

Fundamentals Level – Skills Module

Taxation (Hong Kong)

Monday 1 June 2009

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 2.

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

SUPPLEMENTARY INSTRUCTIONS

1. Calculations and workings should be rounded down to the nearest HK\$.
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 | | |
|--|---------------|---------------|
| | 2007/08 | 2008/09 |
| | \$ | \$ |
| Basic allowance | 100,000 | 108,000 |
| Married person's allowance | 200,000 | 216,000 |
| Single parent allowance | 100,000 | 108,000 |
| Child allowance – 1st to 9th child (each) | 50,000 | 50,000 |
| – additional allowance in the year of birth (each) | 50,000 | 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 | | |
|--|---------|---------|
| | 2007/08 | 2008/09 |
| | \$ | \$ |
| Self-education expenses (maximum) | 60,000 | 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 | | | |
|-----------------------------------|----------|----------------|---------|
| | 2007/08* | | 2008/09 |
| Salaries tax rates: | | | |
| First \$35,000 | 2% | First \$40,000 | 2% |
| Next \$35,000 | 7% | Next \$40,000 | 7% |
| Next \$35,000 | 12% | Next \$40,000 | 12% |
| Remainder | 17% | Remainder | 17% |
| Standard rate | 16% | | 15% |
| Profits tax rate for corporations | 17.5% | | 16.5% |

* 75% of salaries tax, property tax, profits tax and tax under personal assessment for the year of assessment 2007/08 will be waived subject to a ceiling of \$25,000.

Depreciation allowance rates

| | |
|------------------------|---------------|
| 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 Johnson, a UK resident, is single and working as a marketing manager for a UK company (the Company). From December 2007, he started to travel around the region visiting the Company's operations and meeting clients. David's travelling schedule is extracted as follows:

| | | Place of stay | Purpose of stay |
|------|-------------------------|--------------------|--------------------------------------|
| 2007 | 10–31 December | Hong Kong | Business |
| 2008 | 1–20 January | Hong Kong | Business |
| | 1–18 February | Hong Kong | Business |
| | 1–15 March | Singapore | Business |
| | 1–21 April | Hong Kong | Business |
| | 1 May –30 July | Hong Kong | Business and 10 days of annual leave |
| | 8–31 August | Hong Kong | Business |
| | 5–20 September | Malaysia/Singapore | Business |
| | 1–21 October | Hong Kong | Business |
| | 15 November–20 December | Hong Kong | Business |
| 2009 | 20 January–20 February | Singapore/China | Business |

All remuneration was paid into David's bank accounts in the UK. The following information is provided:

- Basic salary is \$100,000 per month.
- Lump sum housing allowance is \$20,000 per month, paid in cash.
- On 1 December 2007, David was granted options for 10,000 shares in the Company at a cost of \$2,000. There is no vesting period but the options will expire at the fifth anniversary from the date of granting the options.
- During his stay in Hong Kong, David stayed in a hotel serviced apartment at a monthly rental of \$10,000. This was paid by the Company to the hotel directly.
- On 15 May 2008, David acquired a flat in Hong Kong at the price of \$3 million, and mortgaged it to a bank for \$2 million. The balance of the purchase price, \$1 million, was funded by a staff loan obtained from the Company at a below-market interest rate. During the year ended 31 March 2009, David paid interest of \$80,000 to the bank, and \$12,000 to the Company. If a market interest rate had been charged by the Company, his interest cost would have been \$50,000.
- With effect from 1 July 2008, David leased the flat to a friend at a monthly rent of \$15,000. Before leasing out the flat, he spent \$400,000 to renovate the flat and another \$20,000 to replace the old air-conditioners and furniture. A monthly management fee of \$2,000 is payable by David.
- He placed fixed deposits with a bank in Hong Kong and earned interest of \$7,000 for the period ended 31 March 2009.

Required:

- (a) Based on the information provided, determine whether David is subject to salaries tax in Hong Kong in respect of the employment income he received from the UK company for each of the years of assessment 2007/08 and 2008/09 and if yes, on what basis. (8 marks)

- (b) Calculate David's Hong Kong tax liabilities, if any, for the years of assessment 2007/08 and 2008/09, making the election that is most beneficial to him.

Note: you should ignore overseas and provisional taxes.

(16 marks)

- (c) Pursuant to the Revenue Ordinance 2008 enacted after the Government Budget for 2008/09, tax concessions are granted to Hong Kong taxpayers to reduce the burden of tax payments, including the reduction of 75% of their 2007/08 final tax payment, but capped at \$25,000. State whether, and if so to what extent, this tax reduction is applicable to David. (1 mark)

(25 marks)

- 2 PP Ltd (PP) was incorporated in 2004, as a trading company carrying on business in Hong Kong. PP's profit and loss account for the year ended 31 December 2008 is as follows:

| | Notes | \$ | \$ |
|-----------------------------|-------|-----------|-------------|
| Income | | | |
| Business income | 1 | 3,000,000 | |
| Lease income | 2 | 120,000 | |
| Interest income | 3 | 20,000 | 3,140,000 |
| Expenses | | | |
| Director's fee | 4 | 1,000,000 | |
| Staff salaries and benefits | 5 | 1,800,000 | |
| Lease rental | 6 | 600,000 | |
| Interest | 7 | 32,000 | |
| Finance charge | 8 | 35,000 | |
| Compensation | 9 | 1,100,000 | |
| Transportation | 10 | 500,000 | |
| Depreciation | 11 | 220,000 | |
| MPF contribution | | 53,000 | |
| Bad debts | 12 | 60,000 | |
| Legal fees | 13 | 49,000 | |
| Other expenses | 14 | 51,000 | (5,500,000) |
| Net profit/(loss) | | | (2,360,000) |

Notes:

- About one-third of the business is done with customers in Mainland China. Starting from 1 January 2008, PP leased a warehouse in Mainland China to provide temporary storage services to customers in need. PP treated all its business income as arising in Hong Kong.
- From 1 January 2005, PP sub-leased part of its office space in Hong Kong to AA Ltd, at a monthly rental of \$10,000. Since 1 July 2008, AA Ltd has failed to pay the rental, although various reminders have been sent by PP. AA Ltd notified PP that no further rental would be paid, and asked PP to offset the two months' rental deposit against the monthly rental in arrears. AA Ltd finally moved out of the office space on 30 December 2008.
- Interest consists of:

| | |
|---|--------|
| | \$ |
| Interest on bank deposit (with customers' money deposited with PP) | 12,000 |
| Interest on loan to a director to finance his purchase of property in Hong Kong (no loan agreement is in place) | 8,000 |
| Total per accounts | 20,000 |
- The director's fee was paid to the company's director who is also the sole shareholder of PP.
- Staff salaries and benefits include \$400,000 being Hong Kong salaries tax paid for the director, and \$80,000 being two air tickets for the director's vacation.
- PP leases its Hong Kong office at a monthly rental of \$30,000, and its warehouse in Mainland China at a monthly rental of \$20,000. Both lease rentals are inclusive of rates and management fees.
- The interest expense of \$32,000 was paid on bank borrowing, which was guaranteed by the director on a personal basis.
- PP bought some cabinets under hire purchase at an annual lease rental of \$100,000 including an annual finance charge of \$35,000. The lease term started on 1 January 2008 and is for five years.
- During 2008, PP was sued by a businessman in Mainland China for the use of the same tradename in Mainland China. In order to settle the case without going into court, PP agreed to pay the businessman \$1,100,000 if he agreed to stop using the tradename.

10. PP engaged a transportation company to provide delivery vans to serve customers when needed. The fixed annual fee paid to the transportation company was \$500,000.
11. Depreciation includes \$50,000 being the amortisation of a tradename registered in Hong Kong in 2008. The total registration capitalised cost of the tradename was \$100,000.
12. Bad debts include \$40,000 for the office lease rentals irrecoverable from AA Ltd and a \$20,000 general provision for other unexpected irrecoverable trade debts.
13. Legal fees consist of:
- | | \$ |
|--|--------|
| Office lease contract renewal | 13,000 |
| Warehouse lease contract (note 1) | 15,000 |
| Office sub-lease contract | 6,000 |
| Contract with transportation company (note 10) | 7,000 |
| Tradename registration | 8,000 |
| Total charged | 49,000 |
14. Other expenses are all tax allowable.
15. The company acquired the following assets during the period:
- | | | |
|-----------------|---|--|
| 1 January 2008 | – | Cabinets (hire purchase, note 8) \$65,000 paid |
| 1 February 2008 | – | Furniture and equipment \$200,000 |
| 1 April 2008 | – | Computers \$80,000 |
| 1 June 2008 | – | Motor car \$220,000 |
16. PP's 2007/08 tax return shows a tax loss carried forward of \$1,200,000; and the written down values of the plant and machinery pools as:
- | | |
|----------|-------------|
| 20% pool | – \$300,000 |
| 30% pool | – \$120,000 |

Required:

- (a) (i) **Calculate PP Ltd's tax depreciation allowances, including in respect of the hire purchase cabinets for the year ended 31 December 2008;** (6 marks)
- (ii) **Compute PP's Hong Kong profits tax liability in respect of the year ended 31 December 2008, clearly identifying both the year of assessment and the basis period; and showing the loss, if any, to be carried forward to the year 2009.**

Notes:

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

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

(17 marks)

- (b) **Explain the principles and the underlying reasoning relevant to the tax treatments accorded to the items under notes (2), (3) and (9) above.**

Note: marks are allocated as follows: note (2) – 3 marks; note (3) – 2 marks; note (9) – 2 marks.

(7 marks)

(30 marks)

3 J, K and L Co Ltd (L) have been operating as a partnership since 2000. The original partnership agreement stated that:

1. J and K would each receive an annual salary of \$360,000;
2. L would be paid interest at the rate of 12% per annum on its capital contribution of \$1,500,000;
3. any additional loans made by the partners or their spouses to the partnership would attract interest at the rate of 10% per annum; and
4. the balance of profits or losses would be shared amongst the partners equally.

In early 2008, K wanted to retire from the partnership but was persuaded to stay with a reduced responsibility at a reduced salary and lower profit-sharing ratio. Effective from 1 February 2008, the partnership agreement was revised as follows:

1. K's annual salary was reduced to \$180,000;
2. the balance of profits or losses would be shared amongst the partners in the ratio of 2:1:2 (J:K:L); and
3. the salary to J and interest to L would remain unchanged.

The adjusted profits/loss of the partnership in recent years for tax purposes were:

| | |
|--------------------------|------------------|
| Year ended 31 March 2007 | \$630,000 |
| Year ended 31 March 2008 | (\$156,000) loss |
| Year ended 31 March 2009 | \$1,890,000 |

Additional information:

1. During all years, K's wife was appointed as the partnership's secretary at an annual salary of \$144,000.
2. On 1 April 2007, J's wife made a loan of \$2,400,000 to the partnership and charged interest at 10% per annum. The loan was fully repaid on 31 March 2008.
3. J and his wife elected to be personally assessed in 2008/09.
4. K had no other sources of income and so did not elect for personal assessment.
5. L also carries on a trading business in Hong Kong through L Co Ltd. Its adjusted taxable profits/loss in recent years as per its profits tax returns were:

| | |
|-----------------------------|-----------------|
| Year ended 31 December 2006 | \$246,000 |
| Year ended 31 December 2007 | \$130,000 |
| Year ended 31 December 2008 | (\$46,000) loss |

Required:

- (a) Compute the assessable profits/adjusted loss of the partnership for each of the years of assessment 2007/08 and 2008/09 and the tax payable thereon, if any, claiming any relief that is available to L Co Ltd.**

Notes:

- (1) Full details of the allocation of the profits/loss for the partnership business must be shown.
- (2) You should ignore provisional tax. (16 marks)

- (b) Compute the assessable profits/adjusted loss of L Co Ltd for each of the years of assessment 2007/08 and 2008/09 and the tax payable thereon, if any, claiming any relief that is available.**

Note: you should ignore provisional tax. (4 marks)

(20 marks)

- 4 Mr New incorporated a limited company in Hong Kong, named New Co Ltd, on 1 May 2008. Its first accounting period ended on 31 December 2008. Mr New is not familiar with the tax filing requirements in Hong Kong in relation to starting up a business, and has the following questions in mind:
- (a) Who should file and sign the profits tax return?
 - (b) When should the profits tax return be filed?
 - (c) How can I obtain the profits tax return form and how should it be filed?
 - (d) What documents are needed when filing the profits tax return?
 - (e) What will be the consequences if the profits tax return is not filed?

Required:

Based on the Inland Revenue Ordinance and the commonly known prevailing practice in Hong Kong, prepare short answers to each of the above questions as relevant to New Co Ltd.

Note: marks are allocated as follows: (a) – 2 marks; (b) – 2 marks; (c) – 4 marks; (d) – 3 marks; (e) – 4 marks.

(15 marks)

- 5 Boy HK Ltd (Boy) is carrying on a trading business in Hong Kong. Some of Boy's customers are referred by its related company in the US, which also provides after-sale services to Boy's customers in the US. During the year ended 31 December 2008, a service fee of US\$100,000 (equivalent to HK\$780,000) was charged by this US related company to Boy for its referral of customers and after-sales services. The US company provides all its services in the US, and does not have any office or staff in Hong Kong and does not carry on business in Hong Kong.

Required:

- (a) **Explain the principles relevant to the deduction of the payments made to the US company and identify the criteria that will need to be satisfied if a tax deduction is to be secured for the payment made by Boy HK Ltd.** (8 marks)
- (b) **Assuming that the US company does not carry on business in Hong Kong and it does not have a permanent establishment in Hong Kong, state whether there is any risk of the US company being subject to Hong Kong tax if the fee charged is considered excessive.** (2 marks)

(10 marks)

End of Question Paper