SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1

Ms Poon
Salaries tax computation
Year of assessment 2015/16

		HK$
Salary (HK$95,000 x 12)		1,140,000
Discretionary bonus		150,000
		1,290,000
Add:	Rental value of residence [HK$(1,290,000 - 3,500) x 10%] – [HK$(19,000 - 17,000) x 12]	104,650
Assessable income		1,394,650
Less:	Annual subscription fee	(3,500)
	Self-education expenses (HK$120,000 ÷ 2)	(60,000)
Net assessable income		1,331,150
Less:	Concessionary deduction Contribution to approved provident fund scheme (HK$1,500 x 12)	(18,000)
		1,313,150
Less:	Basic allowance	(120,000)
Net chargeable income		1,193,150

Answer 2

For reducing the overall salaries tax liabilities in a specific year and in accordance with s.10(2)(a) of the Inland Revenue Ordinance ("IRO"), Ms Poon and Dr Ho may consider electing for joint assessment by assessing their salaries income jointly if one spouse's net assessable income is less than the deductions under Part 4A and personal allowances under Part 5 of the IRO, while the other spouse continues to remain chargeable to salaries tax (DIPN No. 18 (Revised) issued in January 2005, Para. 10(a)).

On the other hand, Ms Poon and Dr Ho may, both together, elect for personal assessment (i.e. aggregating their income chargeable to salaries tax, profits tax and property tax) in a specific year to reduce their overall tax liabilities on the basis that the following items can be deducted specifically under personal assessment:

(i) Interest payable on money borrowed for the acquisition of property generating rental income assessable to property tax (the amount of interest deduction is limited to the net assessable value of the property) (s.42(1) of the IRO).

(ii) The business loss(es) suffered by Ms Poon or Dr Ho for setting off against other taxable income (s.42(2)(b) of the IRO).

(iii) Unrelieved donation which cannot be claimed for deduction without applying personal assessment.

However, it should be noted that under personal assessment, Ms Poon and Dr Ho's total income are in the first instance computed individually before being aggregated for further deduction against the statutory allowances under Part 5 of the IRO. The resultant total net chargeable income is chargeable to tax at progressive tax rates. This may cause more income to be subject to higher marginal tax rate such that it would become a tax disadvantage to elect for personal assessment.

Answer 3(a)

Dr Ho
Assessable value of the Property
Year of assessment 2015/16

	HK$
Rental income:	
- April 2015	15,000
- July to December 2015 (HK$150,000 x 6/12) (s.5B(4) of the IRO)	75,000
	90,000
Less: Irrecoverable rent [(HK$15,000 x 3) - HK$30,000]	(15,000)
Assessable value	75,000

Answer 3(b)

In accordance with ss.5(1) and 5B(2) of the IRO, the relevant considerations payable for the right of use of the Property to Dr Ho, being the owner of the Property before January 2016, are regarded as the assessable value of the Property. Accordingly, the amount should include the rental income for April 2015 (notwithstanding that the amount had not been received by Dr Ho) and that for the period from July 2015 to December 2015. As Dr Ho ceased to be the owner of the Property after December 2015, the rental income for the period from January to March 2016 should not be regarded as rental income attributable to him in ascertaining the assessable value, notwithstanding that the same amount has been retained by him under the arrangement mutually agreed with Ms Poon. Instead, the relevant rental income should be regarded as the assessable value attributable to Ms Poon, being the owner of the Property since January 2016, regardless of whether the same amount has been actually received by her.

In addition, the amount of rental income attributable to the period after April 2016 should be excluded in computing the assessable value of the Property for the year of assessment 2015/16, regardless of whether it was derived by Dr Ho or Ms Poon as the owner of the Property. Specifically, according to s.5B(4) of the IRO, any consideration in respect of the right of use which is not contained within any one year of assessment shall be deemed to be payable in equal monthly instalments during the period of the right of use or during a period of 3 years commencing from the date of the lease, whichever is shorter. As such, the rental income from July to December 2015 should be HK$75,000 (i.e. HK$150,000 x 6/12).

Outstanding rents for the period from February 2015 to April 2015 proved to the satisfaction of the assessor of the Inland Revenue Department ("IRD") as irrecoverable in September 2015 are regarded as bad debts and are deductible in computing the assessable value under s.7C(1) of the IRO. However, the deductible amount should be netted off by the rental deposit previously paid by the tenant.

Answer 4

The Service Company Arrangement is generically regarded as a "Type II" arrangement by the IRD. Notwithstanding that there is no specific anti-avoidance provision to curb this Type II arrangement, the IRD issued DIPN No. 24 (Revised) in July 2009 ("DIPN No. 24") to explain the circumstances under which service company claims will be challenged. Specifically, an acceptable Type II arrangement applicable to the Service Company Arrangement should be structured along with the following:

(a) The service company has to function and be properly constituted as a separate business operating on an arm's length basis in its dealing with the partnership. Sufficient documentation should be maintained in order to substantiate the separate status of each party and the operational mechanism of the arrangement. The documents should include the service agreement, minutes of meeting, invoices and receipts, working papers, bank records and employment contracts, etc. (DIPN No. 24, Para. 15).

(b) The management fee charged by the service company to the partnership should be quantified by the cost element in connection with the provision of qualifying services with a mark-up thereon of not exceeding 12.5% of the respective cost element. Qualifying services encompass non-professional services which are required to provide the infrastructure in which the partnership operates and to cater for its day-to-day operations, e.g. provision of premises, staff, plant and equipment and miscellaneous supplies. However, the term does not include the provision of any services to the partnership by the partners in the capacity of employees of the service company. The cost element is the sum of the tax deduction, including depreciation allowances, claimable by the service company in respect of the expenditure directly attributable to the provision of the qualifying services (DIPN No. 24, Para. 17 to 18, 23 to 26).

(c) Remuneration of other professionals employed by the service company directly facilitating the business of the partnership should be charged to the partnership by the service company on an actual basis without any mark-up. "Professionals" herewith should be regarded as persons where day-to-day duties require them to apply expertise they have acquired through training or experience in the profession of the party for who the duties are performed (DIPN No. 24, Para. 19 to 20).

Answer 5

(i) There is no specific qualification or experience requirement for a person to act as a tax consultant. As a member of the Hong Kong Institute of Certified Public Accountants ("HKICPA"), Ms Ho nevertheless should observe the guidance provided by the HKICPA on ethics in tax practice under s.430 'Ethics in tax Practice' of the Code of Ethics for Professional Accountants.

(ii) Before accepting the appointment as the tax consultant in evaluating the tax exposure of the Service Company Arrangement, Ms Ho should ensure that the appointment does not in any way impair her standard of integrity and objectivity, especially since her brother Dr Ho is one of the stakeholders of the Service Company Arrangement. In addition, Ms Ho should also ensure that her practice has the competent professional knowledge to provide the respective tax consulting services.

* * * END OF SECTION A * * *

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

Answer 6(a)

Equator may rely on s.16(1)(d) of the IRO for its deduction claim of the Outstanding Service Fees.

To satisfy the deductibility, Equator had to prove to the satisfaction of the assessor of the IRD that the Outstanding Service Fees were included in its trading receipts chargeable to tax before, and had become bad debts, or doubtful debts estimated to the extent that they had become bad, during the year of claim for deduction. This is a question of fact and there should be evidence of some definite action to recover the debt or reasonable justification for non-action.

As the advance payment of HK$500,000 was only due on 31 March 2015, and by that time Equator had not yet rendered the service to A Ltd, the relevant amount has not been accrued to Equator as income for the year of assessment 2014/15. Therefore, the bad debts claim for the advance payment will not be considered under s.16(1)(d) in the year of assessment 2014/15.

On the assumption that Equator had included the whole service fee payable by A Ltd in its chargeable profits for the year of assessment 2015/16, the assessor would not accept the claim of bad debts by Equator for the year of assessment 2016/17 either. Although A Ltd subsequently failed to pay any of the service fee to Equator, apart from sending the reminders, Equator had not taken any concrete recovery actions (e.g. commencement of legal actions) against A Ltd due to the close relationship. In addition, though A Ltd had cash flow problems, it was a profitable business on accounts and sought for extensions of time for repayment rather than refused to pay at all. Under such circumstances, the assessor would not be satisfied that the Outstanding Service Fees had become bad or irrecoverable under s.16(1)(d). No deduction would be allowed on the bad debts claimed by Equator for the year of assessment 2016/17.

Answer 6(b)

The service fee, if not outstanding, should be included in the revenue of Equator from its ordinary business operation. On such a basis, the consideration of HK$600,000 in respect of the sale of the Rights should form part of the assessable profits of Equator for the year of assessment 2017/18.

In ***Barr Crombie & Co Ltd v CIR*** [1945] 26TC406, it was held that where a company received a payment for the loss of the contract upon which the whole trade of the company has been built, where the expected profits of the contract are used to measure the loss of them for a period of future years, and where in consequence of the loss the company's structure and character are greatly affected, the payment should be beyond doubt a capital payment. Following this authority, unless Equator can prove that the service contract with A Ltd is its capital asset and that the loss had undermined its business structure, there is no ground to accept the sale of the Rights under the contract as being capital in nature.

However, with the sale of the Rights on 5 April 2017, the outstanding balance due from A Ltd is clearly irrecoverable by Equator. As such, Equator can claim the tax deduction of bad debts for the year of assessment 2017/18.

As such, the overall net effect is that Equator will be able to claim bad debts deduction of HK$900,000 (HK$1,500,000 - HK$600,000) for the year of assessment 2017/18.

Answer 6(c)

(i) There is no tax effect on A Ltd when Equator sold the Rights to Universe. The transfer of the Rights from Equator to Universe does not mean A Ltd was released from its liability.

(ii) S.15(2) of the IRO provides that where a deduction has been allowed for any debt incurred for the purposes of the trade, profession or business, the whole or any part of that debt being released afterwards shall be deemed to be the trading receipts at the time when the release is effected.

As A Ltd had claimed deductions of the service fee in its tax computation for the year of assessment 2015/16, when Universe released A Ltd from the liability to settle the Outstanding Service Fees on 15 April 2017, A Ltd should include the forgiven debts of HK$1,500,000 in computing its chargeable profits for the year of assessment 2017/18.

Answer 7(a)

The group recharge of a share-based payment is deductible under ss.16 and 17 of the IRO so long as the "incurred" test is satisfied and that such expenses are incurred in the production of profits chargeable to profits tax.

"Incurred" means that there is a definite commitment. Where the liability is contingent upon some future event, it cannot be said to have been incurred and is not deductible until the contingency crystallizes. A taxpayer has to prove that it has become unconditionally liable to pay the recharge. Any recharge claimed for deduction in the basis period in which the stock option/share award has not been exercised/vested does not meet the "incurred" test.

In the present case, even though Lavender charged Polar fully for the costs of share awards on 1 January 2013 (i.e. during the year ended 31 December 2013) and Polar had to settle the charge immediately, Polar could claim deduction of the recharge by Lavender on the share awards only in the year of assessment 2016/17 when the share awards were vested to Mr Chan on 1 January 2016.

Even though the market value of the share on the vesting date was US$350, which was higher than the charge of US$300 per share by Lavender, Polar could only claim the deduction of US$300,000 representing the amount incurred and actually paid to Lavender for its employees' share award benefits.

Answer 7(b)

Under s.9(1) of the IRO, income from any office or employment includes, among others, perquisite, whether derived from the employer or others. Mr Chan's entitlement of the share awards under the share benefits scheme clearly constitutes a perquisite assessable to salaries tax.

Mr Chan's argument that the share awards arose from his employment with Lavender cannot be accepted. He was only an employee of Polar up to 29 February 2016 and an employee of Vista from 1 March 2016 onwards. There is no information to suggest he had ever held any separate employment with Lavender directly either at the time when the share awards were granted or vested to him. Therefore, the 1,000 share awards granted or vested to him should not be sourced from employment with Lavender. Instead, the 1,000 share awards on the vesting date should be sourced from his employment with Polar.

As Mr Chan was an employee of Polar on the date of vesting, the 1,000 shares vested should be subject to salaries tax and the assessable amount is:
HK$(350 x 1,000 x 7.8)
=HK$2,730,000

From 1 March 2016 onwards, as Mr Chan was under the employment of Vista and he stayed in mainland China thereafter, his employment income for March 2016 was not liable to salaries tax under s.8(1A)(b)(ii) of the IRO.

The total assessable income of Mr Chan for the year of assessment 2015/16 is:
HK$(2,730,000 + 2,000,000)
=HK$4,730,000

Answer 7(c)

Mr Chan should not be a tax resident in mainland China as he and his family did not habitually reside there. However, even not being a Chinese tax resident, he was still subject to Individual Income Tax ("IIT"), depending on his length of stay in mainland China, whether he held a senior management position, the locality of services rendered by him and whether tax treaty exemption was applicable to him.

As Mr Chan resided in mainland China for more than 183 days but less than 1 full year during the year ended 31 December 2016, he was subject to IIT only on the income sourced from Vista.

Monthly IIT payable by Mr Chan in mainland China during the year ended 31 December 2016 is computed as follows:

Taxable monthly income in mainland China
= RMB¥(200,000 + 50,000 - 4,800*)
= RMB¥245,200

Monthly IIT payable
= RMB¥(245,200 x 45% - 13,505#)
= RMB¥96,835

(*) Standard deduction
(#) Quick deduction

Answer 8(a)

Under s.19C(4) of the IRO, where a corporation sustains a loss in any trade, profession or business carried on by it, the amount of that loss shall be carried forward and set off against the amount of its assessable profits from that trade, profession or business for subsequent years of assessment.

Where upon the set off under s.19C(4) of the IRO that a corporation has incurred loss in another trade, profession or business carried on by it in partnership in Hong Kong and such loss has not been utilised under the partnership, the corporation may elect under s.19C(5) of the IRO to use its share of loss from the partnership to set off against the assessable profits from its own trade for the same year of assessment.

There is no provision under the IRO which allows a taxpayer to choose retaining the loss sustained from its own trade and use the loss incurred from the partnership for set off purposes under s.19 of the IRO.

As Fast had an unutilised loss of HK$21,000,000 carried forward from the year of assessment 2014/15, this loss amount must be used first to set off against Fast's assessable profits of HK$38,200,000 from the same trade during the year of assessment 2015/16. Fast can then set off its share of partnership loss from Orange against its assessable profits under s.19C(5) of the IRO.

After the loss set-off from Orange, Fast did not have any net assessable profits for the year of assessment 2015/16.

The computations of profits tax payable by Fast for the year of assessment 2015/16 are shown below:

Fast		HK$
Assessable profits		38,200,000
Less:	Set-off of its own unutilised loss brought forward	(21,000,000)
		17,200,000
Less:	Set-off of share of loss under s.19C(5)	(17,200,000)
Net assessable profits		Nil

Orange		
Share of adjusted loss (50% of HK$123,000,000)		(61,500,000)
Less:	Set-off by profits from Fast under s.19C(5)	17,200,000
Unabsorbed loss carried forward		(44,300,000)

Answer 8(b)

There is no provision under s.19C of the IRO which allows the loss set-off against the assessable profits between the partnerships. Therefore, Fast cannot use its share of adjusted loss from Orange to set off its share of assessable profits from Apple and Lemon.

The computation of the profits tax payable by Fast on its share of assessable profits from Apple for the year of assessment 2015/16 is:
HK$88,750,000 x 50% x 16.5%
= HK$7,321,875

The computation of the profits tax payable by Fast on its share of assessable profits from Lemon for the year of assessment 2015/16 is:
HK$56,250,000 x 50% x 16.5%
= HK$4,640,625

Answer 9(a)

By its failure to submit the profits tax return by the due date, X Limited breached s.51(1) of the IRO.

As X Limited's first set of accounts were prepared up to a date (i.e. 31 January 2014) within the basis period of the year of assessment 2013/14, it also failed to notify its chargeability to profits tax to the IRD by 31 May 2014 as required under s.51(2) of the IRO.

The IRD may take different courses of punitive actions against X Limited. Possible actions include compounding the offences under s.80(5) of the IRO, initiating prosecution under s.80(2) of the IRO, or making an assessment of additional tax under s.82A(1) of the IRO.

Answer 9(b)

Mr B might rely on s.27(4) of the Stamp Duty Ordinance ("SDO") to claim exemption from ad valorem stamp duty ("AVD") on the conveyance of the property in Hong Kong from his father. However, it had to clearly provide in the related instrument for conveyance that the voluntary disposition of the property by Mr B's father was in consideration of Mr B's marriage.

The further assignment of the property from Mr B to Miss A would be subject to AVD. The conveyance was operating as voluntary disposition inter vivos chargeable to AVD under s.27(1) of the SDO.

The AVD will be calculated by reference to the scale 2 rate in Head 1(1)(i) in the First Schedule to the SDO.

Computation of AVD is as follows:
HK$9,200,000 x 3.75%
= HK$345,000

While Mr B had transferred the interests to Miss A without a resale within 36 months from the date of his acquiring the interests from his father, as Miss A was his wife, the conveyance would not be subject to special stamp duty as provided under s.29CA(10) of the SDO.

Even though Miss A is not a Hong Kong permanent resident, she would not be liable to the buyer's stamp duty ("BSD") on the assignment. This is because she and Mr B are closely related persons under s.29AD of the SDO. By virtue of s.29CB(2)(c) of the SDO, BSD is not chargeable on the transfer of a residential property between closely related persons and where the transferee is acting on his/her own behalf.

* * * END OF EXAMINATION PAPER * * *