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# Answers

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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.

Section B

Marks

1 Mrs Jonathan

A person is subject to profits tax in Hong Kong if (i) the profits are derived from a trade, profession or business carried on in Hong Kong; and (ii) such profits are sourced in Hong Kong, except for the profits from the sale of a capital asset (s.14(1)). The residency of the person and the source of financing are not relevant.

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In the case of Mrs Jonathan, if the sale of the property is accepted as the 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.

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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'; these 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 a 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 the asset is held for trading. In this case, the property was acquired in February 2016 and sold presumably in November (or December) 2016. The holding period is less than 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 to decide whether Mrs Jonathan has sold properties in Hong Kong before.
- (4) Any supplementary work done 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, insufficient information is available to determine this.
- (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 put up for sale after Mrs Jonathan resigned, probably due to the need to repay the staff loan. If there is evidence to prove that the sale was driven by a financial problem due to her resignation, it should be possible to argue that a trading intention did not exist.
- (6) Profit seeking motive – whether there is any motive for profit-making to explain why the whole transaction was conducted, including the motive for acquiring the property and that driving the sale of the property. In this case, it was given that Mrs Jonathan acquired the property during her stay in Hong Kong on vacation, and right after the acquisition, the property was leased for rental. Moreover, the acquisition was partly financed by a staff loan which was presumably medium to long term. The circumstances tend to indicate that Mrs Jonathan's motive for acquiring the property was for long-term personal investment purposes. As discussed in (5) above, the disposal was then motivated by the need to liquidate the asset to repay the staff loan as a result of the termination of her employment. Considering the surrounding environment encompassing the whole transaction, it is likely that a trading motive does not exist.

1 mark each

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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.

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Taking into account the above factors, on balance, it is highly likely that the office held by Mrs Jonathan would be accepted as a capital asset, and the profits arising from its sale would not be taxable.

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2 (a) Statutory obligation to keep business records

Every person carrying on a trade, profession or business is required to keep sufficient records, either in English or Chinese, of his income and expenditure to enable his assessable profits to be readily ascertained (s.51C). Such records should be retained for at least seven years after the transactions to which they relate, unless the corporation has been dissolved or the Commissioner has specified that such records need not be preserved.

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**(b) A profits tax return is received but not filed**

When a profits tax return is not filed, the Inland Revenue Department (IRD) may issue an estimated assessment based on an estimation of the assessable profits and demand payment of tax in accordance with that assessment. If a company considers the estimated assessment excessive, it may lodge an objection in writing within one month from the date of assessment together with a properly completed tax return and the required supporting documents.

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Moreover, a company which fails to file a profits tax return without reasonable excuse is regarded as guilty of an offence under s.80(2). A penalty will therefore be imposed comprising a fine at level 3 (i.e. \$10,000) plus treble the amount of tax which was either undercharged or would have been undercharged. However, the Commissioner may compound the penalty to a smaller amount depending on the circumstances.

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Alternatively, instead of prosecuting via the court, the Commissioner or his deputy may personally raise an assessment of 'additional tax' under s.82A on the person up to treble the amount of tax undercharged or would have been undercharged.

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**(c) Profits tax which is due is not paid**

Where a notice of assessment has been issued to a company showing the amount of tax payable and the due date for payment and there is no objection to the tax assessment or no holdover of the tax payment, the tax must be paid on or before the due date as stipulated.

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If there is any default in payment, a surcharge will be imposed, amounting to 5% of the total amount unpaid (including the second instalment of the tax payment, if any). If the tax payment is late for six months or more, an additional surcharge will be imposed, amounting to 10% of the total outstanding payment including the initial 5% surcharge. If the tax is still unpaid, the IRD is empowered to recover the tax amount from any debtor of the company holding money or for the account of the company (such as a bank holding the company's account).

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**3 Mr Lee**

**Property tax computation for the year of assessment 2015/16**

	Property A	Property B	Total \$	
Rental				
- Lease 1 (1 April to 30 November 2015) \$50,000 x 8	400,000		400,000	0.5 + 0.5 for furniture
Lease 2 (1 March to 31 March 2016)	45,000		45,000	0.5
- Property B (1 June 2015 to 31 March 2016) \$30,000 x 10		300,000	300,000	0.5
Rental deposit forfeited - Lease 1	100,000		100,000	1
Premium - Lease 1				
- \$90,000 x 22/24	82,500		82,500	2
Assessable value			927,500	
Less: Rates paid by Mr Lee				
- Property B \$1,000 x 11		(11,000)	(11,000)	1
			916,500	
Less: Statutory allowance 20%			(183,300)	1
Net assessable value			<u>733,200</u>	
Tax at 15%			<u>109,980</u>	0.5

Non-adjusted items: rental deposit (other than lease 1) non-taxable; rent in arrears for property B non-deductible; rates for lease 1 non-deductible; management fee for lease 1 non-deductible; management fee for property B non-taxable.

0.5 mark each

2.5

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## 4 Mr and Mrs Au

## (a) Partnership allocation – Year of assessment 2015/16

1 January to 30 September 2015 [(\$600,000) + \$480,000] x 9/12 = (\$90,000) 0.5

	Au \$	Bao \$	Chow \$	Total \$	
Salaries	180,000	180,000	–	360,000	0.5
Balance (1:1:2)	(112,500)	(112,500)	(225,000)	(450,000)	0.5
Share of profit/(loss)	67,500	67,500	(225,000)	(90,000)	
Reallocation	(67,500)	(67,500)	135,000	–	1
Net share of loss	<u>0</u>	<u>0</u>	<u>(90,000)</u>	<u>(90,000)</u>	

1 October to 31 December 2015 [(\$600,000) + \$480,000] x 3/12 = (\$30,000) 0.5

	Au \$	Bao \$	Total \$	
Salaries	60,000	60,000	120,000	0.5
Balance (1:1)	(75,000)	(75,000)	(150,000)	0.5
Share of loss	<u>(15,000)</u>	<u>(15,000)</u>	<u>(30,000)</u>	

## Total allocation for 1 January to 31 December 2015

	Au \$	Bao \$	Chow \$	Total \$	
Share of loss	(15,000)	(15,000)	(90,000)	(120,000)	0.5
Loss lapsed upon retirement	–	–	90,000	90,000	0.5
Loss transferred to personal assessment	15,000	–	–	15,000	0.5
Loss carried forward	<u>0</u>	<u>(15,000)</u>	<u>0</u>	<u>(15,000)</u>	0.5
					<u>6</u>

## (b) Personal assessment computation for Mr and Mrs Au – Year of assessment 2015/16

	Mr Au \$	Mrs Au \$	Total \$	
Net assessable profits from distributorship business after ACD [200,000 x (1 – 35%)]	130,000			1
Net assessable income from employment		750,000		0.5
Total income	130,000	750,000		
Less: Concessionary deductions				
ACD – Mrs Au		(30,000)		0.5
Unabsorbed ACD transferred from spouse (80,000 – 70,000)		(10,000)		1
MPF contributions (maximum)		(18,000)		0.5
Share of partnership loss	(15,000)			0.5
Reduced total income	<u>115,000</u>	<u>692,000</u>	<u>807,000</u>	

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## 5 Roger

- (a) Salaries tax is charged on income from an employment, office and pension arising in, or derived from Hong Kong (s.8(1)). In the case of income from an office, the source is the place where the office legally exists. In *McMillan v Guest* (24 TC 190), it was held that the office of a director is located at the place where the management and control of the corporation is exercised. 1

In the case of Silver Ltd, although the directors' meetings are conducted in Hong Kong, all business decisions are made by Golden Ltd and the directors of Silver Ltd in the US. Hence, Silver Ltd is managed and controlled outside Hong Kong; and Roger's director's fees from Silver Ltd are sourced outside Hong Kong and not taxable under s.8(1). 2

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(b)	Hong Kong salaries tax – Year of assessment 2015/16	Marks
	\$	
Salary	1,440,000	0·5
Reimbursement of clubhouse joining fee	6,000	0·5
Reimbursement of petrol, etc (60,000*20%)	12,000	0·5
Refund of utilities bills	38,000	0·5
Reimbursement of extra hospital bills (24,000*2/3)	16,000	1
	<u>1,512,000</u>	
Time-apportionment:		
HK: $140 + 15 \times 140 / (365 - 15) = 146$ days		2
Taxable: $1,512,000 \times 146 / 365$	604,800	0·5
HK salaries tax borne by employer	<u>63,000</u>	0·5
	667,800	
Rental value at 10%	<u>66,780</u>	1
Assessable income	734,580	
Less: Part 4A concessionary deductions		
Mandatory provident fund contributions (maximum)	<u>(18,000)</u>	0·5
	716,580	
Less: Part 5 allowances		
Married person's allowance	(240,000)	0·5
Child allowance	<u>(200,000)</u>	0·5
Net chargeable income	<u>276,580</u>	
Tax at progressive rates	<u>35,018</u>	0·5
Tax at standard rate ( $\$716,580 \times 15\% = \$107,487$ ) is not applicable.		0·5
Non-taxable/non-deductible items for which marks are allocated:		
1. Gain on exercise of share options (not taxable).		
2. Cost of serviced apartment of \$360,000 (not taxable).		
3. Clubhouse joining fee of \$12,000 (not deductible).		
4. Car rental of \$72,000 (not taxable).		
5. Driver's wages of \$115,200 and amah's wages of \$54,000 (not taxable).		
6. Annual insurance premium of \$5,500 (not taxable).		
7. Reimbursement of basic hospital fees and public ward fees of \$45,000 (not taxable).		
8. Payment of PRC and overseas tax (\$110,000 and \$50,000) (not taxable).		
	<i>0·5 mark each, maximum</i>	<u>2·5</u>
		<u>12</u>
		<u><b>15</b></u>

## 6 Snow Ltd

## Profits tax computation for the year of assessment 2015/16

Basis period: year ended 31 March 2016

0.5

0.5

	\$	\$	
Profit for the year per accounts		103,000	0.5
<i>Add:</i> Excess MPF contribution (maximum 15%)	25,000		0.5
Donation	200,000		0.5
Club debenture written off	260,000		0.5
Loan to staff written off	300,000		0.5
Commission to undisclosed agent	20,000		1
Depreciation	100,000		0.5
Interest on loan from shareholder	5,000	<u>910,000</u>	0.5
		1,013,000	
<i>Less:</i> Profit from securities trading in China	400,000		0.5
Dividends	10,000		0.5
Rental income from China	120,000		0.5
Environmental protection vehicle	400,000		1
Depreciation allowance	21,768	<u>(951,768)</u>	0.5
		61,232	0.5
<i>Less:</i> Donation (maximum 35% x 61,232)		<u>(21,431)</u>	0.5
Assessable profits		<u>39,801</u>	
Profits tax payable at 16.5%		<u>6,567</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 to China	2,000,000	Loss from Hong Kong securities trading	100,000	
Interest income from customer	12,000	Interest on bank overdraft	13,800	
		Finance charge	200	
				<i>0.5 mark each, maximum</i> 2

## Depreciation allowance schedule

	20%	30%	HP – 20%	Total allowance	
	\$	\$	\$	\$	
Written down value (WDV) brought forward	20,000	30,000			0.5
Additions					
Fax machine			25,600		0.5
Initial allowance (5,600 + 2,000) x 60%			<u>(4,560)</u>	4,560	1
			21,040		
Annual allowance	<u>(4,000)</u>	<u>(9,000)</u>	<u>(4,208)</u>	17,208	1
WDV carried forward	<u>16,000</u>	<u>21,000</u>	<u>16,832</u>		
				<u>21,768</u>	

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