

SECTION A – CASE QUESTIONS (Total: 50 marks)

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

CASE

Champion Group

Before group restructuring

Champion Group is a US-based trader of health care and pharmaceutical products. Champion Inc, a company incorporated in the US and listed on the New York Stock Exchange, set up a branch in Hong Kong to trade a health product that protects against infection from influenza, called Inlu-Proof. Inlu-Proof is supplied by unrelated overseas suppliers and traded mainly to customers in the Mainland.

After group restructuring

After a series of restructuring, Champion Inc set up Champion (Services) Limited ("Champion Services") in Hong Kong during the year ended 31 December 2018. Champion Services provides corporate services to Champion Inc to conduct re-invoicing activities in Hong Kong. Employees of Champion Inc travel to the factories of suppliers outside Hong Kong to negotiate the terms of purchase transactions with those suppliers. When an agreement is reached, employees of Champion Inc will tell the factory that the transaction will be conducted through Champion Services. Upon returning to the US, employees of Champion Inc will send a purchase order to Champion Services offering to buy the goods such that a profit is "booked" in the books of Champion Services. Champion Services has no offices or employees of its own. On behalf of Champion Services, Janice Wong ("Janice"), the General Manager of Champion Inc, will follow instructions from the employees of Champion Inc to automatically accept the purchase order issued by Champion Inc, and issue a purchase order on behalf of Champion Services to the supplier outside Hong Kong to buy the goods for the originally agreed price.

The financial statements of Champion Services showed, amongst others, the following information:

Profits and loss account for the year end	31 December 2019	31 December 2020
	<u>HK\$ (million)</u>	<u>HK\$ (million)</u>
Sales	100	380
Cost of sales	50	100
Gross Profits	50	280
Investment income	50	50
Balance sheet as at	31 December 2019	31 December 2020
	<u>HK\$ (million)</u>	<u>HK\$ (million)</u>
Total assets	250	350

The notes to the financial statements of Champion Services disclosed the following controlled transactions:

For the year ended	31 December 2019 HK\$ (million)	31 December 2020 HK\$ (million)
Transfer of properties	NIL	NIL
Transactions in respect of financial assets	NIL	NIL
Transfers of intangibles	NIL	NIL
Other transactions	10	30

Janice Wong

Janice is a citizen of the US and has been employed by the Champion Group for 30 years. She currently maintains an employment contract with Champion Inc which was negotiated and concluded in the US. She was asked to work in Hong Kong at Champion Services for two years effective from 1 January 2019. She will return to the Champion Group in the US after the secondment.

Janice is responsible for the overall control and management of Champion Services in Hong Kong. She stayed in Hong Kong during the following periods for the year 2019/20.

<u>Year 2019</u>		<u>Year 2020</u>	
April	1 to 16	March	1 to 18
July	1 to 19		
October	1 to 13		

Champion Inc operated a share incentive plan ("the Plan") whereby conditional awards might be made to employees of the Champion Group. The shares would only be vested on the grantee should he/ she remain an employee of the Champion Group on the date of vesting. The shares will be held by the nominees until they are vested on the grantee.

Janice was awarded at NIL cost under the Plan the following shares:

<u>Award date</u>	<u>No. of shares awarded</u>	<u>Tranche</u>	<u>No. of shares released</u>	<u>Released date</u>
1 April 2018	20,000	1 st	10,000	31 March 2019
		2 nd	10,000	31 March 2020

The market price of Champion Inc in Hong Kong dollar equivalent on the relevant dates is as follows:

1 April 2018	\$100
31 March 2019	\$120
31 March 2020	\$150

Champion Inc declared a dividend per share of US\$ 1 (i.e. 7.8 Hong Kong dollar equivalent) on 31 December 2018 and 31 December 2019 respectively.

Janice is divorced. She is solely responsible for maintaining her 16-year-old son. She received salary and discretionary bonus in the amount of HK\$3,000,000 and HK\$2,000,000, respectively, in the year 2019/20. When she travelled to Hong Kong, she lived in a serviced apartment in Kowloon. All the expenses related to the serviced apartment were borne by Champion Services. Champion Services also reimbursed all the dining and travelling expenses incurred by Janice in Hong Kong. The amount that was reimbursed to Janice in the year 2019/20 was HK\$200,000.

Question 1 (14 marks – approximately 25 minutes)

- (a) Evaluate the potential profits tax liabilities of Champion Inc in respect of the profits made from the sale of Influ-Proof by the branch in Hong Kong and advise on any additional information required to facilitate your analysis. (7 marks)
- (b) Advise whether the profits from re-invoicing activities conducted by Champion Services will be subject to profits tax. (7 marks)

Question 2 (15 marks – approximately 27 minutes)

- (a) Advise with reference to relevant provisions of the Inland Revenue Ordinance ("IRO") whether Champion Services needs to prepare a master file and local file for the years ended 31 December 2019 and 2020. (10 marks)
- (b) Advise with reference to relevant provisions of the IRO on :
- (i) The time that Champion Services has to prepare and submit a master file and local file if it has to do so.
 - (ii) The penalties for non-compliance.
- (5 marks)

Question 3 (8 marks – approximately 14 minutes)

Advise on the source of Janice's employment income for the year ended 31 March 2020 and any exemption that may be available to Janice.

(8 marks)

Question 4 (13 marks – approximately 24 minutes)

Compute the salaries tax liability of Janice for the year of assessment 2019/20 (ignore provisional tax) with explanatory notes on your treatment of the following items:

- (i) Shares awarded under the Plan.
- (ii) Reimbursement of dining and travelling expenses.

(13 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/ calculation and appropriate presentation of the answers.

Question 5 (15 marks – approximately 27 minutes)

Varian Limited ("VL") is a company incorporated and carrying on property holding and investment businesses in Hong Kong. In prior years, VL demolished one of its shabby industrial buildings in San Po Kong, Hong Kong and redeveloped the site into a modern factory building. The redevelopment project was completed last year and, with the launching of letting promotion, tenants in various business sectors (including but not limited to printing factories, food processing, warehouses, retail outlets, etc.) have been secured and have moved into the building gradually for business operations. It is estimated that about 70% of the building's units have been leased out and used by the tenants in the latest accounting year of VL. VL will treat the rental income from letting of the building's units as subject to profits tax.

In view of the complexity in preparing the profits tax computation, the accounting department of VL has appointed a reputable tax consulting firm named SK & Co to provide profits tax computation services.

Required:

- (a) **In the context of computing statutory depreciation allowance of VL attributable to the abovesaid redeveloped factory building in San Po Kong:**
- (i) **Explain, with reference to relevant provisions of the IRO, how VL should ascertain the industrial building allowance and commercial building allowance.**
(5 marks)
 - (ii) **Advice VL on what actions it should take to support the computation of the allowance(s).**
(5 marks)
- (b) **Describe the ethical considerations SK & Co should be aware of in the course of providing profits tax computation services to VL.**
(5 marks)

Question 6 (23 marks – approximately 41 minutes)

Mr Lam (a Hong Kong permanent resident) and Mrs Lam (a national of the People's Republic of China ("PRC")) are a married couple ordinarily residing in Hong Kong and Mainland China, respectively, and occasionally travel across the border for family gatherings. Both of them own immovable properties in Hong Kong (a residential property in Tsuen Wan owned by Mr Lam and a shop premises in Kwun Tong owned by Mrs Lam) and in the Mainland (a residential property in Shenzhen owned by Mr Lam and another residential property in Zhuhai owned by Mrs Lam) for rental purposes.

The tenancy details of the abovesaid Hong Kong properties are as follows:

		Residential property in Tsuen Wan	Shop premises in Kwun Tong
1.	Term of lease	2 years from 1 March 2019	4 years from 1 December 2018
2.	Monthly rent	HK\$35,000 payable in advance on the first day of each month	HK\$48,000 payable in advance on the first day of each month
3.	Rent free period	1 month from 1 March 2019	½ month from 1 December 2018
4.	Premium	N/A	HK\$72,000 payable on 1 December 2018
5.	Refundable deposit	HK\$70,000 payable on 1 March 2019	HK\$96,000 payable on 1 December 2018
6.	Rates	HK\$2,500 per quarter (after Rates concession, if any), payable by Mr Lam	HK\$6,000 per quarter (after Rates concession, if any), payable by Mrs Lam
7.	Property management fee	HK\$2,300 per month, payable by Mr Lam	HK\$3,200 per month, payable by the tenant

It is also noted that the couple had not applied for personal assessment for all relevant years of assessment.

Required:

- (a) Calculate the Hong Kong property tax liabilities of Mr Lam and Mrs Lam for the year of assessment 2019/20. (7 marks)
- (b) Without considering the implications arising from any double taxation arrangement, discuss the PRC tax exposure of Mr Lam and Mrs Lam, respectively. (5 marks)
- (c) Mr and Mrs Lam have engaged you as tax advisor. In the context of 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, prepare a letter to them to explain and analyse:
- (i) The applicable Hong Kong and PRC tax exposure; and
 - (ii) Reliefs, if any, available to Mr Lam and Mrs Lam, respectively

with respect to each of their immovable properties located in Hong Kong and the Mainland (computation of tax liabilities is not required).

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

(11 marks)

Question 7 (12 marks – approximately 22 minutes)

Discuss whether stamp duty is payable in the following circumstances (discussion on Special Stamp Duty and Buyer's Stamp Duty is not required; calculation of the stamp duty liability, if applicable, is required):

- (a) Mr Poon is the sole shareholder of A Limited, whilst A Limited is the 100% shareholder of B Limited and C Limited. It is also noted that C Limited currently holds 80% shares of D Limited, whilst the remaining 20% shareholding of D Limited is directly held by Mr Poon. Recently, it is resolved that a portfolio of securities listed on the Hong Kong Stock Exchange currently held by D Limited with a market value of HK\$15 million will be transferred to B Limited for cash consideration at current market value. (4 marks)
- (b) Mr Lam will get married to Ms Yeung next month. As a wedding gift, Mr Lam will transfer a residential property in Hong Kong (owned by Mr Lam for more than 10 years with a current market value of HK\$9 million) to Ms Yeung at nil consideration. Both of them are Hong Kong permanent residents and Ms Yeung does not have any residential property in Hong Kong at the present time. (3 marks)

(c) Mr Cheung's mother, Madam Yu, passed away last month. According to the will prepared by Madam Yu, a shop premises in Hong Kong owned by her at the market value of HK\$20 million would be inherited to Mr Cheung upon the execution of the relevant estate administered by a lawyer.

(2 marks)

(d) Ms Hung will transfer the entire shares of H Limited, a Hong Kong incorporated company, to her son, Mr Wong, at nil consideration as a gift in recognition of his graduation with first-class honours in accounting. H Limited does not have any assets or liabilities except for an immovable property in Japan with a current market value of HK\$6 million.

(3 marks)

* * * END OF EXAMINATION PAPER * * *

SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1(a)

Under s.14, profits derived from Hong Kong from a business carried on in Hong Kong are chargeable to profits tax. According to s.50AAC(5) and ss.4(1) and (2)(b) of Schedule 17G of the IRO, an enterprise that is a non-DTA territory resident person has a permanent establishment in Hong Kong if it has a fixed place of business, including a branch, in Hong Kong through which the business of the enterprise is wholly or partly carried on.

As Champion Inc is a company in the US which is a non-DTA territory resident person and has a permanent establishment in the form of a branch in Hong Kong, Champion Inc would be regarded as carrying on business in Hong Kong through its branch by virtue of s.50AAK(1).

The issue is therefore whether the profits earned from the branch operation are derived from Hong Kong. In deciding this issue, the broad guiding principle is to ascertain what the taxpayer has done to earn the profits and where it is done (see *Hang Seng Bank* and *TVBI*).

In the present case, the IRD considers that the location of the trading profits is determined by the place where the contracts of purchase and sale are effected. However, this does not only mean the place where contracts are legally executed, but also includes all relevant operations carried out to earn profits, including solicitation of orders, negotiation, conclusion, trade financing, shipment, and performance of contracts.

Furthermore, the IRD's practice is that no matter if both the contracts of purchase and sale are effected in Hong Kong, or if either the contract of purchase or the contract of sale is effected in Hong Kong, the whole of the profits will be chargeable. The IRD does not accept apportionment for trading profits.

Although both the suppliers and customers are situated outside of Hong Kong, it does not necessarily follow that the IRD will accept that the contracts of purchase and sale are effected offshore. Evidence is needed to substantiate how and where the contracts are initiated, negotiated, concluded, and executed.

In addition, more information is needed about the operations of the company's branch in Hong Kong. It should be noted that the following will all be used by the IRD to determine the source of the profits in question (see *Magna Industrial* and *Consco Trading*): (a) How the goods were procured and stored; (b) How the sales were solicited; (c) How the orders were processed; (d) How the goods were shipped; (e) How the financing was arranged; and (f) How payment was effected.

Answer 1(b)

Referring to fundamental principles, a person will be subject to profits tax if (a) it carries on a business in Hong Kong, and (b) its profits from that business "arise in or are derived from" (i.e., sourced in) Hong Kong.

The first condition is satisfied because Champion Services is performing re-invoicing business activities in Hong Kong. The second condition, namely whether Champion Services' profits from its re-invoicing activities are derived from Hong Kong, is contentious.

In the question, Champion Services (through Janice) itself does not appear to do anything outside Hong Kong, and it therefore appears that all its activities are conducted in Hong Kong. To demonstrate otherwise, Champion Services would have to point to activities that it itself conducts outside Hong Kong that are responsible for generating the profits.

Champion Services does not have any offices nor employees of its own in Hong Kong, and the real decision-making authority rests with Champion Inc, who has no presence in Hong Kong. It appears that none of the active negotiations with suppliers are conducted in Hong Kong but rather by Champion Inc dealing directly with the overseas factories. To this extent, one could argue that, realistically, all that is happening in Hong Kong is that profits are merely "booked" by Champion Services. Janice likely performs the necessary "paperwork" activities on behalf of Champion Services, and does so in her capacity only as a General Manager of the holding company (Champion Inc) who does not actively participate in Champion Services' business. In this connection, it is necessary to verify where does Janice perform such activities, i.e., in Hong Kong or otherwise.

If Janice carries on the necessary "paperwork" activities on behalf of Champion Services in Hong Kong, it therefore logically follows that all the operations that Champion Services itself performs that give rise to its profits take place in Hong Kong through the activities of Janice. In this regard, reference should be made to the definition of "profits arising in or derived from Hong Kong" in s.2, which defines the term to "include all profits from business transacted in Hong Kong, whether directly or through an agent".

It is also necessary to evaluate activities performed on Champion Services' behalf by an agent abroad. It is noted that the real negotiations were conducted by Champion Inc who, in a sense, was dealing with the overseas factories on behalf of Champion Services. However, there is nothing in the facts that indicates the existence of a formal agency arrangement – Champion Services did not formally appoint Champion Inc as its agent for the purpose of negotiating and, at least in substance, concluding the necessary arrangements with the overseas factories. It is an arguable case that entering into a formal agency agreement may have proved advantageous for profits tax purposes if Champion Inc has signed the purchase and sale contracts outside Hong Kong on behalf of Champion Services. The IRD would unlikely accept this position because, according to DIPN 21 (Revised), the IRD would generally only attribute to Champion Services activities of an agent where the overseas agent is "fully accredited": para. 26, DIPN 21 (Revised) states that an agent is regarded as "fully accredited" if he has and habitually exercises a general authority to negotiate and conclude contracts on behalf of Champion Services.

Answer 2(a)

Group in the extended sense

S.58C(1) provides that a Hong Kong entity of a group in the extended sense engaging in transactions with associated entities needs to prepare a master file and a local file unless conditions specified in s.58C(1) are satisfied.

A group in the extended sense is defined in s.58B(2) to mean a group in the usual sense. A group in the usual sense is defined in s.58B(2) to mean a collection of enterprises related through ownership or control such that it is required to prepare consolidated financial statements for financial reporting purposes or for reasons, amongst others, that equity interests in any of the enterprises were traded on a public securities exchange.

Champion Inc is a company listed on the New York Stock Exchange. It is the holding company of Champion Services, and Champion Services sells goods to Champion Inc after restructuring. Champion Services is clearly within the meaning of entity of a group in the extended sense. Coupled with the fact that it has engaged in transactions with associated entity, Champion Services has to prepare a master file and local file unless exemptions provided in s.58C(1) are available to it.

Exemption based on size of business

For the accounting period from 1 January 2019 to 31 December 2019, the revenue (i.e., \$150 million), assets (i.e., \$250 million), and average number of employee (i.e., nil) of Champion Services are all below the threshold specified in Part 2 of Schedule 17I, which is \$400 million, \$300 million, and 100, respectively. As such, Champion Services can be exempted from the preparation of a master file and local file for this accounting period (i.e., the year of assessment 2019/20).

Regarding the accounting period from 1 January 2020 to 31 December 2020, the revenue (i.e., \$430 million = \$380 million + \$50 million) and asset (i.e., HK\$350 million) are above the exemption threshold. As two out of the three items are above the exemption threshold, Champion Services has to prepare a master file and local file for this accounting period (i.e., the year of assessment 2020/21).

Exemption based on amount of controlled transactions

However, the total of each type of controlled transaction undertaken by Champion Services are below the threshold specified in Part 2 of Schedule 17I, which is \$220 million, \$110 million, \$110 million, and \$44 million, respectively. Champion Services can thus still be exempted from the preparation of a master file and local file in the year of assessment 2020/21.

Answer 2(b)

Time to prepare and submit a master file and local file

S.58C(2)(a) of the IRO provides that a Hong Kong entity must prepare a local file and a master file no later than 9 months after the end of its accounting period.

The accounting period of Champion Services ended on 31 December. As such, the 2 files, master and local, for the accounting periods from 1 January 2019 to 31 December 2019 and 1 January 2020 to 31 December 2020 must be ready by, at the latest, 30 September 2020 and 2021, respectively. Champion Services does not need to submit the files at its own initiative but has to declare in the profits tax return and the supplementary form S2 that a master file and a local file have to be prepared. The files are to be submitted upon request by the Assessor.

Penalties relating to the master file and local file

Penalties for non-compliance are provided under s.80(2Q), (2R) and (2S). Should Champion Services fail to prepare a master file and a local file in accordance with the requirements set out in s.58C, the Assessor may institute prosecution against it. Upon conviction, Champion Services may be liable to a fine at level 5 (i.e., HK\$50,000) and the court may order Champion Services to prepare the files within a specified time. If Champion Services fails to comply with the court order, it would be liable to a further fine at level 6 (i.e., HK\$100,000) on conviction.

Answer 3

Based on the available information, the contract of employment for Janice was negotiated, concluded, and enforceable with Champion Inc outside Hong Kong. In addition, her employer Champion Inc is a company managed and controlled in the US (i.e., residency of Champion Inc is outside Hong Kong). Further, her remuneration might be paid outside Hong Kong during the year.

Following the principles established in the Goepfert case and as elaborated in para. 7 to 25 of the DIPN No. 10 (Revised), Janice's employment with Champion Inc was located outside Hong Kong. As such, the income that Janice derived from the employment with Champion Inc would be chargeable to salaries tax under s.8(1A)(a) of the IRO, not s.8(1)(a). Under s.8(1A)(a), income chargeable to salaries tax is the income that is derived from services rendered in Hong Kong, including leave pay attributable to such services (i.e., time apportionment).

However, if Janice renders services in Hong Kong during "visits" and she spends 60 days or less in Hong Kong during that year, such services would be disregarded and the income received for that year of assessment would be exempt from salaries tax under ss.8(1A)(b)(ii) and 8(1B).

For the purpose of counting the day under s.8(1B), the Board of Review in D29/89 IRBRD vol. 4, 340 (para. 48, DIPN No. 38, Revised) held that "any part of a day counts as a day".

Following D29/89, the number of days that Janice was present in Hong Kong for the year ended 31 March 2020 is as follows:

April 2019 (1 – 16) 16 days
 July 2019 (1 – 19) 19 days
 October 2019 (1 – 13) 13 days
 March 2020 (1 – 18) 18 days

Total: 66 days

As Janice was present in Hong Kong for more than 60 days of the year, exemption of salaries tax under s.8(1A)(b)(ii) as read with s.8(1B) of the IRO is not available to her no matter if the services rendered in Hong Kong were rendered during visits or not.

Answer 4

Janice Wong
 Salaries tax computation
 2019/20

	HK\$
Salary	3,000,000
Discretionary Bonus	2,000,000
Share Benefits [see Note 1]	1,500,000
Dividend received during vesting period (US\$1 x 7.8 x 10,000)	<u>78,000</u>
Income from employment	6,578,000
Income attributable to services rendered in Hong Kong (HK\$6,578,000 x 62 / 366) [see Note 2]	1,114,306
Add: Reimbursement of private expenses [see Note 3]	<u>200,000</u>
	1,314,306
 Add: Value of residence provided	 131,430
 Assessable Income	 1,445,736
 Less: Basic allowance	 132,000
Single Parent Allowance	132,000
Child Allowance	<u>120,000</u>
Net chargeable income	<u>1,061,736</u>

Salaries tax payable (at progressive rate)

HK\$50,000 @ 2% = HK\$1,000

HK\$50,000 @ 6% = HK\$3,000

HK\$50,000 @ 10% = HK\$5,000

HK\$50,000 @ 14% = HK\$7,000

HK\$861,736 @ 17% = HK\$146,495

Total = HK\$162,495

Salaries tax payable (at standard rate)

HK\$1,445,736 x 15% = HK\$216,860

Tax payable, at lower one = HK\$162,495

Less: tax reduction (100% restricted to HK\$20,000) HK\$20,000

Tax payable thereon = HK\$142,495

Note 1

S.11D(b) provides that income accrues to a person when he becomes entitled to claim payment. In the case of a share award, this means being "entitled to ownership of the shares".

Since shares would only be vested on Janice after expiry of the vesting period, the "back end" approach is more appropriate for assessing the share benefits [paragraph 60 of DIPN 38 (Revised) refers]. As such, the share price as at 31 March 2020 of HK\$150 is taken for determining the amount of taxable perquisite.

Note 2

Number of days in Hong Kong according to the "midnight rule":

April 2019 (1 – 16): 15 days

July 2019 (1 – 19): 18 days

October 2019 (1 – 13): 12 days

March 2020 (1 to 18): 17 days

Total: 62 days

Note 3

As the sum related solely to Janice's services in Hong Kong, the entire sum was chargeable to salaries tax without apportionment.

* * * END OF SECTION A * * *

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

Answer 5(a)(i)

Pursuant to ss.34(1) and 34(2) of the IRO, an initial allowance of 20% and an annual allowance of 4%, respectively, on qualifying capital expenditure for the construction of an industrial building or structure for the purpose of a trade, and on the basis that the industrial building or structure has been used accordingly at the end of the basis period (for annual allowance), would be granted to the taxpayer who has incurred the said qualifying expenditure and has a relevant interest in relation to the qualifying expenditure at the end of the basis period. Specifically, under s.40(1) of the IRO, an industrial building or structure means any building or structure or part thereof which is used in a qualifying trade, i.e., (i) mill, factory; (ii) transport, tunnel docks; (iii) manufacture of goods or materials; (iv) storage of goods used in the manufacture of goods or are subjected to any process; (v) farming business; or (vi) for the purpose of research and development related to any trade, profession, or business. In order to qualify for the allowance, the qualifying expenditure must be capital expenditure incurred on the construction of an industrial building or structure. It is not necessary for the industrial building to be used as a qualifying trade by the taxpayer. If the industrial building is leased out by the taxpayer to a tenant carrying on a qualifying trade, the taxpayer, being the person having the relevant interest in the respective qualifying capital expenditure, is entitled to the industrial building allowance (DIPN No. 2, Para. 19).

If the building or structure has been used for purposes other than a qualifying trade at the end of the basis period, it would then be regarded as a commercial building or structure, and the taxpayer entitled to the relevant interest with respect to the abovesaid capital expenditure incurred for the construction of the commercial building or structure would be granted annually a commercial building allowance based on 4% of the abovesaid capital expenditure (s.33A of the IRO).

Answer 5(a)(ii)

In order to compute the tax depreciation allowance in accordance with the requirements under the provisions of the IRO, VL should ascertain the capital expenditure incurred exclusively and specifically for the construction of the building in San Po Kong and adopt a fair methodology (engagement of professional surveyor and valuation expert may be required) to apportion the appropriate cost of construction to each and every unit in the building in order to arrive at the qualifying capital expenditure on the construction of specific units, and the results should be properly documented in a report to support the bases adopted in VL's profits tax computation. VL should also ascertain the tenants of all leased units and confirm whether any tenants have used the respective units in a qualifying trade pursuant to the definition under s.40(1) of the IRO, and this review should ideally be done on a yearly basis and the results documented in a yearly summary. In this regard, the qualifying capital expenditure attributable to the units leased to tenants carrying on qualifying trade should be eligible for the industrial building allowance, whilst the qualifying capital expenditure attributable to the units leased to tenants carrying on non-qualifying trade should be eligible for the commercial building allowance. On the same token, no allowance would be granted with respect to the qualifying capital expenditure attributable to the units not used in the production of profits chargeable to profits tax at the end of the basis period.

Answer 5(b)

SK & Co should comply with the following matters in line with s.600 "Ethics in Tax Practice" of Chapter C "Additional Ethical Requirements" in the Code of Ethics for Professional Accountants (Revised June 2021) published by the Hong Kong Institute of Certified Public Accountants:

- (i) put forward the best position in favour of VL with professional competence and not in any way impair its standard of integrity and objectivity;
- (ii) ensure that VL is aware of the fact that the profits tax computation prepared is not beyond challenge;
- (iii) ensure that the profits tax computation is properly prepared based on the information received from VL, and that the information is correct and appears to be reasonable;
- (iv) advise VL that the responsibility for the contents of the profits tax computation rests primarily with VL;
- (v) prepare written records for any computational works or advice given to VL;
- (vi) not associate themselves with any false or misleading information; and
- (vii) ensure that if estimates are used in the profits tax computation, the estimates are reasonable under the circumstances.

Answer 6(a)

Property tax liabilities of Mr Lam and Mrs Lam Year of assessment 2019/2020

	Mr Lam HK\$	Mrs Lam HK\$
Rent		
(\$35,000 x 12)	420,000	
(\$48,000 x 12)		576,000
Premium		
(\$72,000 x 12 / 36)	-	24,000
	<u>420,000</u>	<u>600,000</u>
Less: Rates		
(\$2,500 x 4)	(10,000)	
(\$6,000 x 4)		(24,000)
	<u>410,000</u>	<u>576,000</u>
Less: 20% statutory deduction	<u>(82,000)</u>	<u>(115,200)</u>
Net assessable value	<u><u>328,000</u></u>	<u><u>460,800</u></u>
Property tax @15%	<u><u>49,200</u></u>	<u><u>69,120</u></u>

Answer 6(b)

Mr Lam is a non-resident individual under the PRC Individual Income Tax ("IIT") Law as he is not a PRC national and only resides in the mainland on an occasional basis. Accordingly, he would be subject to IIT with respect of his rental income sourced from the PRC, i.e., from the residential premises in Shenzhen. Specifically, Mr Lam can deduct either RMB800 (for monthly rental income below RMB4,000) or 20% (for monthly rental income above RMB4,000) from his rental income and then compute the IIT at a 20% tax rate. In addition, the tenant is the tax withholding agent on behalf of Mr Lam in arranging the tax payment accordingly.

Regarding Mrs Lam, she is a resident individual under the PRC IIT Law as she is a PRC national that habitually resides in the mainland. In this regard, her worldwide income (i.e., both the mainland and Hong Kong rental income) would be subject to IIT under the PRC IIT Law. Yet Mrs Lam would be eligible to claim IIT tax credit in respect of the income tax paid outside the PRC under the PRC IIT Law. Similar to her husband, Mrs Lam can deduct either RMB800 (for monthly rental income below RMB4,000) or 20% (for monthly rental income above RMB4,000) from her Hong Kong and PRC rental income each and respectively, and then compute the IIT at a 20% tax rate.

Answer 6(c)

Dear Mr and Mrs Lam,

Legal Background

The purpose of having 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 ("the Arrangement") is to allocate the right to tax between the two sides (i.e., Hong Kong and the mainland) so as to avoid double taxation of the same item of income on both sides. Specifically, rental income derived by an individual is chargeable to property tax and IIT in Hong Kong and the mainland, respectively, and both taxes are covered in Article 6 of the Arrangement.

Pursuant to Article 4 of the Arrangement, Mr Lam is a Hong Kong resident individual as he ordinarily resides in Hong Kong. On the other hand, Mrs Lam is a resident of the mainland under the laws of mainland China by reason of her nationality. Tax residency classification is essential as the Arrangement is applicable only to residents in either one side or both sides.

In the allocation of taxing rights, with respect to rental income derived from immovable properties, para. 1 of Article 6 of the Arrangement specifically provides that income derived by a resident of one side from immovable property situated in the other side may be taxed in that other side.

Implications to Mr Lam

In view of the relevant IRO provisions, the Articles of the Arrangement, and the tax residency of Mr Lam, his rental income derived from immovable property located in Hong Kong is chargeable to property tax under the IRO, and relief from Hong Kong tax is irrelevant in the context of the Arrangement. With respect to the rental income derived from his immovable property in the mainland, Article 6 of the Arrangement provides that the taxing right of such rental income is in the mainland tax authority. Specifically, there is no relief or exemption allowed thereon for individuals on one side having rental income on the other side under the Agreement. Nevertheless, as rental income derived from letting of immovable property situated outside of Hong Kong is not subject to property tax (the scope of charge under s.5(1) of the IRO is limited to land and/ or buildings located in Hong Kong only) nor profits tax (Hang Seng bank case), the respective rental income would not be chargeable to any tax in Hong Kong, which is also irrelevant in the context of the Arrangement.

Implications to Mrs Lam

With respect to Mrs Lam, her rental income derived from immovable properties in the mainland is solely chargeable to IIT on the basis that she is a PRC national and the immovable property is situated in the mainland, whilst the chargeability of this PRC sourced rental income to Hong Kong tax is not applicable according to the source principle established for the Hong Kong tax regime. The problem of allocation of taxing right between the mainland and Hong Kong is irrelevant in this context. Pursuant to Article 6 of the Arrangement and the source principle of the Hong Kong tax regime, the rental income derived by Mrs Lam with respect to her immovable property in Hong Kong would be chargeable to property tax in Hong Kong.

As Mrs Lam is a PRC tax resident and chargeable to IIT on a worldwide income basis, her rental income derived from immovable property located in Hong Kong would also be subject to IIT in the Mainland. In this regard, the elimination of double taxation with respect to her Hong Kong rental income by the allowance of a tax credit is confirmed under Article 21 of the Arrangement and would be available to Mrs Lam.

Should you need further assistance on the above issues, please feel free to contact me.

Yours sincerely,
XXXXXXXX

Answer 7(a)

Pursuant to the corporate structure provided, relief on stamp duty under s.45 of the Stamp Duty Ordinance ("SDO") is not applicable with respect to the transfer of the securities portfolio from D Limited to B Limited. This is on the basis that although B Limited is beneficially 100% owned by A Limited, D Limited is only 80% beneficially owned by A Limited, i.e., less than 90% as stipulated under s.45(2) of the SDO. Specifically, Mr Poon's 20% ownership in D Limited is irrelevant to the relief under s.45 of the SDO as the relief only applies to transfers between associated bodies corporate instead of natural persons.

As no other relief is applicable to the circumstances, the abovesaid transfer would be subject to stamp duty in aggregate of 0.2% on the market value of the shares in the portfolio or consideration, whichever is higher, together with a fixed duty of HK\$5 under Head 2(1) and Head 2(4) of the SDO, respectively. The relevant stamp duty would then be HK\$30,005 (HK\$15 million x 0.2% + HK\$5).

Note:

Marks will be awarded if candidates use the new applicable stamp duty rate of 0.26%.

Answer 7(b)

When a Hong Kong immovable property is transferred at nil consideration or at a consideration substantially below the market value, the transfer is deemed to be a conveyance or transfer operating as a voluntary disposition *inter vivos* and is chargeable with stamp duty under s.27(4) of the SDO on its market value. However, s.27(4) of the SDO specifically provides that the conveyance or transfer is not deemed to be a conveyance or transfer operating as a voluntary disposition *inter vivos* if marriage is the respective consideration. In this regard, the transfer of the residential property from Mr Lam to Ms Yeung for the purpose of marriage should not be chargeable to stamp duty, subject to the adjudication conducted by the Stamp Office.

Answer 7(c)

S.27(5) of the SDO specifically provides that the deemed conveyance or transfer operating as a voluntary disposition *inter vivos* under s.27(4) of the SDO would not be applicable to a conveyance or transfer under which no beneficial interest passes in the property conveyed or transferred thereon. As the transfer of immovable property is effected by the execution of relevant estate administered by a lawyer under a will, essentially it does not constitute any change of beneficial interest on the subject property. The said transfer should therefore not be chargeable to stamp duty accordingly.

Answer 7(d)

The transfer of the shares of H Limited from Ms Hung to her son at nil consideration would be deemed as a voluntary disposition *inter vivos* and would be chargeable to stamp duty at 0.2% on the market value of shares plus a fixed amount of HK\$5 under Head 2(1) and Head 2(4) of the SDO. The parental relationship between Ms Hung and Mr Wong is irrelevant to any stamp duty relief analysis in this perspective. In addition, the location of the assets embedded in H Limited is also irrelevant to the chargeability or valuation of the shares for stamp duty assessment purposes. In this regard, the stamp duty payable should be HK\$12,005 (HK\$6 million x 0.2% + HK\$5).

Note:

Marks will be awarded if candidates use the new applicable stamp duty rate of 0.26%.

* * * END OF EXAMINATION PAPER * * *



Qualification Programme Examination Panelists' Report

Module 14 – Taxation (December 2021 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 questions in Section A covered a wide range of topics including the determination of source of profits and the locality of employment, the definition of permanent establishment (“PE”) involving a non-DTA territory, knowledge on transfer pricing documentation, and tax treatments on various payments and benefits to employees.

Candidates scored more satisfactorily on questions relating to salaries tax than profits tax. It appears that candidates were unfamiliar with less common topics in previous sessions, such as transfer pricing. Most candidates did not refer to the information provided in the case when applying their knowledge or coming to a solution. In addition, some candidates appeared to not have read the questions carefully and therefore failed to address all the requirements of the questions. The overall performance of the candidates in this section was satisfactory.

Specific Comments

Question 1(a) – 7 marks

This question required candidates to determine whether a Hong Kong branch of an overseas company in a non-DTA territory constituted a PE in Hong Kong. Candidates were then asked to analyse the source of trading profits. The performance of the candidates in this question differed greatly, with some scoring full marks and some performing poorly. Most candidates could conclude the existence of a PE in Hong Kong through the form of a branch and correctly explained that the locations where the purchase and sale contracts were effected were important factors in determining the source of trading profits. However, some candidates did not identify that the overseas company in question was a non-DTA territory resident person and therefore they did not apply the relevant provisions of the Inland Revenue Ordinance (“IRO”) concerning PE. In addition, most of the candidates could not specify what other operation activities were also relevant in determining the source of trading profits.



Question 1(b) – 7 marks

This question required candidates to analyse the source of profits from re-invoicing activities. The performance of the candidates in this question was unsatisfactory. Most candidates failed to give a comprehensive analysis of the activities carried out by the company in question and its parent company with reference to the relevant tax principles. Most candidates only focused on the contract effected test in determining the source of profits and failed to evaluate the activities performed by the parent company as an agent.

Question 2(a) – 10 marks

This question required candidates to demonstrate their knowledge of transfer pricing documentation. This was a relatively straightforward question, but the performance of the candidates in this question was unsatisfactory. Many candidates correctly identified the exemption thresholds of preparing a master file and local file. However, many simply jumped to concluding whether the exemption applied without applying the information provided in the case. Many candidates did not include the investment income in arriving at the company's total revenue. In addition, some candidates failed to consider the exemption based on the controlled transactions.

Question 2(b) – 5 marks

This question required candidates to demonstrate their knowledge of timing for preparing the master and local files and penalties for non-compliance. The candidates appeared to have been unfamiliar with the topic, and thus performance in this question was poor. Most candidates identified the statutory requirement of the deadline for preparing the files and came up with the correct deadlines as would apply in the scenario posed by the question. However, many candidates failed to mention the need to make declaration in the profits tax return and the supplementary form S2 or to submit the files upon request. In addition, many candidates did not identify the correct penalty provisions for non-compliance. These candidates erroneously mentioned other penalty provisions, such as s.80(1), s.80(1A), or even s.82A of the IRO.

Question 3 – 8 marks

This question required candidates to determine the locality of employment and to evaluate the salaries tax liabilities with reference to the relevant charging sections and exemption provisions of the IRO. Performance on this question was very good. Most candidates were able to achieve high or full marks. Notably, although some candidates correctly concluded that it was a non-Hong Kong employment, they still applied the exemption provision of s.8(1A)(c) of the IRO, which is not applicable to non-Hong Kong employment.



Question 4 – 13 marks

This question consists of two requirements: computing the salaries tax liabilities and advising on the salaries tax treatments on share awards and reimbursement of private expenses by employer. Some candidates misunderstood the question requirements and only explained the tax treatments on the two items without providing a salaries tax computation. Most of the candidates failed to note that the reimbursement of private expenses by employer was taxable. In addition, most candidates did not use 366 days as the total number of days in the year of assessment 2019/20. Some candidates omitted the single parent allowance. Overall, the performance of the candidates on this question was fair.

(II) Section B – Essay/Short Questions

General Comments

The questions in this section covered a wide range of topics, including tax depreciation allowance for property letting business, ethical considerations in terms of delivery of tax service, taxation of rental income from property letting in Hong Kong and mainland China and related cross-border issues in the context of DTA, property tax calculation, tax advisory letter writing, and stamp duty implications and relief. Candidates generally scored very high marks in computational questions and satisfactory marks for technical questions on topics which the study text had covered, but performed poorly in analytical and practical questions. Candidates appeared to have spent too much time on areas they were familiar with, thus leaving insufficient time to tackle other areas that required analysis of information and critical thinking. Candidates should strive to avoid reading carelessly, ignoring important information provided, or mis-interpreting the requirements when answering questions.

Candidates should study the examination materials thoroughly (e.g., striking a balance between technical knowledge and practical application of the same) and should focus on improving their time management during the examination—in particular, they should be wary of the proper allocation of time that should be given to each question.



Specific Comments

Question 5(a)(i) – 5 marks

This question required candidates to demonstrate their knowledge of conditions for claiming industrial building allowance and commercial building allowance and related computational rules under the IRO. Most candidates were able to provide an overview of the regime for granting of allowances based on the materials from the study text; thus, these candidates scored a reasonably high mark. However, some candidates appeared to have spent more than the time required in writing the answers, which could have possibly impacted their performance in the ensuing questions negatively. Some candidates appeared to not have been aware that the building was only partially leased to tenants at year-end, which made them unable to highlight the requirement to apportion the allowance attributable to units that had been put into use at year-end. Other candidates misunderstood that VL was carrying on the business of property letting, which was not a qualifying trade and thus only entitled to commercial building allowance.

Question 5(a)(ii) – 5 marks

This question required candidates to go further into the practical aspect of claiming tax depreciation allowance by suggesting ways to find out the information necessary to compute the allowance, which was not specifically highlighted in the questions. Few candidates pointed out the need to survey the activities conducted by the tenants in the units in order to ascertain whether qualifying trade was conducted therein; however, no further discussion was provided on the need for apportionment. Most candidates did not go on to suggest the need to find out the qualifying capital expenditures on construction of the building (though the question clearly stated that the building was re-developed/constructed by VL), and many simply repeated the points already answered in 5(a)(i) without additionally providing a practical solution to the allowance computation that took into account the information provided in the questions. The performance of candidates was less than satisfactory.

Question 5(b) – 5 marks

This question required candidates to outline the ethical considerations during the delivery of tax service. Performance was satisfactory as this topic should have been familiar to all candidates. Some candidates misunderstood the question requirement and focused their answers on engagement acceptance rather than delivery of tax service, leading to a lower than average mark.



Question 6(a) – 7 marks

This question required candidates to compute the property tax liabilities. This question was straightforward and the adjusting items were obvious; therefore, most candidates scored full marks. A few candidates computed the property tax liability on a “combined” basis without noticing that the two properties were in fact separately owned by two individuals.

Question 6(b) – 5 marks

This question required candidates to demonstrate their knowledge of taxation of rental income earned by individuals in mainland China. In general, candidates performed quite well as they were able to comment on how tax residency can affect the PRC taxation of the rental income derived from Hong Kong and mainland China, and many commented on the individual income tax (“IIT”) implications. However, quite a number of candidates did not suggest the applicable tax rate, eligibility to the standard deduction in computing the IIT liability, or the tax withholding agent role.

Question 6(c) – 11 marks

This question required candidates to demonstrate their abilities and skills in writing a tax advisory letter to client. Whilst the technical content of this letter was considered important, candidates were also required to structure the letter properly so that it could facilitate the delivery of the key tax messages to the client in a logical and precise manner. Unfortunately, very few candidates demonstrated this ability, and thus the scores were far from satisfactory. Most candidates did not provide reasonable coverage on how DTA can help to define the taxing right and provide relief for double taxation, and the discussion on Hong Kong and mainland China taxation of the rental income derived from the HK/mainland China properties was loosely connected. Most candidates were, however, able to highlight the relief of double taxation by way of tax credit under a DTA. In addition, most candidates wrote the answer in memo format rather than in the required letter format.

Question 7(a) – 4 marks

This question required candidates to analyse the application of group relief for an intra-group asset transfer. Most candidates were able to spot that the ownership structure did not support the requirement for group relief and thus came to the correct conclusion. Candidates’ performance was satisfactory, though candidates generally appeared to have spent too much time writing the answers to this part of the examination, which may have caused a lack of focus on the other questions in the examination.



Question 7(b) – 3 marks

This question required candidates to demonstrate understanding on the stamp duty relief for voluntary disposition *inter vivos* in consideration of marriage. Most candidates were aware of this relief and thus came to the correct conclusion and scored high marks. A few candidates only wrote the conclusion without giving the complete reasoning, possibly due to having had insufficient time to fully answer the question.

Question 7(c) – 2 marks

This question tested candidates' awareness on beneficial interest and the stamp duty implications. Again, most candidates came to the correct conclusion, but very few were able to specifically point out that the reason was due to no beneficial interest change, thus losing marks.

Question 7(d) – 3 marks

This question required candidates to analyse the transaction and point out that the key event was transfer of shares in a Hong Kong company and the requirement for voluntary disposition *inter vivos*. Performance was diverse, with some candidates having given the correct analysis and thus scoring very high marks. Other candidates, however, appeared to have been confused by the location of the property or by the subject matter being transferred (the shares rather than the property); thus, these candidates came to the wrong conclusion and stamp duty calculation.

(III) Conclusion and Recommendation

Similar to previous sessions, candidates performed better in computational questions, while analytical questions, in particular those involving in-depth analyses, remained a challenge for most candidates. To obtain better results and avoid confusion, candidates should read the questions carefully. For analytical questions, especially those allocated substantial marks, candidates should construct a comprehensive skeleton and develop their answers beginning with the relevant legal principles which are generally allocated marks, particularly those well-established in the courts' judgments. They should then clearly and logically apply the legal principles to the facts set out in the questions. Conclusions should be made based on this analysis.

Candidates should manage time allocation properly, attempt all questions, and avoid spending excessive time on copying substantial material from their Learning Pack without effective analysis.