Student Notes

Module D (Jun 2013)

Workshop Outline and Learning Methodologies

Session	Methodologies	Chapters covered	Guidance Notes
Workshop 1			
1. Introduction	• Presentation • Group discussion		
2. Profits tax	• Group exercise	Ch. 3 & 11	Pg. 1 to 6
3. Negotiation	• Role play • Group exercise		
4. Tax for individuals	• Case study • Group discussion	Ch.5 & 11	Pg. 7 to 9
Workshop 2			
5. Reboot	• Presentation • Group discussion		
6. Tax-avoidance	• Group discussion	Ch. 3, 4, 9 & 11	Pg. 1 to 4
7. Cross border tax issues	• Group discussion	Ch. 3, 4, 12 & 13	Pg. 5 to 6
8. Tax planning	• Case study • Group reflection	Ch.3, 4, 5, 7, 9, 11 & 12	Pg. 7 to 9
9. Conclusion	• Presentation • Group discussion		

Preamble

The focus of the workshops under the Enhanced Qualification Programme is on formative development of skills, i.e. to train students to become future CPAs.

As such, many of the cases and issues discussed during the workshops were designed to encourage different points of view which may result in different conclusions being drawn by the students during the workshops.

These guidance notes will point out some of the main observation points from these discussions to facilitate a better understanding of those cases or issues. These guidance notes are not intended to be 'model answers' and should not be used for any purpose other than for a better understanding of the key points discussed during the workshops.

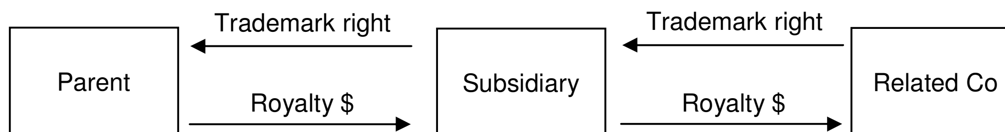
Workshop Two – Tax Avoidance Cases **(Group Discussion Exercise)**

Reason for activity

CPAs need to be familiar with anti-avoidance provisions in order to identify and manage the risk of possible challenges by the IRD on current or proposed arrangements.

Issue 1: Royalty income

Details were provided of a company incorporated outside Hong Kong, which acquired the right to use a trademark from a related overseas company and then sub-licenced the right to use the trademark to its parent company in Hong Kong.



The royalty paid by the parent company to the subsidiary was based on an independent valuation. Since the trademark was used by the parent company in Hong Kong, the IRD has accepted that only 30% of the royalty income received by the non-resident subsidiary be assessed to profits tax in Hong Kong on a withholding basis.

Additional information

The directors of the subsidiary were nominees who acted under the instructions of the directors of the parent company. The agreement to acquire the right to the trademark from the related company and the agreement to licence the right to the parent company were negotiated in Hong Kong but signed by the nominee directors outside Hong Kong.

Main observation points

The non-resident subsidiary, which did not carry on business in Hong Kong, would be assessed on 30% of its royalty income under s.15(1)(b) of the IRO, since the trademark was used in Hong Kong. S.15(1)(ba) would not be applicable since the trademark was used in Hong Kong.

Based on the additional information, it would appear that all the decisions were made in Hong Kong, and the company had actually carried on business in Hong Kong. As per the *Lam Soon Trademark* case, the IRD may seek to assess 100% of the royalty income under s.14 instead of 30% under s.15(1)(b) of the IRO.

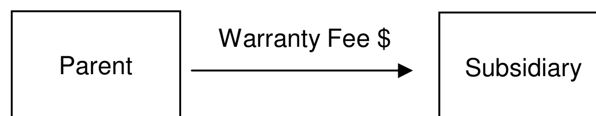
To determine the source of the royalty income under s.14 of the IRO, some students correctly referred to Departmental Interpretation and Practice Notes (DIPN) No. 49 (paragraphs 72-76) which explains how the source principle can be applied under different circumstances.

In this case, as the intellectual property right is not owned by the licensor (i.e. the subsidiary did not own the right to the trademark), the place where the subsidiary acquired and granted the right to use the trademark would determine the source of the royalty income. Since both agreements to acquire and grant the right to the trademark were negotiated in Hong Kong, it is likely that the royalty income would be treated as sourced in Hong Kong. The mere signing of the agreements by the nominee directors outside Hong Kong would not affect the source of the royalty income.

Issue 2: Transfer pricing

Details were provided of a company incorporated in Hong Kong, which engaged its overseas subsidiary to provide product warranty services to its customers during the warranty period.

The product warranty fee paid to the overseas subsidiary would initially be based on a 10% mark-up on cost. Subsequently, a year-end adjustment would be made to the warranty fee paid to the overseas subsidiary.



The overseas subsidiary did not perform any of the services itself, as it engaged independent agents to provide product warranty services in the country where the customers were located. The overseas subsidiary is not chargeable to tax in its home country and has not filed any tax return in Hong Kong.

The IRD has issued an enquiry letter requesting for more details on the above arrangement.

Main observation points

This arrangement may lead to the Hong Kong company paying no profits or less than the ordinary profits which might be expected to arise in or derived from Hong Kong. The IRD may, under s.20(2) of the IRO, deem the non-resident person to have carried on business in Hong Kong, and assess the non-resident in respect of the profits derived in Hong Kong.

Based on the information provided, there appears to be no commercial reason to insert the overseas subsidiary into the arrangement and the IRD may disregard the overseas subsidiary under s.61 of the IRO.

S.61A of the IRO may be applicable if the sole or dominant purpose of the arrangement was for a tax benefit. In the *Ngai Lik Electronics* case, it was held that the year-end adjustments were made with the sole or dominant purpose of obtaining a tax benefit, and the IRD can disregard the transactions, or can assess as appropriate to counteract the tax benefit.

In this case, the parent company in Hong Kong will need to justify to the IRD the total amount of product warranty fee paid to the overseas subsidiary each year. If the IRD subsequently determines that the product warranty fee paid over the years were overstated, the IRD may issue additional assessment to the parent company.

Issue 3: Acquisition of trademarks

Details were provided on a Hong Kong company which acquired two trademarks during the year. For the first trademark, the company purchased the trademark and licenced it back to the seller. For the second trademark, the company terminated a licensing agreement before its expiry and purchased the trademark from the licensor.

Main observation points

Some students correctly referred to DIPN 49 (paragraphs 52-67) for the circumstances in which the IRD would disallow the deduction on purchase of intellectual properties.

For the first trademark, most students correctly cited s.16EC(4)(a) of the IRO, which may disallow the deduction if there was a sale and leaseback arrangements. However, s.16EC(4)(a) may not be invoked for genuine commercial financing arrangements if the conditions under s.16EC(5) is satisfied. Students should refer to paragraph 61 of DIPN 49.

For the second trademark, deduction may not be allowed under s.16EC(1) of the IRO. Students should refer to the factors in paragraph 55 of DIPN 49 which the CIR would consider in determining whether the purchase price paid was a reasonable consideration. If not, the deduction may be disallowed under s.16EC(1) of the IRO.

Issue 4: Interest deduction

Details were provided on a Hong Kong company which entered into two loan arrangements. The first loan was borrowed from a bank in Hong Kong to acquire a building in Hong Kong for long-term investment. At the same time, the bank in Hong Kong entered into a sub-participation arrangement with its overseas subsidiary. During the middle of the year, the overseas bank assigned the right to receive the interest income from the loan to an overseas fellow subsidiary of the Hong Kong company. The second loan was borrowed from the overseas bank to purchase machineries, and the loan was secured by shares and an overseas deposit placed by an overseas subsidiary of the company.

Main observation points

For the first loan, many students recognised that despite having satisfied s.16(1)(a) and s.16(2)(d) of the IRO, the sub-participation arrangement leading to the overseas fellow subsidiary of the company receiving the interest income (which is not taxable in Hong Kong) would contravene s.16(2B) of the IRO. The amount of deductible interest expense would therefore be reduced accordingly (from the time the loan was further sub-participated by the overseas fellow subsidiary of the company).

For the second loan, most students correctly identified that the loan would contravene s.16(2A) of the IRO, and therefore, the amount of deductible interest expense would be reduced by the amount of non-taxable interest income (as explained in paragraphs 23-24 of DIPN 13A).

Workshop 2 – Cross Border Tax Issues **(Group Discussion Exercise)**

Reason for activity

CPAs should have an awareness of the tax issues arising from cross-border transactions, especially due to the increase in cross-border transactions between Hong Kong and the Mainland.

Case 1: Importation and distribution

Details were provided of a company incorporated in the Mainland which imported cosmetic goods, further processed and repacked the cosmetic goods for sale in the Mainland. Students were required to discuss the turnover tax issues.

Main observation points

Consumption Tax (CT) and Value-added Tax (VAT) are payable on importation and on subsequent sale of the cosmetic goods. The CT payable and VAT payable would be computed as follow:

On importation

CT payable	=	Composite taxable value	x	CT rate
VAT payable	=	Composite taxable value	x	VAT rate

Composite taxable value	=	$\frac{(A + B)}{(1 - C)}$
A	=	Value of goods on which custom duty is paid
B	=	Customs duty
C	=	CT rate

On subsequent sale

CT payable	=	Sales value (exclude VAT)	x	CT rate	-	CT paid on importation
VAT payable	=	Sales value (exclude VAT)	x	VAT rate	-	Input VAT

Case 2: Tourism business

Details were provided on a Mainland enterprise which arranges tours in Hong Kong and Japan. The Mainland enterprise owns a Hong Kong company which owns and runs a hotel in Hong Kong. Students were required to discuss the turnover tax implications.

Main observation points

Business Tax (BT) is imposed on:

(i) the provision of taxable services;

(ii) assignment of intangible assets; and

(iii) the sale of immovable property in the Mainland.

Tourism is included in "taxable services" and if chargeable, is subject to BT at 5%.

For **(i)** the provision of taxable services, BT is chargeable if the service recipient or provider was located in the Mainland. However, per *Caishui* (2009) 111, overseas entities which provide hotel and catering services outside the Mainland are not subject to BT.

In this case, the Mainland enterprise would be subject to BT on its business income for arranging the tours, which is net of the expenses incurred (i.e. meal charges, transportation fees etc).

Note: These exercises provide students a chance to experience the challenges faced by CPAs in practice. Certain aspects of the question, which may be beyond the scope of this module, are retained to ensure that the scenario closely resembles the cases encountered by CPAs in real life. Students would not be expected to have knowledge beyond level one (awareness) for China Tax in the module examination.

Workshop 2 – Tax Planning for Individuals (Group Discussion Exercise)

Reason for activity

CPAs should be able to apply up-to-date tax knowledge together with innovative and critical thinking to minimise the tax exposure of an individual in a legal and commercially realistic manner.

Case Study: Employment / service arrangement

Details were provided on the income and expenses of a designer employed by a US company, resides in Hong Kong and travels frequently around the region. He has received "tax advice" that he could set up a consultancy company to receive consultancy fees from the US company so that he can pay less tax in Hong Kong. He was further advised that he could also set up an offshore company so that his income is offshore and need not be reported to the IRD in Hong Kong. Students were required to explain the alternative arrangements from a tax perspective, provide a proposal, advise whether he can apply for an Advance Ruling on the proposed arrangement, and to comment on the "tax advice" from an ethical perspective.

Main observation points

Most students correctly pointed out that setting-up a consultancy company may be challenged by the IRD under s.9A of the IRO as a "disguised employment". However, some students incorrectly assumed that all consultancy companies would be challenged under s.9A, even though some consultancy companies are for genuine commercial arrangements and can continue to be assessed under profits tax, rather than salaries tax.

In this case, students should refer to paragraphs 21-33 of DIPN 25 (revised) for the specified criteria in s.9A(3)(a) to (f) used by the IRD to determine if s.9A would apply.

The majority of the students recognised that using an offshore company for the above consultancy company arrangement would not make any difference to the tax implications, and can equally be challenged by the IRD under s.9A (if it does not satisfy the criteria under s.9A(3)(a) to (f) of the IRO).

An alternative for the designer would be to ascertain whether he has a non-Hong Kong employment. If so, his income may be assessed on a time-apportioned basis, since he frequently travels outside Hong Kong. Most students correctly referred to the three factors in paragraph 6 of DIPN 10 (revised), which the IRD will look at (in addition to other relevant facts) to determine whether the taxpayer has a non-Hong Kong employment:

(1) Where the employment contract was negotiated, concluded and enforceable;

(2) Where the employer is resident; and

(3) Where the remuneration is paid.

If the designer seriously contemplates the alternative arrangement and would like added certainty on whether it will be accepted by the IRD, he may apply for an Advance Ruling. Some students correctly referred to paragraph 46 of DIPN 31 (revised) which explains the situation where the Advance Ruling is not binding, and paragraphs 48-52 where the ruling can be withdrawn or cease to apply.

In terms of the "tax advice", if it was provided to the designer by a CPA, he/she should maintain a high standard of professional conduct and act with integrity and honesty. Some students correctly referred to s.430 "Ethics in Tax Practice" of the Code of Ethics for Professional Accountants (revised June 2010) which sets out the fundamental principles and how they can be applied by a member rendering professional tax services.

The relevant extract from s.430 are included in the Module D (Taxation) Learning Pack for students' reference (Section 3 of Chapter 9 and Section 1.3 of Chapter 11).

Workshop 2 – Tax Planning for Corporations **(Group Discussion Exercise)**

Reason for activity

CPAs should be able to apply up-to-date tax knowledge together with innovative and critical thinking to minimise the tax exposure of a company or a group of companies in a legal and commercially realistic manner.

Case Study: Sports and recreational club

Details were provided of a company incorporated in Hong Kong which operates a sports and recreational club in Hong Kong for the use of members and non-members. The club plans to diversify its business in order to maintain a healthy cash flow to maintain the club's operations. Students were required to advise on the existing tax position of the club, and on possible ways to improve the tax efficiency of the club, taking into consideration the proposed business diversification.

Main observation points

Most students correctly referred to Example 78 in Section 14.8 of Chapter 3 of the Learning Pack to compute the existing tax position of the club. Some of the student correctly applied the 50% test to determine which year of assessment the club is deemed to have carried on business and is chargeable to profits tax.

Some students correctly pointed out that the applicable profits tax rate would be 16.5% instead of 15% as the taxpayer in this case is a limited company.

For tax efficiency, most students correctly focused on ways to ensure that more than 50% of the club's total gross receipts are from members, in order to be exempt from profits tax for that year of assessment.

For the business diversification, some students correctly pointed out that the club may lose its exemption status (as a club) if it ventures into new businesses which are not incidental to its operation as a club. They also correctly pointed out that the club will need to take into account other non-tax issues in considering the proposals.