be completed by online suppliers through online meeting. All engineers will be either working from home or conducting field work at the customer's premises.

Q2 will not obtain any registration under the Companies Ordinance and Business Registration Ordinance. On the other hand, Q2 will maintain a bank account with DBB bank in Singapore, for receipt of customer service revenue and disbursement of operating expense. The bank account will be operated by Jerry in Hong Kong.

Business relocation – administrative department

Lily, who leads the administrative department, would like to move her department to a lower cost location. The location in mind is Foshan (one of the cities in the Greater Bay Area).

Below is the basic research conducted by Lily on the comparison of the administrative expenses (for the year ended 31 December 2020) between Hong Kong and Foshan:

	Hong Kong (Before relocation)	Foshan (After relocation)	Variance
	HK\$	HK\$	HK\$
Annual salary costs	2,400,000	1,800,000	(600,000)
Annual office rental	600,000	300,000	(300,000)
Annual office expense	300,000	200,000	(100,000)
Total	3,300,000	2,300,000	(1,000,000)

The business activities of the administrative department are low-risk, not complex and routine in nature and they will be conducted by a newly established mainland entity jointly owned by Jerry and Lily.

Question 1 (10 marks – approximately 18 minutes)

With respect to the payment of royalty fee by Q1 to the non-resident recipient K Limited:

- (a) Outline the tax withholding and related reporting obligations of Q1 under the Inland Revenue Ordinance ("IRO") as payer of the royalty fee. (5 marks)
- (b) Under the double tax agreement between Hong Kong and Country X, royalty paid to a tax resident in Country X can enjoy a reduced withholding tax rate of 3%.

With reference to the OECD model tax convention, describe the typical procedures Q1 should undertake in order to determine whether K Limited is able to enjoy the reduced withholding tax rate. State the information/document(s) Q1 should provide to K Limited in order to assist the latter's tax filing obligation and obtaining tax relief in its tax jurisdiction.

(5 marks)

Question 2 (10 marks – approximately 18 minutes)

- (a) If Jerry's business sale initiative is executed, analyse the taxation of the business disposal gain earned by Q1 under profits tax. (5 marks)
- (b) Analyse whether Q2 is carrying on a business in Hong Kong, and evaluate whether its profits are subject to profits tax. (5 marks)

Question 3 (22 marks – approximately 40 minutes)

After the management meeting on the proposed business restructuring initiatives, it was decided that Jerry's business sale initiative will not be carried out (i.e. operation of the engineering department will remain in Hong Kong under the name of Q1), whilst Lily's business relocation initiative will go ahead (i.e. the administrative department of Q1 will be moved to Foshan). The management would like to understand the tax impact of the relocation plan with reference to the financial information for the year ended 31 December 2020.

(a) Evaluate which one of the following transfer pricing methodologies (no calculation is required) is more appropriate if the administrative department is relocated to Foshan, and its financial position should be sustainable.

- Cost plus method
- Resale price method

(4 marks)

(b)(i) Calculate the profits tax liability of Q1 for the year of assessment 2020/21 assuming all expenses are deductible.

Then calculate the profits tax liability of Q1 and the Mainland China corporate income tax liability of the mainland entity as if the business relocation initiative has been carried out, using the financial information provided in the case and the tax rate of 16.5% and 25% respectively. Assume the mainland entity will be remunerated on cost plus 10% basis for the administrative services it provides to Q1. Ignore the 2-tier profits tax regime in Hong Kong for the above calculations.

Further calculate the after-tax earnings available to the shareholders Jerry and Lily, taking the 5% dividend withholding tax rate in mainland China. Analyse whether there is a benefit overall, taking into account the amounts of tax liability and cost saving.

For clear presentation, you are suggested to:

- Calculate the post-relocation profit or loss for Q1 and the mainland entity in separate columns in tabular format.
- Ascertain the post-relocation after-tax profit of Q1 and the mainland entity by applying the appropriate tax rates.
- Quantify the net benefit brought by the relocation, if any to the shareholders.

(10 marks)

(b)(ii) Explain (no calculation is required) how the amount of net benefit from restructuring will change when the service fee charged to Q1 by the mainland entity is increased.

(4 marks)

(c) Describe a possible action Q1/ mainland entity can take in advance in order to avoid the undesirable situation that the Hong Kong and Mainland tax authorities disagree with the transfer price between Q1 and the mainland entity. Evaluate whether this possible action is appropriate in the circumstances.

(4 marks)

Question 4 (8 marks – approximately 14 minutes)

Jerry was elected as the Legislative Council member of Country Y. Since the election Jerry has to spend more time on council meetings and provision of business consultancy services to overseas contractors bidding for government civil contracts. Knowing this you would like to propose to Jerry outsourcing his Tax Return – Individuals filing with the Inland Revenue Department to your accounting firm.

A junior member of your firm has drafted a tax compliance service proposal to Jerry, below is an extract of the service proposal:

".....the following tax compliance services are proposed on the grounds that you are not holding any prominent public functions in Hong Kong or overseas.

We will prepare your Tax Return – Individuals and supporting tax computation for the year of assessment 2021/22. On condition that you have paid the fee of HK\$xxx to us, we will claim your business consultancy fee income of HK\$xxx as offshore, not subject to salaries tax, and assure you that (1) the claim will be accepted by the Inland Revenue Department ("IRD") and (2) the claim will not be challenged by the IRD within 6 years.

We will collect and, if necessary, produce all information/ estimates/ documents that support the above claim. Please rest assured that we will think out of the box and be creative in preparing the tax return and tax computation, and we are responsible for the content therein....."

Required:

In respect of client acceptance procedures, highlight the issues to the partner that the firm should pay attention to in terms of the new role of Jerry in Country Y and the requirements under the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) (Amendment) Ordinance 2018.

As the manager-in-charge of this pursuit, suggest 3 ethical issues to be discussed with the partner in respect of the draft service proposal.

(8 marks)

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End of Section A

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

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

Question 5 (15 marks – approximately 27 minutes)

Mr Johnson was born in England and is the Vice President of an investment bank in England. Mr Lo was born in Hong Kong. He is employed by M&L Company Limited as Senior Finance Manager in Hong Kong. He is also the sole proprietor of a boutique in Hong Kong. Mr Lo has been the sole owner of a property in Hong Kong, Amber Residence, since 2017 and has been residing there.

On 30 June 2019, Mr Johnson was legally married to Mr Lo in England. On 1 July 2019, it was Mr Johnson's first-time travel to Hong Kong. During his stay in Hong Kong, Mr Johnson purchased two properties, Bella Building and Charlotte Court.

On 30 September 2019, Mr Johnson returned to England and he did not travel to Hong Kong until 1 April 2021.

Other information:

- (i) Mr Lo received the net income of HK\$735,000 from M&L Company Limited for the period from 1 April 2019 to 31 March 2020 after deducting his mandatory contributions made to a mandatory provident fund scheme in the amount of HK\$18,000.
- (ii) Mr Lo's boutique had an adjusted loss of HK\$80,000 (after deducting approved charitable donation of HK\$3,000).
- (iii) Mr Lo's mother has been eligible for an allowance under the Government's Disability Allowance Scheme since January 2019. On 1 October 2019, Mr Lo moved out of Amber Residence and lived with his mother to take care of her.
- (iv) Bella Building and Charlotte Court were both let out commencing from 1 September 2019 for a monthly rental income of HK\$16,000 and HK\$20,000 respectively.
- (v) Mortgage loans were obtained to finance the purchase of Amber Residence, Bella Building and Charlotte Court and the monthly mortgage interests paid were as follows:

<u>Property</u>	The monthly mortgage interest <u>HK\$</u>
Amber Residence	7,000
Bella Building	17,000
Charlotte Court	14,000

Required:

- (a) With reference to the relevant provisions of the IRO and the legal principles, analyse whether Mr Johnson and Mr Lo could elect for personal assessment for the year of assessment 2019/20.

(5 marks)

- (b) Compute the total tax liabilities of Mr Johnson and Mr Lo for the year of assessment 2019/20 assuming that they elected for personal assessment jointly and claimed deductions and allowances entitled to them. No apportionment of tax payable between Mr Johnson and Mr Lo is needed.

(10 marks)

Question 6 (10 marks – approximately 18 minutes)

JC Trading Inc is a leading grocery and food distributor incorporated in the United States. It expanded its business to Hong Kong and set up a branch in Hong Kong. At first, JC Trading Inc employed two employees in Hong Kong to conduct market research on the customers' preferences and purchase patterns for grocery and food. They also set up roadshows to build brand awareness in Hong Kong. Two years later, JC Trading Inc sent its employee Ms Morrison to negotiate all trading terms and conclude contracts with customers in Hong Kong. All trading contracts were signed under JC Trading Inc's name.

Required:

JC Trading Inc has engaged you as its tax advisor. Prepare a memo to JC Trading Inc to advise, with reference to the relevant provisions of the IRO, the profits tax implications of JC Trading Inc in Hong Kong.

Note: A maximum of 2 marks for communication skill and 2 marks for analytical skill will be awarded.

(10 marks)

Question 7 (13 marks – approximately 23 minutes)

Mr Wong was employed by KT & Co. Solicitors & Notaries ("KT & Co") as Solicitor and he enjoyed the following fringe benefits for the period from 1 April 2018 to 31 March 2019:

- (i) Under his employment contract, Mr Wong was entitled to a housing benefit that a monthly rent capped at HK\$20,000 would be refunded to him by KT & Co. Mr Wong was required to submit to KT & Co an application form together with copies of the tenancy agreement and rental receipts on or before 31 March of each relevant year of assessment. He rented a flat in Lai Chi Kok at a monthly rent of HK\$22,000 for the period from 1 April 2018 to 31 March 2019. On 1 July 2019, Mr Wong only submitted an application form to KT & Co.

- (ii) KT & Co and Good Health Clinic entered into an agreement under which an employee of KT & Co could visit Good Health Clinic by presenting a medical card and the medical bill would be settled by KT & Co at the end of every month. The amount of medical expenses paid by KT & Co in respect of Mr Wong was HK\$6,800.
- (iii) To promote a healthy work-life balance, an employee of KT & Co would be reimbursed for the membership fee for joining any fitness centers in Hong Kong. Mr Wong purchased an annual pass in Strong Fitness at HK\$10,000 and was reimbursed the same amount by KT & Co.
- (iv) Mr Wong was required to handle KT & Co's clients in Macau. KT & Co paid Mr Wong an allowance of HK\$150 for each day Mr Wong worked in Macau to cover his travelling expenses in Macau. The total amount of allowance received by Mr Wong was HK\$4,500.
- (v) Mr Wong was required to work overtime during peak season. KT & Co reimbursed Mr Wong for the taxi fare in the total amount of HK\$2,000 for those days he left office later than 11 pm.

Required:

Analyse, with reference to the relevant provisions of the IRO and the legal principles, the salaries tax implications of each of the fringe benefits (i) to (v) above.

(13 marks)

Question 8 (12 marks – approximately 22 minutes)

K&K Limited is a company carrying on business of property development and letting in Hong Kong. It closes its accounts on 31 December annually. K&K Limited was engaged in a redevelopment project in District A.

On 1 June 2015, it acquired a vacant site in District A ("the Site") at a consideration of HK\$210,000,000 with an aim to create residential flats for sale.

On 1 January 2017, the construction work commenced and the cost of construction was HK\$250,000 per month.

On 31 December 2017, K&K Limited announced that the Site would be developed into two buildings with 150 serviced apartments and the market value of the Site was HK\$400,000,000 on that date.

On 1 July 2018, construction of the two buildings in District A were completed and all serviced apartments were then leased out for a total rental income of HK\$4,000,000 per month. The expenses for operating the serviced apartments were HK\$500,000 per month.

On 1 September 2018, K&K Limited sold the two buildings in District A to its subsidiary at HK\$800,000,000.

Required:

Ignore the commercial building allowances in answering 8(a) and (b) below.

- (a) Analyse, with reference to the relevant provisions of the IRO and the legal principles, the profits tax implications on K&K Limited in respect of the redevelopment project in District A.

(8 marks)

- (b) Compute the amount of assessable profits of K&K Limited in respect of the redevelopment project in District A for the years of assessment 2017/18 and 2018/19.

(4 marks)

* * * END OF EXAMINATION PAPER * * *