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Examination Techniques Seminar on QP Module Examinations

Module D (December 2017 Session)

Date: 1 Nov 2017





Agenda

- 1 • Introduction
- 2 • Common Weaknesses
- 3 • Sharing with Markers
- 4 • Preparation for Examinations
- 5 • Q & A Session



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Part 1: Introduction





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Today's objective:
***Finding ways to pass the
Module Examination!***



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HKICPA QP Module Examinations

Examination Format:

- Section A – Case Questions (50%)
- Section B – Essay / Short Questions (50%)
- 3 hours duration for each Paper
- All compulsory questions



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Part 2: Common Weaknesses





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Major causes to examination failure



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Aspect 1: Questions

- Difficulty in identifying the specific question requirements
- Misinterpretation of the question requirements



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Aspect 2:

Answers

- Approach or structure of answers are disorganized
- Answers are either too long or too short
- Answers are wrong, irrelevant, or lack of practical consideration
- Answers are not linked to the case facts
- Answers are straight copy from LP or reference materials
- Did not attempt all questions



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Aspect 3: **Candidates**

- Inadequate or ineffective preparation
- Other commitments affecting examination preparation
- Not in a good form to perform on examination day
- Felt panicking or got nervous in the examination centre
- Poor time management

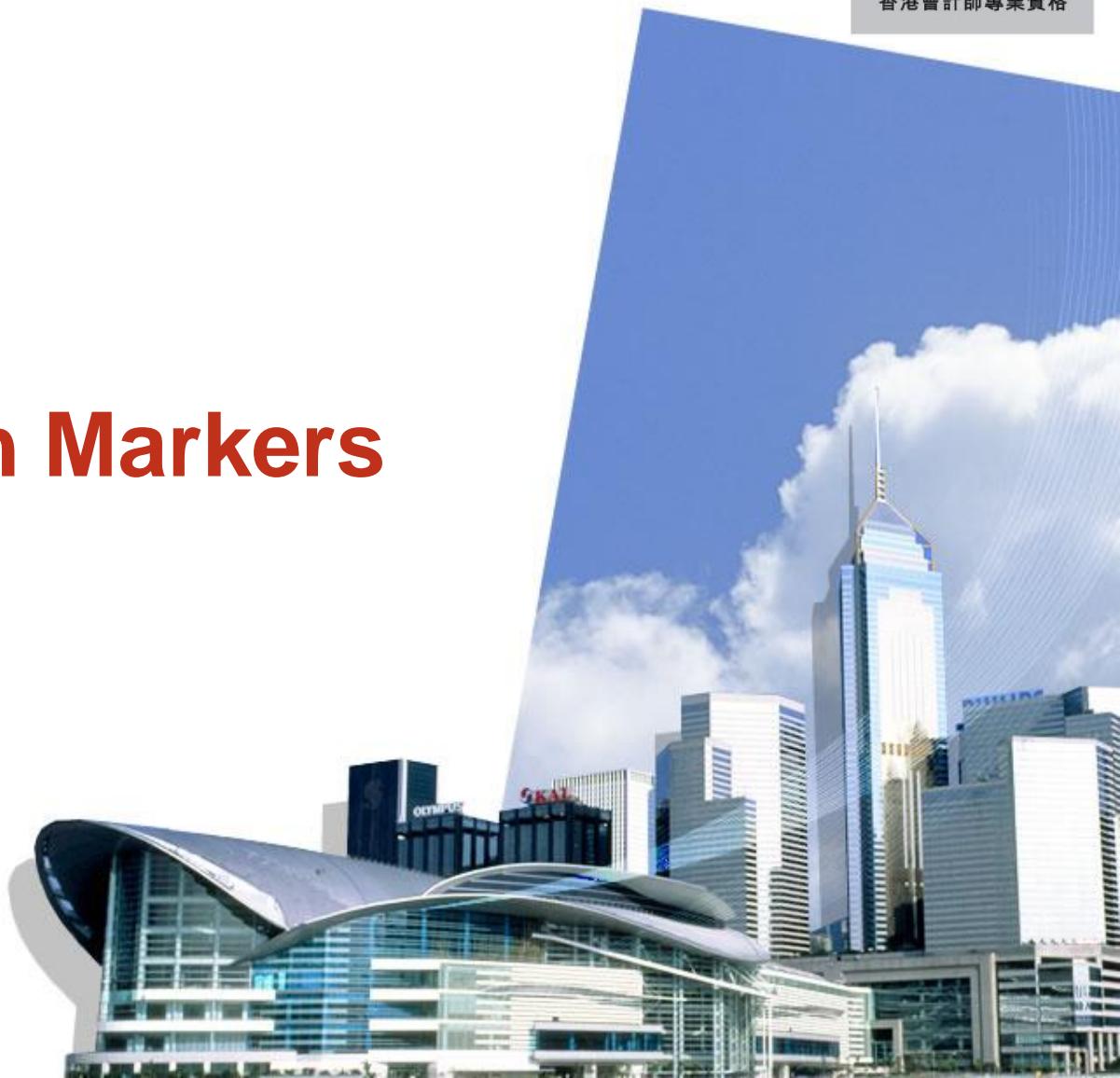


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Part 3: Sharing with Markers





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Ms. Edith Chan



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Key points recapped

- Interpretation of the requirements
- Understanding and application of knowledge
- Structure of the answer
- Time management



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Section A – Case Questions



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Case background

1. Case

Ms Poon is the Chief Executive Officer of City Education (HK) Limited ("City"), a reputable enterprise in Hong Kong providing assistance to students to find overseas study options. The information in Annex 1 was provided by Ms Poon with respect to her remuneration details for the year ended 31 March 2016.

➤ Q2

Ms Poon married Dr Ho at the end of March 2016. In a recent discussion with her friends, Ms Poon has been advised to consider electing for joint assessment or personal assessment upon filing her future Tax Returns to reduce the overall tax liabilities of herself and Dr Ho.



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Case background

1. Case

Dr Ho, the spouse of Ms Poon, is a senior medical practitioner specialized in Ophthalmology and works in a private hospital in Hong Kong. In addition to his salary income, Dr Ho also derives property rental income from his property investment in Hong Kong. The information in Annex 2 was provided by Dr Ho with respect to his rental income for the year ended 31 March 2016.

➤ Q2



Case background

1. Case

Recently, Dr Ho has been approached by his peer group to set up a business practising medicine privately by establishing a sizable clinic with different specialties. Specifically, a partnership will be formed and Dr Ho will be a partner of the partnership running the medical practising business. To facilitate the operations of the business, another limited company will be established by the partners of the partnership and act as a service company providing daily and essential routine services to the partnership's medical business, e.g. leasing of clinic premises, hiring of nurses, and other administrative services ("Service Company Arrangement"). Costs incurred by the abovementioned service company will be covered through the payment of a management fee from the partnership business. Dr Ho has also been further advised that the Service Company Arrangement may produce considerable tax savings.

➤ Q2

➤ Q4



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Case background

1. Case

Notwithstanding that the invitation to form the partnership is attractive to Dr Ho, he is a bit worried about the integrity of the Service Company Arrangement from the tax perspective. Dr Ho suggests appointing his sister Ms Ho as the tax consultant in order to evaluate the tax exposure of the arrangement. Ms Ho is the sole proprietor of an audit firm specializing in providing audit services for small companies. Although Ms Ho is a Certified Public Accountant with a Practising Certificate, she has little experience in providing tax consultancy services.

➤ Q5



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➤ **Annex 1**

Information provided by Ms Poon Remuneration from City and other relevant details For the year ended 31 March 2016

1. A monthly salary of HK\$95,000.
2. A discretionary bonus of HK\$150,000.
3. A reimbursement of monthly rental of HK\$17,000. The property was leased directly by Ms Poon as her residence from the landlord with monthly rental of HK\$19,000. Relevant stamped tenancy agreement and rental receipts have been submitted to City in line with its rental reimbursement scheme.
4. A holiday journey voucher of HK\$80,000 awarded to her by City at the end of March 2016 as a gift upon her marriage.

➤ **Q1**



Information provided by Ms Poon Remuneration from City and other relevant details For the year ended 31 March 2016

➤ Annex 1

5. Payment of annual subscription fee of HK\$3,500 as the member of an international chartered secretaries association. In prior years, the amount has been agreed by the Inland Revenue Department ("IRD") as a deductible outgoing expense incurred in the production of assessable income.
6. Payment of HK\$120,000 to a local university for studying on a master's programme in counseling. City reimbursed half of the tuition fee to Ms Poon in view of the relevance of the programme to her job duties.
7. A contribution of HK\$1,500 per month to an approved provident fund scheme.

➤ Q1

Ms Poon also advised that she was not entitled to claim any statutory allowance other than the basic allowance for the year.



Information provided by Dr Ho

Property rental details

For the year ended 31 March 2016

➤ **Annex 2**

- A property at Shatin ("the Property") has been owned by Dr Ho and leased out for generating property rental income for years. In early August 2014, a tenancy agreement was entered into by Dr Ho with an expatriate residing in Hong Kong on the following terms:

Term of lease:	2 years from 1 August 2014
Rent:	HK\$15,000 per month, payable on the first day of each month
Two-month rental deposit:	HK\$30,000 refundable upon completion of the lease
Rates and management fee:	HK\$4,500 per quarter and HK\$1,300 per month respectively, all payable by the landlord

➤ **Q3**

- At the end of April 2015, the tenant moved out from the Property, leaving Hong Kong with three months' outstanding rents and could not be reached thereafter. The IRD agreed with Dr Ho that the respective outstanding rents were irrecoverable in September 2015.



Information provided by Dr Ho

Property rental details

For the year ended 31 March 2016

➤ Annex 2

- The Property was successfully leased out again in July 2015 to a university student from mainland China on the following terms:

Term of lease:	12 months from 1 July 2015
Rent:	HK\$150,000 for the whole 12-month period all payable in advance
Two-month rental deposit:	HK\$10,000 refundable upon completion of the lease
Rates and management fee:	HK\$4,500 per quarter and HK\$1,300 per month respectively, all payable by the landlord

➤ Q3

- As a marriage gift, Dr Ho transferred the ownership of the Property to Ms Poon at the end of December 2015. Specifically, it has been mutually agreed that Dr Ho would retain all of the rental income from the tenant (i.e. the university student from mainland China) and would refund to the tenant the rental deposit of HK\$10,000 upon completion of the lease, whilst Ms Poon would pay all rates and the management fees of the Property after the transfer of the Property's ownership to her.



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June 2017 Session – Sect A – Q1 **(11 marks – approximately 20 minutes)**

Compute the (i) assessable income, (ii) net assessable income, and (iii) net chargeable income of Ms Poon for the year of assessment 2015/16.

➤ Q1

(11 marks)



(Question No. 1)

The tax treatment of income derived from a Hong Kong source employment is regulated under SDO 5-3.

If an employee is located in Hong Kong, all the income derived from that employment is fully chargeable to salaries tax even though the employee performs some services outside Hong Kong.

Therefore, the basic salary for Mr. Lee = HK\$ 95,000 + HK\$ 1,100,000 is fully chargeable.

For the voluntary payments (i.e. discretionary bonus and wedding gift), whether made by the employer or a third party, such payments may be assessable if they are paid wholly solely or mainly by reason of the employment. (E.g. bonus or gratuity not provided for in the contract of employment, tips to a taxi driver, tips to waiters in a restaurant, etc.) and for services rendered in the past, present or future, except:

(i) gift of an exceptional kind (not exceptional amount), e.g. gift to an employee who has done well in an examination; and

(ii) testimonial given for personal services, e.g. wedding gift.

Therefore, the discretionary bonus of HK\$ 50,000 is assessable, but the wedding gift of HK\$ 20,000 is not assessable.

As the property was leased directly by Mr. Lee as his residence from the landlord with monthly rental of HK\$ 1,000, his company will provide the reimbursement of monthly rental of HK\$ 1,000.

The amount received in the form of home finance, home purchase and subsidies on repayment of mortgage loan or rental allowance (without control of use by the employer) are fully taxable in the form of cash allowance.

~~Reimbursement of home finance reimbursement is fully assessable~~

However, rental refund or rental reimbursement is different from rental allowance in that:

under rental reimbursement scheme, the amount received by the employee from the employer is not chargeable to salaries tax, but the benefit is chargeable to salaries tax in the form of rental value.

For a contribution of HK\$ 1,500 per month to an approved provident fund scheme. Any amount (other than a pension) received by an employee from a retirement scheme or provident fund, other than a RPS, is taxable to the extent that it represents the employee's contributions to the scheme. Section 12(1)(e) provides that with effect from the year of assessment 1996/1997, qualifying self-education expenses are available for deduction under salaries tax. The maximum amount is HK\$ 8,000 from 2013/2014.

Self-education expenses are defined in Section 12(6)(b) as fees (including tuition and exam) in connection with a prescribed course of education. Prescribed course or education is defined in

(Question No. 2)

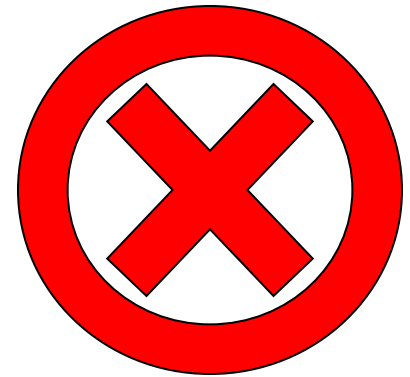
Section 12(1)(f) is a course, programme provided by an undertaking or institution to maintain a qualification for use in the employment.

If the self-education expenses are wholly or partly reimbursed by an employer or other party, the amount so reimbursed for the purpose of self-education expenses is not treated as the employee's income, and they are not assessable under salaries tax, while the same amount cannot be claimed as a deduction under salaries tax by the employee.

Salaries:	HK\$ 1,195,000
Bonus:	HK\$ 50,000
Assessable income:	HK\$ 1,245,000
Less:	
Professional subscription:	(HK\$ 3,500)
Self-education expense:	(HK\$ 80,000)
Add: Rental value:	HK\$ 1,000
Less: Rent suffered:	(HK\$ 2,000)
Net assessable income:	HK\$ 1,114,500
Less: Contributor to recognized scheme:	(HK\$ 15,000)
Less: Basic Allowance:	(HK\$ 110,000)
Net chargeable income:	HK\$ 989,500



Question 1



Wrong answers

- Marriage gift is taxable benefit

- Rental value was wrongly computed:
 - Omit the deduction of outgoing expenses
 - Wrong treatment of rent incurred



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Question 1



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Irrelevant answers

- Compute the salaries tax liabilities which had not been requested



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Question 1



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Problem

- Did not understand the tax treatment of rental refund, so did not calculate the rental value



Answer 1

Ms Poon

Salaries tax computation

Year of assessment 2015/16

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



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June 2017 Session – Sect A – Q2 **(9 marks – approximately 16 minutes)**

In the context of evaluating the pros and cons of electing for joint assessment and personal assessment, analyze in what circumstances Ms Poon should make any of the elections in filing her future tax returns to reduce the overall tax liabilities of herself and Dr Ho.

➤ **Q2**

Note: Computation is not required.

(9 marks)



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Question 2



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Problem

- Confused between Joint Assessment and Personal Assessment
- Answers without referring to the case



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Question 2



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Analysis

Ms. Poon

- Salary income

Dr. Ho

- Salary income
- Rental income
- Profit from partnership



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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)).



Answer 2 (cont'd)

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.



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Answer 2 (cont'd)

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.



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June 2017 Session – Sect A – Q3 **(14 marks – approximately 25 minutes)**

(a) Compute the assessable value of the Property attributable to Dr Ho for the year of assessment 2015/16.

(5 marks)

(b) Advise your basis in ascertaining the abovementioned assessable value of the Property attributable to Dr Ho.

➤ Q3

(9 marks)



Information provided by Dr Ho

Property rental details

For the year ended 31 March 2016

➤ Annex 2

- A property at Shatin ("the Property") has been owned by Dr Ho and leased out for generating property rental income for years. In early August 2014, a tenancy agreement was entered into by Dr Ho with an expatriate residing in Hong Kong on the following terms:

➤ Q3

Term of lease:	2 years from 1 August 2014
Rent:	HK\$15,000 per month, payable on the first day of each month
Two-month rental deposit:	HK\$30,000 refundable upon completion of the lease
Rates and management fee:	HK\$4,500 per quarter and HK\$1,300 per month respectively, all payable by the landlord

- At the end of April 2015, the tenant moved out from the Property, leaving Hong Kong with three months' outstanding rents and could not be reached thereafter. The IRD agreed with Dr Ho that the respective outstanding rents were irrecoverable in September 2015.



Information provided by Dr Ho

Property rental details

For the year ended 31 March 2016

➤ Annex 2

- The Property was successfully leased out again in July 2015 to a university student from mainland China on the following terms:

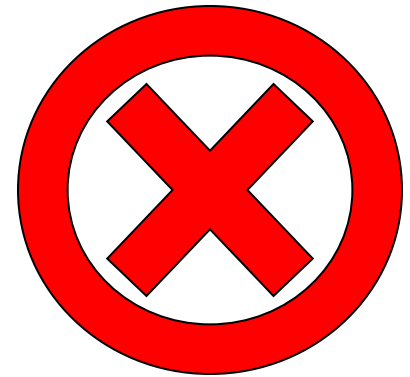
➤ Q3

Term of lease:	12 months from 1 July 2015
Rent:	HK\$150,000 for the whole 12-month period all payable in advance
Two-month rental deposit:	HK\$10,000 refundable upon completion of the lease
Rates and management fee:	HK\$4,500 per quarter and HK\$1,300 per month respectively, all payable by the landlord

- As a marriage gift, Dr Ho transferred the ownership of the Property to Ms Poon at the end of December 2015. Specifically, it has been mutually agreed that Dr Ho would retain all of the rental income from the tenant (i.e. the university student from mainland China) and would refund to the tenant the rental deposit of HK\$10,000 upon completion of the lease, whilst Ms Poon would pay all rates and the management fees of the Property after the transfer of the Property's ownership to her.



Question 3(a)



Wrong answers

- Wrongly calculate the bad debts
- Wrongly apportion the rental income



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Question 3(a)



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Problem

- Calculate the property tax liabilities which was not requested



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)	<u>75,000</u>
	90,000
Less: Irrecoverable rent [(HK\$15,000 x 3) - HK\$30,000]	<u>(15,000)</u>
Assessable value	<u>75,000</u>



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Question 3(b)



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Problem

- Unable to discuss the correct approach for the apportionment of assessable income
- Unable to discuss the correct treatment of bad debts and the rental deposits



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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.



Answer 3(b) (cont'd)

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. $\text{HK\$150,000} \times 6/12$).



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Answer 3(b) (cont'd)

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.



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June 2017 Session – Sect A – Q4 **(11 marks – approximately 20 minutes)**

Advise how the Service Company Arrangement should be structured in order to comply with the regulatory framework stipulated by the IRD's relevant Departmental Interpretation and Practice Notes.

(11 marks)

➤ **Q4**



Case background

1. Case

Recently, Dr Ho has been approached by his peer group to set up a business practising medicine privately by establishing a sizable clinic with different specialties. Specifically, a partnership will be formed and Dr Ho will be a partner of the partnership running the medical practising business. To facilitate the operations of the business, another limited company will be established by the partners of the partnership and act as a service company providing daily and essential routine services to the partnership's medical business, e.g. leasing of clinic premises, hiring of nurses, and other administrative services ("Service Company Arrangement"). Costs incurred by the abovementioned service company will be covered through the payment of a management fee from the partnership business. Dr Ho has also been further advised that the Service Company Arrangement may produce considerable tax savings.

➤ Q2

➤ Q4



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Question 4



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Irrelevant answers

- Wrongly discuss Type 1 service company
- Wrongly discuss source of profit, transfer pricing



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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:



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Answer 4 (cont'd)

- (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).



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Answer 4 (cont'd)

- (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, 51 Para. 17 to 18, 23 to 26).



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Answer 4 (cont'd)

- (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).



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June 2017 Session – Sect A – Q5 **(5 marks – approximately 9 minutes)**

With respect to the appointment of Ms Ho as the tax consultant, describe (i) the statutory eligibility of Ms Ho, and (ii) the ethical considerations before accepting the appointment.

(5 marks)

➤ Q5



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Hong Kong's
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Case background

1. Case

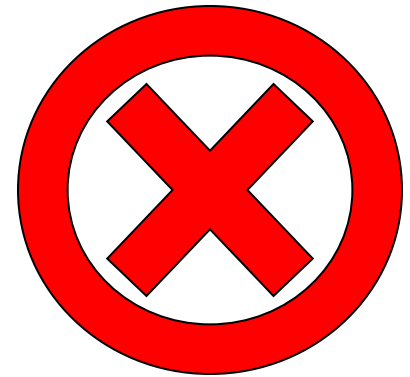
Notwithstanding that the invitation to form the partnership is attractive to Dr Ho, he is a bit worried about the integrity of the Service Company Arrangement from the tax perspective. Dr Ho suggests appointing his sister Ms Ho as the tax consultant in order to evaluate the tax exposure of the arrangement. Ms Ho is the sole proprietor of an audit firm specializing in providing audit services for small companies. Although Ms Ho is a Certified Public Accountant with a Practising Certificate, she has little experience in providing tax consultancy services.

➤ Q5



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Question 5



Wrong answers

- Wrongly discuss the ethical considerations during the provision of services (e.g. confidentiality)



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Question 5



Hong Kong's
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Problem

- Unable to describe the statutory eligibility
- Wrongly state that only CPA can be appointed as tax consultant



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.



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Section B – Essay/Short Questions



June 2017 Session – Sect B – Q6 **(16 marks – approximately 29 minutes)**

Equator Corporation ("Equator") is a wholly owned subsidiary of Universe Limited ("Universe"). Equator is engaged in providing consultancy services in business mergers and acquisitions. It closes its accounts on 31 March.

On 20 March 2015, Equator entered into a contract to provide services to A Ltd, which was a company jointly owned by Universe and other companies. A Ltd closes its accounts on 31 March. The service fee was agreed at HK\$1,500,000 and Equator would provide the services to A Ltd from 15 June 2015 to 31 October 2015. It was also agreed that A Ltd would pay an advance payment of HK\$500,000 to Equator on 31 March 2015. The balance would be payable upon completion of the services by Equator. ➤ **Q6**



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June 2017 Session – Sect B – Q6 **(16 marks – approximately 29 minutes)**

A Ltd had cash flow problems and failed to settle the advance payment. Following the contract term, Equator proceeded to provide the services to A Ltd. A Ltd did not settle the payment of the service fee ultimately.

In view of the close relationship, Equator only sent a few reminders to A Ltd to urge payment. A Ltd could not resolve its cash flow problem even though it was making more than HK\$100 million of profits on its books.

A Ltd replied to Equator's reminders by requesting extensions of time for payment. Having said that, A Ltd claimed the service fee as deductible expenses in its tax computation for the year ended 31 March 2016.



June 2017 Session – Sect B – Q6 (16 marks – approximately 29 minutes)

Meanwhile, Equator claimed for a tax deduction of the outstanding advance payment for the year ended 31 March 2015 and a tax deduction of the balance of service fee for the year ended 31 March 2017 ("Outstanding Service Fees").

On 5 April 2017, Equator sold its rights to the Outstanding Service Fees ("the Rights") under the contract with A Ltd to Universe at HK\$600,000 and claimed the receipt being capital in nature. The sale was a genuine commercial transaction conducted on an arm's length basis. On 15 April 2017, Universe agreed with A Ltd that it was not required to settle the payment of the Outstanding Service Fees.



June 2017 Session – Sect B – Q6 (16 marks – approximately 29 minutes)

Required:

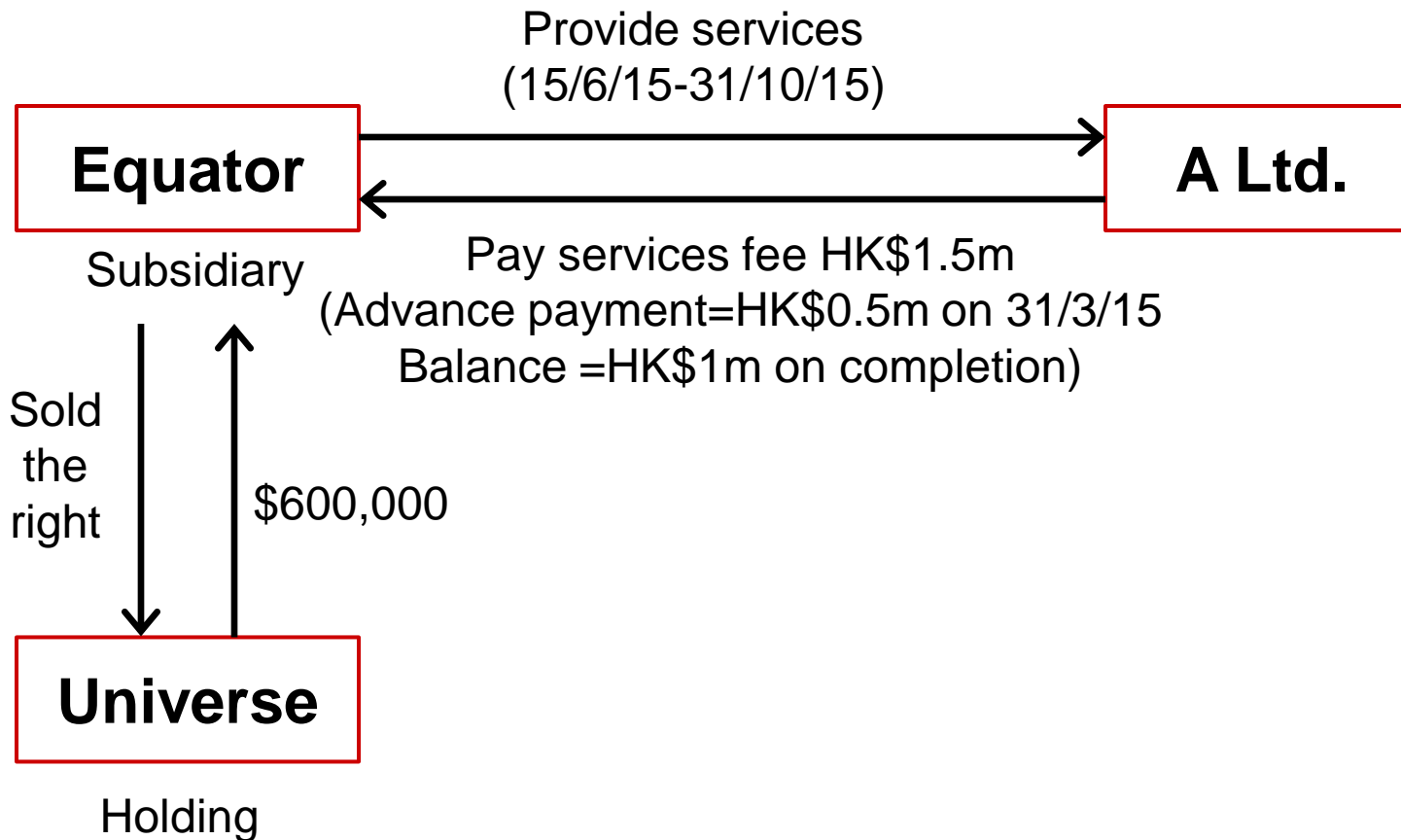
- (a) Analyse the deductibility of the Outstanding Service Fees claimed by Equator with reference to the relevant provision(s) in the Inland Revenue Ordinance ("IRO") for each of the years of assessment 2014/15 and 2016/17.
(9 marks)
- (b) Evaluate the taxability of the sale of the Rights by Equator to Universe and how the sale would affect Equator's deduction claims.
(4 marks)
- (c) Analyse the tax implications applicable to A Ltd, if any, when (i) Equator sold the Rights to Universe and when (ii) Universe reached the agreement with A Ltd on the settlement of the Outstanding Service Fees.
(3 marks)



Question 6



Analysis





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Question 6(a)



Hong Kong's
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Problem

- Unable to analyze bad debt deductibility on a year by year basis
- Only write down the content under S16(1)(d)



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Question 6(a)



Hong Kong's
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Irrelevant answers

- Wrongly discuss source of profits, transfer pricing and anti-avoidance provisions



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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.



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Answer 6(a) (cont'd)

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.



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Answer 6(a) (cont'd)

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. 68



June 2017 Session – Sect B – Q6 (16 marks – approximately 29 minutes)

Required:

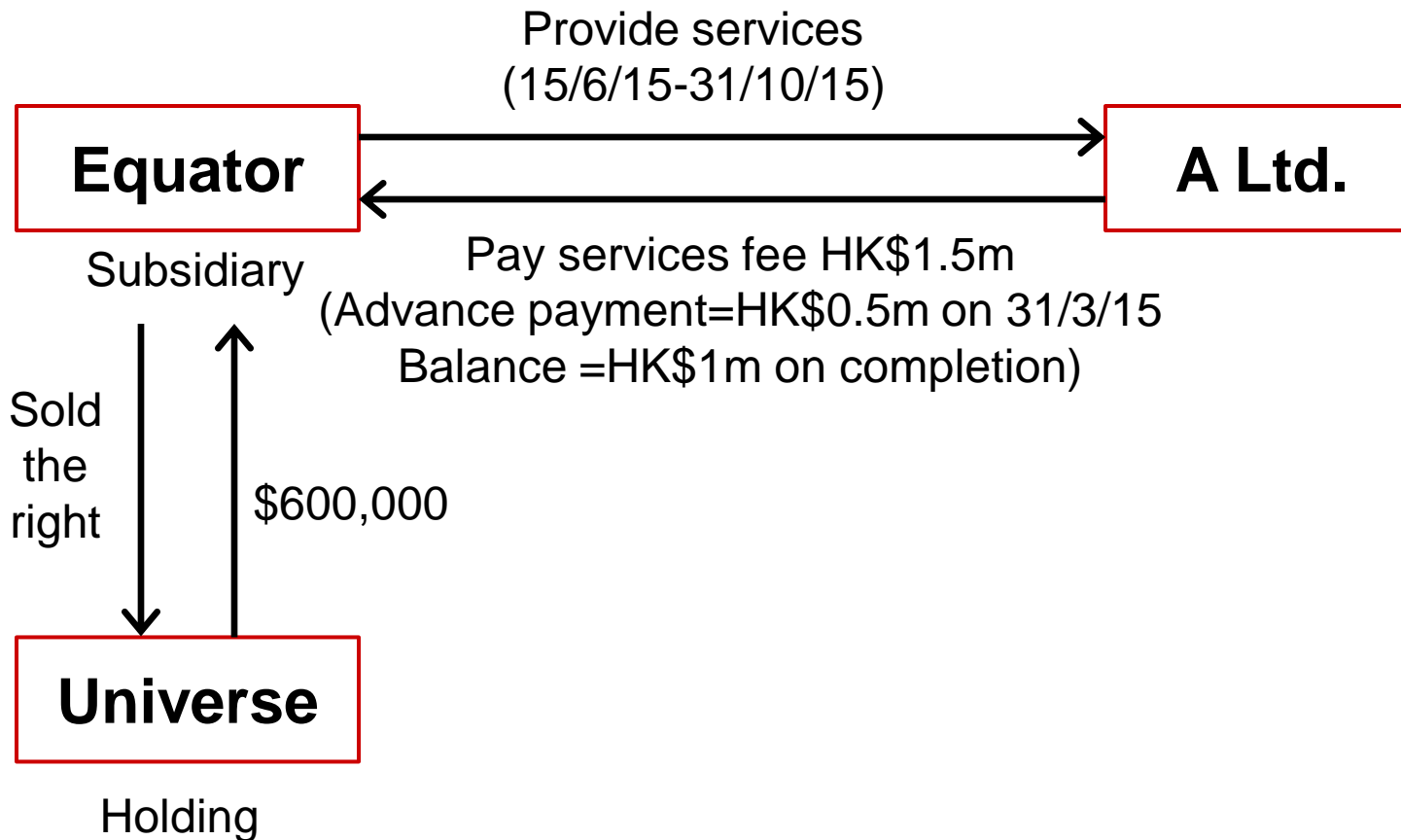
- (a) Analyse the deductibility of the Outstanding Service Fees claimed by Equator with reference to the relevant provision(s) in the Inland Revenue Ordinance ("IRO") for each of the years of assessment 2014/15 and 2016/17.
(9 marks)
- (b) Evaluate the taxability of the sale of the Rights by Equator to Universe and how the sale would affect Equator's deduction claims.
(4 marks)
- (c) Analyse the tax implications applicable to A Ltd, if any, when (i) Equator sold the Rights to Universe and when (ii) Universe reached the agreement with A Ltd on the settlement of the Outstanding Service Fees.
(3 marks)



Question 6



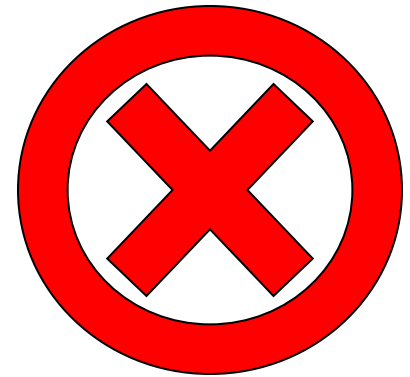
Analysis





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Question 6(b)



Wrong answers

- The receipt was capital in nature, not taxable



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Question 6(b)



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Problem

- Did not discuss how the sale would affect Equator's deduction claims



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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.



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Answer 6(b)

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.



June 2017 Session – Sect B – Q6 (16 marks – approximately 29 minutes)

Required:

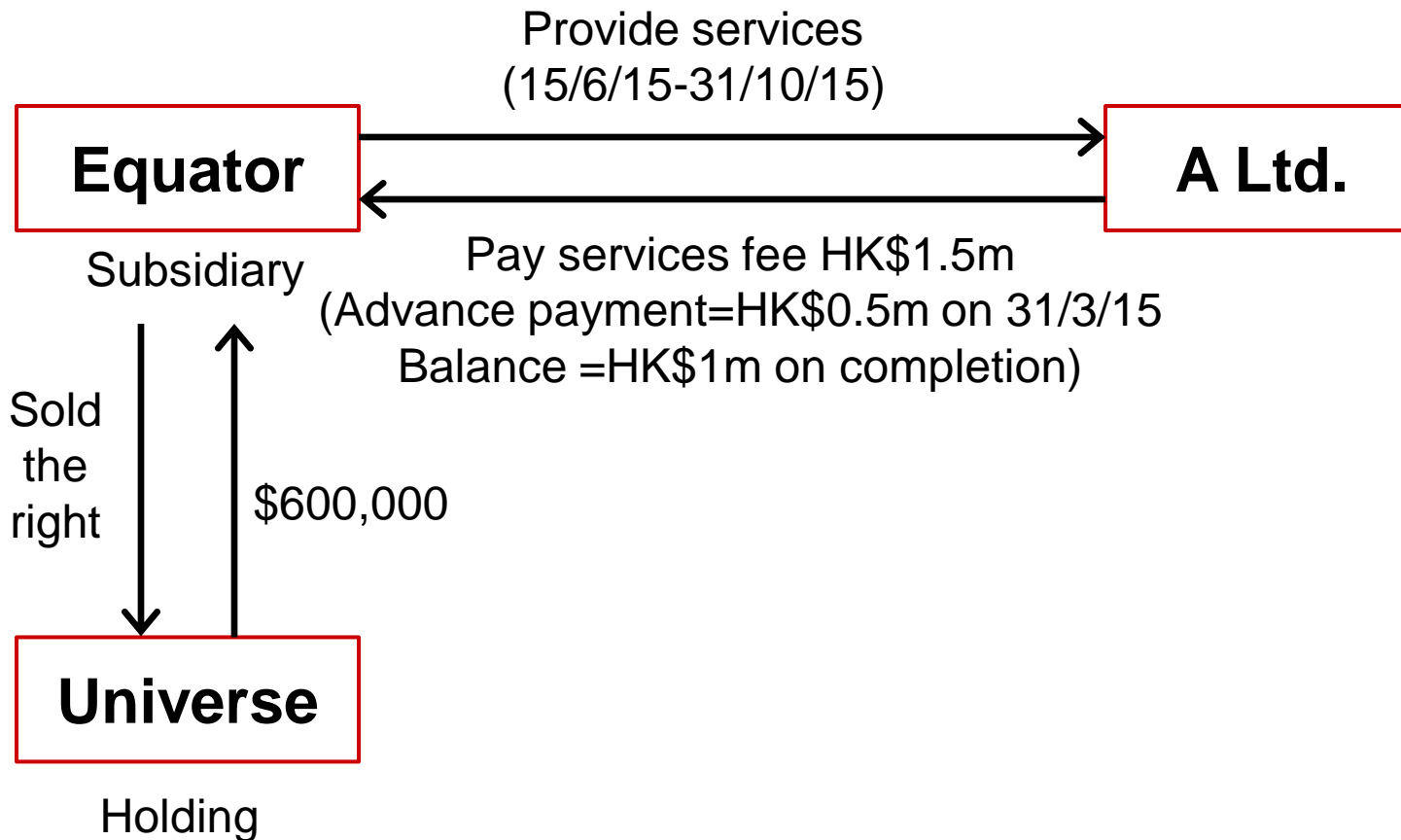
- (a) Analyse the deductibility of the Outstanding Service Fees claimed by Equator with reference to the relevant provision(s) in the Inland Revenue Ordinance ("IRO") for each of the years of assessment 2014/15 and 2016/17.
(9 marks)
- (b) Evaluate the taxability of the sale of the Rights by Equator to Universe and how the sale would affect Equator's deduction claims.
(4 marks)
- (c) Analyse the tax implications applicable to A Ltd if any, when (i) Equator sold the Rights to Universe and when (ii) Universe reached the agreement with A Ltd on the settlement of the Outstanding Service Fees.
(3 marks)



Question 6



Analysis





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Question 6(c)



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Problem

- Did not understand the requirement
- Confused the parties involved in the transactions regarding the provision of service fee, payment of service fee, sale of the right, deduction of bad debt



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.



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June 2017 Session – Sect B – Q7 **(16 marks – approximately 29 minutes)**

Polar Stars Limited ("Polar") is a private company incorporated in Hong Kong and closes its accounts on 31 December. Lavender Dream Inc. ("Lavender") is the parent company of Polar and its shares are listed on the New York Stock Exchange. On 31 October 2012, Lavender introduced a share benefits scheme for the staff members of the companies in the group. Polar has participated in the scheme since 15 December 2012.

➤ **Q7**



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June 2017 Session – Sect B – Q7 **(16 marks – approximately 29 minutes)**

Under the scheme, each eligible staff member is granted a specific number of share awards for the shares of Lavender. On 1 January of each year, the participating company has to inform Lavender of the total number of shares it would grant to the staff member in that year. Lavender charges a share-based payment when it receives the notification from the participating company, which has to settle the charge immediately.



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June 2017 Session – Sect B – Q7 **(16 marks – approximately 29 minutes)**

Each staff member has to work in the participating company for three consecutive years after the date of grant, before he/she is unconditionally vested with the interests and could take up the shares then. Failure to meet this condition means the forfeiture of the entire awards. The staff member does not need to pay any money to his/her employer for the vested share awards, but has to send a written confirmation via the employer to take up the share awards on the vesting date. Lavender either issues new shares or purchases its shares from the secondary market on the vesting date to meet the liability.



June 2017 Session – Sect B – Q7 (16 marks – approximately 29 minutes)

Polar sent the notification to Lavender on 1 January 2013 for granting share awards to its finance director Mr. Chan (a Hong Kong permanent resident). Details are as below:

Number of share awards granted	Date of grant	Date of vesting
1,000	1 January 2013	1 January 2016

The market prices of the Lavender shares on the relevant dates were as follows:

Date	Market price per share (US\$)
15 December 2012	310
1 January 2013	300
1 July 2013	200
1 January 2016	350



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June 2017 Session – Sect B – Q7 **(16 marks – approximately 29 minutes)**

On 1 January 2013, Lavender charged Polar US\$300,000 in total for the 1,000 share awards granted to Mr. Chan on the same date. Mr Chan was directed by Lavender to take up the post of senior finance director in another group company Vista Limited ("Vista") in mainland China from 1 March 2016 onwards. During the period from 1 April 2015 to 29 February 2016, Mr. Chan's total salary and commission from Polar was HK\$2,000,000. Vista was responsible for the payroll of Mr. Chan from 1 March 2016 onwards.



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June 2017 Session – Sect B – Q7 **(16 marks – approximately 29 minutes)**

Mr. Chan sent a written confirmation on the vesting date to take up the share awards. He considered that the share awards arose from Lavender incorporated in the USA and claimed that he should not be chargeable to salaries tax in Hong Kong on the benefit. Vista paid a directors' fee of RMB¥200,000 plus a cost-of-living allowance of RMB¥50,000 per month to Mr. Chan.

Mr. Chan is single and owns a flat in Hong Kong. His parents live in Canada. Mr. Chan has continuously stayed in mainland China since his employment with Vista.

For the purpose of computation, the exchange rate is US\$1 = HK\$7.8.



June 2017 Session – Sect B – Q7 (16 marks – approximately 29 minutes)

Required:

(a) Apply the relevant tax principles to evaluate the deductibility of the charge by Lavender on the share awards in the profits tax computation of Polar. If the charge is considered to be deductible, state the year of assessment in which the deduction can be allowed and the deductible amount.

(3 marks)

(b) Evaluate whether Mr. Chan was able to claim that the share awards were derived from his employment with Lavender and whether the share awards are chargeable to salaries tax in Hong Kong. Compute the assessable income of Mr. Chan for the year of assessment 2015/16, if applicable, with the explanation on the basis of computation.

(8 marks)



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June 2017 Session – Sect B – Q7 **(16 marks – approximately 29 minutes)**

Required:

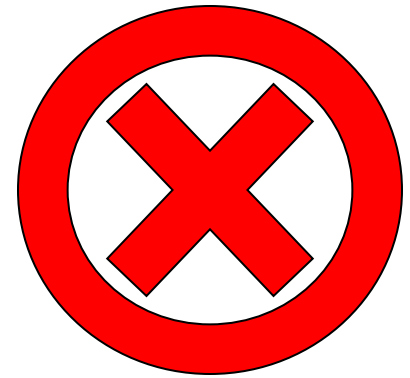
- (c) Explain how to determine the liability of Mr. Chan to Individual Income Tax ("IIT") in mainland China for the year ended 31 December 2016. Compute the relevant monthly IIT (in RMB¥) payable by Mr. Chan. Ignore the share awards for the purpose of computation.

Note: Assuming that Mr. Chan's IIT liability is paid and borne by himself.

(5 marks)



Question 7(a)



Wrong answers

- Wrongly used the price on the vesting date instead of the actual cost when computing the allowable amount
- Wrongly allocated the cost over the vesting period



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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.



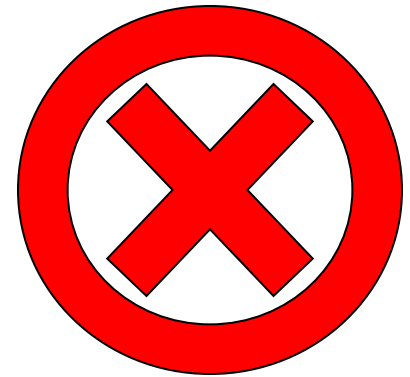
Answer 7 (a) (cont'd)

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.



Question 7(b)



Wrong answers

- Mistakenly treated share awards as share options and computed assessable amount of share award incorrectly
- Failed to translate the amount into HK\$
- Failed to multiply the unit price by the no. of shares



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Question 7(b)



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Problem

- Computed the tax liability which was not required



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.



Answer 7 (b) (cont'd)

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:

$$\begin{aligned} & \text{HK}\$(350 \times 1,000 \times 7.8) \\ & = \underline{\text{HK}\$2,730,000} \end{aligned}$$

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:

$$\begin{aligned} & \text{HK}\$(2,730,000 + 2,000,000) \\ & = \text{HK}\$4,730,000 \end{aligned}$$



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Question 7(c)



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Problem

- Failed to deduct the standard deduction of RMB 4,800
- Failed to apply the correct tax rate of 45%



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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.



Answer 7 (c) (cont'd)

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

$$= \text{RMB¥}(200,000 + 50,000 - 4,800^*)$$

$$= \text{RMB¥}245,200$$

Monthly IIT payable

$$= \text{RMB¥}(245,200 \times 45\% - 13,505\#)$$

$$= \text{RMB¥}96,835$$

(*) Standard deduction

(#) Quick deduction



June 2017 Session – Sect B – Q8 (10 marks – approximately 18 minutes)

Fast Track Limited ("Fast") is a building construction company. It has formed different joint ventures with different unrelated parties, each on 50:50 basis, for bidding for construction projects from the Hong Kong Government. During the year ended 31 March 2016, the following joint ventures were in operation, and their relevant assessable profits/(adjusted losses) are as below:

➤ Q8

Name of joint ventures	Total assessable profits/(adjusted loss) for the year of assessment 2015/16 HK\$
Apple	88,750,000
Orange	(123,000,000)
Lemon	56,250,000



June 2017 Session – Sect B – Q8 (10 marks – approximately 18 minutes)

According to the tax computations of Fast under its own business, it had an unutilised loss of HK\$21,000,000 carried forward from the year ended 31 March 2015, and the assessable profits were HK\$38,200,000 for the year ended 31 March 2016.

Fast would like to claim its share of adjusted loss sustained from Orange (instead of its own loss brought forward) to set off against its own assessable profits. It also wished to claim to set off its share of assessable profits from Apple and Lemon by its share of adjusted loss from Orange.



June 2017 Session – Sect B – Q8 (10 marks – approximately 18 minutes)

Required:

(a) With reference to the provisions in the IRO, analyse whether, and if so, how Fast could make a claim to set off the losses against its own assessable profits for minimizing tax exposure, with the computation of its profits tax liability after the loss set-off for the year of assessment 2015/16.

(6 marks)

(b) With reference to the provisions in the IRO, analyse whether, and if so, how Fast could set off its share of assessable profits from Apple and Lemon by its share of adjusted loss from Orange. Compute the respective amounts of the profits tax payable by Fast on its share of assessable profits from Apple and Lemon after the loss set-off, if applicable, for the year of assessment 2015/16.

(2 marks) 99



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Question 8(a)



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Irrelevant answers

- Wrongly discuss S.61B
- Wrongly discuss the election of personal assessment so as to utilize the tax loss



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.



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Answer 8 (a) (cont'd)

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.



Answer 8 (a) (cont'd)

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:

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

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



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Question 8(b)



Hong Kong's
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Irrelevant answers

- Wrongly discuss S.61B



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:

$$\begin{aligned} & \text{HK\$}88,750,000 \times 50\% \times 16.5\% \\ & = \text{HK\$}7,321,875 \end{aligned}$$

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:

$$\begin{aligned} & \text{HK\$}56,250,000 \times 50\% \times 16.5\% \\ & = \text{HK\$}4,640,625 \end{aligned}$$



June 2017 Session – Sect B – Q9 **(10 marks – approximately 18 minutes)**

Describe the legal obligations and liability under the IRO and the Stamp Duty Ordinance, with the computation where appropriate, in the following independent scenarios:

➤ Q9

- (a) X Limited commenced its business on 12 May 2012. Its first set of accounts was made up to 31 January 2014, with assessable profits of HK\$1,000,000 and the directors signed the accounts on 1 March 2014. The directors considered the Profits Tax Return would be automatically issued by the IRD to the company sooner or later and that all they had to do was only to wait. X Limited finally received the Profits Tax Return on 10 January 2015 with a due date of three months. However, since the directors were out of Hong Kong, X Limited submitted the completed return and accounts to the IRD on 15 May 2015.

(4 marks)



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Question 9(a)



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Problem

- Mentioned some obligations unrelated to the facts of the case (e.g. employee obligation)
- Did not discuss the penalty under various provisions



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.



June 2017 Session – Sect B – Q9 (10 marks – approximately 18 minutes)

(b) Mr. B is a Hong Kong permanent resident without any immovable property. Miss A is a resident in mainland China without a Hong Kong identity card and any immovable property in Hong Kong. Mr. B was going to marry Miss A in December 2015.

On 1 October 2015, the father of Mr. B transferred his solely-owned property in Hong Kong to Mr. B as a wedding gift. After the marriage ceremony, Mr. B assigned the same property to Miss A as a gift on 1 March 2016. Mr. B and Miss A were not sure if they had to pay ad valorem stamp duty, special stamp duty and buyer's stamp duty. The market value of the property was HK\$8,500,000 on 1 October 2015, and HK\$9,200,000 on 1 March 2016.

(6 marks)



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Question 9(b)



Hong Kong's
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Problem

- Did not understand the treatment of a marriage gift
- Mixed up S.27(1) with S.27(4) of SDO



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.



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Answer 9 (b) (cont'd)

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.



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December 2016 Session – Sect B – Q7 **(18 marks – approximately 32 minutes)**

Global Holdings Limited (“Global”) is a company established in Hong Kong engaging in the garment trading business. During the financial year ended 31 March 2015, Global acquired a used commercial property (“the Property”) as its office premises at a consideration of HK\$96,000,000. In preparing the profits tax return and computation for the year of assessment 2014/15, the accountant of Global used 1/3 of the purchase consideration as the qualifying expenditure, and claimed 4% thereon as the commercial building allowance (“CBA”). The return and other supporting documents were subsequently filed to the IRD.



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December 2016 Session – Sect B – Q7 **(18 marks – approximately 32 minutes)**

Recently, Global received a letter from the IRD pointing out that CBA should be computed with reference to the capital expenditure incurred on the construction cost of a commercial building or structure, and if the relevant interest is sold, with reference to the residue of expenditure as stipulated in the IRO. Specifically, in case the cost of construction is not available, the first assignment price should be used as a reference. It was further provided that the Property was acquired by Global from the first hand owner, and the first assignment price paid by the first hand owner to the Property's developer was HK\$8,400,000. In addition, the first hand owner commenced to claim rebuilding allowance in the year of assessment 1984/85.



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December 2016 Session – Sect B – Q7 **(18 marks – approximately 32 minutes)**

Based on this information, the IRD requested Global to re-compute the CBA by using 1/3 of the first assignment price as the cost of construction of the Property in computing the residue of expenditure, and to quantify the over/under-claimed CBA made by Global correspondingly.

The accountant of Global did not have the relevant tax knowledge to recompute the CBA as requested by the IRD, and therefore Global appointed Messrs. Kenneth Chu & Chu as the tax representative to handle the matter.



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December 2016 Session – Sect B – Q7 **(18 marks – approximately 32 minutes)**

Required:

(a) Describe the ethical considerations Messrs. Kenneth Chu & Chu should be aware of (i) prior to and (ii) upon the acceptance of the appointment from Global.

(5 marks)

(b) Based on the information available, compute the CBA Global is entitled to in accordance with the IRD's request, and compute the over/under-claimed CBA in Global's original profits tax computation.

(10 marks)



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December 2016 Session – Sect B – Q7 **(18 marks – approximately 32 minutes)**

Required:

(c) Assuming that you are the tax manager of Messrs. Kenneth Chu & Chu, advise Global with justification as to how to maximize the CBA claim under the IRD's proposed method in using the first assignment price as a reference for quantifying the cost of construction of the Property.

(3 marks)



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Question 7(a)



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Irrelevant answers

- Discussed ethical considerations after commencing the tax services.
(e.g. confidentiality)



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Answer 7(a)

Prior to the appointment as tax representative, Messrs. Kenneth Chu & Chu should ensure the objectivity of its firm to Global by confirming that conflict of interest does not exist with respect to the appointment. In this regard, Global should not impose any influence on Messrs. Kenneth Chu & Chu alerting its tax practice on the engagement. In addition, Messrs. Kenneth Chu & Chu should gear up with competent professional knowledge to accomplish the engagement.

In addition to the above and particularly upon the acceptance of the engagement, Messrs. Kenneth Chu & Chu should issue a comprehensive engagement letter to Global specifying clearly the scope of tax services to be provided, and requesting Global to sign off the engagement letter before commencing the works.



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Question 7(b)



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Problem

- Not familiar with the computation of CBA in respect of an used building.
- Did not calculate the over / under claimed CBA.
- Unable to calculate the notional rebuilding allowance / notional CBA.



Answer 7(b)

The CBA of the Property Global is entitled to (For the year of assessment 2014/15):

	HK\$
Deemed cost of construction (1/3 of HK\$8,400,000)	2,800,000
Less: Notional rebuilding allowance	
(1984/85 to 1989/90, 6 years @ 0.75%)	(126,000)
(1990/91 to 1997/98, 8 years @ 2%)	<u>(448,000)</u>
	2,226,000
Less: Notional CBA	
(1998/99 to 2013/14, 16 years x HK\$2,226,000 x 4%)	<u>(1,424,640)</u>
Residue of expenditure before sale	801,360
Less: Sales proceeds (1/3 of HK\$96,000,000)	<u>32,000,000</u>
Excess	<u>31,198,640</u>
Residue of expenditure before sale	801,360
Add: Balancing charge	
(Restricted to CBA previously claimed)	<u>1,424,640</u>
Residue of expenditure after sale (A)	<u>2,226,000</u>
Year of first use (Deemed under s.33A(4)(b))	1998/99
25 th year from the year of first use	2023/24
Number of years from 2014/15 to 2023/24 (B)	10
CBA thereon ((A) x 1/(B))	222,600
Original CBA claimed by Global	
(@ 4% x 1/3 x HK\$96,000,000)	<u>1,280,000</u>
CBA over-claimed by Global	<u>(1,057,400)</u>



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Question 7(c)



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Irrelevant answers

- Suggest to acquire another property with higher cost.
- Suggest to incur more decoration cost.



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Answer 7(c)

S.33A of the IRO does not specify any stipulated or prescribed percentage of the first assignment price as the capital expenditure for computing the respective CBA of commercial buildings and structures. In this regard, Global may submit to the IRD to take a portion higher than 1/3 of the first assignment price as the cost of construction of the Property in computing CBA with reasonable grounds (e.g. higher cost of construction ratio compared to land cost in early 1980's, etc).



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December 2016 Session – Sect B – Q9 **(12 marks – approximately 22 minutes)**

Cambridge Holdings Limited (“Cambridge”) is a group holding company established in Hong Kong with subsidiaries engaging in various businesses locally. Since the year of assessment 2004/05, Cambridge has employed senior management executives and incurred substantial overheads for providing strategic management and administrative services to the subsidiaries. Yet due to adverse market sentiments and other economic factors, the operating performance of Cambridge’s subsidiaries was generally not satisfactory, and Cambridge did not charge nor derive any management fee income from the subsidiaries notwithstanding the provision of the abovementioned management services up to the year of assessment 2014/15. Cambridge did not derive any other income during the relevant years either.



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December 2016 Session – Sect B – Q9 (12 marks – approximately 22 minutes)

In preparing the profits tax returns for the years of assessment from 2004/05 to 2014/15, Cambridge stated its principal business activity as “investment holding” and claimed tax loss for each year, which substantially resulted from the expenditure incurred in connection with the salaries of its management executives and other essential overhead expenses. However, the IRD consistently refused to allow any tax loss to Cambridge, and only issued notices with a remark “no trading, no loss agreed” as the tax position of Cambridge for the respective years.

In the year of assessment 2015/16, the subsidiaries of Cambridge experienced favorable business performances. Cambridge charged and derived management fee income from its subsidiaries, and generated a substantial amount of assessable profits for the year. Cambridge would like to utilise its tax loss brought forward from prior years to set off the assessable profits, notwithstanding that the tax loss was not agreed by the IRD as indicated above. 125



December 2016 Session – Sect B – Q9 (12 marks – approximately 22 minutes)

Required:

(a) From the perspectives of (i) Cambridge and (ii) the IRD, analyse the deductibility of the expenses incurred by Cambridge during the years of assessment from 2004/05 to 2014/15 in the contexts of the IRO.

(8 marks)

(b) On the assumption that the abovementioned expenses were essentially deductible, analyse how and when Cambridge could claim the set-off of the losses sustained against its assessable profits for the year of assessment 2015/16 pursuant to the relevant provisions stipulated in the IRO.

(4 marks)



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Question 9(a)



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Irrelevant answers

- Wrongly discussed the taxability of management fee income.



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Question 9(a)



Hong Kong's
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Problem

- Only quote the general provisions governing the deductibility of expenses.
- Unable to provide sufficient elaboration.
- Unable to identify the importance of ensuring that the income received and the expenses claimed should be commercially realistic.



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Answer 9(a)(i)

From the perspective of Cambridge

S.16(1) of the IRO provides for a deduction of all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by a person in the production of assessable profits in which he is chargeable to profits tax for any period, subject to the deduction restrictions as stipulated under s.17(1) of the IRO. In this regard, it is possible in the contexts of the IRO that an expense may be deducted in the basis period in which it is incurred, and the related income may be charged to tax in prior or subsequent years of assessment. Quantum of income generated therefrom should have no relevancy to the amount of deductible expenses incurred. However, there must have been sufficient distinct and direct relationship between the expenditure incurred and actual earning of the income in specific years.



Answer 9(a)(i) (cont'd)

With respect to Cambridge, the expenses incurred during the years of assessment 2004/05 to 2014/15 could be claimed as deductible only if the amounts were essentially incurred in a business in which income assessable to profits tax has been generated in the year of assessment 2015/16. From this perspective, Cambridge must prove to the satisfaction of the IRD that there was a distinct and direct relationship between the expenditure incurred and actual earning of the income, and that the expenses incurred were not excessive in the context of s.16(1) of the IRO, i.e. there was a direct causation between the expenses incurred in the years of assessment 2004/05 to 2014/15 and the taxable income derived In the year of assessment 2015/16 longitudinally, and that the respective services provided in the years of assessment 2004/05 to 2014/15 were accordingly not “free of charge” essentially.



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Answer 9(a)(ii)

From the perspective of IRD

However, the IRD may take the view that the provision of the management and administrative services to the subsidiaries at no charge during the years of assessment 2004/05 to 2014/15 was not an arm's length transaction. The entering into the transaction was therefore considered artificial and not commercially realistic. The relationship between the expenses incurred in prior years and the generation of income in the year of assessment 2015/16 was too remote so that the IRD, with reference to s.17(1) of the IRO, may disallow the deduction of the expenses under s.16(1) of the IRO for the reason that they were not incurred in the production of Cambridge's assessable profits. It may also invoke the general anti-avoidance provisions, i.e. under ss.61 and 61A of the IRO, to deny the deduction claim so as to counteract the tax benefit by the postponement of the liability to pay tax.



December 2016 Session – Sect B – Q9 (12 marks – approximately 22 minutes)

Required:

(a) From the perspectives of (i) Cambridge and (ii) the IRD, analyse the deductibility of the expenses incurred by Cambridge during the years of assessment from 2004/05 to 2014/15 in the contexts of the IRO.

(8 marks)

(b) On the assumption that the abovementioned expenses were essentially deductible, analyse how and when Cambridge could claim the set-off of the losses sustained against its assessable profits for the year of assessment 2015/16 pursuant to the relevant provisions stipulated in the IRO.

(4 marks)



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Question 9(b)



Hong Kong's
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Problem

- Did not understand what is a statement of loss.
- Wrongly discussed hold-over application.
- Only discuss how to lodge an objection in general, did not show how to apply to the case.



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Answer 9(b)

A statement of loss or loss notice (“the Notice”) issued by the IRD is an administrative document and not an assessment within the meaning of the IRO. As the Notice has no statutory force, it cannot become final and conclusive under s.70 of the IRO (***Common Empire Ltd v CIR*** [2007] 1 HKLRD 679). Taxpayers in this connection can lodge a disagreement with the Notice regarding the quantum of tax loss at any time, until any loss claimed affects an assessment to tax (Para. 26, DIPN No. 8 (Revised) issued in September 2009), under which a right of objection under s.64 of the IRO arises.



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Answer 9(b) (cont'd)

As there is no statutory time limit in lodging the disagreement with the Notices regarding the tax loss for the years of assessment 2004/05 to 2014/15, Cambridge may pursue the disagreement to revise its profits tax position for the years concerned with relevant justifications any time before the issue of the 2015/16 notice of assessment. Alternatively, Cambridge may lodge a written objection against the 2015/16 profits tax assessment claiming the set-off of the tax loss brought forward from prior years against the assessable profits within the one-month period after the date of the notice of assessment.



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Thank you



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Part 4: Preparation for the Examinations





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- 1. Prepare your examination**
- 2. Prepare yourself for examination**



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1. Prepare your examination Before examination

DO

- Commit to your **Study Plan**
- Cover beyond LP
- Form **Study Group** with fellow students
- Prepare **Critical File**
- Practise past papers
- Visit QP Learning Centre
 - Past papers and Examiners' reports;
 - Special topics and/or Important notice; and
 - Examination preparation seminar archives



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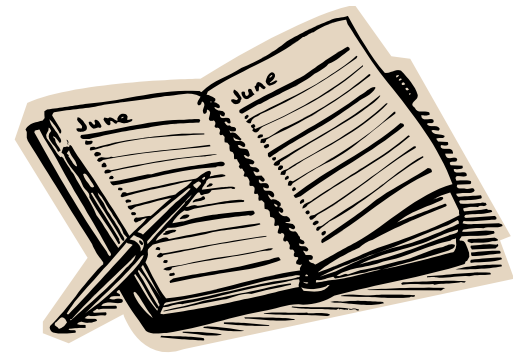


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Commit to your Study Plan

Advantages:

- Schedule ahead
- Build long term memories → maximize efficiency
- Avoid last minute work and minimize impact of unpredicted events...





Prepare Critical File

How to prepare:

- Use different colour post-it for different standards / topics
- Organise materials by different standards / topics
- Understand theories behind each standards / topics
- Get familiar with this file

Advantages:

- Colour coding for standards / topics allows easy identification (same file used in examination – time saving!)
- Build up long term memories
- Avoid indexing without understanding





During examination

DO

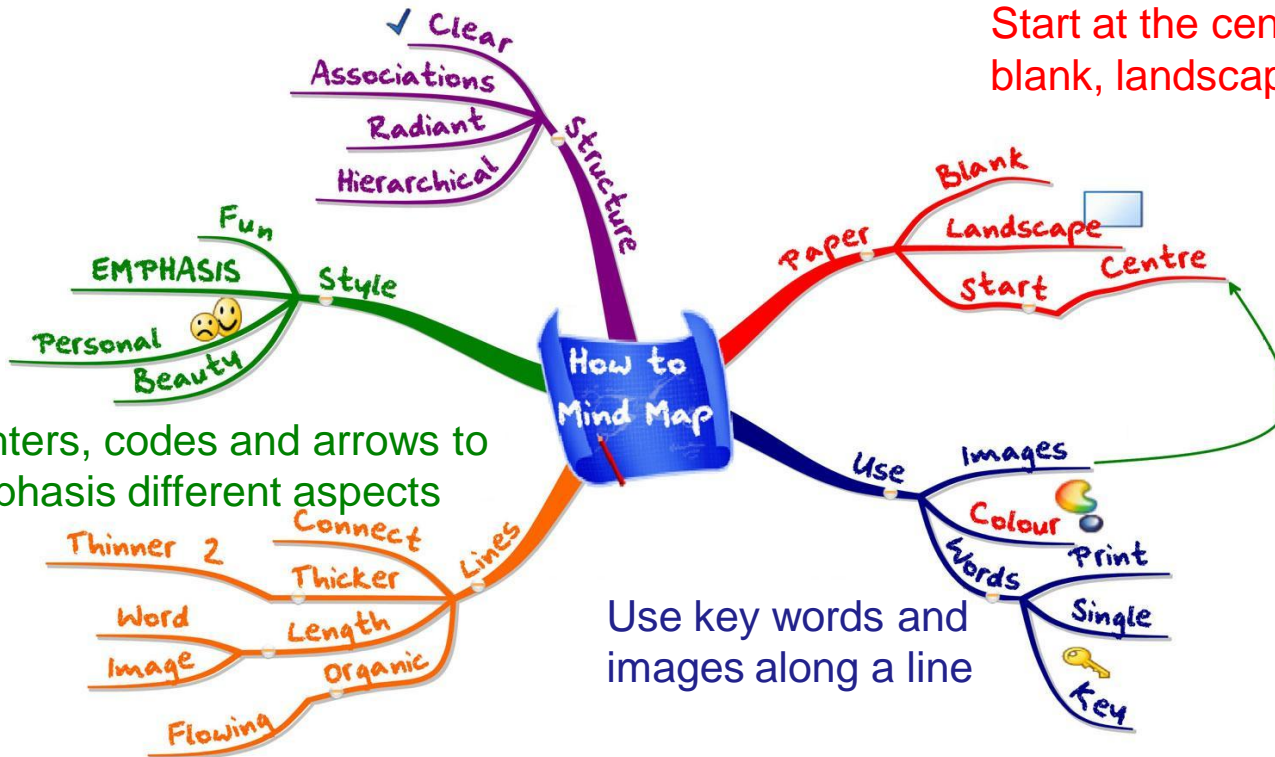
- Identify question requirements
- Highlight key words (e.g. Calculate / Advise / Propose etc...)
- **Mind-map** or sketch the question requirements
- Outline answers or approach
- Pay attention to specific format requirement (e.g. Write a memorandum)
 - Start with an introduction and end with a conclusion
→ Get easy marks!

Mind Map

Radiate the ideas out
from the central theme
and main branches

Start at the centre of a
blank, landscape paper

Use highlighters, codes and arrows to
link and emphasis different aspects



Use key words and
images along a line

Make the lines associate
as clear as possible



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During examination

DO

- Apply technical knowledge
- Do an easy question first to gain confidence
- Leave time at the end to check for careless mistakes
- **Write legibly**

DON'T

- Don't make up any information that is not provided by the question
- Don't write more than required as indicated by marks allocation
- Don't struggle, move to another question

(Question No. 2.)

- a) Even ABC is a ~~an~~ costing method suitable for ~~the~~ requirement to apportion the cost.
However, it cannot reflect all the cost and consideration that related to the new customer policy.
- b) ABC is a complicated ~~and~~ system, it might inability to ~~access~~ non-controllable cost to the relevant division.
New policy for the firm can help it to be focus on provide better service to customer and focus on high revenue's customer.
(To start with the new customer policy, we should use more than one analyse or costing method to make decision.)
However, the firm may loss the low cost but high contribution's customer and loss the customer's ~~costs~~ confidence once the customer cannot meet the target.
- c) KWL can get profit under new policy (set up a "re-use system" once the customer can). The company also can set up "quality system" ~~if the customer can~~ if the customer can meet the quality control which under new policy that can be ~~re-use~~ re-use again.



Examples of handwriting

Example 1:

adverse opinion

adverse opinion

Example 2:

substantive matters

substantive matters ??

Example 3:

seriously misleading

seriously misleading ????



2. Prepare yourself for examination

- Study HARD before examination
- Arrive early (examination centre opens for entry 45 minutes before start)
- Be aware of the **examination regulations** printed on the Examination Attendance Docket ("EAD")
 - The EAD will be posted to students 2 weeks before the examination

Failure to follow any of the examination regulations may result in marks penalty or even disqualification from the entire examination!



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- **There is no shortcut to any examinations including QP!**
- **This is your examination and not others' examination**
- **The only way to pass is to prepare properly for it!**



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Part 5: Q&A Session

