# Answers

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

*Marks*

**1 Damon Cha**

(a) Salaries tax assessment
Year of assessment 2013/14

| | $ | |
|---|---|---|
| Salary ($60,000*12) | 720,000 | 0·5 |
| *Less:* Amount charged to income tax in China ($60,000*12*2/3) | (480,000) | 1 |
| | 240,000 | |
| Holiday journey benefit | 30,000 | 0·5 |
| | 270,000 | |
| Rental value ($270,000*10/12*10%) | 22,500 | 1·5 |
| | 292,500 | |
| Share option benefit | | |
| – On exercise ($60 – $40)*8,000 – $10,000*8/10 | 152,000 | 1·5 |
| – On sale ($1,000 – $10,000*2/10) | 0 | 1·5 |
| Assessable income | 444,500 | |
| *Less:* Concessionary deductions | | |
| Approved charitable donations | (10,000) | 0·5 |
| Contributions to mandatory provident fund (maximum) | (15,000) | 0·5 |
| | 419,500 | |
| *Less:* Part V allowances | | |
| Married person's allowance | (240,000) | 0·5 |
| Child allowance | (70,000) | 0·5 |
| Net chargeable income | 109,500 | |
| Salaries tax liability at progressive rates | 7,140 | 0·5 |
| Salaries tax liability at standard rate is not applicable ($419,500*15%) | 62,925 | 0·5 |

**Correct treatment of:**

| | |
|---|---|
| Salary taxable in full (no time apportionment). | 0·5 |
| No deduction for elderly residential care expense. | 0·5 |
| No dependent parent allowance | 0·5 |

**Explanations:**

(i) The medical insurance policy purchased by REDL is a contractual obligation between REDL and the insurance company. REDL is discharging its own liability and hence the benefit is not money's worth and is not taxable. The reimbursement of the medical costs is not taxable as it is made under the insurance contract, not Damon's employment contract. 1

(ii) Any housing allowance received by Damon by virtue of his employment would be subject to salaries tax [s.9(1)(a)]. However, by entering into the housing arrangement with REDL, the monthly rental income of $15,000 was received by Damon in his capacity as landlord of the property and would not be chargeable to salaries tax. Damon is only required to pay salaries tax on the rental value, being 10% of his net assessable income. However, the rental income would be subject to property tax; and Damon will not be entitled to a deduction for the home loan interest [s.26E]. 2·5

(iii) Holiday journey benefits are specifically chargeable [s.9(2A)(c)] whether or not they are convertible into cash. The amount chargeable is the cost paid by REDL, not the resale value [DIPN 41, paragraphs 9 and 10]. The chargeable amount is also included in the rental value calculation. 1

(iv) Any gain realised on the exercise, release or assignment of a share option is deemed to be income from 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 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, so the loss from the sale of the shares is not deductible as it is not incurred to earn the assessable income. 2·5

*Marks*

(v) Damon is entitled to claim the married person's allowance and a child allowance for the son who was a full-time student for part of the year. However, he is not entitled to claim a child allowance in respect of his daughter as she was working and not maintained by Damon. 2

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**(b)** As Damon is employed by a Hong Kong company, his employment with REDL is obviously located in Hong Kong and all his remuneration for services under this employment, wherever rendered, is within the scope of salaries tax, unless exempted where all services are rendered outside Hong Kong [s.8(1A)(b)]. 1

If the Inland Revenue Department (IRD) accepts that Damon has two separate and distinct employments under Contract 1 and Contract 2, the salary accruing to Damon under Contract 2 will be exempted from tax, as Damon rendered all the services in connection with his employment under Contract 2 outside Hong Kong. Damon's salary accruing under Contract 1 would remain taxable in Hong Kong. 1·5

However, the Commissioner may look behind the appearances to discover the reality: *Goepfert's* case. The Commissioner is entitled to scrutinise all relevant evidence, such as the intent of REDL and Damon, the basis for the apportionment of the salary between Contracts 1 and 2 and the indistinguishable nature of the services rendered by Damon in and outside Hong Kong. It is highly likely that the IRD would conclude that there is in fact only one contract of employment between REDL and Damon. 2·5

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**Tutorial note:** *The Commissioner may also invoke the anti-avoidance provisions of ss.61 and 61A to counteract any claim for exemption in respect of the salary income under Contract 2.*

## 2 Summer Ltd

**(a)** **Profits tax computation for the year of assessment 2013/14** 0·5
**Basis period: year ended 31 December 2013** 0·5

| | $ | $ | |
|---|---|---|---|
| Loss for the year per accounts | | (483,000) | 0·5 |
| *Add:* Depreciation | 100,000 | | 0·5 |
| Compensation to staff for restrictive covenant | 120,000 | | 1 |
| Rebate commissions to undisclosed agents | 56,000 | | 0·5 |
| Refurbishment to retail outlets ($46,000*80%) | 36,800 | | 1 |
| New false ceiling to office | 100,000 | 412,800 | 0·5 |
| | | (70,200) | |
| *Less:* Depreciation allowance for machinery and plant | 87,700 | | 0·5 |
| Commercial building allowance | 6,000 | | 0·5 |
| Profit from disposal of fixed assets | 5,000 | | 0·5 |
| Interest income – HK$ deposit | 24,000 | | 0·5 |
| Interest income – EUR€ deposit | 34,000 | | 0·5 |
| Interest income – US$ deposit | 26,000 | | 0·5 |
| Interest income – tax reserve certificate | 1,000 | | 0·5 |
| Gain from trading in China listed shares | 435,000 | | 0·5 |
| Dividend – HK listed shares | 39,000 | | 0·5 |
| Dividend – China listed shares | 15,000 | | 0·5 |
| Exchange gain from year-end conversion of bank deposits | 36,000 | | 0·5 |
| Last year's special contribution to pension fund ($250,000*20%) | 50,000 | (758,700) | 1 |
| | | (828,900) | |
| *Less:* Tax loss brought forward | | (180,000) | 0·5 |
| Total tax loss to be carried forward | | (1,008,900) | |
| Net assessable profits | | Nil | 0·5 |
| Profits tax payable | | Nil | 0·5 |

*Marks*

**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 | $ | |
|---|---|---|---|---|
| Sales | 10,800,000 | Loss from trading in HK listed shares | 200,000 | |
| Rebates from suppliers | 500,000 | Rental for director's accommodation | 320,000 | |
| Interest from shareholder | 160,000 | Salaries tax for director | 90,000 | |
| Exchange gain from settlement | 90,000 | Carpet replacement | 4,000 | |
| | | Stamp duty/legal fees for lease renewal | 160,000 | |
| | | Legal fees for ad hoc disputes | 6,000 | |
| | | Hire purchase finance charge | 2,000 | |
| | | (0·5 mark each) **maximum** | | 3·5 |

**Depreciation allowance**

| | 20% $ | 30% $ | HP – 30% $ | Total allowance $ | |
|---|---|---|---|---|---|
| Written down value (WDV) brought forward | 200,000 | 60,000 | | | 0·5 |
| Additions | | | | | |
| Motor vehicle | | 20,000 | | | 0·5 |
| Computer | | | 55,000 | | 0·5 |
| | | 80,000 | | | |
| Initial allowance (IA) 60% | | (12,000) | | 12,000 | 0·5 |
| IA – HP (6,000 + (8,000 – 1,000)*2)*60% | | | (12,000) | 12,000 | 1 |
| Disposals | (30,000) | (12,000) | – | | 1 |
| | 170,000 | 56,000 | 43,000 | | |
| Annual allowance | (34,000) | (16,800) | (12,900) | 63,700 | 1·5 |
| WDV carried forward | 136,000 | 39,200 | 30,100 | | |
| | | | | 87,700 | |

**Commercial building allowance**

| | Qualifying expenditure $ | Written down value $ | |
|---|---|---|---|
| Balance from 2012/13 | 50,000 | 40,000 | 0·5 |
| Addition – false ceiling | 100,000 | 100,000 | 1 |
| | | 140,000 | |
| Commercial building allowance (150,000*4%) | | (6,000) | 0·5 |
| | 150,000 | 134,000 | |
| | | | 24 |

**(b)** The royalty payment is made by Summer to a European individual owner of the trade-name pursuant to a licence granted to Summer for the use of, or right to use, the trade-name in Hong Kong. Where the recipient of a payment for the use of, or right to use, in Hong Kong a patent, design, trademark, copyright material, secret process or formula or any other similar property or for imparting the related know-how is a person outside Hong Kong, then the royalty payment is taxable under profits tax [s.15(1)(b)]. 1

The assessable profit is deemed [by s.21A] to be 30% of the royalty payment received or accrued to the recipient, unless the recipient is an associate of Summer and the trade-name has been owned at any time by a person carrying on business in Hong Kong. In the latter case, the deemed profit would become 100% of the royalty payment. Based on the deemed profit, the applicable profits tax rate would apply to arrive at the profits tax payable, depending on whether the recipient is a corporation or not. In the case of Summer, the recipient is a person who is not an associate of Summer. Therefore, the 15% standard rate would apply to 30% of the annual royalty payment, that is $63,000 [($1,400,000*30%)*15%]. 3

Summer is obliged to withhold the tax amount of $63,000 from the annual payment, and remit only the net amount of $1,337,000 to the owner. Summer is also required to inform chargeability to profits tax (on or before 30 April 2014), and to file a profits tax return on behalf of the owner reporting the chargeable royalty income and the appropriate tax amount withheld. Upon receiving the assessment, Summer will be required to pay the $63,000 on behalf of the owner. 2

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**30**

*Marks*

**3 Rebecca Lee**

**(a)** As Rebecca is employed by a Hong Kong company, her employment with CP Airways is a Hong Kong employment and her income is subject to salaries tax [s.8(1)]. However, as an air-hostess, Rebecca may be exempt from tax if she was present in Hong Kong for not more than:

(i) a total of 60 days in the basis period for that year of assessment; and
(ii) a total of 120 days falling partly within each of the basis periods for two consecutive years of assessment, one of which is that year of assessment [s.8(2)(j)]. 1·5

Rebecca's salaries tax positions for the years of assessment concerned are as follows:

| Year of assessment | No. of days present in HK | Marks |
|---|---|---|
| 2012/13 | 35 (fully exempt) | |
| 2013/14 | 70 (fully liable) | |
| | 105 | 1 |

The presence during 1 April 2012 to 31 August 2012 is not to be taken into account for the purpose of s.8(2)(j) because during this period she did not derive her income as an air-hostess. 0·5

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**(b)** For the purpose of an election for personal assessment, 'permanent resident' means an individual who ordinarily resides in Hong Kong, whereas 'temporary resident' means an individual who stays in Hong Kong for a period or a number of periods amounting to more than 180 days during the year of assessment in respect of which the election is made or for a period or periods amounting to more than 300 days in two consecutive years of assessment, one of which is the year of assessment in respect of which the election is made [s.41(4)]. 1·5

For the year of assessment 2012/13, Rebecca was in Hong Kong for a total of 188 days (153 days during the period from 1 April 2012 to 31 August 2012 and 35 days during the period from 1 September 2012 to 31 March 2013). Rebecca can therefore elect for personal assessment for the year of assessment 2012/13 because she is a temporary resident in that year. 1

For the year of assessment 2013/14, Rebecca stayed in Hong Kong for a total of 70 days. Therefore, she is not eligible to elect for personal assessment because she is neither a temporary resident (as she stayed in Hong Kong for less than 180 days in the year of assessment and less than 300 days in two consecutive years of assessment) nor a permanent resident in Hong Kong. 1

However, Rebecca will be able to elect for personal assessment for 2013/14 if she stays in Hong Kong for more than 230 days in 2014/15. 0·5

4

Marks

**(c)** Tax computation under personal assessment
Year of assessment 2013/14

| | $ | $ | |
|---|---|---|---|
| Assessable profits from Partnership X ($265,000 – $120,000) | | 145,000 | 1 |
| Net assessable income (salary) | | 180,000 | 0·5 |
| Net assessable value (NAV) | | | |
| – Property A | | | |
| Rental ($15,000*12) | 180,000 | | 1 |
| *Less:* Rates | (1,200) | | 0·5 |
| | 178,800 | | |
| *Less:* 20% statutory deduction | (35,760) | 143,040 | 0·5 |
| – Property B | | | |
| Rental ($20,000*10) | 200,000 | | 0·5 |
| Premium ($72,000*10/24) | 30,000 | | 0·5 |
| | 230,000 | | |
| *Less:* 20% statutory deduction | (46,000) | 184,000 | 0·5 |
| Total income | | 652,040 | |
| *Less:* Deductions | | | |
| Mortgage loan interest | | | |
| – Property A | | (130,000) | 0·5 |
| – Property B (restricted to NAV) | | (184,000) | 0·5 |
| Approved charitable donation [$(652,040 – 130,000 – 184,000)*35%] | | (118,314) | 1 |
| Contributions to mandatory provident fund | | (9,000) | 0·5 |
| Loss from Partnership Y | | (50,000) | 1 |
| Reduced total income | | 160,726 | |
| *Less:* Part V allowances | | | |
| Basic allowance | | (120,000) | 0·5 |
| Dependent parent allowance | | (38,000) | 0·5 |
| Net chargeable income | | 2,726 | |
| Tax payable ($2,726 at 2%) | | 54 | 0·5 |

Tax computation if personal assessment is not elected
Year of assessment 2013/14

| | $ | Total $ | |
|---|---|---|---|
| Property tax | | | |
| 15% of net assessable value ($143,040 + $184,000) | | 49,056 | 1 |
| Profits tax | | | |
| 15% of net assessable profits of Partnership X ($145,000) | | 21,750 | 0·5 |
| Salaries tax | | | |
| Net assessable income | 180,000 | | 0·5 |
| *Less:* Approved charitable donations 35% | (63,000) | | 0·5 |
| Total allowances ($120,000 + $38,000) | (158,000) | | 0·5 |
| Net chargeable income | 0 | | |
| Tax payable | | 0 | |
| Total tax liabilities | | 70,806 | |
| | | | 13 |
| | | | **20** |

*Marks*

**4** Mary

**(a)** **(i)** The necessary conditions to be met for a claim for the home loan interest to be a tax deduction against assessable income [s.26E(1)] are:

- the interest is paid on a loan of money which is applied wholly or partly for the acquisition of a dwelling;
- the dwelling is owned solely or partly by the taxpayer;
- the dwelling is used by the taxpayer as their principal place of residence in Hong Kong;
- the loan must be secured by a mortgage or charge over that dwelling or any other property in Hong Kong; and
- the interest is paid to the Government, a financial institution, a credit union, licensed money lender, Hong Kong Housing Society, claimant's employer or an organisation recognised by the Commissioner of Inland Revenue. 5

The maximum amount of deduction for each year is a maximum of $100,000, for a total of 15 years of assessment. The 15 years of claim do not necessarily need to be consecutive. 1

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**(ii)** The home loan interest deduction can be claimed as a concessionary deduction against Mary's assessable income under salaries tax. Mary does not have to apply for personal assessment in order to claim the home loan interest deduction. 1

**(b)** **(i)** From April 2014, Mary will earn no assessable income but will continue to incur the bank loan interest expense. A home loan interest deduction against Mary's taxable income will therefore have no value. 0·5

However, in the case of a couple who are not living apart from each other, the home loan interest deduction may be claimed by the spouse who has assessable income. As Mary will continue to use the dwelling as her principal place of residence, together with her husband, she may nominate him to claim the deduction. Her husband will then be entitled to a home loan interest deduction of the $100,000 maximum against his assessable income under salaries tax. 2·5

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**(ii)** If Mary leases out the apartment and earns rental income, even though Mary continues to pay the bank loan interest, she will no longer be entitled to a home loan interest deduction for the reason that the apartment is no longer occupied by Mary as her principal place of residence. Nor will she be eligible to nominate the home loan interest deduction to her husband. 1·5

The rental income earned by Mary will be subject to property tax [s.5 IRO]. However, there is no provision available under property tax to allow for the deduction of bank loan interest (the only deductions allowed are for rates paid by the owner, irrecoverable rent as a bad debt and the 20% statutory deduction). 1

Therefore, the only way that Mary can get a tax deduction for the bank loan interest is to elect for personal assessment together with her husband, subject to their eligibility to do so. By making this election, the apartment's net assessable value will be aggregated with Mary and her husband's other assessable income and the bank loan interest paid by Mary on the leased apartment will be eligible for deduction against the net assessable value of the property under the personal assessment. However, the available deduction is restricted to an amount equivalent to the net assessable value of the property. 2·5

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**15**

*Marks*

**5** Tai Hing Ltd

Depreciation allowances for the year of assessment 2013/14

Apportionment of commitment fees and loan interest

| | Cost $ | Interest $ | Total cost $ | Marks |
|---|---|---|---|---|
| Old building ($5m + $85,000 + $95,000) | 5,180,000 | 518,000 | 5,698,000 | 1 |
| New building ($65,000 + $52,500 + $185,000 + $3·15m) | 3,452,500 | 345,250 | 3,797,750 | 1 |
| Plant and machinery ($240,000 + $175,000) | 415,000 | 41,500 | 456,500 | 1 |
| | 9,047,500 | 904,750 | 9,952,250 | |

Industrial building allowance (IBA)

Floors qualifying as an industrial building:

| | | |
|---|---|---|
| Ground floor | 10,000 sq ft | |
| First floor | 10,000 sq ft | |
| Second floor (10,000 – 1,200) | 8,800 sq ft | |
| Third floor | 10,000 sq ft | |
| | 38,800 sq ft | 2 |

Capital expenditure qualifying for industrial building allowance
= $3,797,750*38,800 sq ft/50,000 sq ft
= $2,947,054 0·5

Initial allowance = $2,947,054*20% = $589,411 0·5

Annual allowance = $2,947,054*4% = $117,882 0·5

Total IBA = $589,411 + $117,882 = $707,293

**Tutorial notes:**

1. *As the non-qualifying area, viz the showroom of 900 sq ft, is less than 10% of the total area, the whole of the first floor is treated as an industrial building.*
2. *As the non-qualifying area, viz the office of 1,200 sq ft, is more than 10% of the total area, only part of the second floor (8,800 sq ft) is treated as an industrial building.*
3. *As the trade carried on by the tenant of the fourth floor is not a qualifying trade, the fourth floor does not qualify as an industrial building.*

Commercial building allowance (CBA)

Floors qualifying as a commercial building:

| | | |
|---|---|---|
| Second floor | 1,200 sq ft | |
| Fourth floor | 10,000 sq ft | |
| | 11,200 sq ft | 1 |

Capital expenditure qualifying for commercial buildings allowance
= $3,797,750*11,200 sq ft/50,000 sq ft = $850,696 0·5

Annual allowance = $850,696*4% = $34,028 0·5

Depreciation allowance for lift and air-conditioner

| | 10% $ | Total allowance $ | Marks |
|---|---|---|---|
| Cost | 456,500 | | 0·5 |
| Initial allowance 60% | (273,900) | 273,900 | 0·5 |
| | 182,600 | | |
| Annual allowance | (18,260) | 18,260 | 0·5 |
| Written down value carried forward | 164,340 | 292,160 | |
| | | | **10** |