
Answers

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.

	Marks
<p>1 (a) Under section (s.) 8, salaries tax is charged on income from an employment, office and pension arising in or derived from Hong Kong. The phrase 'arising in or derived from Hong Kong' is not defined in the Inland Revenue Ordinance (IRO), but s.8(1A) provides that income from employment includes income derived from services rendered in Hong Kong and excludes income derived from services rendered outside Hong Kong. Apart from this, no guidance is given in the IRO and the phrase 'arising in or derived from Hong Kong' is to be interpreted according to case law and Board of Review decisions.</p> <p>In accordance with the principle in the <i>Goepfert</i> case, Frank's employment has its source in Hong Kong as his employer is a Hong Kong company resident in Hong Kong. His income will be fully chargeable to salaries tax unless he has rendered all his services outside Hong Kong. For this purpose, services rendered in Hong Kong during visits not exceeding 60 days are ignored. As Frank has performed services in Hong Kong during visits of more than 60 days to Hong Kong, he cannot claim the exemption under s.8(1A)(b) as qualified by s.8(1B). However, as he has paid tax in the Mainland, he qualifies for the exemption under s.8(1A)(c), which excludes income from services rendered outside Hong Kong if the taxpayer is chargeable to tax in the country in which services are rendered and tax of substantially the same nature as salaries tax in Hong Kong, has been paid in respect of the income attributable to the services rendered in that country. It does not matter that the tax was paid or reimbursed by the employer.</p>	<p>1·0</p> <p>3·0</p> <p>4·0</p>

(b)

Frank Ko
Salaries tax assessment
Year of assessment 2007/08

	\$	
Salary (\$60,000 x 12)	720,000	0·5
Less: Amount charged to income tax in China (\$720,000 x 2/3)	(480,000)	1·0
	240,000	
Holiday benefit	30,000	0·5
	270,000	
Rental value (\$270,000 x 10/12 x 10%)	22,500	1·5
	292,500	
Cash allowance to cover accommodation cost	15,000	0·5
Difference between market value and purchase price of the house	200,000	0·5
Share option benefit (\$18 – \$15) x 10,000	30,000	1·0
Assessable income	537,500	
Less: self-education expenses	(40,000)	0·5
Net assessable income	497,500	
Contributions to mandatory provident fund (maximum)	(12,000)	0·5
	485,500	
Married person's allowance	(200,000)	0·5
Child allowance (\$50,000 x 2)	(100,000)	0·5
Net chargeable income	185,500	
Salaries tax payable at progressive rates (\$7,350 + \$80,500 x 17%)	21,035	0·5
Salaries tax at standard rate is not applicable (\$485,500 x 16%)	77,680	0·5

Explanations:

- | | |
|---|-----|
| (i) The cash allowance to cover accommodation cost is taxable under s.9(1)(a). Rental value is 10% of the income from employment for the period during which rent-free accommodation is provided. | 1·0 |
| (ii) Purchasing the house in Beijing at a price lower than the market value is a benefit that is convertible into cash and taxable. The taxable benefit is the difference between the market value and the price paid. As the benefit is not derived for the period during which rent-free accommodation is provided, it is not included in the rental value calculation. | 1·5 |
| (iii) Holiday benefit is taxable under s.9(2A)(c) and included in the rental value calculation. | 0·5 |

	Marks
(iv) The gain from the share option is taxable when the option is exercised and the taxable gain is the difference between the market value of the shares at the time of exercise and the consideration paid. The gain is taxable under s.9(1)(d) and is thus excluded from the calculation of rental value.	1·5
(v) The self-education expense (half of the tuition fee) is deductible as the course is offered by a university and is an approved course under s.12(6). Reimbursement of deductible expense (half of the tuition fee) is not taxable.	1·0
(vi) His wife's employment is a foreign employment not subject to Hong Kong salaries tax.	0·5
(vii) Frank is entitled to claim both the married person's allowance and child allowance, even though his wife and children reside in China. However, he is not entitled to claim the dependent parent allowance in respect of his mother as she was not ordinarily residing in Hong Kong under s.30.	1·5
	<u>16</u>
(c) The transfer of Frank's employment to the subsidiary needs to be properly documented, in respect of the termination of the original employment contract, the writing of a new contract with new terms and notifying the Inland Revenue Department (IRD) of the cessation of the original employment. Otherwise it is likely that the IRD will treat the transfer as resulting in no change in employment and the salaries tax position of Frank will remain the same.	2·0
Even if the transfer is regarded as a genuine change in employment, the salaries tax position of Frank is likely to remain the same. The subsidiary company, though incorporated outside Hong Kong, is still considered as resident in Hong Kong as its place of business is in Hong Kong. The whole income from the employment is still taxable unless Frank performs no services in Hong Kong or the services are performed in Hong Kong during visits of not more than 60 days (see <i>BR 106/02</i>).	3·0
	<u>5·0</u>
Total	<u><u>25</u></u>

2 (a)	Clean and Clear Ltd		
	Profits tax computation for the year of assessment 2007/08		
	Basis period: year ended 31 March 2008		0·5
	\$	\$	
Profit before tax		1,662,000	0·5
Add: Depreciation	140,000		0·5
Loss on fixed asset disposal	25,000		0·5
Legal fee on new lease	22,000		0·5
Proceeds of prescribed fixed asset – computer	2,000	189,000	1·0
		<u>1,851,000</u>	
Less: Depreciation allowance (\$102,000 + \$39,000 + \$64,168)	205,168		0·5
Interest income from bank	2,000		0·5
Prescribed fixed assets – computer	20,000	(227,168)	1·0
		<u>1,623,832</u>	
Loss brought forward from 2006/07		(300,000)	1·0
Adjusted profit/(loss) for the year		<u>1,323,832</u>	
Profits tax payable at 17·5%		<u>231,670</u>	0·5

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.

Taxable items	\$	Deductible items	\$	
Interest from director	23,000	Salaries tax paid	80,000	
Compensation	1,000,000	Air tickets	120,000	
Maintenance over-accrual		Factory moving cost	200,000	
written back	30,000	Bank loan interest	30,000	
		Finance charge	35,000	
		MPF contribution	23,000	
		Legal cost for customer case	18,000	
		(0·5 mark each)		5·0

Depreciation allowance schedule

	20%	30%	Allowance	
	\$	\$	\$	
Written down value brought forward	320,000	36,000		0.5
Additions – furniture	40,000	–		0.5
Initial allowance at 60%	(24,000)	–	24,000	0.5
Disposal	0	–		0.5
	<u>336,000</u>			
Annual allowance	(67,200)	(10,800)	78,000	1.0
Written down value carried forward	<u>268,800</u>	<u>25,200</u>	<u>102,000</u>	

Hire purchase schedule for washing machines

	20%	Allowance	
	\$	\$	
2005/06			
Additions (\$65,000 x 10)	650,000		1.0
Initial allowance (\$65,000 x 60%)	(39,000)	39,000	0.5
	<u>611,000</u>		
Annual allowance at 20%	(122,200)	122,200	0.5
	<u>488,800</u>		
2006/07			
Initial allowance (\$65,000 x 60%)	(39,000)	39,000	0.5
	<u>449,800</u>		
Annual allowance at 20%	(89,960)	89,960	0.5
	<u>359,840</u>		
2007/08			
Initial allowance (\$65,000 x 60%)	(39,000)	39,000	0.5
	<u>320,840</u>		
Annual allowance at 20%	(64,168)	64,168	0.5
	<u>256,672</u>		<u>19</u>

(b) Rent and rates

Under s.16(1) of the IRO, any expense or outgoing is allowable as a tax deduction to the extent to which it is incurred during the basis period for the year of assessment in the production of profits chargeable to profits tax. In the case of Clean and Clear Ltd, the annual rent of \$1,000,000 incurred is tax deductible on the basis that the factory is used to produce assessable profits. In addition, rent paid in respect of land and buildings occupied for the purpose of producing assessable profits is specifically deductible under s.16(1)(b).

2.0

The removal cost of \$200,000, is only tax deductible if it is revenue in nature, but not tax deductible if otherwise. There is no general rule to determine whether expenditure is capital or revenue in nature. However, various principles have been derived from case law. For example, in *Vallambrosa Rubber Co v Farmer* (5 TC 529), it was suggested that capital expenditure must be made 'once and for all' and revenue expenditure will 'recur year by year'. However, this is regarded as over-simplified. In *British Insulated and Helsby Cables v Atherton* (10 TC 155), it was suggested that not only 'once and for all' but also 'with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade' should be considered. By reference of *Mallett v Staveley Coal and Iron Co* (13 TC 772), generally the cost of removing an undesirable capital asset creates an enduring benefit which is considered as capital in nature. Based on this principle, the removal cost incurred as part of a scheme for improvement and expansion or in the interests of the business, should be regarded as capital in nature and not tax deductible. However, based on the Second Inland Revenue Ordinance Revenue Committee report, it has become a practice of the IRD that 'if the removal is not voluntary but is primarily forced upon the trader by circumstances such as the refusal of a landlord to renew a lease or the redevelopment of the site, the cost of removal is normally allowed as a revenue charge.' The allowable deduction is extended to cover that part of the removal cost relating to the fixed assets moved. Therefore, Clean and Clear Ltd should be able to deduct the removal cost.

4.0

6.0

(To marker: marks should be given if candidates are able to discuss the general principles underlying the capital vs revenue expenditure argument, even though the practice may not be mentioned.)

(c) Directors' fees and reporting obligations

Under s.52(2), an employer is obliged to make a return at the end of the tax year giving details of taxable remuneration paid to each employee plus other specified details. Under s.52(3), a company director or an individual engaged in the management of the company is to be regarded as an employee of the company. As a result, Clean and Clear Ltd is obliged to report the taxable remuneration paid to Mr and Mrs Chan as directors, in the annual employer's returns.

2.0

The fees paid to Mr and Mrs Chan are taxable remuneration under Hong Kong tax law, if the source of the fee payments is in Hong Kong. Since Mr and Mrs Chan are directors of the company as appointed by the company's Board, the position is an 'office' rather than an employment. An 'office' is a position which is independent from the individual holding it and which continues to exist even though unfilled (*McMillan v Guest* (24 TC 190)). The source of income from an 'office' is the place where the office legally exists. In the case of a directorship, the general test is that the office of a director is located at the place where the central management and control of the company is located. The question does not specifically mention the place where the company is managed and controlled, but the fact that the company is carrying on business in Hong Kong should be sufficient to suggest that the company is managed and controlled in Hong Kong. As a result, the fees paid for the directorship should be taxable in Hong Kong. The fact that the same fees are reported for Canadian tax purposes is not relevant to ascertain the taxability of the fees in Hong Kong.

3.0

5.0

Total**30****3 (a)**

French Restaurant
Computation of assessable profits/adjusted loss

	\$	\$	
Net profit per accounts		573,750	0.5
Add: Wages to partner and spouse	495,000		1.0
Purchase of new utensils	27,000		1.0
Legal fee	2,250		1.0
Depreciation	168,750	693,000	0.5
Adjusted profits before depreciation allowance		<u>1,266,750</u>	
Year of assessment 2006/07			
Basis period: 1 January 2007–31 March 2007			
Adjusted profits before depreciation allowance (\$1,266,750 x 3/15)		253,350	0.5
Less: Depreciation allowance		(315,000)	0.5
Adjusted (loss)		<u>(61,650)</u>	
Year of assessment 2007/08			
Basis period: 1 April 2007–31 March 2008			
Adjusted profits before depreciation allowance (\$1,266,750 x 12/15)		1,013,400	0.5
Less: Depreciation allowance		(225,000)	0.5
Assessable profits		<u>788,400</u>	

Partnership Allocation
Year of assessment 2006/07

	Alex \$	Barbara \$	Cheerful Ltd \$	Total \$	
Wages	45,000	54,000	–	99,000	0·5
Balance (2:1:1)	(80,325)	(40,162)	(40,163)	(160,650)	0·5
Assessable profits/(loss)	(35,325)	13,838	(40,163)	(61,650)	
Reallocation	6,476	(13,838)	7,362	–	1·0
Net share of profit/(loss)	(28,849)	–	(32,801)	(61,650)	
Profits tax payable				Nil	0·5
Loss transferred – s.19C(5)	–	–	(15,000)	(15,000)	1·0
Loss carried forward	(28,849)	–	(17,801)	(46,650)	0·5

Year of assessment 2007/08

	Alex \$	Barbara \$	Cheerful Ltd \$	Total \$	
Wages	180,000	216,000	–	396,000	0·5
Balance (2:1:1)	196,200	98,100	98,100	392,400	0·5
Assessable profits	376,200	314,100	98,100	788,400	
Loss brought forward	(28,849)	–	(17,801)	(46,650)	0·5
Loss transferred – s.19C(4)	–	–	(30,000)	(30,000)	1·0
Transferred to personal assessment	(347,351)	–	–	(347,351)	0·5
Net assessable profits	–	314,100	50,299	364,399	
Profits tax payable at 16%/17·5%	–	50,256	8,802	59,058	1·0

15

(b) 2007/08 Personal assessment computation for Alex and Doris

	Alex \$	Doris \$	
Salary	–	200,000	0·5
Partnership business income	347,351		
Proprietorship business income (net of approved charitable donations limited to 25%) (\$120,000 – \$30,000)	90,000	–	1·0
	437,351	200,000	
Less: Approved charitable donations (limited to 25%)	(65,000)	(50,000)	0·5
Approved charitable donations transferred from spouse (\$60,000 – \$50,000)	(10,000)		0·5
Contributions to mandatory provident fund (maximum)	–	(12,000)	0·5
Reduced total income	362,351	138,000	
Joint total income		500,351	
Married person's allowance		(200,000)	0·5
Net chargeable income		300,351	
Tax payable at progressive rates		40,559	0·5
Tax payable by Alex = \$40,559 x 362,351/500,351		29,373	0·5
Tax payable by Barbara = \$40,559 x 138,000/500,351		11,186	0·5
			5·0
Total			20

		Marks																											
4	<p>(a) In Hong Kong, property tax is levied on the owner of the land or buildings or land and buildings situated in Hong Kong, under s.5(1) of the IRO in respect of income earned from the property. The term 'owner' includes mortgagors and mortgagees in possession and is not restricted to Hong Kong residents.</p> <p>With effect from 1 April 2007, Mr Robinson earned rental income from a property situated in Hong Kong. Therefore, Mr Robinson is chargeable to Hong Kong property tax under s.5(1) irrespective of the fact that he is not a resident in Hong Kong at the time the property income is earned. Citizenship and residentship of the owner are not relevant for the purposes of s.5(1).</p>	<p>1-0</p> <p>1-0</p> <p><u>2-0</u></p>																											
	(b) Mr Robinson's property tax liability for the year of assessment 2007/08:																												
	<table> <tr> <td></td><td>\$</td><td></td></tr> <tr> <td>Rental (\$20,000 x 11)</td><td>220,000</td><td>1-0</td></tr> <tr> <td>Repairs paid by tenant</td><td>7,000</td><td>1-0</td></tr> <tr> <td>Assessable value</td><td>227,000</td><td></td></tr> <tr> <td>Less: rates (\$3,000 x 4)</td><td>(12,000)</td><td>0-5</td></tr> <tr> <td></td><td>215,000</td><td></td></tr> <tr> <td>Less: 20% statutory deduction</td><td>(43,000)</td><td>0-5</td></tr> <tr> <td>Net assessable value</td><td>172,000</td><td></td></tr> <tr> <td>Property tax at 16% thereon</td><td>27,520</td><td>0-5</td></tr> </table>		\$		Rental (\$20,000 x 11)	220,000	1-0	Repairs paid by tenant	7,000	1-0	Assessable value	227,000		Less: rates (\$3,000 x 4)	(12,000)	0-5		215,000		Less: 20% statutory deduction	(43,000)	0-5	Net assessable value	172,000		Property tax at 16% thereon	27,520	0-5	
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	<p>Explanations:</p> <ol style="list-style-type: none"> As no rental was receivable during the first month because of the rent-free period, there is no taxable consideration for that period. Repairs paid by the tenant but not reimbursed by the owner are regarded as additional income to the owner, since repairs are covered by the 20% statutory deduction. Rates paid by the owner are allowed by statute as a deduction under property tax. 20% deduction is the statutory standard allowance for repairs and outgoings. The rental deposit of \$40,000 which is repayable to the tenant under certain circumstances, is not regarded as income of the owner until such time as the deposit is used to settle any outstanding rental payment. Thus, it is not assessable in the year of assessment 2007/08. The management fee paid by the tenant directly to the management company is not treated as additional income of the owner and not assessable. The agency fee for letting the property and the agency management fee of 0-2% of rentals, are not statutorily allowed under property tax. The mortgage loan interest is also not allowed under property tax. <p>(0-5 mark each, maximum)</p>	<p>3-5</p> <p><u>7-0</u></p>																											
	<p>(c) An individual earning property income may be able to claim a deduction for the bank mortgage loan interest against the property income under personal assessment. Personal assessment allows an individual to aggregate assessable income (including business losses, if applicable) from various statutory heads of charge (profits tax, salaries tax and property tax) and to deduct interest payments which are not otherwise deductible, concessionary deductions and personal allowances. The net chargeable income is then subject to tax at progressive rates, as applicable.</p> <p>In the event that income earned from a property is aggregated with other income under personal assessment, interest payable on money borrowed to acquire the property would be tax deductible only to the extent of the amount of property income aggregated.</p> <p>However, to be eligible for electing personal assessment, the individual taxpayer must be either a temporary or permanent resident of Hong Kong. The term 'permanent resident' refers to an individual who ordinarily resides in Hong Kong. Based on <i>R v Barnet London Borough Council</i>, a person is resident in a place 'where a person lives and conducts his daily life in circumstances which lead to the conclusion that he is living there as an ordinary member of the community would live for all the purposes of his daily life.' Mr Robinson has returned to Canada. Assuming that he does not maintain his connections in Hong Kong, he would not be regarded as a permanent resident of Hong Kong.</p>	<p>1-0</p> <p>1-0</p> <p>2-0</p>																											

A temporary resident refers to an individual who is present in Hong Kong for a period or periods during the year of assessment, amounting to more than 180 days, or, for more than 300 days over two consecutive years, one of which is the year for which an election is sought. This test is simple to apply and only requires a count of the number of days that Mr Robinson is present in Hong Kong. In the absence of further information provided in the question, it is uncertain whether Mr Robinson is eligible for electing personal assessment in respect of 2007/08 and any subsequent years. If he qualifies as a temporary resident of Hong Kong in any year of assessment, he can elect for personal assessment and reduce his tax liability by deducting the mortgage loan interest, limited to the net assessable value, against the property income.

2.0

6.0

Total**15**

- 5 The charge of Parent Pte Ltd to Baby Ltd is effectively a service fee charged for head office support services provided by Parent Pte Ltd for the benefit of Baby Ltd, regardless of the fact that the description in the invoice is 'recovery of cost'. From the perspective of Baby Ltd, the payment is an expense or outgoing and thus it needs to observe the general tax deduction rule under the Hong Kong tax law in order to secure a deduction for the payment against its assessable profits.

1.0

The general tax deduction rule primarily follows that under s.16(1), i.e. the expense or outgoing has to have been incurred in the production of assessable profits. Where this is not the case, a deduction will be denied. In the case of Baby Ltd, it must be able to prove that the payment made to Parent Pte Ltd is genuinely paid for the services which were rendered for the benefit of Baby Ltd, in particular in the production of Baby Ltd's assessable profits. The types of services provided by Parent Pte Ltd and a description of the benefits enjoyed by Baby Ltd, may be questioned by the IRD.

2.0

Other than the 'production of assessable profits' test, there are other general requirements which must be satisfied before a tax deduction is allowed. Above all, the amount charged should be on an arm's length basis, i.e. the amount charged is comparable to that charged between independent parties. Baby Ltd should be able to explain the basis of the amount charged, i.e. why it is \$500,000 and not more or less, and to prove that the quantum is reasonable and not excessive if compared to that charged by an independent party for similar types of services. The basis should be consistently applied each year and should not represent a repatriation of profit out of Hong Kong. Since the invoice states that the amount charged represents the 'recovery of costs incurred', Baby Ltd should be able to substantiate the charge by providing details of the costs incurred and recovered; and explain that these costs are commensurate with the benefits accrued to Baby Ltd.

4.0

Apart from the invoice, there should be a valid agreement in place between Baby Ltd and Parent Pte Ltd to substantiate the transaction, as the transaction must be commercially justified, not artificial or fictitious; and is not done for the sole and dominant purpose of obtaining any tax benefit.

1.0

Tutorial note: If the transaction does not satisfy these criteria, the IRD may seek to challenge the transaction under the anti-avoidance provisions of s.61 or s.61A. However, knowledge of these sections is not within the syllabus at this level.

Under s.20(2), if a payment is made by a Hong Kong resident (i.e. Baby Ltd) to a closely connected person outside Hong Kong (i.e. Parent Pte Ltd), the Commissioner may deem a business to be carried on in Hong Kong by the non-resident if the business is arranged so as to allocate less profits to the resident than might normally be expected. In other words, if the amount charged by Parent Pte Ltd is considered excessive so that it has the effect of reducing the assessable profits of Baby Ltd, Parent Pte Ltd may be deemed to be carrying on business in Hong Kong and be subject to tax in Hong Kong.

2.0

Total**10**