
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.

		<i>Marks</i>	
1 (a)	Regarding the termination payment, it is not known how this figure is made up. To the extent that it represents compensation for loss of employment, it is not taxable on the grounds that it is a payment for breach of contract rather than a payment for services rendered. For this ground to be valid, the 'breach' must be a real and identifiable breach, and not be a pre-arranged term under the employment contract. Similarly to the extent that it represents a payment from a recognised occupational retirement scheme or mandatory provident fund scheme upon termination of employment, it is exempt from salaries tax (subject to the proportionate benefit rule). Conversely, if the genuine reason for paying the compensation is to recognise past services, or as a substitute for a reward-type of payment such as a bonus, the compensation would be taxable.	<u>3</u>	
(b)	<p>Mr Mak Salaries tax assessment Year of assessment 2012/13</p>		
	\$	\$	
Salary (80,000*12)		960,000	0.5
Meal allowance		36,000	0.5
Entertainment allowance		60,000	0.5
Holiday journey benefit (80,000 + 2,000)		82,000	1
Petrol cost (2,000*12*20%)		4,800	1
Reimbursement of annual membership fee (37,000/2)		18,500	0.5
		<u>1,161,300</u>	
Rental value [(1,161,300 – 2,500)*4/12*10%]	38,626		1.5
Less: Rent suffered (6,000*4)	(24,000)	14,626	0.5
Electricity and water bills		20,000	0.5
Share award benefit		50,000	0.5
Assessable income		1,245,926	
Less: ACCA membership fee	2,500		0.5
Self-education expenses (35,000/2)	17,500	(20,000)	0.5
Net assessable income		1,225,926	
Less: Concessionary deductions			
Approved charitable donations (limited to 35% of (1,245,926 – 2,500))	80,000		1
Elderly residential care expenses (maximum)			
– Mr Mak's father	76,000		1
Home loan interest (maximum)	100,000		0.5
Contributions to mandatory provident fund (maximum)	14,500	(270,500)	1
		<u>955,426</u>	
Less: Part V allowances			
Married person's allowance	240,000		0.5
Child allowance:			
– Elder child	0		0.5
– Younger child	63,000		0.5
Dependent parent allowance			
– Mrs Mak's mother	38,000		0.5
Disabled dependant allowance			
– Mr Mak's father	66,000	(407,000)	0.5
Net chargeable income		<u>548,426</u>	
Salaries tax liability at progressive rates		81,232	0.5
Salaries tax liability at standard rate is not applicable (955,426*15%)		<u>143,313</u>	0.5
		<u>15</u>	

(c) Brief explanations for specific items

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| (1) Reimbursement of medical expenses of \$35,000 is not taxable as the payment is made under the insurance contract and not for services rendered. The annual premium of \$5,000 paid by Gold is not taxable as Gold is discharging its own liability and not that of Mr Mak. | 1 |
| (2) Although the package tour was not convertible into money, the total amount of \$82,000 was paid by Gold in connection with a holiday journey taken by Mr Mak and his family members. Therefore, such amount would be included as Mr Mak's assessable income under s.9(2A)(c). | 1 |
| (3) The benefit of using the company-owned car (the cost and the second-hand value) cannot be converted into cash and is therefore not taxable. On the other hand, payment of the credit card balance is assessable income as Gold is discharging Mr Mak's personal liability. However, since 80% is for business use, only 20% of the payment by Gold is taxable. | 1 |
| (4) The entrance fee and annual membership fee paid to the International Golf Club are not necessarily incurred in the production of income and are not allowable expenses. Therefore, reimbursement of the annual membership fee is taxable. | 1 |
| (5) The refund of rent is specifically exempt from tax under s.9(1A)(a). Instead, Mr Mak is assessed on the excess of the rental value over the rent suffered. The rental value is calculated at 10% of the income from employment less outgoings and expenses for the period during which the accommodation is provided. On the other hand, the benefit of the low interest rate loan, being the interest differential of \$40,000, cannot be converted into cash and is not taxable. | 1 |
| (6) Payment of the electricity and water bills by Gold is fully taxable as Gold is discharging Mr Mak's liability. On the other hand, the benefit of using the domestic helper cannot be converted into cash and is not taxable. | 1 |
| (7) The 5,000 shares granted to Mr Mak are a taxable perquisite, forming part of Mr Mak's employment income when the shares vested in him on 30 April 2013. The value of the shares on 30 April 2013, i.e. \$50,000, is included in Mr Mak's salaries tax assessment for 2012/13 according to s.11D(b) proviso (ii), which deems income received after the cessation of employment to accrue on the last day of employment. | 1 |

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2 (a)

Marks

CC Ltd			
Profits tax computation for the year of assessment 2012/13			
Basis period: year ended 31 March 2013		0.5	
	\$	\$	
Profit for the year per accounts		1,009,600	0.5
<i>Add:</i> Loss from trading in China listed shares	30,000		0.5
Property tax accrued	14,400		0.5
Special contribution to MPF (8,000*80%)	6,400		1
Donations	5,000		0.5
Interest expense on shareholder loan (Mr Chen)	17,000		0.5
Legal fee for trademark acquisition	18,000		0.5
Depreciation	100,000	190,800	0.5
		<u>1,200,400</u>	
<i>Less:</i> Dividend income from HK listed shares	3,400		0.5
Dividend income from China listed shares	1,600		0.5
Exchange gain (unrealised) from the year-end conversion	22,000		0.5
Interest income on RMB deposit	2,000		0.5
Interest income on other foreign currency deposits	3,500		0.5
Interest income on the loan made to Mrs Chen	4,000		0.5
Trademark acquisition [(400,000 + 18,000)*20%]	83,600		1
Replacement of carpets	40,000		0.5
Prescribed fixed asset – computer	38,000		0.5
Environment-friendly car	240,000		1
Depreciation allowance for plant and machinery	157,360		W1
Commercial building allowance	120,000	(715,460)	W2
		<u>484,940</u>	
<i>Less:</i> Donations		(5,000)	0.5
Assessable profits for the year		479,940	
<i>Less:</i> Losses brought forward		(600,000)	0.5
Loss carried forward		<u>(120,060)</u>	
Profits tax payable		Nil	0.5
<i>Less:</i> Property tax paid (set-off under s.25)		(14,400)	1
Property tax refundable		<u>14,400</u>	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	\$
Sales income	2,900,000	Wages to driver for director's use	100,000
Gain from HK listed shares	400,000	Fee and rates on leased property	35,000
Gain from foreign currencies	150,000	Fee, rent and rates on office	55,000
Interest income on HK\$ deposit	1,500	Fee, rent and rates on store	60,000
Interest income from customer	3,000	Director's salaries tax paid	22,000
Rental income	120,000	Travelling and entertainment	12,000
		Contribution to MPF (\$24,000 + \$4,800)	28,800
		Finance charge on hire purchase	200
		Interest on bank loan of \$100,000	2,200
		Legal fee on disputes with customers	60,000
		Agency fee for lease renewal	10,000
		Stock loss due to fire	20,000

(0.5 mark each) **Maximum** 5

Workings:

1. Depreciation allowance schedule

	20% \$	30% \$	HP – 20% \$	Total allowance \$	
Written down value (WDV) brought forward	20,000	30,000			0.5
Additions					
Microwave	6,000				0.5
Truck		200,000			0.5
Photocopier			15,000		0.5
	<u>26,000</u>	<u>230,000</u>	<u>15,000</u>		
Initial allowance (IA) 60%	(3,600)	(120,000)		123,600	1
IA – HP (5,000 + 1,000*1)*60%			(3,600)	3,600	1
	<u>22,400</u>	<u>110,000</u>	<u>11,400</u>		
Disposal: Truck		(32,000)			0.5
	<u>22,400</u>	<u>78,000</u>	<u>11,400</u>		
Annual allowance	(4,480)	(23,400)	(2,280)	30,160	1.5
WDV carried forward	<u>17,920</u>	<u>54,600</u>	<u>9,120</u>		
				<u>157,360</u>	

2. Commercial building allowance

	\$		
Residential property (leased)		3,000,000	
		<u>120,000</u>	1
Commercial building allowance at 4%			<u>26</u>

- (b) Since the leased property is owned by CC Ltd, any rental income earned by the Company would be subject to property tax under s.5(1). On the other hand, according to s.2, property letting (and sub-letting) by a corporation is included in the definition of 'business' and thus the same letting income would also be subject to profits tax under s.14(1). This gives rise to double taxation. While the rental income is included in the Company's statement of profit or loss as well as its assessable profits, the property tax accrued (or paid) is capital in nature and not tax deductible. 1.5

The most effective way to alleviate the double taxation burden is for the Company to apply for an exemption from property tax under s.5(2)(a) as long as the same rental income has been included in the Company's chargeable income subject to profits tax. If the exemption is granted, the Company would not be required to file a property tax return, and its rental income would only be subject to profits tax. Should the exemption not be granted or applied for, the Company would have to continue to rely on s.25 to offset the property tax paid against the profits tax payable. Any excess of property tax paid would be refundable. 2.5

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3 Mr Chan

(a)

Partnership allocation
Year of assessment 2012/13

1 January to 30 September 2012 [(\$300,000) + \$240,000]*9/12 = (\$45,000)					0.5
	Chan \$	Chu \$	Lau \$	Total \$	
Salaries	90,000	90,000	–	180,000	0.5
Balance (1:1:2)	(56,250)	(56,250)	(112,500)	(225,000)	0.5
Share of profit/(loss)	<u>33,750</u>	<u>33,750</u>	<u>(112,500)</u>	<u>(45,000)</u>	
Reallocation	(33,750)	(33,750)	67,500	–	1
Net share of loss	<u>–</u>	<u>–</u>	<u>(45,000)</u>	<u>(45,000)</u>	

1 October to 31 December 2012 [(\$300,000) + \$240,000]*3/12 = (\$15,000)				Marks
	Chan	Chu	Total	
	\$	\$	\$	
Salaries	30,000	30,000	60,000	0.5
Balance (1:1)	<u>(37,500)</u>	<u>(37,500)</u>	<u>(75,000)</u>	0.5
Share of loss	<u>(7,500)</u>	<u>(7,500)</u>	<u>(15,000)</u>	

Total allocation for 1 January to 31 December 2012

	Chan	Chu	Lau	Total	
	\$	\$	\$	\$	
Share of loss	(7,500)	(7,500)	(45,000)	(60,000)	0.5
Loss lapsed upon retirement	–	–	45,000	45,000	0.5
Loss transferred to personal assessment	<u>7,500</u>	<u>–</u>	<u>–</u>	<u>7,500</u>	0.5
Loss carried forward	<u>0</u>	<u>(7,500)</u>	<u>0</u>	<u>(7,500)</u>	0.5
				<u>6</u>	

**(b) Personal assessment computation for Mr and Mrs Chan
Year of assessment 2012/13**

	\$	Mr Chan	Mrs Chan	
		\$	\$	
Assessable profits				
Profits from distributorship business	60,000			0.5
Approved charitable donations (ACD) 35%	<u>(21,000)</u>	39,000		0.5
Net assessable income				
Salary	500,000			0.5
Self-education expenses (maximum)	<u>(60,000)</u>		440,000	0.5
Net assessable value (NAV)				
Rental received (15,000*12)	180,000			0.5
20% statutory deduction	<u>(36,000)</u>	144,000		0.5
Total income		183,000	440,000	
Less: Deductions				
Mortgage interest		(60,000)		0.5
ACD – Mr Chan (183,000 + 21,000 – 60,000)*35% – 21,000		(29,400)		1
Unabsorbed ACD transferred from spouse (100,000 – 21,000 – 29,400) = 49,600 [limited to 154,000 (440,000*35%)]			(49,600)	1
Contributions to mandatory provident fund (maximum)			(14,500)	0.5
Share of partnership loss		<u>(7,500)</u>	<u>0</u>	0.5
Reduced total income		<u>86,100</u>	<u>375,900</u>	
Joint total income			462,000	0.5
Less: Part V Allowance				
Married person's allowance		240,000		0.5
Child allowance (63,000*2)		<u>126,000</u>	<u>(366,000)</u>	0.5
Net chargeable income			<u>96,000</u>	
Tax payable at progressive rates			<u>5,520</u>	0.5
Tax payable at standard rate is not applicable (462,000*15%)			<u>69,300</u>	0.5
By Mr Chan (5,520*86,100/462,000)			<u>1,029</u>	0.5
By Mrs Chan (5,520*375,900/462,000)			<u>4,491</u>	0.5
			<u>10</u>	

(c) Explanation of specific items

(1) Assessable profits from the sole proprietorship business are included in the personal assessment calculation after deduction of approved charitable donations. However, the donation is limited to 35% of the assessable profits and therefore only \$21,000 is deductible.	0.5
(2) The flat in Chai Wan was leased out and therefore the net assessable value is to be included in the personal assessment calculation. The net assessable value is the rental received as reduced by the 20% statutory allowance. Mortgage interest, limited to the net assessable value, is deductible under personal assessment; therefore, the mortgage interest of \$60,000 is deductible.	1
(3) The donation to the Community Chest is deductible on the basis that the Community Chest is an approved charitable organisation and the amount is in excess of \$100. It is assumed that the donation is made in the form of money/cash with no consideration in return. Part of the donation, \$21,000 (\$60,000*35%), has been allowed in Mr Chan's distributorship business (per item 1 above). The excess donation of \$29,400 [(183,000 + 21,000 – 60,000)*35% – 21,000] can be deducted by Mr Chan against his total income under personal assessment; and the remaining unabsorbed balance of \$49,600 (100,000 – 21,000 – 29,400) can be transferred to his spouse, Mrs Chan.	2
(4) Self-education expenses in connection with a course provided by an overseas university for the purpose of gaining a qualification for use in an individual's employment are deductible subject to the statutory limit of \$60,000.	0.5
	<u>4</u>
	<u>20</u>

4 Mrs Gwen

(a) Computation of property tax liability for the year of assessment 2012/13

	\$	
Rental income (25,000 x 8)	200,000	0.5
Repairs borne by tenant	<u>2,000</u>	0.5
Assessable value	202,000	
Less: 20% statutory deduction	<u>(40,400)</u>	0.5
Net assessable value	<u>161,600</u>	
Property tax liability at 15%	<u><u>24,240</u></u>	0.5

Correct treatment of the following items:

Rent deposit; management fee; government rent; rates; bank loan interest; renovation; agency fee and irrecoverable rent.

(0.5 mark each) Maximum	<u>3</u>
	<u>5</u>

(b) Under s.14(1) 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 Mrs Gwen, if the sale of the property is accepted as a sale of a capital asset, no profits tax would arise. However, if the sale transaction is regarded as a trade, or an adventure in the nature of a trade, the profits so derived from the sale would be assessable under profits tax. The fact that the property is located in Hong Kong is sufficient to determine that the profit is sourced in Hong Kong.	2
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In determining whether a sale is a trade or an adventure in the nature of trade, it is common to apply the so-called 'badges of trade' which take into account the following factors:

- (1) Subject matter – judging by the nature of the subject matter, whether it is one for personal enjoyment, income earning or speculation. In this case, the property is the subject matter which is considered as common for trading purposes.
- (2) Length of ownership/holding – the shorter the period of ownership/holding, the more likely it is that it is for trading. In this case, the property was acquired in January 2012 and sold in January 2013. The holding period is about 12 months, which is too short to demonstrate a long-term intention to hold the property.

- (3) Frequency or number of similar transactions in the past – if similar sale transactions have been frequently made in the past, it is likely that a trading intention exists. In this case, there is insufficient information in the question to determine whether Mrs Gwen has sold properties before.
- (4) Any supplementary work on the property – if supplementary work has been done to increase or secure the saleable value of the property, a trading intention exists. In this case, there is insufficient information in the question to determine whether the renovation work was for the purpose of securing a sale or because of the letting.
- (5) Circumstances responsible for the sale – any other valid reasons to justify the sale may help argue that the sale is not driven by a trading intention. In this case, the property was immediately put up for sale after its acquisition. It was subsequently leased for the reason that no seller was found. In the absence of other information, it is obvious that the subsequent sale of the property was made when a buyer with the right price was found. A trading intention is obvious.
- (6) Motive for disposal – whether there is any other valid motive for sale other than profit-making. In this case, the property was initially placed for sale at a price higher than its cost, with an intention to make a profit. The final sale of the property also made a profit for the owner. Moreover, both the bank loan and the lease were short term, indicating that the landlord had no intention to hold the property for long-term investment, and the disposal was motivated by the profit from the sale before the bank loan and the lease expired.

(1 mark each) 6

Other factors, such as financing and the use of the sale proceeds, could also be considered by the IRD in ascertaining whether a trade or an adventure in the nature of trade has actually been carried out. 1

In this case, Mrs Gwen's act of placing the property for sale immediately after its acquisition was a strong indication of her intention to trade in the property for profit. Taking into account the above factors, it is highly likely that the profit derived by Mrs Gwen would be assessable to profits tax on the basis that the sale is a trade and the profit is revenue trading profit sourced in Hong Kong. 1

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- 5 (a)** OS Ltd does not carry on business in Hong Kong, so s.14(1) does not apply to charge OS Ltd in respect of its royalty income. However, OS Ltd may still be subject to Hong Kong profits tax if the royalty income is deemed a trading receipt under s.15(1). Under s.15(1)(b), any payments received for the use of, or right to use, in Hong Kong a patent, design, trademark, copyright material, secret process or formula or any similar property or for imparting know-how in connection with the use of any of those properties are deemed to be receipts arising in Hong Kong from a trade, profession or business carried on in Hong Kong. In the case of OS Ltd, part of the royalty income is earned for the use of the trademark by HK Ltd for the manufacture and sale of products in Hong Kong. Therefore, the royalty received for the use of the trademark in Hong Kong would fall within the scope of s.15(1)(b). 3

In the case where the right to use is located offshore Hong Kong, such as in this case Mainland China, s.15(1)(ba) may apply to tax the royalty payment for the use outside Hong Kong if the royalty payment is claimed as tax deductible by the payer for Hong Kong tax purposes. In the case of OS Ltd, part of the royalty income is earned due to the use of the trademark in Mainland China. As the total royalty payment has been claimed for tax deduction by HK Ltd, s.15(1)(ba) would apply. As a result, the total royalty payment made to OS Ltd would be deemed a taxable trading receipt under either s.15(1)(b) or s.15(1)(ba) and subject to profits tax. 2

The deemed assessable profits from the royalty income chargeable under s.15(1)(b) and s.15(1)(ba) are 30% of the gross royalty payment received by OS Ltd (s.21A). The applicable tax rate in this case is 16.5% as OS Ltd is a corporation. Based on the figure provided, the estimated profits tax payable by OS Ltd in respect of the year of assessment 2012/13 will be:

$(\$100,000,000 \times 1\%) \times 30\% \times 16.5\% = \$49,500$ 2

If OS Ltd were an associate of HK Ltd, and the trademark has been owned and used by a company carrying on business in Hong Kong, the deemed assessable profit for the royalty income would be 100% instead of 30%. The estimated profits tax payable by OS Ltd in respect of the year of assessment 2012/13 will then be:

$(\$100,000,000 \times 1\%) \times 100\% \times 16.5\% = \$165,000$ 1
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- (b) As OS Ltd is not carrying on business in Hong Kong, the person making the payment, HK Ltd, would be deemed to be acting as the agent of OS Ltd. HK Ltd is obliged to inform chargeability to profits tax and file the appropriate tax return on behalf of OS Ltd. Before making the payment to OS Ltd, HK Ltd is obliged to withhold the appropriate tax amount from the payment, and pay the tax amount to the IRD on behalf of OS Ltd upon the receipt of the tax assessment. Failure to do so would trigger a penalty.

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