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# Answers

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Cases are given in the answers for educational purposes. Unless specifically requested, candidates were not required to quote specific case names to obtain the marks, only to provide the general principles involved.

	<i>Marks</i>
<p>1 (a) In Hong Kong, salaries tax is charged under s.8 of the IRO on income from an employment, office and pension arising in or derived from Hong Kong. In the case of employment income, the Board of Review adopts the 'totality-of-facts test' and looks at all the facts of the case. No single factor or particular factors can determine the issue. The court ruled in the <i>Goepfert</i> case that the correct approach is to look for the place where the income really comes to the employee, i.e. where the employment is located. As a consequence of this decision, the IRD issued DIPN 10 and accepts that employment is located outside Hong Kong (a foreign employment) where the following three factors are present:</p> <p>(1) the contract of employment was negotiated, entered into and is enforceable outside Hong Kong;  (2) the employer is resident outside Hong Kong; and  (3) the employee's remuneration is paid to him outside Hong Kong.</p> <p>If not all of the above factors are outside Hong Kong, it appears that the second factor is more important than the other factors, and the place of payment of remuneration is of least importance. If a person is recruited by an employer resident in Hong Kong, the employment is unlikely to be located outside Hong Kong, even though the contract is concluded outside Hong Kong and his remuneration is paid outside Hong Kong.</p> <p>The IRD reserves the right to look beyond the three factors where in reality the employment is a Hong Kong employment but manipulation exists.</p> <p>John Stevenson, although assigned to Hong Kong and having a position as a project manager of the Hong Kong branch, continued to be employed by Hi-tech, the UK company. Even though the terms of his employment were changed, the contract of employment was still made with the UK company. Irrespective of whether the contract of employment was a new contract or a mere variation of the existing one with the UK company, John's employment should still be a foreign one.</p> <p>However, as John performs some of his duties in Hong Kong, he is still subject to Hong Kong salaries tax under s.8(1A)(a) in respect of his income derived from services rendered in Hong Kong, including the leave pay attributable to such services. In ascertaining his taxable income, the time apportionment basis would be used, i.e. the employment income is apportioned according to the number of days that he is present in Hong Kong. As John's income is already assessed on a time-basis, it is not necessary for him to claim the exemption for the prevention of double taxation under s.8(1A)(c).</p>	<p>2</p> <p>1</p> <p><i>Bonus</i> 1</p> <p>1.5</p> <hr/> <p>1.5</p> <hr/> <p>6</p>

		Marks
<b>(b) John Stevenson's salaries tax computation for 2009/10</b>		
	\$	
Salary	1,200,000	0·5
Cost of living allowance	5,000	0·5
Entertainment allowance	15,000	0·5
Reimbursement of school fees	50,000	0·5
Reimbursement of air ticket	8,000	0·5
Private expenses paid by corporate credit card	22,000	0·5
	<u>1,300,000</u>	
Time-apportionment:		
Hong Kong: $170 + 25 \times 170 / (365 - 25) = 182·5$ days		1
Taxable: $1,300,000 \times 182·5 / 365$	650,000	1
Hong Kong salaries tax borne by employer	60,000	0·5
	<u>710,000</u>	
Rental value at 10%	71,000	1
Rent suffered $(32,000 - 28,000) \times 12$	(48,000)	0·5
	<u>23,000</u>	
Exercise of share option $(50 - 40) \times 8,000$	80,000	0·5
Sale of share option $(2,000 \times 2)$	4,000	0·5
	<u>84,000</u>	
Apportioned on time-basis $(84,000 \times 182·5 / 365)$	42,000	0·5
Assessable income	775,000	
Mandatory provident fund contributions (maximum)	(12,000)	0·5
	<u>763,000</u>	
Net assessable income	763,000	
Married person's allowance	(216,000)	0·5
Child allowance	(50,000)	0·5
	<u>497,000</u>	
Net chargeable income	497,000	
Tax payable at progressive rates	<u>72,490</u>	0·5
Tax payable at standard rate $(\$763,000 \times 15\% = \$114,450)$ is not applicable		0·5
		<u>11</u>
<b>(c) Brief explanations of the tax treatment:</b>		
<b>Item:</b>		
(2) The air tickets to relocate John's family to Hong Kong are not for holiday nor for services rendered; therefore they are not taxable.		0·5
(3) The cost of living allowance accrued in the year in which John was entitled to claim payment thereof is taxable. He was entitled to the allowance in the year ended 31 March 2010.		0·5
(4) The claim for deduction of entertainment expenses cannot be accepted as John cannot provide evidence and details to prove that the expenses were incurred wholly, exclusively and necessarily in the production of assessable income and were not private and domestic in nature. The reimbursement of non-allowable expenses is wholly taxable.		1
(5) Payment for the education of John's child is assessable as it represents a discharge of the employee's personal liability [s.9(2A)(b)]. Likewise, the reimbursement of the cost of the air ticket is taxable [s.9(2A)(c)].		1
(7) The reimbursement of the medical consultation fees is not taxable as it is made under the insurance contract not his employment contract.		0·5
(8) John is not entitled to any tax deduction in respect of the cost of the car as this is domestic and private in nature. On the other hand, the payment of the credit card balance is assessable income as Hi-tech is discharging John's personal liability.		1
(9) Any gain realised on the exercise, release or assignment of a share option is deemed to be income from the employment or office [s.9(1)(d)]. In the case of the exercise of an option, the gain is equal to the open market value of the shares at the time of exercise less the consideration paid for the option and the amount paid for the shares. In the case of a release or assignment, the gain is simply the amount of any consideration received less the amount paid for the option. Any loss realised on the exercise, release or assignment is ignored. The subsequent sale of the shares is irrelevant and the loss from the sale of shares is not deductible as it is not incurred to earn the assessable income.		1·5

	Marks
The exercise of the first share option on 1 July 2009 is not taxable as the option was granted in December 2008 before John was assigned to the Hong Kong branch. Although the option was exercised in Hong Kong, the benefit arising from the option is not attributable to services rendered in Hong Kong.	0.5
On the other hand, the exercise of the second share option on 2 January 2010 is taxable on the basis that the option was granted for partial completion of the project in Hong Kong and the benefit arising from the option is attributable to services rendered in Hong Kong.	0.5
(10) The individual income tax paid in the PRC is not relevant as John's income for services rendered outside Hong Kong is already exempt. However, the payment of Hong Kong salaries tax by Hi-tech is John's income for services rendered in Hong Kong and is fully taxable.	1
	8
	<b>25</b>

2 (a)

PPP Ltd			
Profits tax computation for the year of assessment 2009/10			
Basis period: year ended 31 December 2009			
	\$	\$	
Profit per accounts		43,200	0.5
Add: Depreciation	188,000		0.5
Interest to bank for Property C	10,000		1
Interest to director for Property C	20,000		1
Balancing charge for Property B	480,000		0.5
Property tax accrued for Property A	28,800		1
Deemed profit from sale of Property C (note to marker)	1,000,000	1,726,800	1
		1,770,000	
Less: Bank interest income (500 + 2,000 + 2,500)	5,000		1.5
Depreciation allowance for plant and machinery	130,000		0.5
Commercial building allowance (CBA)	160,000		0.5
Profit from sale of Property B	1,100,000	(1,395,000)	1
		375,000	
Profits tax at 16.5%		61,875	0.5
Less: Property tax for Property A (if paid)		(28,800)	1
Net profits tax payable		33,075	

[Note to marker: The deemed profit of \$1,000,000 from the sale of Property C may not be included in the tax computation above on the basis that this profit is not shown in the Company's profit and loss account and the Company may not wish to voluntarily offer the profit for assessment. However, the one mark will only be awarded to candidates if the candidates demonstrate in their answers that such profit may be deemed by the IRD in issuing the assessment. If such profit is not included in the above, the Company would incur a tax loss of \$625,000 (0.5 mark) with no profits tax payable (0.5 mark); and a refund of property tax of \$28,800 (if paid).]

## Depreciation allowance schedule for 2009/10

	20%	30%	CBA	Total DA	
	\$	\$	\$	\$	
Written down value (WDV) b/f	200,000	300,000			0.5
Annual allowance	(40,000)	(90,000)		130,000	0.5
WDV c/f	<u>160,000</u>	<u>210,000</u>			
Qualifying expenditure – Property A			4,000,000		0.5
CBA at 4%			<u>160,000</u>	<u>160,000</u>	0.5
Qualifying expenditure – Property B			1,200,000		0.5
CBA from 1999/2000 to 2008/09 at 4% (\$48,000*10)			<u>(480,000)</u>		1
Residue of expenditure before sale			720,000		
Less: Sale proceeds (building portion)			<u>(1,800,000)</u>		1
Balancing charge			<u>(1,080,000)</u>		0.5
Balancing charge restricted to CBA granted			<u>(480,000)</u>	<u>(480,000)</u>	1

Correct treatment of items that require no adjustment (candidates are NOT required to prepare the following table in their answers). Marks will be awarded if they are not adjusted in the tax computation.

Taxable/non-deductible Items	\$	Deductible/non-taxable Items	\$
Property management fee	1,500,000	Bank loan interest for Property A	25,000
Property rental income	360,000	Bank loan interest for Property B	30,000
Compensation	30,000	Legal fees – litigation	50,000
		Severance payment	90,000
		Gratuity	38,000
		Salaries tax of director	40,000
		Salaries tax of manager	30,000
		Retirement fund	40,000

0.5 mark each, max 5

22

## (b) Profit from the sale of Property C

Under s.14 of the IRO, if a person carries on a trade, profession or business in Hong Kong and derives profits from that trade, profession or business, other than profits arising from the sale of capital assets, and those profits arise in or are derived from Hong Kong, the person is subject to profits tax in Hong Kong in respect of the profits so derived. In the case of PPP Ltd, it is carrying on business in Hong Kong and Property C is situated in Hong Kong. *Prima facie*, the profits, if any, derived from the sale of Property C would be assessable under s.14, unless either of the following circumstances applies:

- (i) it is proved to the satisfaction of the Commissioner that there is no profit or gain made from the sale; or
- (ii) the profit so derived is capital in nature.

1.5

In general terms, an asset which a business acquires in order to or with an intention to sell or to process into goods for sale, is regarded as 'trading stock'. Although this definition is not included in the Hong Kong Accounting Standards, one would have to rely on the facts and circumstances in order to determine whether the property held is trading stock or a capital asset. This distinction is important as, for tax purposes, the tax treatment of each category is different. In the case of PPP Ltd, Property C has been held and classified in the 2008 accounts as an 'Asset Held for Resale'. Thus, unless there is evidence to prove otherwise, the property would be regarded as 'trading stock'. Any profits derived from its sale would be regarded as revenue in nature and taxable.

1.5

The IRO does not contain any provisions or guidelines as to the valuation of trading stock other than s.15C which applies to the cessation of business. Under s.15C, the value of trading stock sold to a person carrying on a business in Hong Kong would be the amount realised on the sale if the purchaser would claim a tax deduction on the stock purchase price for tax purposes. In situations other than this, the trading stock would be valued, upon cessation, at the amount which it would have realised if it had been sold in the open market on the date the taxpayer's business ceased.

1

Property C was sold to a director at cost which is below the market price. The shortfall of \$1,000,000 is potentially challengeable by the IRD as taxable. The main reason is that the property was sold to a director who has control over the company's affairs, and the sale price is equivalent to the cost, which does not justify a commercial course of action.

2

Reference can be made to various case law. The value of trading stock should be the 'market value' or 'realisable value' of the stock, that is the amount that would be realised from the sale of the stock in question in the ordinary course of business [*Australian Jam Co Pty Ltd*]. When a trading stock has been used by a taxpayer for his or her own personal purposes, converted into assets for use in the business, or disposed of outside the course of business; the taxpayer is required to account for the stock as if it had been sold in the due course of trade [*Sharkey v Wernher*]. This rule has been extended to situations where trading assets are sold for less than their market value in the course of trade [*Petrotim Securities Ltd* case].

1.5

Alternatively, the IRD may choose to impose the anti-avoidance provisions to tackle arrangements involving the sale of trading stocks for less than their market value.

0.5

8**30****3 (a)**

**Depreciation allowance schedule**  
**Year of assessment 2009/10**  
**1 October 2008–31 July 2009**

0.5

	20% \$	30% \$	Allowance \$	
Written down value b/f	18,000	200,000		0.5
Additions				
Fax machine	5,000			0.5
Initial allowance at 60%	(3,000)		3,000	0.5
	<u>20,000</u>			
Disposals				
Motor car		(100,000)		0.5
		<u>100,000</u>		
Group sale (102,000*2/12)	(17,000)			1
(102,000*10/12)		(85,000)		0.5
		<u>(102,000)</u>		
Balancing allowance	<u>3,000</u>	<u>15,000</u>	<u>18,000</u>	1
Total allowances for 2009/10			<u><u>21,000</u></u>	<u>5</u>

**(b)**

**Partnership business**

**Computation of assessable profit for 1 October 2008–31 July 2009**

	\$	
Net profit per account	103,500	0.5
Salary to partner	300,000	0.5
Air tickets	6,000	0.5
Purchase of prescribed fixed asset – computer	(12,000)	0.5
Sale of prescribed fixed asset – computer	8,000	0.5
Depreciation	82,500	0.5
	<u>488,000</u>	
Adjusted profit before depreciation allowance		

**Profits tax computation**

**Year of assessment 2009/10**

**Basis period: 1 April 2009–31 July 2009**

0.5

	\$	\$	
Adjusted profits before depreciation allowance (488,000 x 4/10)		195,200	1
Add: Profits of relevant period (1 October 2008–31 March 2009)			
(488,000 x 6/10)	292,800		1
Less: Transitional amount (1 November 1974–31 March 1975)			
(192,000 x 5/12)	(80,000)	<u>212,800</u>	1
		408,000	
Less: Depreciation allowance and balancing allowance (as per (a))		(21,000)	0.5
		<u><u>387,000</u></u>	<u>7</u>

(c) Partnership allocation and tax payable Year of assessment 2009/10					Marks
	Albert \$	Best Ltd \$	Colbert \$	Total \$	
Salary (300,000*4/10)	120,000	–	–	120,000	1
Air tickets	6,000			6,000	0·5
Balance (2:1:1)	130,500	65,250	65,250	261,000	0·5
Share of assessable profit	256,500	65,250	65,250	387,000	
Loss brought forward – s.19C(2)	–	(60,000)	(60,000)	(120,000)	1
Loss transferred – s.19C(4)		(5,250)		(5,250)	1
Transferred to personal assessment – s.19C(3)	(256,500)	–	–	(256,500)	0·5
Net assessable profit	–	–	5,250	5,250	
Tax payable at 15%			787	787	0·5
					5

- (d) Colbert participates in the partnership business in the capacity of an individual partner. The fact that Colbert also carries on another proprietorship business does not affect Colbert's tax position under the partnership unless Colbert elects for personal assessment. Under personal assessment, Colbert is able to aggregate all his sources of income (or losses) whereby the share of profits from the partnership can be aggregated and offset by the losses incurred by the proprietorship business. The proprietorship business is not a corporation and it is not a partner of the partnership. Therefore, if personal assessment is not elected, the losses incurred by the proprietorship business are not eligible for set off against the partnership profit, and must be carried forward under the name of the proprietorship business.

3

**20**

4 (a) Iris Johnson's property tax computation  
Year of assessment 2009/10

	\$	
Rental (\$20,000 x 11)	220,000	0·5
Repairs borne by tenant	5,000	0·5
Assessable value	225,000	
Less: rates paid by landlord (\$1,000 x 4)	(4,000)	0·5
	221,000	
Less: 20% statutory deduction	(44,200)	0·5
Net assessable value	176,800	
Property tax at 15%	26,520	0·5

**Explanations:**

- (1) As no rental was payable during the one-month rent-free period, the total number of months of rental during the year was 11. 0·5
- (2) Although BB Ltd has defaulted in rental payment since December 2009, no bad debt deduction will be allowed for the year 2009/10 on the basis that BB Ltd was still leasing the property, contactable, and responding to Iris in respect of the outstanding debt. From a tax perspective, the debt has not yet been proved as bad and irrecoverable. 1
- (3) The rent deposit is not consideration earned by Iris and thus not assessable. 0·5
- (4) A property management fee paid by the tenant directly to the management company is not regarded as consideration earned by Iris and thus not assessable. The outstanding property management fee settled by Iris is not tax deductible as it is not specifically allowed as a statutory deduction. 1
- (5) Rates paid by the landlord are specifically allowed as a tax deduction before the 20% statutory allowance. Rates are payable per quarter but pursuant to the 2009/10 budget, a rates concession was granted for all four quarters ended 31 March 2010 up to the maximum of \$1,500 per quarter. As such, Iris was expected to have paid the \$1,000 balance of rates due per quarter, and thus only \$4,000 can be deducted. 0·5

	<b>Marks</b>
(6) Government rent payable by the landlord is not deductible under property tax. It is meant to be covered by the 20% statutory deduction and no separate deduction was allowed.	0.5
(7) Mortgage interest paid on a loan obtained to fund the acquisition of a property is not tax deductible under property tax.	0.5
(8) The renovation cost incurred by Iris is regarded as capital expenditure but there is no capital allowance provided under property tax, thus, no deduction is available for the renovation.	0.5
(9) Repairs relating to the property are regarded as the liability of the landlord. In this case, the repair cost was paid and borne by the tenant. Thus, it is deemed as consideration earned by the landlord and assessable to property tax.	0.5
(10) The property agency fee for introducing the tenant is deemed to be covered by the 20% statutory deduction and thus not separately allowed as a deduction.	0.5
(11) The fact that BB Ltd has sub-let the property to its director does not affect the property tax liability of Iris.	0.5
	<u>9</u>
<b>(b)</b> An individual earning property income in Hong Kong may be able to deduct the related bank mortgage loan interest payable on the money borrowed to acquire the property but only to the extent of the income earned from that property under personal assessment.	1
Under personal assessment an individual can aggregate their assessable income (including business losses if applicable) from the various statutory heads of charge (being profits tax, salaries tax and property tax), deducting from this the normal eligible deductions including interest payments which are not otherwise deductible, concessionary deductions such as home loan interests and personal allowances. Tax is then payable at progressive rates on the net chargeable income or at the standard rate on the net assessable income before personal allowances whichever is lower.	1
However, to be eligible to elect for personal assessment, the individual taxpayer must be either a temporary or permanent resident of Hong Kong. Permanent resident refers to an individual who ordinarily resides in Hong Kong. Based on <i>R v Barnet London Borough Council</i> , a person is resident in a place 'where a person lives and conducts his daily life in circumstances which lead to the conclusion that he is living there as an ordinary member of the community would live for all the purposes of his daily life'.	1
A temporary resident refers to an individual who is present in Hong Kong for a period or periods during the year of assessment amounting to more than 180 days or for more than 300 days over two consecutive years, one of which is the year for which an election is sought.	1
Iris is not a permanent resident of Hong Kong and only came to Hong Kong for work on a short-term assignment. However, she has stayed for 170 days during 2009/10. If she stays for another 130 days during 2010/11, she would be able to qualify as a temporary resident and be eligible to elect personal assessment for 2009/10. If she did so her mortgage loan interest could be deducted against the property income earned.	2
	<u>6</u>
	<u><b>15</b></u>

- 5 (a)** For the purpose of revising the cost of sales in the profit tax return filed, One Ltd is entitled to lodge a claim under s.70A to have the 'error or omission' corrected in respect of 2009/10. A s.70A claim must be made in writing within six years after the end of the year of assessment or within six months after the service of the notice of assessment, whichever is later.
- 1
- The claim is accepted only if it can be established to the satisfaction of the Inland Revenue Department (IRD) that the assessment is excessive by reason of:
1. an error or omission in a return or statement submitted; or
  2. an arithmetical error or omission in the calculation of the assessable profits or the tax charged.
- 1
- However, the assessment cannot be re-opened for an error or omission in a return or statement where that return or statement was made on the basis of prevailing practice. Whether the tax treatment is a prevailing practice or not is a question of fact, and it is normally distinguished from the basis, which is made according to the stipulated law. Based on case law, a taxpayer must demonstrate the existence of an error or omission in a return or statement, and an 'error' for the purpose of s.70A is generally referred to only as an inadvertent error and would not extend to a deliberate error. Evidence as to how the error would have come to be made would still be required to be established.
- 2



In the case of One Ltd, it would be required to produce evidence to explain the error due to the missing purchase invoice and the reason why this cost of sales was not detected and included in its accounts in support of the tax return filed. It is expected that its accountant or auditor, if any, may be required to produce evidence. Provided that it can be established to the satisfaction of the IRD that the understated cost of sales was an 'error' or 'omission', its s.70A claim would be allowed and the profits tax assessment for 2009/10 would be revised accordingly.

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- (b) At the time when the error was discovered, the time limit of one month from the date of notice of assessment for lodging a valid objection against the notice of assessment has already lapsed. No objection is, therefore, allowed to be made unless One Ltd has reasonable grounds (such as directors' absence from Hong Kong) to explain why it could not lodge the objection in time, in which case a late objection may be accepted.

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One Ltd is however able to hold over the provisional profits tax in respect of 2010/11 if it is anticipated that the assessable profits for 2010/11 would be, or are likely to be, less than 90% of the amount assessed to provisional tax. This may or may not be as a result of the understatement of cost of sales that occurred in 2009/10. The application for holdover must be made in writing and lodged with the Commissioner of Inland Revenue 28 days before the due date, i.e. by 31 December 2010.

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If no application for the holdover of provisional tax is made, One Ltd is required to pay the tax as required at the amount demanded on the date specified. However, should it be ultimately determined that the 2009/10 profits tax liability was overstated due to the error, and the notice of assessment is revised to reflect a lower profits tax liability, a tax refund will be issued by the IRD to One Ltd.

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**10**