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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.

	Marks
<p>1 (a) Under s.8, salaries tax is charged on income from an employment, office and pension arising in or derived from Hong Kong. In the case of employment income, the Board of Review adopted the 'totality-of-facts test' and looked at all the facts of the cases. No single factor or particular factors could determine the issue. The court ruled in the <i>Goepfert</i> case that the correct approach is to look for the place where the income really comes to the employee, i.e. where the employment is located. As a consequence of this decision, the IRD issued DIPN 10 and accepts that employment is located outside Hong Kong (a foreign employment) where the following three factors are present:</p> <p>(1) the contract of employment was negotiated, entered into and is enforceable outside Hong Kong;  (2) the employer is resident outside Hong Kong; and  (3) the employee's remuneration is paid to him outside Hong Kong.</p> <p>In accordance with the principle in the <i>Goepfert</i> case, White's employment has its source outside Hong Kong as his employment contract was discussed and signed in New York, his employer is an overseas company based in the USA; and his remuneration is paid to him outside Hong Kong.</p> <p>However, as White performs some of his duties in Hong Kong, he is subject to Hong Kong salaries tax under s.8(1A)(a) in respect of his income derived from services rendered in Hong Kong, including leave pay attributable to such services. In ascertaining his taxable income, the time apportionment basis would be used, i.e. the employment income is apportioned according to the number of days that he is present in Hong Kong.</p> <p>As regards the source of income derived by White holding the office of a company director, the basic rule is that directors' fees are sourced where the central management and control of the company are located: <i>McMillan v Guest</i>. In this case, the central management and control of the Hong Kong subsidiary are <i>prima facie</i> located in Hong Kong as this is the place where the directors' meetings are held. However, if it can be proved (as is stated in the facts) that the board in Hong Kong acts merely as a rubber stamp for the real controllers in the USA, then the central management and control can be said to be outside Hong Kong. In this event, the directors' fees are not subject to tax, notwithstanding that the subsidiary was incorporated in Hong Kong.</p>	<p>2</p> <p>1</p> <p>2</p> <p>2</p> <p>7</p>

(b) White's Hong Kong salaries tax computation for the year of assessment 2008/09

	\$	
Salary	1,200,000	0.5
Reimbursement of clubhouse joining fee	10,000	0.5
Reimbursement of petrol etc (50,000*20%)	10,000	0.5
Refund of utilities bills	30,000	0.5
Reimbursement of extra hospital bills (21,000*2/3)	14,000	0.5
	<u>1,264,000</u>	
Time-apportionment:		
HK: $140 + 15 \times 140 / (365 - 15) = 146$ days		1
Taxable: $1,264,000 \times 146 / 365$	505,600	1
HK salaries tax borne by employer	<u>60,000</u>	1
	565,600	
Rental value at 10%	<u>56,560</u>	1
Assessable income	622,160	
Mandatory provident fund contributions (maximum)	<u>(12,000)</u>	0.5
	610,160	
Married person's allowance	<u>(216,000)</u>	0.5
Child allowance	<u>(100,000)</u>	0.5
Net chargeable income	<u>294,160</u>	
Tax payable at progressive rates	38,007	0.5
Tax waived (ceiling)	<u>(8,000)</u>	1
Net tax payable	<u>30,007</u>	
Tax payable at standard rate ( $\$610,160 \times 15\% = \$91,524$ ) is not applicable		0.5

**Marks**

Correct treatment of:	
Cost of service apartment	0·5
Wages of amah	0·5
Overseas tax paid by employer (2 x 0·5)	1
	<hr/> 12

**(c) Brief explanations of the tax treatments:**

(1) The provision of the car and driver, which is not convertible into cash, is a non-taxable benefit in kind: see <i>Tennant v Smith</i> . The reimbursement of petrol and maintenance costs, an allowable expenditure, is not taxable to the extent of 80% of the total expenditure. Reimbursement of the portion for private use is however taxable.	1·5
(2) Payment by the trustee direct to the employee's child is not chargeable: see <i>BR 6/70</i> and <i>Barclays Bank v Naylor</i> referred to in DIPN 16.	1
(3) The payment of annual premium by the employer is not taxable as the employer is discharging its sole liability. The reimbursement of basic hospital fees and public ward fees is also not taxable as it is made under the insurance contract and not the employment contract. However, the reimbursement of the fees for the private room is an allowance which is taxable and not a discharge of the employer's sole liability. The related hospital expenses borne by White are private in nature and not deductible under s.12(1)(a): <i>Fahy</i> case.	2
(4) The cost of the computer is a capital expense. It is therefore precluded from deduction under s.12(1)(a). The next question is whether the computer qualifies for depreciation allowances as it is an item of plant. As White only finds it helpful to use the computer for work purposes, it cannot qualify under s.12(1)(b) as it is not essential to the production of assessable income.	1·5
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	<hr/> <b>25</b>

- 2 (a)** Interest incurred on a loan borrowed is tax deductible if (i) the interest is incurred in the production of chargeable 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)(d) provides that interest on money borrowed from a financial institution 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 taxpayer (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 taxpayer (or its connected person) who is not taxed on such interest received (s.16(2B)).

In this case, interest is incurred on a bank overdraft. Assuming that the loan borrowed is used by PSL in its business, s.16(1) and s.16(1)(a) would be satisfied. As regards s.16(2), s.16(2)(d) applies to a loan borrowed from a bank. However, s.16(2)(d) would be subject to s.16(2A) and s.16(2B). The question states that the overdraft is secured by the US\$ fixed deposit placed with HSBC, New York branch. Since the interest earned on the deposit is offshore and not taxed in Hong Kong, s.16(2A) would not be satisfied and the overdraft interest would not be deductible.

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			Marks
(b) Professional Services Ltd			
Profits tax computation for the year of assessment 2008/09			
Basis period: year ended 31 December 2008			0.5
Loss per accounts		(81,000)	0.5
Add: Depreciation	56,000		0.5
Disposal proceeds of PFA – computers	30,000		0.5
Legal and professional fees	4,000		0.5
Contribution to provident fund (60,000*5/20)	15,000		1
Interest on bank overdraft	12,000		0.5
Travelling for Singapore seminars	14,000		0.5
Donations	8,500		0.5
Staff loan written off	4,500		0.5
Increase in general provision	500		0.5
Tax late filing penalty	3,000		0.5
Singapore income tax	17,000	164,500	0.5
		83,500	
Less: Profit on disposal of fixed asset	5,000		0.5
Service income from Singapore	220,000		0.5
Interest income (20,000 + 6,000 + 400 + 600)	27,000		2
Exchange gain	1,000		0.5
Depreciation allowance	86,290		0.5
Prescribed fixed assets – computers	20,000	(359,290)	0.5
Adjusted loss for the year		(275,790)	
Loss brought forward from 2007/08		(10,000)	0.5
Loss carried forward		(285,790)	0.5
Profits tax payable		Nil	0.5
			13

Note to marker: Service income from Singapore of \$220,000 and the corresponding travelling cost of \$14,000, legal fees for collection of trade debts of \$4,000 and Singapore income tax of \$17,000 should all be treated on the same basis. The above computation assumes the income to be claimed as offshore and non-taxable and thus the travelling cost, legal fees and Singapore income tax are non-deductible. If candidates assume the income to be taxable, the travelling cost, legal fees and Singapore income tax should then be deductible. In this case, no tax adjustment will be found, and a total mark of 1.5 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.

Taxable/Non-deductible items	\$	Deductible/non-taxable items	\$
Bad debts recovered	11,000	Fees for collection of trade debts	5,000
		Fees re mandatory provident fund	20,000
		Fees re copyright infringement	10,000
		Audit and taxation fees	11,000
		Bank charges	8,000
		Receivables written off	4,000
		Compensation for staff on termination	12,000
		Salaries tax for directors	13,000

(0.5 mark each, max 3 marks)

## Depreciation allowance schedule

	20% \$	30% \$	HP – 30% \$	Allowance \$	
WDV brought forward	55,000	60,000			0.5
Additions	40,000	20,000	60,000		1
Initial allowance (IA) 60%	(24,000)	(12,000)		36,000	0.5
IA – HP (6,000 + 4,500*3)*60%			(11,700)	11,700	1.5
Disposals		(35,000)			0.5
	<u>71,000</u>	<u>33,000</u>	<u>48,300</u>		
Annual allowance	(14,200)	(9,900)	(14,490)	38,590	1
WDV carried forward	<u>56,800</u>	<u>23,100</u>	<u>33,810</u>	<u>86,290</u>	<u>5</u>

*Tutorial note: The \$5,000 instalment payment includes hire purchase interest of \$500, which would be deductible as a revenue expense and the depreciation allowance is calculated on the capital portion of \$4,500 only.*

- (c) Under s.16(1)(c), foreign taxes paid on interest income, gains from bills of exchange etc which are deemed to be trading receipts and chargeable to tax under s.15 are allowable as a tax deduction. However, the section does not allow a tax deduction for any other foreign taxes attributable to income other than those specified in s.15. Therefore, the deductibility of the foreign tax is governed by the general deduction rule under s.16(1), i.e. whether the expense is incurred in the production of chargeable profits. 2

By reference to DIPN 28, if the tax payment is a charge on the profits themselves, it is regarded as a disbursement and not 'incurred in the production of chargeable profits'. It is not deductible under s.16(1). However, if the tax is paid on the gross amount of the income, regardless of whether a profit is made, a deduction may be allowed under s.16(1). 2

In conclusion, on the basis that the Singapore tax is levied on profit, it is not incurred in the production of chargeable profits and therefore prohibited as a tax deduction under s.16(1) and s.17(1)(b). 1

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3 (a)

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Computation of assessable profit/adjusted loss for the year of assessment 2008/09

Basis period: year ended 31 December 2008

	\$	
Net profit per accounts	213,000	
Add: Salaries to partners (120,000 + 240,000)	360,000	0.5
Depreciation	180,000	0.5
Loan interest to partners (200,000 + 100,000)	300,000	0.5
	<u>1,053,000</u>	
Less: Depreciation allowance	(140,000)	0.5
Assessable profits	<u>913,000</u>	
Correct treatment of rent and contributions to MPF scheme (2 x 0.5)		1

## Partnership Allocation

Year of assessment 2008/09

1 January 2008 – 30 June 2008 (\$913,000 x 6/12 = \$456,500) 0.5

	Alex	Bonnie	Cherry Ltd	Total	
Salaries	120,000	120,000	–	240,000	0.5
Interest	–	50,000	100,000	150,000	0.5
	<u>120,000</u>	<u>170,000</u>	<u>100,000</u>	<u>390,000</u>	
Balance (1:1:2)	16,625	16,625	33,250	66,500	0.5
Assessable profits	<u>136,625</u>	<u>186,625</u>	<u>133,250</u>	<u>456,500</u>	

1 July 2008 – 31 December 2008 (\$913,000 x 6/12 = \$456,500)					Marks
	Andy	Bonnie	Cherry Ltd	Total	0·5
Salaries		120,000	–	120,000	0·5
Interest		50,000	100,000	150,000	0·5
		170,000	100,000	270,000	
Balance (1:1:2)	46,625	46,625	93,250	186,500	0·5
Assessable profits	46,625	216,625	193,250	456,500	
<b>Total allocation for 1 January 2008 – 31 December 2008</b>					
	Alex	Andy	Bonnie	Cherry Ltd	Total
Share of profit	136,625	46,625	403,250	326,500	913,000
Transferred to personal assessment	–	(46,625)	(403,250)	–	(449,875)
Loss set-off under s.19C(4)	–	–	–	(300,000)	(300,000)
Net assessable profits	136,625	–	–	26,500	163,125
Tax payable at 15%/16·5%	20,493			4,372	24,865
					1
					10

**(b) Personal assessment computation for Andy and Bonnie  
Year of assessment 2008/09**

	Andy \$	Bonnie \$	
Net assessable income	100,000	–	0·5
Net assessable value (rental*80%)	96,000	144,000	1
Share of partnership profit	46,625	403,250	0·5
Proprietorship business profit (net of approved charitable donations limited to 35%) (40,000*65%)	26,000	–	1
	268,625	547,250	
Less: Mortgage interest (restricted to NAV)	(90,000)	(144,000)	1
	178,625		
Approved charitable donations (36,000 – 14,000)	(22,000)		1
		403,250	
Loss from property trading		(90,000)	0·5
Reduced total income	156,625	313,250	
Joint total income		469,875	
Less: Married person's allowance	216,000		0·5
Child allowance	50,000		0·5
Dependant brother allowance	30,000	(296,000)	0·5
Net chargeable income		173,875	
Tax payable at progressive rates		17,558	0·5
Tax waived (ceiling)		(8,000)	1
Net tax payable		9,558	
Tax payable at standard rate (469,875*15% = \$70,481) is not applicable			0·5
Tax payable by Andy = 9,558*156,625/469,875		3,186	0·5
Tax payable by Bonnie = 9,558*313,250/469,875		6,372	0·5
			10
			<b>20</b>

- 4 (a) Any person aggrieved by an assessment may object to the assessment under s.64(1) of the Inland Revenue Ordinance (IRO). In order to lodge a valid objection, the following conditions must be complied with:
- (1) it must be in writing and addressed to the Commissioner of Inland Revenue (CIR);
  - (2) it must state precisely the grounds for the objection;
  - (3) it must be received by the CIR within one month after the date of the notice of assessment; and
  - (4) it must be accompanied by a valid tax return if the assessment was made under s.59(3).
- 2
- Although condition (3) above has not been complied with, under s.64(1) proviso (a), the CIR is given power to extend the time limit in case of absence from Hong Kong where the taxpayer was prevented from objecting within the one-month period. On the facts given, the proviso is satisfied and the CIR would allow the late objection. A valid objection can therefore be lodged against the assessment.
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- (b) A recent House of Lords decision, *Shilton v Wilmschurst* has applied and explained the classic test for taxability of employment income set out in *Hochstrasser v Mayes*. An emolument is 'from' employment if the payment in question is made to a person as a reward for past services, or as an inducement for him to become or remain an employee. The payment is not taxable only if it is paid in consideration of the surrender by the recipient of his rights in respect of the office or employment.
- 2
- Applying this principle to the present case, the payment is taxable. Black was not deprived of any rights and the lump sum could therefore only be regarded as remuneration for his agreeing to continue to render services as a director, in other words, a payment for future services. The objection, therefore, would be unsuccessful.
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- (c) Black would have committed an offence and be liable to the penalty thereof under s.80(1) if he ignores the notice issued under s.51(3).
- 1
- If prosecuted, the penalty for the above offence is a fine at level 3 (\$5,001 to \$10,000), and the court may order the person convicted within a time specified in the order to do the act which he has failed to do. Alternatively, the CIR may compound the offence for a smaller amount.
- 2
- If a court orders for compliance and Black fails to comply with the court order, he shall be guilty of an offence and liable to a further fine at level 4 (\$10,001 to \$25,000) under s.80(2B).
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- (d) Reliance on professional advice is a reasonable excuse (*BR 80/76*), but that reliance must be reasonable in the circumstances: *D28/84*. Reliance on a statement like 'the IRD would not know about it' hardly seems to be a reasonable reliance. If the professional adviser considered there was doubt as to the tax position, full details should be given in the return. Only when the adviser gives advice that the sum is not taxable could reliance on that advice be said to be reasonable: *D24/84*.
- 3
- Black might have had a reasonable excuse if he had researched the position carefully and took the considered view that the amount was not taxable. However, the facts show that he did not do this.
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**15**

**Industrial buildings allowance (IBA)**  
**Abacus Ltd**

**Marks**

	\$	Allowances \$	
<b>2007/08</b>			
Cost of construction	7,000,000		0.5
Loan interest	350,000		0.5
	<u>7,350,000</u>		
Qualifying expenditure	7,350,000		
Initial allowance (IA) (20%)	(1,470,000)	<u>1,470,000</u>	0.5
WDV carried forward	<u>5,880,000</u>		
Note: No annual allowance (AA) is granted as the factory was not yet put into use.			0.5
<b>2008/09</b>			
Cost of construction	2,250,000		0.5
Loan interest (412,500*10/12)	343,750		1
	<u>2,593,750</u>		
Qualifying expenditure	2,593,750		
IA (20%)	(518,750)	518,750	0.5
	<u>2,075,000</u>		
WDV brought forward	5,880,000		
	<u>7,955,000</u>		
AA (7,350,000 + 2,593,750)*4%	(397,750)	<u>397,750</u>	1
		<u>916,500</u>	
<b>2009/10</b>			
Residue before sale	7,557,250		
Sale proceeds (restricted to cost)	(9,943,750)		0.5
Balancing charge restricted to allowances given		<u>2,386,500</u>	0.5

**Bee Ltd**

<b>2008/09</b>			
Residue before sale		7,557,250	0.5
Add: Balancing charge		2,386,500	0.5
Residue after sale		<u>9,943,750</u>	
Year of first use of the building		2008/09	0.5
25th year thereafter		2033/34	0.5
Year of assessment in the basis period for which the sale takes place		2008/09	0.5
Annual allowance for 2008/09			
= \$9,943,750 x $\frac{1}{2008/09 \text{ to } 2033/34 \text{ inclusive}}$			1
= \$9,943,750*1/26			
= \$382,452			0.5

**10**