

Fundamentals Level – Skills Module

Taxation (Hong Kong)

Monday 1 December 2008

Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

ALL FIVE questions are compulsory and MUST be attempted.
Tax rates and allowances are on page 3.

Do NOT open this paper until instructed by the supervisor.

During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants

Paper F6 (HKG)

ACCA

This is a blank page.
The question paper begins on page 3.

SUPPLEMENTARY INSTRUCTIONS

1. Calculations and workings should be rounded down to the nearest \$. Unless otherwise specified, all amounts are denominated in Hong Kong currencies.
2. Apportionments need only be made to the nearest month, unless the law and prevailing practice require otherwise.
3. All workings should be shown.

TAX RATES AND ALLOWANCES

The following tax rates and allowances are to be used in answering the questions

Allowances		
	2006/07	2007/08
	\$	\$
Basic allowance	100,000	100,000
Married person's allowance	200,000	200,000
Single parent allowance	100,000	100,000
Child allowance – 1st to 9th child (each)	40,000	50,000
– additional allowance in the year of birth (each)	–	50,000
Dependent parent/grandparent allowance – basic	15,000/30,000	15,000/30,000
– additional	15,000/30,000	15,000/30,000
Dependent brother/sister allowance	30,000	30,000
Disabled dependant allowance	60,000	60,000

Deductions		
	\$	\$
Self-education expenses (maximum)	40,000	60,000
Home loan interest (maximum)	100,000	100,000
Elderly residential care expenses (maximum)	60,000	60,000
Mandatory provident fund contributions (maximum)	12,000	12,000

Tax rates			
	2006/07*		2007/08
Salaries tax rates:			
First \$30,000	2%	First \$35,000	2%
Next \$30,000	7%	Next \$35,000	7%
Next \$30,000	13%	Next \$35,000	12%
Remainder	19%	Remainder	17%
Standard rate	16%		16%

* 50% of salaries tax and personal assessment tax for 2006/07 will be waived subject to a ceiling of \$15,000.

Profits tax rate for corporations	17.5%	17.5%
-----------------------------------	-------	-------

Depreciation allowance rates (2006/07 & 2007/08)

Initial allowance:		
Plant and machinery		60%
Industrial buildings		20%
Annual allowance:		
Computers		30%
Motor cars		30%
Furniture and fixtures		20%
Machines		20%
Industrial buildings		4% or formula
Commercial buildings		4% or formula

ALL FIVE questions are compulsory and MUST be attempted

1 David was employed by Moon Ltd (Moon) as its sales manager for many years, at a monthly salary of \$60,000. In addition to his salary, for the period from 1 April 2006 onwards, David received the following benefits from Moon:

- In April 2006, a holiday warrant for \$15,000. David and his family incurred \$12,000 on a trip to Canada made in August 2006, which was not recovered from Moon.
- A flat for which he paid a monthly rent of \$1,000. Although the flat was made available to him from 1 April 2006, David only moved into the flat with his family on 1 June 2006.

David bought a car on 1 April 2006 at a cost of \$81,000 and used it for both private and employment purposes. He incurred the following running expenses:

1 April 2006 to 31 March 2007	\$36,000
1 April 2007 to 31 July 2007	\$12,000

The Assessor agreed that the extent of private use of his car was 25%. The depreciation allowance on the car for the year of assessment 2006/07 was calculated to be \$58,320.

On 31 July 2007, David's employment was terminated, without prior notice, by Moon and he was paid the following sums:

- (1) \$250,000 from Moon's provident fund, which was a recognised occupational retirement scheme. David and Moon had contributed equal amounts to the fund for fifteen years. The accrued benefit attributable to David's service was \$120,000.
- (2) \$180,000 being three months salary in lieu of notice.
- (3) \$30,000 being three months' housing allowance up to 31 October 2007.
- (4) \$30,000 being payment in lieu of two weeks annual leave.

On the cessation of his employment with Moon, David sold his car for \$42,000. The balancing charge on the car was determined as \$19,320.

With effect from 1 October 2007, David took up new employment with another Hong Kong company, Star Ltd (Star), at a monthly salary of \$65,000. The terms of his employment with Star required David to work both in Hong Kong and Singapore. During the period from 1 October 2007 to 31 March 2008, David was present in Hong Kong for a total of 70 days, being 17 days on holiday and 53 days on business. Star provided David with both a flat in Hong Kong and one room in a hotel in Singapore from the commencement of his employment.

David's wife is a housewife. She owns a property which is leased out on the following terms:

- (i) Term of lease: four years from 1 July 2007
- (ii) Monthly rental: \$22,000, payable in advance on the first day of each month
- (iii) Rent-free period: One half month from 1 July 2007
- (iv) Rent deposit: \$44,000 paid on signing the lease agreement
- (v) Premium: \$36,000 paid on signing the lease agreement
- (vi) Management fee: \$2,000 per month, payable by the tenant to the management company
- (vii) Rates: \$1,800 per quarter, payable by the landlord to the government

Three months' rental was still outstanding as at 31 March 2008, although the tenant has promised to pay her later. For the year ended 31 March 2008, total mortgage loan repayments to the Hong Kong Bank amounted to \$340,000, including interest of \$160,000.

The couple live with their daughter (aged 17) and David's mother-in-law (aged 65) in Hong Kong. Their son (aged 21) is studying part-time in Canada. David's father (aged 70) lives in the PRC but he is fully maintained by David. David's mother (aged 53) broke both her legs in an accident in March 2008. She submitted an application to the Social Welfare Department for the Government's Disability Allowance and approval was received in May 2008. She has been living in a registered Nursing Home since 2006 and the nursing home expenses of \$9,000 per month are paid by David. During the year ended 31 March 2008, David contributed \$12,000 to a mandatory provident fund and donated \$6,000 to the Community Chest.

Required:

- (a) Calculate the tax liability of David and his wife for the years of assessment 2006/07 and 2007/08, making the election that is most beneficial to them.

Note: you should ignore provisional taxes.

(20 marks)

- (b) Briefly explain the treatment you have accorded for tax purposes to each of the following items:

- (i) The payment from the provident fund of \$250,000.
- (ii) The three months' salary in lieu of notice of \$180,000.
- (iii) The three months' housing allowance of \$30,000.
- (iv) The value of the quarters provided by Moon Ltd in 2006/07.
- (v) The hotel accommodation provided by Star Ltd in Singapore.

(5 marks)

(25 marks)

- 2 Good Turn Ltd (GT) commenced business in Hong Kong on 1 January 2006, conducting both a trading and a consultancy business in Hong Kong. GT's profit and loss account for the year ended 31 December 2007 is as follows:

	\$	\$
Income		
Net sales	600,000	
Finance income	(12,000)	
Sundry income	200,000	788,000
Expenses		
Directors' fees	100,000	
Staff costs	276,000	
Rent and rates	300,000	
Interest	75,000	
Depreciation	97,000	
Mandatory provident fund (MPF) contribution	12,000	
Travelling expenses	200,000	
Loss on fixed asset disposal	35,000	
Sundry expenses	79,000	1,174,000
Loss before tax		(386,000)

Extracts from the auditors' working papers for the same year are as follows:

Ref	Account name	Notes and comments	2007/08 \$	2006/07 \$
01	Net sales	Gross sales \$3.5 million (2006 – \$4.2 million); total purchases \$2.4 million (2006 – \$3.2 million); commission paid to the director's relative in China \$0.5 million (2006 – nil).	600,000	1 million
02	Finance income	Bank deposit interest \$4,000 (2006 – \$3,000); gain from buying and selling foreign currencies \$55,000 (2006 – \$13,000); loss from buying and selling Hong Kong securities \$80,000 (2006 – gain \$200,000); dividend from Hong Kong securities \$9,000 (2006 – \$36,000).	(12,000)	252,000
03	Sundry income	Fees received from the director's relative in China for consultancy services provided by the director, who travelled to China at times.	200,000	–
04	Directors' fees	Fees to directors \$100,000 (2006 – \$200,000); board approval minuted.	100,000	200,000
05	Staff cost	1 secretary and 1 clerk, no change this year, total salaries \$240,000 (2006 – the same); transport allowance \$24,000 (2006 – the same); meal allowance \$12,000 (2006 – nil).	276,000	264,000
06	Rent and rates	Office lease signed in January 2006, two-year term; monthly rental \$25,000; asked for rent cut to \$15,000 but rejected by the landlord; legal letter sent, company has refused to pay rent since September 2007.	300,000	300,000
07	Interest	(a) Bank loan \$1 million obtained in 2006 at 6% per annum; secured by the director's property; all used for buying Hong Kong securities and foreign currencies; (b) personal loan \$500,000 at 6% per annum obtained from the director's friend on 1 July 2007; all used for buying goods for resale (2006 – nil).	75,000	45,000
08	MPF	Ordinary contribution to MPF per advice.	12,000	12,000
09	Travelling expenses	The director travelled to China to provide consultancy services; transport and entertainment \$200,000 (2006 – \$120,000); all receipts checked.	200,000	120,000

10	Fixed asset disposal	A lap-top computer acquired in 2006 was sold to a staff member for \$2,000 – the carrying value was \$9,000; furniture of \$28,000 (carrying value) was scrapped (2006 – no disposal).	35,000	–
11	Sundry expenses	Comprising:	\$	79,000
		Insurance	13,000	90,000
		Legal costs re rent cut	10,000	
		Audit and tax fee	32,000	
		Utilities	24,000	
		Total	<u>79,000</u>	
12	Tax	2006/07 tax return shows a tax loss carried forward of \$265,400; no tax provision is required for 2007/08.	–	–

An extract of GT's fixed asset movements for the year is as follows:

	Furniture \$	Computers \$	Motor vehicle \$	Work-in-progress \$
Cost at 1 January 2007	150,000	15,000	220,000	–
Additions	–	20,000	–	20,000
Disposals	(35,000)	(15,000)	–	–
Balance at 31 December 2007	<u>115,000</u>	<u>20,000</u>	<u>220,000</u>	<u>20,000</u>
Depreciation at 1 January 2007	(30,000)	(6,000)	(66,000)	–
Charge for the year	(23,000)	(8,000)	(66,000)	–
Disposals	7,000	6,000	–	–
Balance at 31 December 2007	<u>(46,000)</u>	<u>(8,000)</u>	<u>(132,000)</u>	<u>–</u>
Carrying value at 31 December 2007	<u>69,000</u>	<u>12,000</u>	<u>88,000</u>	<u>20,000</u>
Carrying value of disposal	28,000	9,000	–	–
Proceeds from disposal	0	2,000	–	–
Loss on disposal	<u>(28,000)</u>	<u>(7,000)</u>	–	–

Work-in-progress represents down payments made for a conference table, which was ordered three months ago but has not yet been delivered. The price of the table is \$45,000.

Required:

- (a) Prepare Good Turn Ltd's depreciation allowance calculations from the commencement of the business on 1 January 2006 to 31 December 2007. (5 marks)

- (b) Compute Good Turn Ltd's Hong Kong profits tax liability, if any, in respect of the year ended 31 December 2007, clearly identifying both the year of assessment and the basis period.

Notes:

(1) You should ignore provisional tax and overseas tax.

(2) No detailed explanations are required in this part. (15 marks)

- (c) Explain the principles and the underlying reasoning relevant to the tax deductibility of each of the following items:

(i) The commission of \$500,000 paid to the director's relative in China (ref item 01); (3 marks)

(ii) The loss of \$80,000 from buying and selling Hong Kong securities (ref item 02). (7 marks)

(30 marks)

- 3 ABC Co is a partnership between Alan, Brian and Charm Ltd. The partnership commenced business in 2001 and makes up its accounts to 31 December. The partners shared profits and losses equally to 31 March 2006, but with effect from 1 April 2006, the partners have shared profits and losses in the ratio of 1:1:2 (Alan:Brian:Charm) respectively.

There were disputes between the partners and the partnership ceased business on 30 April 2007. The following is the profit and loss account of the partnership drawn up for the 16 month period from 1 January 2006 to 30 April 2007:

	Notes	\$	\$
Revenue			8,000,000
Cost of goods sold			(5,300,000)
Gross profit			2,700,000
Rent	1	600,000	
Salaries	2	850,000	
Contributions to mandatory provident fund (MPF) schemes	3	84,000	
Other expenses	4	270,000	
Depreciation		80,000	
Loan interest to Charm Ltd		60,000	(1,944,000)
Net profit			756,000

Notes:

- (1) Rent of \$600,000 was paid to Charm Ltd, the landlord of the premises in which the business was operated. The rateable value of the premises is \$540,000.
- (2) Salaries included \$180,000 paid to Alan, \$150,000 paid to Brian and \$120,000 paid to Brian's son.
- (3) Contributions to MPF schemes included \$36,000 paid for Alan, Brian and Brian's son (\$12,000 each).
- (4) Other expenses included severance payments of \$200,000. All other items under this category are deductible.
- (5) The tax written down values as at 31 December 2005 were: 20% pool \$20,000; 30% pool \$30,000. All of the assets were sold in May 2008 for \$18,500.

Other information:

- (i) Alan elected for personal assessment in all relevant years.
- (ii) Charm Ltd carries on another business in Hong Kong, for which it had an assessable profit of \$25,000 for the year ended 30 June 2006 and an adjusted loss of \$35,000 for the year ended 30 June 2007.

Required:

- (a) **Compute the assessable profit/adjusted loss of the partnership for each of the relevant years of assessment and the tax payable thereon, if any, claiming any relief that is available to Charm Ltd.**

Note: you should ignore provisional tax. (18 marks)

- (b) **Compute the assessable profit/adjusted loss of Charm Ltd for each of the relevant years of assessment and the tax payable thereon, if any, claiming any relief that is available .**

Note: you should ignore provisional tax. (2 marks)

(20 marks)

- 4** You have been requested to provide a seminar for the staff of your company's personnel department, addressing the following questions regarding the company's obligations as an employer:
- (a)** Whether there is a requirement to report to the Inland Revenue Department each year in respect of the employment income paid to each staff member? (2 marks)
 - (b)** What should be done each time a new staff member is employed? (2 marks)
 - (c)** What should be done each time a staff member leaves; and whether it makes any difference if the staff member resigns or is dismissed; or if the staff member is a Hong Kong resident or an expatriate? (6 marks)
 - (d)** Whether there is a requirement to report to the Inland Revenue Department when a particular staff member is promoted or gets a salary increment during the year? (1 mark)
 - (e)** Whether there is a requirement to report to the Inland Revenue Department when the company is notified by a former employee that a share option granted to him/her during the employment period but not yet exercised at the time he/she left the company's employment, has now been exercised? (4 marks)

Required:

For each of the above questions (a) to (e), state the position based on the Inland Revenue Ordinance.

Note: Marks are allocated as indicated above.

(15 marks)

- 5** Company A is about to obtain a loan from a local bank. It is considering how to use the bank loan money. The following are the alternatives available:
- (1) To acquire an office for use, rent free, by an associated company of Company A situated in Hong Kong. The office will be used as security for the loan.
 - (2) To acquire a residential flat for use by Company A's director. The loan will be guaranteed by the director on a personal basis.
 - (3) To purchase Company A's trading stock. Part of the bank loan will be secured by a deposit placed with the same bank by an associated company of Company A situated in Singapore. Interest earned by the Singapore Company is tax exempt in both Hong Kong and Singapore.

Required:

- (a) **State the general tax principles, pursuant to the Inland Revenue Ordinance, underlying the tax deductibility of interest incurred on borrowings from financial institutions, in the context of profits tax.** (4 marks)
- (b) **Applying the above tax principles, explain whether or not the interest incurred in respect of each of the three alternatives, (1) to (3) is tax deductible for profits tax purposes.** (6 marks)

(10 marks)

End of Question Paper