

Fundamentals Level – Skills Module

# Taxation (Hong Kong)

Tuesday 3 June 2014



**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 (HKKG)

**ACCA**

**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.
4. Ignore provisional tax and statutory tax reductions, unless specified otherwise.

**TAX RATES AND ALLOWANCES**

The following 2013/14 tax rates, allowances and deductions are to be used in answering the questions.

**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%

**Allowances**

	\$
Basic allowance	120,000
Married person's allowance	240,000
Single parent allowance	120,000
Child allowance – 1st to 9th child (each)	70,000
– additional allowance in the year of birth (each)	70,000
Dependent parent/grandparent allowance – basic	19,000/38,000
– additional	19,000/38,000
Dependent brother/sister allowance	33,000
Disabled dependant allowance	66,000

**Deductions**

	\$
Self-education expenses (maximum)	80,000
Home loan interest (maximum)	100,000
Elderly residential care expenses (maximum)	76,000
Mandatory provident fund contributions (maximum)	15,000

**Depreciation allowance rates (for both 2012/13 and 2013/14)**

Initial allowance:	
Plant and machinery	60%
Industrial buildings	20%
Annual allowance:	
Computers	30%
Motor cars	30%
Furniture and fixtures	20%
Lifts and air-conditioning plant	10%
Machines	10%–30%
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** Damon Cha is employed as a project manager with Real Estate Development Ltd (REDL), a Hong Kong company which conducts a property development business in Hong Kong and China. Damon has his office in Hong Kong, but he is mainly responsible for monitoring the progress of REDL's property development projects in China.

Damon has provided you with the following information relating to the year ended 31 March 2014:

- (1) Damon's basic salary is \$60,000 per month.
- (2) Damon comes back to Hong Kong every other Friday evening to stay with his family and returns to China after reporting his work to his boss at the Hong Kong office, on the following Monday morning. He also comes back to Hong Kong during his vacations. During the year, Damon was in Hong Kong for a total of 120 days. Two-thirds of his salary was attributable to services rendered in China, upon which he was required to pay \$100,000 income tax to the Chinese authority. This Chinese income tax was paid and borne by REDL.
- (3) REDL purchased a medical insurance policy for Damon and his family at a cost of \$16,000. Damon received a reimbursement of medical expenses from the medical insurance scheme which cost him \$12,000.
- (4) In May 2013, Damon purchased a property in Hong Kong for \$5 million, and used it as his place of residence. He financed the acquisition of this property by way of a loan borrowed from the bank, and paid loan interest of \$50,000 for the year. Damon arranged for REDL to rent the property from him at a monthly rent of \$15,000 starting from 1 June 2013 for a two-year period; REDL then provided this property rent-free to Damon. A written tenancy agreement was entered into between Damon and REDL.
- (5) REDL provided Damon with two round-trip tickets to Paris for a holiday. The air tickets cost REDL \$30,000, and Damon could sell them for \$20,000.
- (6) On 15 December 2013, Damon was granted a right to acquire 10,000 shares in REDL at \$40 per share. He paid \$10,000 for this option. On 15 December 2013, REDL's shares were traded at \$45 per share. On 2 January 2014, Damon exercised the option to acquire 8,000 shares when the market value was \$60 per share. Unfortunately, the share price dropped shortly afterwards. On 1 March 2014, Damon sold the option to acquire the remaining 2,000 shares for \$1,000, and all of the 8,000 shares at \$39 per share.
- (7) Damon's wife is a housewife. The couple have two children aged 21 and 23. The 21-year-old son was a full-time student at The Hong Kong University until June 2013 when he graduated. He is now working as a management trainee. The 23-year-old daughter is a graduate student at The Chinese University of Hong Kong. She lives in college at the University and is employed part-time by the University as a teaching assistant for a salary of \$10,000 per month.
- (8) Damon's step-mother (aged 54) lives in a registered nursing home in Shatin. The nursing home expenses of \$10,000 per month were paid by Damon.
- (9) Damon and his wife made cash donations totalling \$10,000 to various approved charities.
- (10) During the year, Damon contributed \$18,000 to the mandatory provident fund (MPF).

All currency amounts are given in Hong Kong dollars.

**Required:**

- (a) Calculate the Hong Kong salaries tax payable by Damon Cha for the year of assessment 2013/14, giving explanations of the treatment you have accorded for tax purposes to items (3) to (7) above. (20 marks)**
- (b) Damon has been advised by REDL's accountant that his Hong Kong tax liabilities could be reduced if instead of signing a single employment contract, he was to sign two contracts: Contract 1 covering his services to be rendered in Hong Kong; and Contract 2 covering his services to be rendered in China.**

**Required:**

**Comment on the advice given by the accountant regarding Damon Cha. (5 marks)**

**(25 marks)**

- 2 Summer Ltd (Summer), a Hong Kong incorporated company, carries on business in Hong Kong in sports products under the trade-name of 'SummerCool'. Summer imports products from Europe and sells them in its retail outlets in Hong Kong. For the year ended 31 December 2013, Summer has the following trading results:

	Note	\$	\$
Sales from outlets	(1)		10,800,000
Cost of goods sold	(1)		<u>(4,500,000)</u>
Gross profit			6,300,000
Interest income	(2)	245,000	
Finance income	(3)	415,000	
Profit from the disposal of fixed assets	(11)	5,000	665,000
			<u>6,965,000</u>
Directors' remuneration	(4)	1,300,000	
Staff costs	(5)	1,200,000	
Selling and distribution	(6)	400,000	
Office rent and rates	(7)	3,000,000	
Royalty payment	(8)	1,400,000	
Legal and professional fees	(9)	30,000	
Interest expenses	(10)	5,000	
Depreciation	(11)	100,000	
Insurance		10,000	
Office consumables		3,000	<u>(7,448,000)</u>
Loss for the year			<u><u>(483,000)</u></u>

**Notes:**

- (1) Details of sales and cost of goods sold are:

	\$	\$
Gross sales from retail outlets in Hong Kong	14,000,000	
Sales from internet transactions	2,000,000	
Less: Sales commission to agents	(4,000,000)	
Handling fee to internet service provider	<u>(1,200,000)</u>	
Sales		10,800,000
Purchases from suppliers in Europe	(5,000,000)	
Less: Rebates from suppliers	<u>(500,000)</u>	
Cost of goods sold		<u>(4,500,000)</u>
Gross profit		<u><u>6,300,000</u></u>

- (2) Interest income comprises:

	\$
Interest on HK\$ deposit with a bank in Hong Kong	24,000
Interest on EUR€ deposit with a bank in Hong Kong	34,000
Interest on US\$ deposit with a bank in Hong Kong (this deposit was used to secure a US\$ loan from the bank to one of the company's directors, Mr Chan)	26,000
Interest on HK\$ loan made to an individual shareholder (the loan amount was remitted to the shareholder's bank account in Hong Kong)	160,000
Tax reserve certificates bought from the HKSAR government	<u>1,000</u>
Total per accounts	<u><u>245,000</u></u>

(3) Finance income comprises:

	\$
Loss from trading in Hong Kong listed shares	(200,000)
Gain from trading in China listed shares	435,000
Dividends from Hong Kong listed shares	39,000
Dividends from China listed shares	15,000
Exchange gain (unrealised) from the year-end conversion of foreign currency bank deposits	36,000
Exchange gain (realised) from the settlement of accounts payables	90,000
Total per accounts	<u>415,000</u>

(4) Directors' remuneration comprises:

	\$
Directors' fees	890,000
Rental for a director's accommodation	320,000
Salaries tax paid for directors	90,000
Total per accounts	<u>1,300,000</u>

(5) Staff costs comprise:

	\$
Salaries and allowances	980,000
Regular contribution to pension fund*	100,000
Compensation payment to a leaving staff member in return for a promise not to join a competitor	120,000
Total per accounts	<u>1,200,000</u>

\* During the previous year (i.e. year of assessment 2012/13), a special contribution of \$250,000 was paid into the pension fund.

(6) The selling and distribution expenses of \$400,000 include \$56,000 paid as rebate commissions to undisclosed agents. This payment was approved by the company's directors.

(7) Office rent and rates include:

	\$
Rental for office and retail outlets	2,632,000
Government rent and rates for office and retail outlets	58,000
Carpet replacements for retail outlets	4,000
Refurbishment to retail outlets	46,000
New false ceilings for office	100,000
Stamp duty and legal fees for renewing leases of retail outlets	160,000
Total per accounts	<u>3,000,000</u>

(8) Summer made an annual royalty payment of \$1,400,000 to the owner of the trade-name 'SummerCool'. The owner is an individual resident in Europe, who is unrelated to Summer. The trade-name was created by the owner's father several years ago. Based on the royalty agreement, any Hong Kong tax liability applicable to this royalty payment will be borne by the owner.

(9) Legal and professional fees comprise:

	\$
Audit and tax filing fees	24,000
Legal fees for ad hoc disputes with customers and suppliers	6,000
Total per accounts	<u>30,000</u>

(10) Interest expenses comprise:

	\$
Hire purchase finance charge on computer (see (11) below)	2,000
Interest on bank overdraft line	3,000
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Total per accounts	5,000
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(11) Details of the company's fixed assets are as follows:

	Furniture/ fixtures \$	Motor vehicles \$
Cost at 1 January 2013	535,000	220,000
Additions*	55,000	20,000
Disposals	(35,000)	(40,000)
	<hr/>	<hr/>
Balance at 31 December 2013	555,000	200,000
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Depreciation at 1 January 2013	245,000	60,000
Charge for the year	80,000	20,000
Disposals	(10,000)	(28,000)
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Balance at 31 December 2013	315,000	52,000
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Net book value at 31 December 2013	240,000	148,000
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Proceeds from disposal	30,000	12,000
Net book value of disposal	(25,000)	(12,000)
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Profit on disposal	5,000	0
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\* The addition to furniture/fixtures refers to a new computer acquired at a cost of \$55,000 under hire purchase. Summer was required to make a down payment of \$6,000 at the time of purchase plus seven monthly instalments of \$8,000 commencing on 1 November 2013.

The tax written down values brought forward in respect of its plant and machinery pools are:

10% – nil  
20% – \$200,000  
30% – \$60,000

The qualifying cost and written down value brought forward for commercial building allowance is \$50,000 and \$40,000 respectively.

(12) Summer has been filing its Hong Kong profits tax returns on the basis that all of its income is subject to Hong Kong profits tax. As shown in its last profits tax return for the year of assessment 2012/13, Summer has a tax loss of \$180,000 eligible for carry forward to future years.

**Required:**

**(a) Prepare Summer Ltd's profits tax computation for the year ended 31 December 2013, showing the net assessable profits/adjusted loss and profits tax payable, if any. Clearly identify both the year of assessment and the basis period and show full details of the depreciation allowance calculations.**

Note: No detailed explanations are required in this part. (24 marks)

**(b) Advise whether the royalty payment to the European trade-name owner (note 8) will be subject to profits tax in Hong Kong, and if so, what reporting and compliance obligations Summer Ltd is required to fulfil when making the royalty payment to the owner.** (6 marks)

**(30 marks)**

- 3 Rebecca Lee is unmarried and a Canadian resident. She commenced employment as a secretary with Merry Ltd on 1 April 2012 at a monthly salary of \$12,000. Merry Ltd is a company incorporated and carrying on business in Hong Kong. On 1 September 2012, Rebecca resigned from Merry Ltd and joined CP Airways, an airline company incorporated in Hong Kong, as an air hostess earning a monthly salary of \$15,000. Her flight schedules for the period from 1 September 2012 to 31 March 2014 were as follows:

	In Hong Kong	In Asia	In Europe
1 September 2012 to 31 March 2013	35 days	85 days	92 days
1 April 2013 to 31 March 2014	70 days	90 days	205 days

Rebecca also runs two small businesses in Hong Kong (X and Y) in partnership with her sister, and owns two properties in Hong Kong (A and B) which she rents out. Particulars of Rebecca's income and expenditure in Hong Kong for the years ended 31 March 2013 and 31 March 2014 are as follows:

Year ended 31 March	Note	2013 \$	2014 \$
Salary		165,000	180,000
Share of profit/(loss) from Partnership X		(120,000)	265,000
Share of loss from Partnership Y		(70,000)	(50,000)
Rent received from Property A	1	180,000	150,000
Rent received from Property B	2	–	200,000
Premium from Property B	2	–	72,000
Mortgage interest on loans borrowed to acquire:			
– Property A		140,000	130,000
– Property B		–	190,000
Expenditure on Property A			
– Rates		1,200	1,200
– Management fees		18,000	18,000
– Repairs		–	20,000
Contributions to mother	3	36,000	36,000
Contributions to mandatory provident fund (MPF)		8,250	9,000
Approved donations		110,000	135,000

**Notes:**

- Property A was rented to a tenant on 1 April 2012 for a term of two years at a monthly rent of \$15,000 payable in advance. The tenant paid a rental deposit of \$30,000, and it was agreed that the rental deposit would be used to cover any rents in arrears. It was also agreed that the rates and management fees and the costs of repairs were all payable by Rebecca.  
  
Effective from 1 December 2013, the tenant, due to financial difficulty, could not afford the full rent and only paid rent of \$10,000 per month. From 1 March 2014, the tenant did not pay any rent. The tenant moved out of the property on 30 April 2014 and left Hong Kong in May 2014. He has been uncontactable since May 2014.
- Property B was rented to a tenant on 1 June 2013 for a term of two years at a monthly rent of \$20,000 payable in advance. An initial premium of \$72,000 was also payable by the tenant. It was agreed that the rates and management fees were payable by the tenant.
- Rebecca's mother, aged 68, is a Hong Kong resident. She did not live with Rebecca during the year of assessment 2013/14.



**Required:**

- (a) Explain whether Rebecca Lee's income from CP Airways is assessable to tax in Hong Kong. (3 marks)
- (b) Define the terms 'permanent resident' and 'temporary resident' for the purposes of an election for personal assessment and state, with reasons, whether or not Rebecca Lee is eligible to elect for personal assessment for the years of assessment 2012/13 and 2013/14 respectively. (4 marks)
- (c) Assuming that Rebecca Lee is eligible to elect for personal assessment for the year of assessment 2013/14 only, compute her tax payable:
- (1) if personal assessment is elected; and
- (2) if personal assessment is not elected for that year. (13 marks)

**(20 marks)**

4 In 2010 Mary obtained a bank loan to finance the acquisition of the apartment in which she lives. The apartment was mortgaged to the bank as security for the loan. During the year ended 31 March 2014, she incurred a total bank loan interest expense of \$120,000.

Mary has been in a Hong Kong employment since 2009, earning employment income which is subject to salaries tax in Hong Kong. Mary has no other sources of income.

**Required:**

- (a) (i) **State the conditions to be satisfied in order to obtain a tax deduction for home loan interest, together with the rules governing such a deduction.** (6 marks)
- (ii) **State the tax deduction, if any, available to Mary for the bank loan interest she incurred in the year to 31 March 2014, assuming she does not elect for personal assessment.** (1 mark)
- (b) Mary got married in April 2014. Her husband's only income is salary income subject to Hong Kong salaries tax. Mary will continue to pay the bank loan interest expense of \$120,000 per annum.

**Required:**

**In respect of each of the following independent scenarios, explain whether, and if so how, a tax deduction for the bank loan interest expense incurred by Mary from April 2014 onwards will be available to Mary, Mary's husband or the couple.**

- (i) **Following her marriage, Mary will continue to live in the apartment together with her husband. She will terminate her employment and become a full-time housewife.** (3 marks)
- (ii) **Following her marriage, Mary will move into the apartment owned by her husband, where the couple will live together. Mary will lease her own apartment for rental which will be subject to property tax in Hong Kong. She will continue with her current employment.** (5 marks)

**Notes:**

- (1) You should assume that the tax law and practice for the year of assessment 2013/14 will continue to apply after April 2014.
- (2) You are NOT required to state the detailed rules under property tax.

**(15 marks)**

- 5 Tai Hing Ltd (THC) is a garment manufacturer in Hong Kong, making up accounts to 31 December annually. During the year ended 31 December 2013, THC purchased an old property which it demolished and then built a new five-storey building on the site, incurring the following expenditure:

	\$
Cost of the old building	5,000,000
Removal compensation for tenants of the old building	85,000
Cost of demolishing the old building	95,000
Architect's fee	65,000
Cost of site investigation	52,500
Cost to lay drains and water mains	185,000
Construction cost of the new building	3,150,000
Air-conditioning plant	240,000
Lifts	175,000
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	9,047,500
Commitment fees and loan interest (up to the date of completion on 30 November 2013)	904,750
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Total	<u>9,952,250</u>

Each floor of the new building had an area of 10,000 sq ft, and the total expenditure was allocable rateably according to floor areas.

From 1 December 2013, the floors were used in the following manner:

Ground and first floor	Used by THL as its factory, except for an area of 900 sq ft on the first floor which is used as a showroom.
Second floor	Let to a toy manufacturer for use as its factory, except for an area of 1,200 sq ft which is used as an office.
Third floor	Let to a chemicals company for use as a scientific research laboratory.
Fourth floor	Let to a garment wholesaler for use as its warehouse.

**Required:**

**Compute the depreciation allowances which Tai Hing Ltd is entitled to claim in respect of the above expenditure for the year of assessment 2013/14.**

**(10 marks)**

**End of Question Paper**