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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, only to provide the general principles involved.

			<i>Marks</i>
<b>1 (a)</b>	<b>Salaries tax computation for David</b>		
	<b>Year of assessment 2006/07</b>		
	<b>\$</b>	<b>\$</b>	
Salary (60,000 x 12)		720,000	0.5
Holiday warrant		15,000	0.5
Rental value [10% x (720,000 + 15,000 – 27,000 – 43,740)]	66,426		1
Less: Rent suffered (1,000 x 12)	(12,000)	54,426	0.5
Assessable income		789,426	
Less: Car expenses (36,000 x 75%)	27,000		0.5
Depreciation allowances (58,320 x 75%)	43,740	(70,740)	0.5
Net assessable income		718,686	
Less: Contribution to recognised retirement scheme	12,000		0.5
Married person's allowance	200,000		0.5
Child allowance (daughter)	40,000		0.5
Dependant parent allowance (David's mother-in-law)	30,000		0.5
Additional dependant parent allowance	30,000	(312,000)	0.5
Net chargeable income		406,686	
Tax payable at progressive rates		66,770	0.5
Less: tax reduction (ceiling)		(15,000)	0.5
		51,770	
Tax payable at standard rate (\$718,686 x 16% = \$114,989) is not applicable			0.5
<b>2007/08 Personal assessment computation for David and wife</b>			
	<b>David</b>	<b>Wife</b>	
	<b>\$</b>	<b>\$</b>	
Net assessable income (NAI)	728,590	–	0.5
Net assessable value (NAV)	–	152,480	0.5
	728,590	152,480	
Less: Mortgage interest (restricted to NAV)	–	(152,480)	0.5
Approved charitable donations	(6,000)	–	0.5
Elderly residential care expenses (David's mother)	(60,000)	–	0.5
Contributions to mandatory provident fund (maximum)	(12,000)	–	0.5
Reduced total income	650,590	–	
Joint total income		650,590	
Less: Married person's allowance	200,000		0.5
Child allowance (daughter)	50,000		0.5
Dependant parent allowance (David's mother-in-law)	30,000		0.5
Additional dependant parent allowance	30,000		0.5
Disabled dependant allowance (David's mother)	60,000	(370,000)	0.5
Net chargeable income		280,590	
Tax payable by David at progressive rates		37,200	0.5
Tax payable at standard rate (650,590 x 16% = \$104,094) is not applicable			
<b>Calculation of net assessable value</b>			
Rental (22,000 x 8.5)		187,000	0.5
Premium (36,000 x 9/36)		9,000	0.5
		196,000	
Rates (1,800 x 3)		(5,400)	0.5
		190,600	
20% statutory allowance		(38,120)	0.5
Net assessable value		152,480	

**Marks**

Calculation of net assessable income

From 1 April 2007 to 31 July 2007

Salary (60,000 x 4)		240,000	0.5
Rental value [10% x (240,000 – 9,000)]	23,100		0.5
Less: rent suffered (1,000 x 4)	<u>(4,000)</u>	19,100	0.5
Provident fund (250,000 x 1/2) – 120,000		5,000	0.5
Payment in lieu of leave		<u>30,000</u>	0.5
		294,100	
Less: car expenses (12,000 x 75%)		<u>(9,000)</u>	0.5
Add: balancing charge (19,320 x 75%)		<u>14,490</u>	0.5
		299,590	

From 1 October 2007 to 31 March 2008

Salary (65,000 x 6)		390,000	0.5
Rental value at 10%		<u>39,000</u>	0.5
Net assessable income		<u>728,590</u>	20

- (b) (i) Sums from a recognised occupational retirement scheme that are attributable to the employee's contributions are exempt from tax, but those attributable to the employer's contributions to the extent that they exceed the proportionate benefit are taxable.
- (ii) The salary of \$180,000 in lieu of notice, being a compensation payment and not for services rendered, is not taxable (see *BR 116/77*).
- (iii) The housing allowance of \$30,000 is not chargeable because it does not arise from employment or as a reward for services (see *BR 116/77*). The allowance is granted to compensate David for the deprivation of the right to enjoy housing benefits for the three months to 31 October 2007, if he were given adequate notice.
- (iv) The rental value is calculated with effect from 1 April 2006, i.e. the date from which the quarters were provided and made available to the employee. It is calculated at 10% on the chargeable income from Moon Ltd. The taxable benefit from the provident fund, the payment in lieu of leave and the balancing charge are not included in the calculation of rental value. The taxable benefit from the provident fund is a payment on the termination of employment, the payment in lieu of leave is for the period after cessation of employment, and the balancing charge is assessed under s.12(5).
- (v) The hotel accommodation provided in Singapore was strictly not a 'place of residence' under s.9, since it is only a place provided during the business trips. Therefore, no rental value is calculated in respect of the hotel accommodation.

(1 mark each)

**Total**

5  
**25**

**2 (a)**

**Good Turn Ltd**  
**Depreciation allowance schedule**

	20%	30%	Total	
	\$	\$	\$	
2006/07				
Cost	150,000	220,000		1
Less: Initial allowance 60%	<u>(90,000)</u>	<u>(132,000)</u>		1
	60,000	88,000		
Less: Annual allowance	<u>(12,000)</u>	<u>(26,400)</u>		1
Written down value carried forward	48,000	61,600		
2007/08				
Less: Annual allowance	<u>(9,600)</u>	<u>(18,480)</u>	28,080	1
Written down value carried forward	<u>38,400</u>	<u>43,120</u>		
Work-in-progress:				
Capital payments made		<u>20,000</u>		0.5
Initial allowance at 60%			<u>12,000</u>	0.5
Total depreciation allowance claimed			<u>40,080</u>	

5

<b>(b) Profits tax computation for the year of assessment 2007/08</b>			<b>Marks</b>
<b>Basis period: year ended 31 December 2007</b>			0·5
	<b>\$</b>	<b>\$</b>	
Loss per accounts		(386,000)	0·5
<i>Add:</i> Depreciation	97,000		0·5
Loss on fixed asset disposal	35,000		0·5
Prescribed fixed asset disposal proceeds	2,000		1
Travelling costs to China (see note)	200,000	334,000	0·5
		(52,000)	
<i>Less:</i> Depreciation allowance	40,080		0·5
Prescribed fixed asset – computer	20,000		1
Dividend	9,000		1
Consultancy fees (see note)	200,000		0·5
Bank interest	4,000	(273,080)	1
Adjusted loss for the year		(325,080)	
Loss brought forward from 2006/07		(265,400)	1
Loss carried forward		(590,480)	
Profits tax for the year		Nil	0·5

Note to markers: Consultancy fees of \$200,000 and the corresponding travelling costs of \$200,000 should be treated on the same basis. The above computation assumes the fees to be claimed as non-taxable and thus the travelling costs are non-deductible. If candidates assume the fees to be taxable, the travelling cost should then be deductible. In this case, no tax adjustment will be found, and a total mark of 1 will still be awarded.

Correct treatment of items that 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.

<b>Taxable/non-deductible items</b>	<b>\$</b>	<b>Deductible/non-taxable items</b>	<b>\$</b>
Sales	3,500,000	Purchases	2,400,000
Gain on foreign currency	55,000	Commission	500,000
		Loss on securities trading	80,000
		Directors' fees	100,000
		Staff cost	276,000
		Rent and rates	300,000
		Bank loan interest	60,000
		Personal loan interest	15,000
		MPF contribution	12,000
		Insurance	13,000
		Legal cost re rent cut	10,000
		Audit and tax fee	32,000
		Utilities	24,000

(0·5 mark each, max 6 marks)

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- (c) (i) Commission of \$500,000 – Whether the commission payment is deductible or not depends on whether it is incurred in the production of assessable profits: s.16(1). It is uncertain what kind of services are rendered by the recipient, i.e. the director's relative in China. But if the services are rendered to enable GT to secure sales or business, the payment for the services would be tax deductible since all income from sales or business is returned as taxable. Residency of the service provider and place where the services are rendered are not relevant. However, it is common practice of the Inland Revenue Department (IRD) to require the paying company to disclose names and details of the recipients of commission payments if a tax deduction is to be claimed. In the event that no details of the recipients are given, tax deduction may not be allowed. 3
- (ii) Loss from trading in Hong Kong securities of \$80,000 – Based on s.14(1), profits (or losses) from a 'trade' carried on in Hong Kong would be taxable (or deductible) unless the profit (or loss) is derived from a source outside of Hong Kong. It is often difficult to determine whether an isolated transaction or a series of transactions constitutes a 'trade'. If a taxpayer makes a profit out of a transaction that can be proved not to be a 'trade' but of a capital nature, the profit is not taxable. By the same token, if a loss is incurred on a capital transaction, it would not be tax deductible. The commonly used criteria for ascertaining whether or not a transaction is a 'trade' are the so-called 'badges of trade', which include: 2

- (i) Subject matter of the transaction – in this case it is listed securities, which are capable of being traded easily.
- (ii) Length of ownership period – this is not given, but the shorter the period of ownership the more likely that the transaction is for trading.
- (iii) Frequency of number of similar transactions – the higher the frequency the more likely it is trading. In this case, GT made a profit of \$200,000 last year on securities sales. This indicates at least that similar buy/sell transactions have been conducted since last year.
- (iv) Supplementary work done – this is not given, but if GT (or its management/director) has been intensively involved in the securities market this is an indicator of trading.
- (v) Circumstances leading to the sale – this is not given, but it depends on the reason why GT made the sale regardless of the fact that the sale would give rise to a loss.
- (vi) Motive – this is also not given, but it depends on the intention of GT in acquiring and selling the securities.

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Other than applying the above badges to the transaction, it is important to note that similar sale transactions have been done by GT last year, but at a gain. If GT has claimed the gain as non-taxable in last year's tax return on the basis that it is capital in nature, it would be advisable for GT to take a consistent position this year and claim the loss of \$80,000 on similar transactions this year as a capital loss and thus not tax deductible.

2

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**Total****30****3 (a)****ABC Co****Computation of assessable profits/adjusted loss for the period 1 January 2006 to 30 April 2007**

	\$	\$	
Net profit per accounts		756,000	0.5
Add: Salaries to partners (180,000 + 150,000)	330,000		0.5
Depreciation	80,000		0.5
Loan interest to Charm Ltd	60,000	470,000	0.5
Adjusted profits before depreciation allowance		<u>1,226,000</u>	

Correct treatment of rent, salary paid to partner's son, contributions to MPF scheme and severance payments.  
(0.5 mark each)

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**Depreciation allowance schedule**

	20%	30%	Total	
	\$	\$	\$	
<b>2006/07</b>				
Written down value brought forward	20,000	30,000		
Annual allowance	<u>(4,000)</u>	<u>(9,000)</u>	<u>13,000</u>	0.5
Written down value carried forward	16,000	21,000		
<b>2007/08</b>				
Sales proceeds	<u>(8,000)</u>	<u>(10,500)</u>		0.5
Balancing allowance	<u>8,000</u>	<u>10,500</u>	<u>18,500</u>	0.5

**Year of assessment 2006/07****Basis period: 1 January 2006 to 31 December 2006**

0.5

Adjusted profits before depreciation allowance	919,500	0.5
(\$1,226,000 x 12/16)		
Depreciation allowance	<u>(13,000)</u>	0.5
Assessable profits	<u>906,500</u>	

**Year of assessment 2007/08****Basis period: 1 January 2007 to 30 April 2007**

0.5

Adjusted profits before depreciation allowance	306,500	0.5
(\$1,226,000 x 4/16)		
Balancing allowance	<u>(18,500)</u>	0.5
Assessable profits	<u>288,000</u>	

**Marks**

**Partnership allocation**  
**Year of assessment 2006/07**

1 January 2006 to 31 March 2006 (\$906,500 x 3/12 = \$226,625) 0.5

	Alan \$	Brian \$	Charm Ltd \$	Total \$	
Salaries	33,750	28,125	–	61,875	0.5
Interest	–	–	11,250	11,250	0.5
	<u>33,750</u>	<u>28,125</u>	<u>11,250</u>	<u>73,125</u>	
Balance (1:1:1)	51,167	51,167	51,166	153,500	0.5
Assessable profits	<u>84,917</u>	<u>79,292</u>	<u>62,416</u>	<u>226,625</u>	

1 April 2006 to 31 December 2006 (\$906,500 x 9/12 = \$679,875) 0.5

	Alan	Brian	Charm Ltd	Total	
Salaries	101,250	84,375	–	185,625	0.5
Interest	–	–	33,750	33,750	0.5
	<u>101,250</u>	<u>84,375</u>	<u>33,750</u>	<u>219,375</u>	
Balance (1:1:2)	115,125	115,125	230,250	460,500	0.5
Assessable profit	<u>216,375</u>	<u>199,500</u>	<u>264,000</u>	<u>679,875</u>	

**Total allocation for the year of assessment 2006/07**

	Alan	Brian	Charm Ltd	Total	
Share of profit	301,292	278,792	326,416	906,500	0.5
Profit transferred to personal assessment	(301,292)	–	–	(301,292)	0.5
Net assessable profit	<u>0</u>	<u>278,792</u>	<u>326,416</u>	<u>605,208</u>	
Tax payable at 16%/17.5%	<u>0</u>	<u>44,606</u>	<u>57,122</u>	<u>101,728</u>	1

**Year of assessment 2007/08**

	Alan \$	Brian \$	Charm Ltd \$	Total \$	
Salaries	45,000	37,500	–	82,500	0.5
Interest	–	–	15,000	15,000	0.5
	<u>45,000</u>	<u>37,500</u>	<u>15,000</u>	<u>97,500</u>	
Balance (1:1:2)	47,625	47,625	95,250	190,500	0.5
Share of profit	92,625	85,125	110,250	288,000	
Profit transferred to personal assessment	(92,625)	–	–	(92,625)	0.5
Loss set-off under s.19C(4)	–	–	(35,000)	(35,000)	0.5
Net assessable profit	<u>–</u>	<u>85,125</u>	<u>75,250</u>	<u>160,375</u>	
Tax payable at 16%/17.5%		<u>13,620</u>	<u>13,168</u>	<u>26,788</u>	1

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(b)

**Charm Ltd**  
**Profits tax computation**

	2006/07 Year ended 30 June 2006 \$	2007/08 Year ended 30 June 2007 \$	
Assessable profit/(adjusted loss)	25,000	(35,000)	0.5
Loss transferred to partnership – s.19C(4)	–	35,000	0.5
Net assessable profit	<u>25,000</u>	<u>–</u>	
Tax payable at 17.5%	<u>4,375</u>	<u>Nil</u>	0.5
Loss carried forward		Nil	
<b>Total</b>			<b>2</b>
			<b>20</b>

- 4 (a) An employer is generally issued with a notice each year, which requires the submission of returns detailing the remuneration of each employee under Forms BIR56A and IR56B. It is the current practice that if the employee's total income is less than the statutory single personal allowance and the employer believes that the employee is not likely to be taxable, the employer may not need to file the employer's return. However, if the employer has any doubts as to the taxability of the employee or the tax treatment of a particular income item, it is advisable for the employer to report the facts in the return. 2
- (b) In the case of the commencement of an employment, the employer is required to file a Notification By Employer of Employee Who Commences To Be Employed (Form IR56E). The notification should be submitted no later than three months from the date of commencement of employment. 2
- (c) In the case of a cessation of an employment, the employer is required to file a Notification By Employer of Employee About To Cease To Be Employed (Form IR56F). The notification should be submitted at least one month before the date of cessation of employment. Where circumstances require, the Inland Revenue Department (IRD) may accept a shorter notice period provided there are reasonable grounds. The requirement is the same regardless of whether the staff member resigns voluntarily or is dismissed. 2
- The above requirement (i.e. to file Form IR56F) is applicable in the case where the leaving staff member is a Hong Kong resident and does not indicate that he will be leaving Hong Kong for more than one month. However, if the employer is aware that the leaving staff member is about to leave Hong Kong for a period exceeding one month (which is more common in the case of an expatriate), the employer is required to file a Notification By Employer of Employee About To Depart From Hong Kong (Form IR56G). This notification has the same effect as Form IR56F and should be submitted one month before the expected date of departure. Where circumstances require, the IRD may accept a shorter notice period provided there are reasonable grounds. After filing the IR56G notification, the employer should not pay any money to the departing staff member, or to other parties on behalf of the departing staff member, within one month of the date of the notification; until a written consent is given by the Commissioner. This is to protect the IRD, as in the event that the departing staff member does not settle the Hong Kong tax liability before leaving Hong Kong, the IRD may demand the tax payment from the employer from any money withheld. However, when the departing staff member has cleared his/her tax liabilities before leaving Hong Kong, the Commissioner will issue a letter to the employer, who can then release all the money to the leaving staff member. 4
- (d) No notification is required to be filed by an employer if there is merely a change in the terms of the employment contract, including a change in job title or salary, unless the change has the retrospective effect that the previously reported details have to be revised. 1
- (e) As the share option was granted by the company to the former employee during the employment period when the former employee rendered his/her services in Hong Kong, any gain arising from the exercise of the share option would fall into the scope of Hong Kong salaries tax. The company is therefore obliged to notify the IRD and report details of the share option exercised, including the date of exercise, number of shares exercised, option cost per share and market price at the date of exercise. 2
- However, there is an exception. If the former employee made an election at the time of filing his/her final tax return prior to his/her departure from Hong Kong (or within three months from the departure), to have his/her tax liability ascertained on the basis of a notional exercise of the share option and the deemed gain on such notional exercise has already been taxed, the company is not required to report the same transaction, to avoid double-taxation. 2
- Bonus mark: As the gain from the exercise of the share option is not a payment from the employer to the employee, the gain cannot be deemed to accrue on the last date of employment. Therefore, the Form IR56F or IR56G as previously filed when the employee left the company need not be revised. The gain on exercising the share option would be taxed in the year of assessment in which the gain arises, i.e. when the share option is exercised.

**Total****15**

- 5 (a) Interest incurred on a loan borrowed is tax deductible if (i) the interest is incurred in the production of assessable profits (s.16(1) and s.16(1)(a)); (ii) the interest is not capital in nature (s.17(1)(c)); and (iii) one of the conditions stipulated under s.16(2) is satisfied. Section 16(2)(c) provides that interest on money borrowed from a financial institution (local or overseas) would be allowed provided that the restrictions under s.16(2A) and s.16(2B) are not applicable. In general, the conditions under s.16(2A) and s.16(2B) include: (i) the loan is not secured or guaranteed, wholly or in part, directly or indirectly, by a deposit made by the company (or its associate) with the bank (or its associate) and the interest on the deposit is not taxable in Hong Kong (s.16(2A)); and (ii) an arrangement is not in place such that any interest on the money borrowed or part thereof is payable to the company (or its connected person) who is not taxed on such interest received (s.16(2B)). 4

		Marks
(b)	(i) In this case, the bank loan is obtained to acquire an office for use by Company A's associated company rent-free. Since the office is not generating any assessable profits, the purpose of the loan does not satisfy the condition under s.16(1) and s.16(1)(a) and no tax deduction would be allowed. The s.16(2) conditions would not be required to be assessed.	1·5
	(ii) In this case, the interest incurred on the bank loan would satisfy s.16(1) and s.16(1)(a) based on the fact that the money is used to acquire the residential flat for use by Company A's director. The purpose of the loan is regarded as provision of a benefit to the company's staff. As regards s.16(2), the interest would be tax deductible under s.16(2)(d), s.16(2A) and s.16(2B) on the basis that the loan is secured by a personal guarantee and not by any deposit, nor under any arrangement whereby the interest would be payable to Company A.	2
	(iii) In this case, the loan is obtained to purchase trading stock, which is assumed to be used by Company A in its business. Therefore, s.16(1) and s.16(1)(a) would be satisfied. As regards s.16(2), either s.16(2)(d) or s.16(2)(e) can be relied upon. Section 16(2)(d) applies to a loan acquired from a bank and s.16(2)(e) applies to a loan acquired wholly and exclusively to finance plant or machinery or trading stock. However, both sections would be subject to s.16(2A) and s.16(2B). The question states that the loan is partly secured by a deposit made by Company A's associated corporation and the interest earned on the deposit is not taxed in Hong Kong. In these circumstances, s.16(2A) would not be satisfied. However, the law allows an adjustment to be made pursuant to an apportionment based on the ratio that the portion of interest attributable to the portion of the loan secured by deposits bears to the total interest incurred. As a result, only part of the interest incurred by Company A on the bank loan may be tax deductible.	2·5
<b>Total</b>		<b><u>10</u></b>