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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, but are required only to provide the general principles involved.

		<i>Marks</i>
<b>1 (a)</b>	Under s.8, salaries tax is charged on income from employment, office and pension arising in, or derived from, Hong Kong. The phrase ‘arising in or derived from Hong Kong’ is not defined in the Inland Revenue Ordinance (IRO), but s.8(1A) provides that income from employment includes income derived from services rendered in Hong Kong and excludes income derived from services rendered outside Hong Kong. However, this section applies only to income from employment. It does not apply to income from office. Apart from this, no guidance is given in the IRO and the phrase ‘arising in or derived from Hong Kong’ is to be interpreted according to case law and Board of Review decisions.	1
	In the case of employment income, 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, that is where the employment is located. As a consequence of this decision, the IRD issued DIPN No. 10 and accepts that employment is located outside Hong Kong (a foreign employment) where the following three factors are present:	
	<ol style="list-style-type: none"> <li>1. the contract of employment was negotiated and entered into, and is enforceable outside Hong Kong;</li> <li>2. the employer is resident outside Hong Kong; and</li> <li>3. the employee’s remuneration is paid to him outside Hong Kong.</li> </ol>	
	If not all of the above factors are outside Hong Kong, it appears that the second factor is more important than the other factors. 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.	2
	The IRD reserves the right to look beyond the three factors where, in reality, the employment is a Hong Kong employment but manipulation may exist.	1
	Although it is the normal practice of the IRD only to look at these three factors, the <i>Goepfert</i> case did not expressly state that the question of the source of employment income is solely determined by these three factors. In fact, the IRD’s interpretation was criticised in <i>D40/90</i> , which is the first Board of Review case on the source of income after the <i>Goepfert</i> case. The Board still preferred the totality-of-facts test. The Board considered that the question of the source of income remains a practical, hard matter of facts to be decided by looking at all relevant facts. However, the three factors accepted by the IRD must be important factors in source of income issues and should be sufficient to resolve the question for most cases.	1
	In the case of income from office, the source is the place where the office legally exists. In <i>McMillan v Guest</i> (24 TC 190), it was held that the office of a director is located at the place where the control and management of the corporation is exercised. Hence, if the corporation is managed and controlled in Hong Kong, the services of the office holder are deemed to be rendered in Hong Kong and fees derived from the office are chargeable to salaries tax under the basic charge, s.8(1), irrespective of where the person resides and whether he renders any service for the company in Hong Kong.	2
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	<b>Maximum</b>	<hr style="width: 100%; border: 0.5px solid black;"/>
		6
<b>(b)</b>	In accordance with the principle in the <i>Goepfert</i> case, Eric’s employment has its source outside Hong Kong as:	
	<ol style="list-style-type: none"> <li>1. the employment contract was entered into outside Hong Kong;</li> <li>2. at all material times his employer is Golden Inc, which is an overseas corporation based in the US;</li> <li>3. his remuneration is paid to him outside Hong Kong; and</li> <li>4. although he performs much of his work in Hong Kong, his location here is a matter of convenience and his work is for the benefit of various affiliated companies outside Hong Kong.</li> </ol>	2
	However, as Eric performs some of his duties in Hong Kong, he will be subject to Hong Kong salaries tax under s.8(1A)(a) in respect of his income derived from the services rendered here, including any leave pay attributable to such services. In ascertaining his taxable income, the time apportionment basis would be used, i.e. his employment income will be apportioned according to the number of days that he is present in Hong Kong.	2
	Eric is a director of Silver Ltd and that company is centrally managed and controlled in Hong Kong. All his directors’ fees from Silver Ltd are sourced in Hong Kong and, thus, taxable under s.8(1), irrespective of whether he attended any of the directors’ meetings.	1
		<hr style="width: 100%; border: 0.5px solid black;"/>
		5

(c)

Eric Johnson  
Salaries tax assessment  
Year of assessment 2011/12

	\$	\$	
Salary (1.3m*219/366)		777,869	1
Rental value at 10%	77,787		0.5
Rent suffered (3,000*12)	<u>(36,000)</u>	<u>41,787</u>	0.5
Assessable income		819,656	
Contributions to MPF		<u>(12,000)</u>	0.5
Net assessable income		807,656	
Basic allowance		<u>(108,000)</u>	0.5
Net chargeable income		<u>699,656</u>	
Salaries tax payable at progressive rates		<u>106,941</u>	0.5
Salaries tax at standard rate is not applicable (807,656*15%)		<u>121,148</u>	0.5
Correct treatment of air ticket to relocate Eric			0.5

Year of assessment 2012/13

	\$	\$	
Salary	1,600,000		0.5
Time-apportionment:			
HK: $210 + 15 * 210 / (365 - 15) = 219$ days			1
Taxable: $1,600,000 * 219 / 365$		960,000	0.5
Directors' fees		<u>30,000</u>	0.5
		990,000	
Rental value ( $990,000 * 10\% * 4/12$ )	33,000		1
Rent suffered (3,000*4)	<u>(12,000)</u>	21,000	0.5
Share option gain			
– on sale of option ( $48,000 - 5,000 * 1/5$ )	47,000		1
– on exercise of option ( $30,000 * 7 - 45,000 - 5,000 * 3/5$ )	<u>162,000</u>	<u>209,000</u>	1
Assessable income		1,220,000	
Home loan interest (maximum)		<u>(100,000)</u>	
Contributions to MPF		<u>(14,500)</u>	0.5
Net assessable income		1,105,500	
Basic allowance		<u>(120,000)</u>	0.5
Net chargeable income		<u>985,500</u>	
Salaries tax liability at progressive rates		<u>155,535</u>	0.5
Salaries tax at standard rate is not applicable ( $1,105,500 * 15\%$ )		<u>165,825</u>	0.5
Correct treatment of interest saving of \$13,000 ( $25,000 - 12,000$ ) on staff loan			0.5

14

25

2 (a)

**International Intelligence Ltd**  
**Profits tax computation for the year of assessment 2012/13**  
**Basis period: year ended 31 March 2013**

**Marks**

	\$	\$	
Profit for the year per accounts		1,710,000	0.5
<i>Add:</i> Donations	260,000		0.5
Depreciation	1,060,000		0.5
Loss on sale of China listed securities	240,000		0.5
Travelling and entertainment re China business	8,000		0.5
Rent and rates for China outlet	350,000		0.5
Salaries and wages re China staff	200,000		0.5
MPF special contribution (80% disallowed)	320,000		1
Tax advisory fee re tax appeals	40,000		0.5
Legal fee re capital injection to subsidiary	100,000		0.5
Interest on bank overdraft	30,000		1
Interest on loan from shareholder	73,000	2,681,000	1
		4,391,000	
<i>Less:</i> Gross profit from China outlet	500,000		0.5
Interest income from HK\$ deposits	10,000		0.5
Interest income from RMB deposits	25,000		0.5
Interest income from US\$ deposits	28,000		0.5
Interest income from director	38,000		0.5
Interest income on tax reserve certificates	1,000		0.5
Commission received from the China factory	230,000		0.5
Dividend income (\$120,000 + \$220,000)	340,000		1
Exchange gain from China customers' trade accounts	30,000		0.5
Exchange gain from foreign currency bank deposits	40,000		0.5
Depreciation allowance for plant and machinery	155,200		0.5
Commercial building allowance for HK retail outlet	56,000		0.5
Energy saving electric motor car	400,000		0.5
Computer system	800,000		0.5
Trademark acquisition (\$300,000*20%)	60,000		1
Profit on disposal of fixed assets	2,000		0.5
Refurbishment (\$200,000*20%)	40,000	(2,755,200)	1
		1,635,800	
<i>Less:</i> Donations		(180,000)	0.5
Net assessable profits		1,455,800	
Profits tax payable at 16.5%		240,207	0.5

**Correct treatment of items which 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	\$
Interest from HK customers	20,000	MPF ordinary contribution for HK staff	600,000
Commission from HK customers	200,000	Travelling costs re dispute	200,000
Compensation from the China factory	200,000	Legal fee re dispute with the China factory	30,000
Profit from sales of HK securities	570,000	Patent registration in HK	300,000
		Trademark registration in HK	400,000
		Finance charge for hire purchase	7,000
		(0.5 mark each) <b>Maximum</b>	

4

Depreciation allowance schedule	20% \$	30% \$	HP – 20% \$	Total allowance \$	Marks
Written down value (WDV) brought forward	200,000	300,000			0.5
Additions Photocopier			40,000		0.5
	200,000	300,000	40,000		
Initial allowance (IA) IA – HP (5,000 + 5,000*7)*60%			(24,000)	24,000	1.5
	200,000	300,000	16,000		
Disposal – photocopier	(10,000)		–		0.5
	190,000	300,000	16,000		
Annual allowance	(38,000)	(90,000)	(3,200)	131,200	1.5
WDV carried forward	152,000	210,000	12,800		
Allowance for plant and machinery				155,200	
 <b>Commercial building allowance</b>					
		Qualifying expenditure \$		Written down value \$	
Balance from 2011/12		1,200,000		528,000	0.5
Addition – reception area		200,000		200,000	0.5
		1,400,000		728,000	
Annual allowance (4%*1,400,000)		1,400,000		(56,000)	1
				672,000	
				<b>30</b>	

3 (a)

**ABC Co**

**Computation of assessable profits/adjusted loss for the period 1 January 2011 to 30 April 2012**

	\$	\$	
Net profit per accounts		1,129,000	0.5
Add: Salaries to partners (270,000 + 225,000)	495,000		0.5
Depreciation	120,000		0.5
Loan interest to Champion Ltd	90,000		0.5
Sale proceeds of prescribed fixed asset (computer)	5,000	710,000	0.5
Adjusted profits before depreciation allowance		1,839,000	

Correct treatment of rent, salary paid to partner's daughter, contributions to MPF scheme and severance payments. 2

**Depreciation allowance schedule**

	20% \$	30% \$	Total \$	
<b>2011/12</b>				
Written down value brought forward	30,000	45,000		
Annual allowance	(6,000)	(13,500)	19,500	0.5
Written down value carried forward	24,000	31,500		
<b>2012/13</b>				
Sales proceeds (27,750*24,000/55,500)	(12,000)			
(27,750*31,500/55,500)		(15,750)		0.5
Balancing allowance	(12,000)	(15,750)	27,750	0.5

**Tutorial note:** For assets sold together for one lump sum, the CIR is empowered under s.38A to allocate a purchase price to each individual asset sold, which is usually done on the basis of the written down value of the assets.

		<b>Marks</b>
<b>Year of assessment 2011/12</b>		
<b>Basis period: 1 January 2011 to 31 December 2011</b>		0·5
	<b>\$</b>	
Adjusted profits before depreciation allowance (\$1,839,000*12/16)	1,379,250	0·5
Depreciation allowance	(19,500)	0·5
Assessable profits	<u>1,359,750</u>	

<b>Year of assessment 2012/13</b>		
<b>Basis period: 1 January 2012 to 30 April 2012</b>		0·5
	<b>\$</b>	
Adjusted profits before depreciation allowance (\$1,839,000*4/16)	459,750	0·5
Balancing allowance	(27,750)	0·5
Assessable profits	<u>432,000</u>	<u>9</u>

**(b)**

<b>Partnership allocation</b>		
<b>Year of assessment 2011/12</b>		
<b>1 January 2011 to 30 April 2011</b> (\$1,359,750*4/12 = \$453,250)		0·5

	Adrian	Beatrice	Champion Ltd	Total	
	\$	\$	\$	\$	
Salaries	67,500	56,250	–	123,750	1
Interest	–	–	22,500	22,500	0·5
	<u>67,500</u>	<u>56,250</u>	<u>22,500</u>	<u>146,250</u>	
Balance (1:1:1)	102,333	102,333	102,334	307,000	0·5
Assessable profits	<u>169,833</u>	<u>158,583</u>	<u>124,834</u>	<u>453,250</u>	

<b>1 May 2011 to 31 December 2011</b> (\$1,359,750*8/12 = \$906,500)		0·5
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	Adrian	Beatrice	Champion Ltd	Total	
	\$	\$	\$	\$	
Salaries	135,000	112,500	–	247,500	1
Interest	–	–	45,000	45,000	0·5
	<u>135,000</u>	<u>112,500</u>	<u>45,000</u>	<u>292,500</u>	
Balance (1:1:2)	153,500	153,500	307,000	614,000	0·5
Assessable profits	<u>288,500</u>	<u>266,000</u>	<u>352,000</u>	<u>906,500</u>	

**Total allocation for 1 January 2011 to 31 December 2011**

	Adrian	Beatrice	Champion Ltd	Total	
	\$	\$	\$	\$	
Share of profit	458,333	424,583	476,834	1,359,750	0·5
Profit transferred to personal assessment	(458,333)	–	–	(458,333)	0·5
Net assessable profits	<u>0</u>	<u>424,583</u>	<u>476,834</u>	<u>901,417</u>	
Tax payable at 15%/16·5%	<u>0</u>	<u>63,687</u>	<u>78,677</u>	<u>142,364</u>	1

	Year of assessment 2012/13				Marks
	Adrian \$	Beatrice \$	Champion Ltd \$	Total \$	
Salaries	67,500	56,250	–	123,750	0.5
Interest	–	–	22,500	22,500	0.5
	67,500	56,250	22,500	146,250	
Balance (1:1:2)	71,438	71,437	142,875	285,750	0.5
Share of profits	138,938	127,687	165,375	432,000	
Profit transferred to personal assessment	(138,938)	–	–	(138,938)	0.5
Loss set off under s.19C(4)	–	–	(52,500)	(52,500)	1
Net assessable profits	0	127,687	112,875	240,562	
Tax payable at 15%/16.5%		19,153	18,624	37,777	1
					11
					20

**4 (a) (i) Salaries tax paid for a company's director**

Salaries tax paid by the company on behalf of one of its directors is regarded as part of the remuneration paid to that director. Provided that the director performs services for the benefit of the company, the remuneration is regarded as an expense incurred by the company in the production of assessable profits under s.16(1) and is tax deductible.

2

**(ii) Property tax paid on the rental income received by the company on the property owned by the company**

As the property is owned by the company, any rental income would be subject to property tax under s.5(1). Such tax expense is a capital expenditure which is disallowed for profits tax deduction under s.17(1)(g). On the other hand, according to s.2, property letting (and sub-letting) by a corporation is regarded as a 'business' and thus the same letting income would also be subject to profits tax. To alleviate the double taxation issue, s.25 applies to allow the property tax paid to be offset against the profits tax chargeable by the company. Any excess of property tax paid would be refunded. Alternatively, the company may apply for an exemption from property tax under s.5(2)(a) so that the property income would only be subject to profits tax.

4

**(iii) Overseas tax withheld by the payer of the income before remittance to the company for its overseas activities**

Overseas tax paid by the company would be specifically tax deductible under s.16(1)(c) if the tax is paid on interest income or gains from bills of exchange deemed as taxable receipts under s.15. However, tax paid on other types of income may still be tax deductible under the general deduction rule of s.16(1), provided that the tax is calculated based on the gross amount of income instead of the net profit (according to DIPN 28). If the tax is paid based on the amount of profit earned by the company from the activity, the tax expense is not deductible for Hong Kong profits tax purposes.

3

9

**(b) Senior Citizen Club**

**(i) Whether subject to profits tax**

Receipts during the year are:

	From members	From non-members	Total
Annual subscriptions	125,000	–	
Entrance fees	100,000	–	
Rental income from the club's property	–	350,000	
Other receipts	300,000	150,000	
Total receipts	525,000	500,000	1,025,000
% of receipts out of total	51.2%	48.8%	

Based on the fact that not less than half of the total gross receipts on revenue account (including entrance fees and subscriptions) are received from members (assumed all members have voting rights), the club is deemed not to be carrying on a business during the year. As a result, the club will not be subject to profits tax during the year.

3

**(ii) Ability to claim back property tax**

Senior Citizen Club is subject to property tax in Hong Kong in respect of its property letting income on the basis that it is the owner of property located in Hong Kong. During the current year, the club is not subject to profits tax in Hong Kong in respect of the income received (including the property letting income) as it is not deemed as carrying on a business. The fact that it is not subject to profits tax in Hong Kong does not affect its tax position under property tax. As a result, the club will continue to be liable to property tax and is not eligible to claim any refund or exemption in respect of the property tax paid. However, in any year in which the club is deemed as carrying on a business in Hong Kong and thus subject to profits tax for that year, including its property letting income, the property tax paid would be eligible to be set off against the profits tax liability in order to eliminate the double taxation. In this scenario, the property income will already have been assessed under profits tax.

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**15**

**5 Magic Ltd**

**(a) Change of accounting date**

Magic Ltd proposes to change its accounting date from 31 December to 30 June. This change will take effect in the year 2013 such that no accounts will be drawn up for 2013. Instead, accounts for 18 months will be drawn up for the period from 1 January 2013 to 30 June 2014. Since accounts will not be made up to the corresponding date of 31 December 2013 in 2013/14, the year of change is regarded as 2013/14 and the year preceding the year of change is 2012/13.

1.5

Based on the 18-month accounts up to 30 June 2014, the 12-month basis period for the year of assessment 2014/15 would be from 1 July 2013 to 30 June 2014. The basis period for the year of assessment 2013/14 would therefore be for only six months, from 1 January 2013 to 30 June 2013.

1

However, the management of Magic Ltd is right that it is normal IRD practice to adopt 12 months as the basis period for assessment purposes. If this is adopted, it is possible for the year of assessment 2013/14 to follow the 12-month basis period from 1 July 2012 to 30 June 2013. In these circumstances, there would be duplication of profits. To alleviate the double taxation effect, in the case of a business which commenced after 1 April 1974 (a new business), the Commissioner is prepared to limit the basis period to the period of less than 12 months, by concession, provided that the change of accounting date is due to a 'compelling reason' other than for taking any tax incentives.

2

In the case of Magic Ltd, it commenced business in 1976 and thus it is a new business. The change of accounting date from 31 December to 30 June was initiated by its UK parent company rather than for the purpose of taking any tax incentives. As a result, it is likely that the Commissioner would apply the concession and adopt a six-month basis period for the year of assessment 2013/14, i.e. from 1 January 2013 to 30 June 2013. The preceding year of assessment is not normally adjusted in this case. Going forward, from the year of assessment 2014/15 onwards, the basis period will be from 1 July to 30 June.

2.5

7

**(b) Under s.59(3), an objection is valid when the following conditions are met:**

- (i) the objection must be lodged in writing addressed to the Commissioner;
- (ii) the objection must state precisely the grounds for the objection, such as the justification for claiming the profits to be offshore;
- (iii) the objection must be received by the Commissioner within one month after the date of the notice of assessment unless the Commissioner extends the permitted period or accepts a late notice based on reasonable cause.

0.5

1

1

Therefore, Magic Ltd should ensure that the objection is received by the Commissioner before 1 May 2013.

0.5

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**10**