



Examination Technique Seminar on Section B (Essay / Short Question)

- December 2013 and June 2014



Past Paper Review

DECEMBER 2013 SECTION B

MD – December 2013 (Essay / Short Question)



Question 6 (16 marks – approximately 29 minutes)

Mr. Au, Mr. Bill and CKL Ltd. have formed a **partnership**, namely ABC & Co. (“the Partnership”), for years in Hong Kong carrying on a business of **providing consultancy services**. According to its partnership agreement, the profit or loss derived by the Partnership is **shared equally** amongst the partners.

Mr. Au retired from the Partnership on **31 August 2012**. Nevertheless, he continued to be employed by the Partnership as a consultant for two years ensuring the seamless transition of the business management to other existing partners.

(Profit allocation split change at this date!!)

[Starting 1 September 2012 – change of partnership structure!!]

MD — December 2013 (Essay / Short Question)



Question 6 (16 marks – approximately 29 minutes)

Capital contribution originally made by Mr. Au to the Partnership has also been reclassified as **a loan from Mr. Au** to the Partnership. After Mr. Au's retirement, the profit or loss sharing ratio between Mr. Bill and CKL Ltd. has **changed to 3:2 respectively.**

(Previous disallow salary and interest to partnership of Mr Au. After changed to partner, it is deductible under s.16(1))

MD — December 2013 (Essay / Short Question)



Question 6 (Cont'd)

The profit and loss account of the Partnership for the year ended 31 December 2012 is as follows:

	Notes	\$
Consultancy income		11,039,960
Less:		
Salary expenses	1	5,480,000
Interest expenses	2	230,000
Rental expenses	3	600,000
Other deductible expenses		1,370,000
		<hr/>
		7,680,000
		<hr/>
		3,359,960
		<hr/>

Consider s.17(2) and s.16(1)(b)

MD — December 2013 (Essay / Short Question)



Question 6 (Cont'd)

Disallow s.17(2)

Notes:

1. Details of salary expenses

Recipients	1 Jan 2012 to 31 Aug 2012	1 Sep 2012 to 31 Dec 2012	Total
	\$	\$	\$
Mr. Au	240,000	80,000	320,000
Mrs. Au (wife of Mr. Au)	80,000	40,000	120,000
Mr. Bill	400,000	200,000	600,000
Mr. Bill Jr. (son of Mr. Bill)	160,000	80,000	240,000
Other employees	2,400,000	1,800,000	4,200,000
	<u>3,280,000</u>	<u>2,200,000</u>	<u>5,480,000</u>

MD — December 2013 (Essay / Short Question)



Question 6 (Cont'd)

2. Detail of interest expenses on capital contribution from the partners and loan from Mr. Au after his retirement

Recipients	1 Jan 2012 to 31 Aug 2012	1 Sep 2012 to 31 Dec 2012	Total
	\$	\$	\$
Mr. Au	100,000	50,000	150,000
CKL Ltd.	60,000	20,000	80,000
	<hr/> 160,000	<hr/> 70,000	<hr/> 230,000

Disallow based on
s.17(2)

Disallow based on
s.16(2)(c)

MD — December 2013 (Essay / Short Question)



Question 6 (Cont'd)

3. Details of rental expenses

Recipients	1 Jan 2012 to 31 Aug 2012 \$	1 Sep 2012 to 31 Dec 2012 \$	Total \$
Independent third party for leasing of head office premises for the Partnership	320,000	160,000	480,000
Mr. Bill for leasing of branch office premises for the Partnership (amount based on market value)	80,000	40,000	120,000
	<hr/> 400,000	<hr/> 200,000	<hr/> 600,000



Question 6 (Cont'd)

Required:

- a) Compute the **assessable profits of the Partnership** for the year of assessment 2012/13.
(5 marks)
- b) Compute the assessable **profits allocation** amongst the partners of the Partnership and their respective tax payable on the allocated profits for the year of assessment 2012/13. (Assume **no** election of Personal Assessment by Mr. Au and Mr. Bill. Ignore provisional profits tax and reduction of profits tax for the year.)
(11 marks)



DECEMBER 2013 SECTION B

Q6 ANSWER

MD — December 2013 (Essay / Short Question)



Answer 6(a)

ABC & Co. Computation of assessable profits Year of assessment 2012/13

	\$	\$
Profit before taxation		3,359,960
Add:		
Salary to Mr. Au (from 1 Jan to 31 Aug)	240,000	
Salary to Mrs. Au (from 1 Jan to 31 Aug)	80,000	
Salary to Mr. Bill (\$400,000 + \$200,000)	600,000	
Interest to Mr. Au (from 1 Jan to 31 Aug)	100,000	
(from 1 Sep to 31 Aug)		
[s.16(2)(c)]	50,000	
Interest to CKL Ltd. (\$60,000 + 20,000)	80,000	
	<hr/>	<hr/>
		1,150,000
Assessable profits		<hr/> <hr/> 4,509,960

MD – December 2013 (Essay / Short Question)



Answer 6(b)

Allocation of assessable profits for 2012/13

Period from 1 January 2012 to **31 August 2012 (Break up point)**

$$\$4,509,960 \times 8/12 = \mathbf{\$3,006,640}$$

	Mr. & Mrs. Au	Mr. Bill	CKL Ltd.	Total
	\$	\$	\$	\$
Salaries	320,000	400,000	–	720,000
Interest	100,000	–	60,000	160,000
	420,000	400,000	60,000	880,000
Balance(1:1:1)	708,880	708,880	708,880	2,126,640
Assessable profits	1,128,880	1,108,880	768,880	3,006,640

Based on partners' agreed profit sharing ratio

MD – December 2013 (Essay / Short Question)



Answer 6(b) (Cont'd) New Partnership combination

Period from **1 September 2012 to 31 December 2012**

$\$4,509,960 \times 4/12 = \mathbf{\$1,503,320}$

	Mr. Au \$	Mr. Bill \$	CKL Ltd. \$	Total \$
Salaries	-	200,000	-	200,000
Interest	-	-	20,000	20,000
	-	200,000	20,000	220,000
Balance(3:2) (New ratio)	-	769,992	513,328	1,283,320
Assessable profits	-	969,992	533,328	1,503,320
Total assessable profits for the year	1,128,880	2,078,872	1,302,208	4,509,960
Tax thereon@15%	169,332	311,830		481,162
Tax thereon@16.5%			214,864	214,864
				<u>696,026</u>

MD — December 2013 (Essay / Short Question)



Question 7 (12 marks – approximately 22 minutes)

CSH Ltd. (“the Company”) is a company incorporated in Hong Kong and engaged in the business of manufacturing and sales of precision electroplating machines. It has a **subsidiary** established in the USA specialised in technology development activities.

[Hong Kong Company] + Any transfer pricing issues?



Question 7 (Cont'd)

In a recent management meeting, the Company considers closing down the USA subsidiary and relocating the technology development activities to Hong Kong which is to be taken up by the Company directly. In this regard, all the tangible assets (i.e. devices, equipment, plant and machinery, etc.) and intangible assets (i.e. patents, trademarks, technical know-how, etc.) currently owned by the USA subsidiary will be sold to the Company with reference to **the prevailing market value**. All the tangible and intangible assets will then be used by the Company in Hong Kong for the continuation of technology development activities in connection with its existing business.

MD — December 2013 (Essay / Short Question)



Question 7 (Cont'd)

Required:

Discuss the deductibility of the expenditures incurred by CSH Ltd. in the contexts of relevant provisions in the Inland Revenue Ordinance with respect to the acquisition, from its USA subsidiary, of the following items:

a) Tangible assets; and

(6 marks)

Claiming depreciation allowances or whether full deductions available + s.16B and s.16G

b) Intangible assets.

(6 marks)

s.16E and s.16EA [DIPN 49]



DECEMBER 2013 SECTION B

Q7 ANSWER

MD – December 2013 (Essay / Short Question)



Answer 7(a)

(Always general deduction first!!! And disallow any capital expenses)

The acquisition cost of the tangible assets is capital in nature and cannot be claimed as deductible under **s.16(1) & s.17(1)(c)** of the IRO.

However, under **s.16G(1)** of the IRO, CSH Ltd. is eligible to claim for full deduction of specified capital expenditure on the tangible assets if the assets are in the category of **prescribed fixed assets** (i.e. fixed assets used specifically and **directly for any manufacturing purpose or computer software and hardware** under **s.16G(6)** of the IRO).



Answer 7(a) (Cont'd)

CSH Ltd. is also eligible to claim for initial and annual allowances [IA and AA] on the capital expenditure incurred for “plant and machinery” under s.39(B)(1) & (2) of the IRO. In this regard, CSH Ltd. should ensure that the tangible assets acquired from its USA subsidiary are within the category of “plant and machinery” under this provision. Inland Revenue Rule 2 provides that the “plant and machinery” shall include the items specified in the second column of the First Part of the table annexed to this Rule.

MD – December 2013 (Essay / Short Question)



Answer 7(a) (Cont'd)

Under s.38(B) of the IRO, if the IRD is of the opinion that **the sales price of a tangible asset** which qualified for initial or annual allowances **and transferred between related companies** does not represent its true market value, the IRD can determine such true market value and the amount so determined shall be deemed to be the sale price of such asset for the purpose of calculating the initial and annual allowances.

[Transfer pricing!!!]

MD – December 2013 (Essay / Short Question)



Question 7(b)

The acquisition cost of the intangible assets is against **capital** in nature and cannot be claimed for deduction under s.16(1) and **s.17(1)(c)** of the IRO.

However, under **s.16E(1)** of the IRO, capital expenditure incurred for the acquisition of **of patent right or right to any know how** for use in trade, profession or business in the production of profits is allowed for **full deduction**.

In addition, capital expenditure incurred by CSH Ltd. for the acquisition of **copyright, registered design or registered trade mark** is specifically allowed for deduction under s.16EA(2) of the IRO and can be **spread over five succeeding years** under s.16EA(3) of the IRO.



Answer 7(b) (Cont'd)

Restrictions

However, the deductions under s.16E(1) and s.16EA(3) of the IRO are not allowed if the respective intangible assets are **purchased wholly or partly from an associate** under s.16EC(2) of the IRO; an associate includes an associate corporate.

As **CSH Ltd. and its USA subsidiary** satisfy the definition of associate corporation, the intangible assets acquired by CSH Ltd. from its USA subsidiary **cannot be claimed for deduction.**

MD – December 2013 (Essay / Short Question)



Question 8 (22 marks – approximately 39 minutes)

VPM Ltd. is a company incorporated in Hong Kong and engaged in the manufacturing and sales of textile products. In order to enlarge its production capacities, VPM Ltd. considers establishing an overseas subsidiary (Newsup) and setting up a factory in that overseas jurisdiction. Products manufactured by Newsup will be sold to VPM Ltd. for onward sales to its customers.

The management of VPM Ltd. would establish Newsup in either Country X, a country which has a Comprehensive Double Taxation Agreement (CDTA) with Hong Kong, or Country Y, a country which does not have any CDTA with Hong Kong. It is also noted that the production costs and prevailing tax rates of Country X and Country Y are substantially the same.

MD — December 2013 (Essay / Short Question)



Question 8 (Cont'd)

In view of the complexities of the tax issues involved, VPM Ltd. has approached a leading professional firm, namely DHK & Co., requesting the provision of taxation advisory services, particularly in transfer pricing matters arising from the abovesaid proposal.

MD — December 2013 (Essay / Short Question)



Question 8 (Cont'd)

Required:

a) Explain from a **transfer pricing perspective** (i) why the Inland Revenue Department (IRD) is likely to scrutinise the transactions between VPM Ltd. and its overseas subsidiaries, (ii) the **principle** that would be used to scrutinise the transactions, and (iii) the relevant provisions in the Inland Revenue Ordinance that may be invoked by the IRD if it decides to **tackle** the transactions.

b) [**Consider Specific anti-avoidance and general –anti-avoidance**]

(Assume VPM Ltd. has not yet chosen the country to establish Newsub.)

(8 marks)



Question 8 (Cont'd)

- b) Identify the **transfer pricing methodologies** available for the IRD's consideration and applicable to VPM Ltd. for the transactions with Newsub. **[DIPN 46]**
- (3 marks)
- c) From a transfer pricing perspective, discuss the different tax implications for VPM Ltd. with respect to the choice between establishing Newsub in Country X and Country Y.
- (8 marks)
- d) Discuss the ethical considerations of DHK & Co. before accepting the tax advisory services engagement requested by VPM Ltd. **[Code of Ethics]**
- (3 marks)



DECEMBER 2013 SECTION B

Q8 ANSWER



Answer 8(a)

The proposed sales of products from Newsub to VPM Ltd. are **controlled transactions** between a Hong Kong resident enterprise (i.e. VPM Ltd.) and an **associated** non-resident enterprise (i.e. Newsub). In this regard, the respective basis of the pricing policy (i.e. **Transfer Pricing Policy**) for the abovesaid transactions will affect the Hong Kong Profits tax position and liabilities of VPM Ltd. Therefore the Inland Revenue Department (“IRD”) will diligently assess the basis of the transactions under relevant provisions in the IRO.



Answer 8(a) (Cont'd)

Endorsed by the Organisation for Economic Co-operation and Development (**the OECD) Transfer Pricing Guidelines** (TPG), the IRD adopts the arm's length principle for assessing transactions with transfer pricing issues **between associated enterprises**. The arm's length principle requires associated enterprises to charge the same price, royalty and other fee in relation to a controlled transaction as that which would be charged by independent enterprises in an **uncontrolled transaction** in comparable circumstances (Para. 36, DIPN No. 46, Dec 2009).

Controlled transactions compared to uncontrolled transactions



Answer 8(a) (Cont'd)

When transactions in this aspect are found without applying the arm's length basis, various provisions in the IRO would be invoked by the IRD in tackling the transfer pricing issues. These provisions include:-

1. **S.16(1) of the IRO** – payments made to an associated enterprise on a basis other than **arm's length** will be disallowed (Para 19, **DIPN No. 46**, Dec 2009) [Arms-length principle]
2. **S.17(1)(b) and (c)** of the IRO – denying a company a deduction for expenditures not connected with or arising from trade of an associated enterprise, or a capital withdrawn from the enterprise carried on in Hong Kong in order to support that of the foreign associated enterprise (Para 21 & 22, **DIPN No. 46**, Dec 2009)



Answer 8(a) (Cont'd)

3. S.61A of the IRO – In abusive profit shifting transactions (Para 23, DIPN No. 46, Dec 2009)

(Discussion of other relevant IRO provision(s) from a transfer pricing perspective (e.g. **s.20(2)** & s.61 of the IRO))

VPM Ltd. therefore should formulate **a transfer pricing policy** in accordance with the arm's length principle in order to avoid the possible challenge from the IRD.



Answer 8(b)

The IRD seeks to apply the principle in the TPG emphasising the importance of **comparability analysis** under various transfer pricing methods. The methodologies include **comparable uncontrolled price, resale price and cost plus methods** under the category of traditional transaction methods. It also includes **profit – split and the transactional net margin methods** under the category of transactional profit methods. (Para 66, DIPN No. 46, Dec 2009).

All these methods are considered by the IRD to satisfy the arm's length principle, and VPM Ltd. should select **the most appropriate transfer pricing method** to apply to the transactions conducted with Newsub.



Answer 8(c)

If Newsub is established **in Country Y** and there is a transfer pricing **adjustment** made by the tax administration of Country Y to increase the taxable income of Newsub with respect to the sales transactions between VPM Ltd. and Newsub, there are **no provisions** under the IRO permitting the relief from double taxation by way of **adjusting the quantum of assessable profits** of VPM Ltd. in the **absence of a CDTA** (Para 9, DIPN No. 45, April 2009). Such relief in the form of revising the assessment of VPM Ltd. can only be possible in accordance with the **relief provision** in the Associated Enterprises Article of the **CDTA and under s.79** of the IRO on the basis that the transfer pricing adjustment is made on the **controlled transactions** between VPM Ltd. and Newsub, which is to be established in country X (i.e. having a CDTA with Hong Kong). (Para 14, DIPN No. 45, April 2009)



Answer 8(c) (Cont'd)

If Newsub is established in Country X, it is possible for VPM Ltd., under the **CDTA**, to reach a **bilateral Advance Pricing Arrangement (APA) with the IRD** and the tax administration of Country X for the determination of an appropriate set of criteria on the transfer pricing of the transactions with Newsub over a fixed period of time (Para 6 & 10, **DIPN No. 48**, March 2012). However, this APA is not applicable to VPM Ltd. if Newsub is established in country Y **without any CDTA** concluded with Hong Kong.



Answer 8(c) (Cont'd)

On the other hand, there is a mechanism on the **exchange of information to the tax administration of Country X** under the CDTA. In this regard, **the IRD could exchange information to Country X** or other countries having a CDTA with Hong Kong in relation to the administration and enforcement of taxes covered by the respective CDTA, and the exchange is also restricted only upon request (Para 5 & 16, DIPN No. 47, June 2010). This exchange of information mechanism is **not applicable to Country Y** or other countries without any CDTA with Hong Kong.

MD – December 2013 (Essay / Short Question)



Answer 8(d)

Before accepting the tax advisory engagement from VPM Ltd., DHK & Co. should ensure the **objectivity** of its firm to VPM Ltd. by confirming that there is **no conflict of interest** between the two entities. Specifically DHK & Co. should not be subject to any undue influence from VPM Ltd. or any other person to **override its professional judgments**.

In addition, DHK & Co. should also ensure that they have **competent professional knowledge** on the current developments in practice, legislation and techniques from a transfer pricing perspective.

[Consider Code of Ethics – Fundamental principles]



Past Paper Review

JUNE 2014 SECTION B

MD – June 2014 (Essay / Short Question)



Question 6 (13 marks – approximately 23 minutes)

A Limited is a company incorporated and listed in Hong Kong. At all relevant times, A Limited **traded actively** in listed shares in Hong Kong. To finance the share dealing and investment activities, A Limited placed **deposits** with the Hong Kong branch of Bank C as security for a back-to-back loan. The deposits were **usually rolled over automatically without much management.**

For the year ended 31 March 2013, the turnover of A Limited consisted of **bank interest income, gains on disposal** of and **dividend income** from the listed shares. A Limited also received **dividend** from B Limited, a wholly-owned subsidiary incorporated in the Mainland of China (“the Mainland”). A Limited did not have its own establishment in the Mainland. **[DTA Article 11]**



Question 6 (Cont'd)

Recently, the Mainland tax authority has carried out an **investigation into** the tax affairs of B Limited. In this regard, the Hong Kong Inland Revenue Department (“IRD”) has been requested by the Mainland tax authority to provide certain information in relation to the dealings between B Limited and A Limited.

[Exchange of information DIPN 47]

MD – June 2014 (Essay / Short Question)



Question 6 (Cont'd)

Required:

- a) Discuss whether the **placing of deposits** by A Limited with Bank C constitutes a carrying on of business in Hong Kong.

[s.14(1) + Operation test + Bartica case]

(3 marks)

- b) Evaluate whether and if so, how A Limited is chargeable to any tax in the Mainland in respect of the dividend income from B Limited. **[DIPN 44]**

(3 marks)

- c) State the factors which the IRD will consider when processing the request for information lodged by the Mainland tax authority. **[DIPN 47]**



June 2014 SECTION B

Q6 ANSWER



MD – June 2014 (Essay / Short Question)



Answer 6(a)

A Limited placed deposits with Bank C in Hong Kong so as to secure a loan for its share dealing and investment activities in Hong Kong. Following *CIR v Bartica Investment Limited* 4 HKTC 129, such on-going activities went beyond the mere passive acquiescence and were sufficient to constitute carrying on a business in Hong Kong.



Answer 6(b)

A Limited is a **non-PRC tax resident** as it was incorporated in Hong Kong with no establishment in the Mainland. Its **dividend income** from B Limited is **subject to Corporate Income Tax** on a withholding basis.

As B Limited is the wholly-owned subsidiary of A Limited, pursuant to **Article 10** of the Double Taxation Arrangement between the Mainland and Hong Kong, the applicable **withholding tax rate is reduced from 10% to 5%**. Following the safe-harbour rule promulgated in Public Announcement No. 30, A Limited can be regarded as **the beneficial owner of its dividend received** from B Limited as A Limited is **listed** in Hong Kong and the dividend income is derived from its shares in B Limited.



Answer 6(c)

In determining whether the request for information lodged by the Mainland tax authority should be acceded to, the IRD will consider the following factors (see **Departmental Interpretation and Practice Notes No. 47**):

1. Whether the **request is specific, bona fide and justifiable** for the purpose of investigating the tax affairs of B Limited, or merely a speculative one that has no apparent nexus to the investigation.
2. Whether the requested information is **“foreseeably relevant” to secure the correct application of the provisions** of the Arrangement or the Mainland tax laws.



Answer 6(c) (Cont'd)

3. Whether the **requested information** is to be used by the Mainland tax authority for the administration and enforcement of taxes covered by the Arrangement. The information obtained pursuant to the **Arrangement cannot be used for non-tax purposes.**
4. Whether the requested information is such that the Mainland Tax authority would **be unable to obtain it in the normal course of its administration.**
5. Whether the provision of the requested information would be contrary to any public policy.



Answer 6(c) (Cont'd)

6. Whether the requested information **constitutes trade or business secrets** of B Limited and/or A Limited.
7. Whether the requested information is **protected by legal professional privilege**.
8. Whether the requesting party is the **competent authority** of a treaty partner.

MD – June 2014 (Essay / Short Question)



Question 7 (12 marks – approximately 22 minutes)

D Limited commenced business on 1 October 2010 and closed its accounts on 31 December. The first and second accounts of D Limited were closed **on 31 December 2011 and 31 December 2012 respectively.**

On 1 January 2011, D Limited entered into a **hire purchase** agreement to acquire a lorry. The total price of the lorry was **HK\$640,000**, including the cash price of **HK\$520,000** and interest of **HK\$120,000**. The agreement provided that a down payment of HK\$40,000 was payable upon the execution of the agreement and the balance to be paid by 24 instalments of HK\$25,000.

MD – June 2014 (Essay / Short Question)



Question 7 (12 marks – approximately 22 minutes)

The first instalment was payable on **31 January 2011** and the remaining 23 instalments were payable on the last day of the following calendar month. Each instalment included capital repayment of HK\$20,000 and interest of HK\$5,000.



Question 7 (Cont'd)

Required:

- a) Determine, **with explanation in support**, the **basis periods** of D Limited for the years of assessment 2010/11, 2011/12 and 2012/13. **[Tax Administration question]**

(7 marks)

- b) **Compute** the depreciation allowance in respect of the lorry for the years of assessment 2011/12 and 2012/13.

(5 marks)



June 2014 SECTION B

Q7 ANSWER

MD – June 2014 (Essay / Short Question)



Answer 7(a)

Year of assessment 2010/11

Basis period: 1 October 2010 **(Date of commencement)** to 31 December 2010

Consider : 1 October 2010 to 31 Dec 2011 = 15 months ?

Year of assessment 2011/12 **(12 months)**

Basis period: 1 January 2011 to 31 December 2011

Year of assessment 2012/13 **(12 months)**

Basis period: 1 January 2012 to 31 December 2012



Answer 7(a) (Cont'd)

Explanation

1. As the **first accounts** of D Limited were prepared for a period in **excess of 12 months and were closed at 31 December 2011** (i.e. within the second year of assessment), by virtue of **s.18C(1)(b)** of the Inland Revenue Ordinance (“IRO”), **the basis period** for the year of commencement will be determined at the Commissioner’s discretion. In such circumstances, the Commissioner will usually determine **the basis period** for the second year of assessment as a period of 12 months counted backwards from the end of the first accounts, whilst the basis period for the first year of assessment will be the **remaining period counted from the date of commencement**.



Answer 7(a) (Cont'd)

2. The **second accounts were prepared for 12 months up** to a day other than 31 March (i.e. 31 December 2012). By virtue of s.18B(2) of the IRO, **the Commissioner will adopt the same accounting period** as the basis period for the year of assessment in which such period ends (i.e. 2012/13).

MD – June 2014 (Essay / Short Question)



Answer 7(b)

<u>Year of assessment 2011/12</u>	<u>Lorry (30%)</u> <u>HK\$</u>	<u>Allowance</u> <u>HK\$</u>
Cash price	520,000	
Less: Initial allowance [(\$40,000 + \$20,000 x 12) x 60%]	168,000	168,000
	<hr/>	
	352,000	
Less: Annual allowance (\$352,000 x 30%)	105,600	105,600
	<hr/>	
Written down value c/f	246,400	273,600
	<hr/>	

**Initial
deposit**

**Monthly principal
repayment**

MD – June 2014 (Essay / Short Question)



Answer 7(b) (Cont'd)

Year of assessment 2012/13

	Lorry (30%) HK\$	Allowance HK\$
Written down value b/f	246,400	
Less: Initial allowance (\$20,000 x 12 x 60%)	144,000	144,000
	<hr/>	
	102,400	
Less: Annual allowance (\$102,400 x 30%)	30,720	30,720
	<hr/>	
Written down value c/f	71,680	174,720
	<hr/>	

**Monthly principal
repayment**



Question 8 (25 marks – approximately 45 minutes)

Discuss the implications of **profits tax, salaries tax, property tax, personal assessment and stamp duty** (including special stamp duty), where applicable, in each of the following scenarios

(Note: No tax computation is required.):

- a) On **1 February 2012**, E Limited entered into an agreement to purchase a shop from F Limited. As a confirmor, E Limited entered into an agreement to sell the shop to G Limited at profits on **15 July 2012**. By an assignment dated **15 October 2012**, the shop was assigned by F Limited to G Limited. E Limited was incorporated on **1 January 2012** and was wholly financed by the contributions of its two shareholders. It became dormant after the completion of the above property transaction.

(7 marks)

MD – June 2014 (Essay / Short Question)



1 February 2012
Purchased flat

15 July 2012
Assignment

15 October 2012
Completion

**F Limited to
E Limited**

**E Limited to
G Limited =
Profit**

**F Limited to
G Limited**

↑
**Incorporated on
1/1/2012 and
dormant after 15
Oct 2012**

MD – June 2014 (Essay / Short Question)



Question 8 (Cont'd)

b) Mr. H and his wife, Ms. I, are retirees. The couple entered into an agreement to **purchase a residential flat** as joint tenants on 1 January 2012. The couple arranged a **mortgage loan** to finance 30% of the consideration, whilst the remainder was settled by the couple's own savings. The flat was **let out** after the completion of the transaction. Pursuant to a Compulsory Sale Order granted by the court under the Land (Compulsory Sale for Redevelopment) Ordinance (Cap. 545), Mr. H and Ms. I entered into an agreement to sell the flat at a profit on 1 June 2013.

**Mortgage
interest
= elect PA ?**

Property Tax

**Disposal
property**

(11 marks)



Question 8 (Cont'd)

- c) Mr. J had a residential flat which was **inherited** in accordance with the will of his deceased father on 1 April 2012. He subsequently entered into an agreement to **sell the flat** to Mr. K on 31 December 2012. Upon assignment on 1 April 2013, Mr. K **admitted his nephew, Mr. L**, as a joint tenant of the flat. Mr. K and Mr. L are both salary earners. They arranged a **mortgage loan** to finance the acquisition of the flat and used the flat as their **residence**.

Home loan interest – residing in the flat!!!

(7 marks)



June 2014 SECTION B

Q8 ANSWER



MD – June 2014 (Essay / Short Question)



Answer 8(a)

Stamp duty

The **assignment executed on 15 October 2012** is chargeable with stamp duty under **head 1(1)** in the First Schedule of the SDO.

Although the shop was sold by E Limited within 24 months after the acquisition, **no special stamp duty (“SSD”)** will be charged as SSD is applicable to residential properties only.



Answer 8(a) (Cont'd)

Profits tax

It is likely that **E Limited** will be regarded as having acquired the shop as **trading stock** and its profits derived from the sale of the shop will be chargeable to profits tax, having regard to the following circumstances:

1. **E Limited** held the shop for a **very short period of time**. It sold the shop as a confirmor without taking up the assignment.
2. **E Limited** is a **newly incorporated company** and has become dormant since the sale of the shop. It does not appear that the shop was acquired by **E Limited** for investment or business purposes.



Answer 8(a) (Cont'd)

3. The operation of E Limited was **wholly financed** by shareholders' contributions. There is no evidence that the **company is financially capable of holding the shop** on a long-term basis.

In ascertaining the amount of **assessable profits**, the stamp duty for the purchase of the shop is **deductible. S.16(1)**

MD – June 2014 (Essay / Short Question)



Answer 8(b)

Stamp duty

The agreements for sale executed **on 1 January 2012 and 1 June 2013 are chargeable with stamp duty** under head 1(1A) in the First Schedule of the SDO.

Although the residential flat was sold by Mr. H and Ms. I within 24 months after the acquisition, **no SSD** will be charged as the agreement for sale dated 1 June 2013 was made pursuant to a **court order: s.29CA(11)(a)** of the SDO.



Answer 8(b) (Cont'd)

Profits tax

In view of the following circumstances, Mr. H and Ms. I may not be regarded as having acquired the flat as trading stock and thus chargeable to profits tax in respect of the profits derived from the sale of the flat: [Badges of Trade]

1. Mr. H and Ms. I had used the flat for **letting before the sale.**
2. Mr. H and Ms. I should have been **financially capable of holding the flat on a long-term basis.** The couple could finance 70% of the consideration by their savings. The **rental income** from the flat should likely provide sufficient means to the couple to repay the mortgage loan.



Answer 8(b) (Cont'd)

3. Mr. H and Ms. I did not sell the flat voluntarily. The sale was made pursuant to the **compulsory sale order** granted by the court.



Answer 8(b) (Cont'd)

Property tax

Mr. H and Ms. I are chargeable to **property tax** in respect of the rental income from the flat.

In ascertaining the **net assessable value of the flat**, the stamp duty paid for the purchase of the flat is not deductible.



Answer 8(b) (Cont'd)

Personal assessment

Mr. H and Ms. I, being retirees, might not have income other than the rental income from the flat. As such, it is likely that the couple can benefit from the election for **personal assessment**.

By electing for personal assessment, Mr. H and Ms. I are entitled to **married person's allowance**. They can also be allowed for deduction of the **mortgage loan interest** incurred in respect of the flat, limited to the net assessable value of the flat.



Answer 8(c)

Stamp duty

The agreement for sale executed on 31 December 2012 is chargeable with **stamp duty under head 1(1A)** in the First Schedule of the SDO. Although the residential flat was sold by Mr. J **within 24 months after the acquisition**, **no SSD** will be charged as the flat was inherited by Mr. J under the will of his deceased's father: s.29CA(11)(b)(iii) of the SDO.

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Answer 8(c) (Cont'd)

Provided that the above agreement for sale is duly stamped, the assignment executed on **1 April 2013** will be chargeable with stamp duty under **head 1(1)** in the First Schedule of the SDO by reference to the consideration **less a fraction of the stamp duty representing the proportion of the flat that is vested in Mr. K** (i.e. 1/2): s.29D(4) of the SDO. Further, Mr. K will be regarded as having acquired the flat on 31 December 2012 and **disposed of 1/2 share** of it to Mr. L on 1 April 2013: s.29DA(8) of the SDO. **SSD will be charged** by reference to the **relevant share** under head 1(1AA) in the First Schedule of the SDO.



Answer 8(c) (Cont'd)

Profits tax

It is **unlikely** that Mr. J will be chargeable to profits tax in respect of his sale of property as the property concerned has **inherited from his father's estate**.

Salaries tax

As both Mr. K and Mr. L are **salary earners**, they will be chargeable to salaries tax in respect of their salary income.

In ascertaining their salaries tax liabilities, Mr. K and Mr. L will each be entitled to **deduct 1/2 share of the mortgage interest** paid in respect of the flat as **home loan interest**, subject to the maximum limit in s.26E(2)(a)(ii) and (c) of the IRO.



Exam Techniques for MD

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Specific Techniques to pass MD



A. What kinds of taxes involved ?

Profits Tax	50%
Salaries Tax	30%
Others (Property tax, Tax admin, Stamp Duty, China Tax)	20%

Specific Techniques to pass MD



B. Income or expenses?

Consider Tax Planning

Profits Tax income

- S14(1) Charging section
- DIPN 21 (Revised) - Operation test [*Hang Seng Bank Case*, *TVBI case*]
- Trade – Badges of Trade
- S15 (Deeming Provisions) – Royalties
- Trading / Manufacturing / Financing / Service income

Profits tax expenses

- Always give General Deduction Rule S16(1) first + Specific Deduction Rules if applicable

Specific Techniques to pass MD



C. Give whole set of answer

For example: Royalties income

- Scope of Charge – S15(1)(b) or S15(1)(ba)
- Tax adjustments – S21A – 30% or 100%
- Tax administration – S20A or S20B
- *Emerson Case*
- Effect of DIPN 49

Specific Techniques to pass MD



D. Count marks

5 marks question: around 7 points

E. Tax computation

3 out of 10 for calculation

7 out of 10 for explanation

- **Remember to use cross referencing**
- **Explanations are the most important**

Final Techniques to pass MD



- A. Consideration of **commencement of business and termination** of business
- B. Always consider **capital or revenue** – capital gain S14(1) not taxable Capital expenditure S17(1)(c)
- C. Disposal of properties or shares – **tax implication and stamp duty implication** – always consider profits tax and stamp duty
 - Profits tax: Badges of Trade
 - Stamp Duty: Heads
- D. Watch out for **most updated cases** (subject to 6-month rule)

Common Techniques to pass MD



- A. Prepare your critical files**
- B. Only need 1 set of notes**
- C. Time yourself**
- D. Start practise writing**
- E. Don't just copy – use key words for application**
- F. Demonstrate logical thinking – sometimes no right or wrong**
- G. No need to highlight everything in the question booklet**
- H. Writing – legible to read**

Final Advice



- **The time to look-up the textbook is limited during an open-book exam**
- **Students should:**
 - ❑ **have a good understanding of the topics before going into the exam**
 - ❑ **read the case and questions carefully**
 - ❑ **answer what is being asked, not what they wanted to be asked**
 - ❑ **identify the core issues of the question and allocate their time accordingly**
 - ❑ **analyse the facts of the case and apply the tax rules or principles to arrive at the conclusion**
 - ❑ **not copy large passages from the textbook**
 - ❑ **use logical thinking to understand and respond to the questions**