

Fundamentals Level – Skills Module

Taxation (Hong Kong)

Monday 6 December 2010

Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

ALL FIVE questions are compulsory and MUST be attempted.
Tax rates and allowances are on page 2.

Do NOT open this paper until instructed by the supervisor.

During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants

Paper F6 (HKG)

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black square.

SUPPLEMENTARY INSTRUCTIONS

1. Calculations and workings should be rounded down to the nearest HK\$.
2. Apportionments need only be made to the nearest month, unless the law and prevailing practice require otherwise.
3. All workings should be shown.

TAX RATES AND ALLOWANCES

The following 2009/10 tax rates and allowances are to be used in answering the questions

Allowances

	\$
Basic allowance	108,000
Married person's allowance	216,000
Single parent allowance	108,000
Child allowance – 1st to 9th child (each)	50,000
– additional allowance in the year of birth (each)	50,000
Dependent parent/grandparent allowance – basic	15,000/30,000
– additional	15,000/30,000
Dependent brother/sister allowance	30,000
Disabled dependant allowance	60,000

Deductions

	\$
Self-education expenses (maximum)	60,000
Home loan interest (maximum)	100,000
Elderly residential care expenses (maximum)	60,000
Mandatory provident fund contributions (maximum)	12,000

Tax rates

Salaries tax rates:	
First \$40,000	2%
Next \$40,000	7%
Next \$40,000	12%
Remainder	17%
Standard rate	15%
Profits tax rate for corporations	16.5%

Depreciation allowance rates

Initial allowance:	
Plant and machinery	60%
Industrial buildings	20%
Annual allowance:	
Computers	30%
Motor cars	30%
Furniture and fixtures	20%
Machines	20%
Industrial buildings	4% or formula
Commercial buildings	4% or formula

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Question 1 begins on page 4.**

ALL FIVE questions are compulsory and MUST be attempted

- 1 (a) John Stevenson has been employed by Hi-tech Ltd (Hi-tech) in the UK as a project manager since 2008.

On 1 April 2009, John was assigned to Hong Kong to handle a project for two years for the Hong Kong branch of Hi-tech. The project required research and development in the PRC and Hong Kong. In consideration of his assignment to Hong Kong, Hi-tech revised John's employment contract such that he enjoyed longer annual leave and the provision of housing benefit in Hong Kong. The organisation chart of the Hong Kong branch listed him as a project manager. However, during the two-year assignment, John is still required to report his work to his senior in the UK. During the year ended 31 March 2010, John worked for 170 days in Hong Kong, 150 days in the PRC, and 45 days (including 25 days annual leave) in the UK.

The Inland Revenue Department in Hong Kong assessed John's income for the full year to Hong Kong salaries tax on the ground that his income was sourced in Hong Kong, contending that he entered into a new employment contract upon assignment to Hong Kong and that he formed part of the organisation team of the Hong Kong branch.

Required:

Explain whether, and if so to what extent, John Stevenson's income should be assessed to Hong Kong salaries tax for the year of assessment 2009/10. (6 marks)

- (b) When answering this part you should assume that only John's income for his services rendered in Hong Kong is chargeable to Hong Kong salaries tax for the year of assessment 2009/10 on a time basis (under s.8(1A) of the Inland Revenue Ordinance).

The following additional information for the year ended 31 March 2010 is available in respect of John Stevenson (all amounts are denominated in Hong Kong dollars):

- (1) Annual salary: \$1,200,000.
- (2) Hi-tech paid \$90,000 to purchase air tickets for John, his wife and son to relocate them from the UK to Hong Kong.
- (3) John became entitled to a cost of living allowance as from March 2010. The allowance, of \$5,000 per month, is payable on the second day of the next month.
- (4) Hi-tech gave John an entertainment allowance of \$15,000 for the year. He informed the Inland Revenue Department that Hi-tech required him to socialise with clients. He spent \$12,000 entertaining clients but he did not keep any receipts or evidence of the entertainment. He kept the balance of \$3,000 for himself.
- (5) John sent his son, who was 15, for study in the USA. Hi-tech reimbursed \$50,000 to him for part of the school fee incurred. Hi-tech also reimbursed the cost of his son's air ticket in the amount of \$8,000.
- (6) John rented a flat in Hong Kong at a monthly rent of \$30,000. He also paid a monthly management fee of \$2,000. Hi-tech reimbursed him \$28,000 per month upon submission of the rental receipts.
- (7) Hi-tech operates a group employee medical scheme. During the year, John paid \$6,000 to his family doctors for medical consultation in respect of his family. He received full reimbursement of this amount from the insurance company.
- (8) On 1 May 2009, John bought a second-hand car for \$50,000 from his own funds. Hi-tech provides John with a corporate credit card, which he used to pay for his private car expenses in the amount of \$22,000. The credit card balance was settled by Hi-tech.
- (9) On 10 December 2008, John was granted a right to subscribe for 6,000 shares in Hi-tech, at a price of \$9 per share. On that date Hi-tech's shares were traded at \$11 per share. On 1 July 2009, when the market value was \$15 per share, John exercised the option in Hong Kong to acquire all the shares allotted. On 15 January 2010, he sold all of the shares for \$24 per share.

On 15 December 2009, upon successful partial completion of the project, John was granted a further right to acquire 10,000 shares at \$40 per share in a UK affiliated company of Hi-tech. On that date the shares were traded at \$45 per share. On 2 January 2010, John exercised the option to acquire 8,000 shares

when the market value was \$50 per share. Unfortunately, the share price dropped shortly afterwards. On 1 March 2010, John sold the option to acquire the remaining 2,000 shares for \$2 per share, and all of the 8,000 shares at \$39 per share.

(10) During the year, Hi-tech paid the following tax bills in respect of John:

Hong Kong salaries tax	\$60,000
PRC individual income tax	\$150,000

(11) John contributed a total of \$18,000 to the Mandatory Provident Fund.

(12) John's wife has not worked since he was assigned to Hong Kong.

Required:

(i) Compute the Hong Kong salaries tax liability of John Stevenson for the year of assessment 2009/10.

Note: you should ignore provisional tax and overseas tax. (11 marks)

(ii) Briefly explain the tax treatment you have applied to items (2) to (5) and (7) to (10) above. (8 marks)

(25 marks)

- 2 PPP Ltd (the Company) has been carrying on a property leasing and management business in Hong Kong. The Company's profit and loss account for the year ended 31 December 2009 is as follows:

	Note	\$	\$
Income			
Property management fee		1,500,000	
Property rental income – Property A	(1)	240,000	
Property rental income – Property B	(2)	120,000	
Profit from the sale of Property B	(2)	1,100,000	
Compensation	(4)	30,000	
Interest income	(5)	5,000	2,995,000
Expenses			
Directors' fees		1,200,000	
Staff salaries		1,000,000	
Interest expenses	(6)	85,000	
Legal fees – litigation	(4)	50,000	
Rent and rates		80,000	
Termination payment	(7)	128,000	
Taxation expenses	(8)	98,800	
Retirement scheme	(9)	40,000	
Depreciation		188,000	
Insurance		82,000	(2,951,800)
Net profit before tax			43,200

The following information, extracted from the audit working papers and other records, gives further details of the Company's operations during the year:

- Property A was acquired by the Company during the year, at a cost of \$8,000,000. The acquisition was 30% funded by a bank mortgage loan, and 70% by new capital issued by the Company. Property A has been leased out for rental since April 2009.
- Property B was acquired by the Company in 1999, at a cost of \$4,000,000. The acquisition was 30% funded by a bank mortgage loan, and 70% by new capital issued by the Company. The property was leased for rental since its acquisition and was sold by the Company in December 2009 for \$4,860,000 (including \$1,800,000 for the building portion). The net asset value at the time of sale was \$3,760,000 (including \$960,000 for the building portion). The profit as shown in the Company's accounts is \$1,100,000.
- In December 2008, the Company acquired Property C at a cost of \$3,000,000. The acquisition was 30% funded by a bank mortgage loan, which was secured over a deposit of \$900,000 placed by a shareholder of the Company, Mr X, with the bank. The interest charged by the bank on the mortgage loan was slightly lower than that charged in the market. The balance of the acquisition cost was funded by another interest bearing loan from a director of the Company, Mr Y. Property C was disclosed in the Company's 2008 accounts as an 'Asset Held for Resale'. It was sold by the Company in February 2009 to a director of the Company, Mr Z, at a price of \$3,000,000, although the market value at the time of sale was around \$4,000,000. No profit or loss was reflected in the Company's accounts.
- In early 2008, the Company started litigation against a former tenant. The case was settled during the year and the tenant paid compensation of \$30,000 to the Company in settlement of the dispute. The total legal fees incurred were \$50,000.
- Details of the interest income received during the year are:

	\$
Tax Reserve Certificates bought from the HKSAR government	500
HK\$ fixed deposit with a Hong Kong bank	2,000
Foreign currency fixed deposit with a Hong Kong bank	2,500
	<u>5,000</u>

(6) Interest expenses comprise:

	\$
Bank loan interest for Property A	25,000
Bank loan interest for Property B	30,000
Bank loan interest for Property C	10,000
Interest to director Mr Y for Property C	20,000
	<u>85,000</u>

(7) A severance payment of \$90,000 as well as a lump-sum gratuity of \$38,000 were made to a leaving member of staff. The severance payment was calculated based on the Employment Ordinance.

(8) Taxation expenses comprise:

	\$
Property tax accrued for Property A	28,800
Salaries tax of director Mr Y	40,000
Salaries tax of a senior manager as per employment contract	30,000
	<u>98,800</u>

The Company was granted exemption from property tax in respect of the rental income from Property B.

(9) The amount of \$40,000 represents the expenses charged to the Company's exempted registered retirement scheme as per the actuarial report. The same amount was actually paid to the scheme during the year.

(10) The Company's tax written down values for plant and machinery as at 31 December 2008 were as follows:

20% pool	\$200,000
30% pool	\$300,000

Qualifying expenditure for commercial building allowance in respect of Property A was \$4,000,000 and of Property B was \$1,200,000. There was no movement in any fixed assets during the year except as stated in notes (2) and (3) above.

Required:

(a) Compute PPP Ltd's Hong Kong profits tax liability in respect of the year ended 31 December 2009, clearly identifying both the year of assessment and the basis period, and showing the depreciation allowance calculation.

Notes:

(1) You should ignore provisional tax and overseas tax.

(2) No detailed explanations are required in this part. (22 marks)

(b) Comment on the possible Hong Kong tax position in respect of the sale of Property C. (8 marks)

(30 marks)

- 3 Albert, Best Ltd and Colbert were in partnership sharing profits and losses in the ratio of 2:1:1 respectively. The partnership ceased business on 31 July 2009, and its final profit and loss account drawn up for the ten months from 1 October 2008 to 31 July 2009 was as follows:

	\$	\$
Turnover		3,280,000
Cost of goods sold		<u>(1,400,000)</u>
Gross profit		1,880,000
Rent	500,000	
Salaries	680,000	
Contributions to mandatory provident fund (MPF) schemes	60,000	
Other expenses	454,000	
Depreciation	<u>82,500</u>	<u>(1,776,500)</u>
Net profit		<u><u>103,500</u></u>

Additional information:

- (1) Salaries include \$300,000 paid to Albert and \$180,000 paid to Colbert's son.
- (2) Contributions to MPF schemes include \$10,000 paid for Albert and \$10,000 paid for Colbert's son.
- (3) Other expenses include \$6,000 paid for Albert's air tickets for a private trip to Japan in May 2009.
- (4) A summary of the movements in plant and machinery is as follows:

Date	Particulars
30 November 2008	Bought a fax machine for \$5,000 and a computer for \$12,000.
18 March 2009	Sold a motor car for \$100,000.
3 August 2009	All of the remaining assets were sold for \$102,000; except for the computer which had an estimated open market value of \$8,000. The cost of the computer had been fully deducted in the tax return filed in the year of purchase.

The tax written down values brought forward for the respective pools at 1 October 2008 were \$18,000 (20%) and \$200,000 (30%).

- (5) As of 30 September 2008, the partnership had an agreed tax loss of \$120,000, which was allocated to Best Ltd and Colbert in the amount of \$60,000 and \$60,000 respectively. Neither Albert nor Colbert elected for personal assessment for 2008/09.
- (6) The adjusted profits of the partnership for the two years to 31 October 1975 were as follows:

12 months to 31 October 1974	\$180,000
12 months to 31 October 1975	\$192,000
- (7) Only Albert elected for personal assessment in 2009/10.
- (8) Best Ltd also carries on a business in Hong Kong, which has an agreed tax loss of \$80,000 for the year ended 30 June 2009.
- (9) Colbert also carries on a proprietorship business in Hong Kong. For the year ended 31 December 2009, this proprietorship business has an agreed tax loss of \$50,000.

Required:

- (a) Calculate the depreciation allowances and balancing adjustments where appropriate for the partnership for the year of assessment 2009/10, clearly identifying the basis period. (5 marks)
- (b) Compute the assessable profit/adjusted loss of the partnership for the year of assessment 2009/10, clearly identifying the basis period. (7 marks)
- (c) Compute the allocation of profits to and tax payable by each of the partners, if any, for the year of assessment 2009/10, claiming any reliefs available to Best Ltd.
Note: you should ignore provisional tax. (5 marks)
- (d) Briefly comment on Colbert's tax position under the Hong Kong profits tax regime. (3 marks)

(20 marks)

4 Iris Johnson came to Hong Kong in January 2009 to work on a short-term assignment. The term of the assignment is not yet determined. During February 2009, she acquired a residential property in Hong Kong and she has signed a lease for this property with a tenant, BB Ltd, which is a Hong Kong incorporated company. The terms under the lease and other information relating to the property are as follows:

- (1) Term of lease: two years from 1 April 2009.
- (2) Rent free period: one month from 1 April 2009.
- (3) Monthly rental: \$20,000, payable in advance. Since 1 December 2009, BB Ltd has failed to pay the rental. Iris engaged a lawyer to send two reminder letters to BB Ltd. Two replies were received from BB Ltd explaining its financial difficulties and requesting an extension for rental payment.
- (4) Rent deposit: two months' rental, paid on signing the lease agreement.
- (5) Management fee: \$2,000 per month, payable by BB Ltd directly to the property management company. Since 1 December 2009 when BB Ltd started to default on the rental payment, BB Ltd has not paid the property management fee. The property management company approached Iris for payment in February 2009 and Iris settled all outstanding fees in March 2009.
- (6) Rates: \$2,500 per quarter, payable by Iris and due on 31 January, 30 April, 31 July and 31 October each year. Hong Kong's 2009/10 budget granted rates concessions for all the four quarters during the year, subject to a maximum of \$1,500 per quarter.
- (7) Government rent: \$1,200 per quarter, payable by Iris and due on same dates as the rates.
- (8) Mortgage interest: \$25,000 per month, incurred on a bank loan obtained by Iris in her own name for acquiring the property.
- (9) Renovation: \$50,000, incurred by Iris on 1 March 2009.
- (10) Repair to balcony: \$5,000 incurred by BB Ltd on 31 July 2009.
- (11) Agency fee: 50% of one month's rental for introducing the tenant, paid by Iris on signing the lease agreement.
- (12) Sub-letting: BB Ltd sublet the property to its director on 1 April 2009.

During the years ended 31 March 2009 and 2010, Iris spent 30 days and 170 days respectively in Hong Kong.

Required:

(a) Prepare a computation of Iris Johnson's property tax liability in respect of the year of assessment 2009/10; and explain the tax treatment accorded to each of the items set out in (2) to (12) above under the property tax regime.

Note: you should ignore provisional tax. (9 marks)

(b) Based on the Inland Revenue Ordinance, state under what circumstances an individual earning property income is able to deduct bank mortgage interest from that property income; and advise Iris Johnson as to whether these circumstances apply to her. (6 marks)

(15 marks)

- 5 One Ltd carries on a fashion retail business in Hong Kong. It closes its accounts on 31 December each year. In August 2010, One Ltd filed its profits tax return for the year of assessment 2009/10 reporting an assessable profit of \$1,000,000. On 1 November 2010, it received a notice of assessment showing the following:

	\$
2009/10 final tax payable	165,000
Less: provisional tax paid	(100,000)
	<hr/>
Balance of tax payable	65,000
2010/11 provisional tax payable	165,000
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Total tax payable	<u>230,000</u>
Payable in two instalments:	
By 28 January 2011	\$188,750
By 28 April 2011	\$41,250

On 20 December 2010, One Ltd discovered that it had over-reported its taxable income in its 2009/10 tax return by under-reporting the cost of sales by \$100,000 due to a missing purchase invoice.

Required:

- (a) Advise One Ltd of its right of action, if any, to correct the errors made in respect of the understated cost of sales in its 2009/10 tax return. (6 marks)
- (b) Advise One Ltd of any appropriate actions it may take in respect of the tax payment as demanded under the 2009/10 notice of assessment. (4 marks)

(10 marks)

End of Question Paper