
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

2

2

0.5

1

0.5

1

1

0.5

2

1

(a)

David's employment is obviously a non-Hong Kong employment according to the *Goepfert's* case and the factors specified in DIPN No. 10 (revised), i.e. (a) residence of the employer is in the UK; (b) place where the employment contract is negotiated and concluded is reasonably assumed to be in the UK; and (c) place of payment is also in the UK. However, he would still be subject to Hong Kong salaries tax in respect of the portion of remuneration attributable to his services rendered in Hong Kong, including leave pay attributable to such services.

There is an exception to this. The law provides that if he only renders services in Hong Kong during 'visits' and he visits Hong Kong for not more than 60 days during the basis period for the year of assessment, such services would be disregarded and the income received for that whole year of assessment would be exempt from Hong Kong salaries tax: sections (ss.) 8(1A)(b)(ii) and 8(1B). In David's case, since he is a UK resident and the question does not seem to indicate that he has any work base or family ties in Hong Kong, it is reasonable to assume that he is a 'visitor' when he stays in Hong Kong.

The next issue is to ascertain the number of days he stays in Hong Kong during the relevant years of assessment. In calculating the number of days of 'visits' in Hong Kong, the Board of Review case *D29/89* held that both the day of arrival and the day of departure are included.

In David's case, for the year of assessment 2007/08, he visited Hong Kong for a total of 60 days:

10 December 2007 to 31 December 2007	22
1 January 2008 to 20 January 2008	20
1 February 2008 to 18 February 2008	18
Total	<u>60</u> days

As David's visit in Hong Kong for the year of assessment 2007/08 is not more than 60 days, he is not subject to Hong Kong salaries tax for that year.

For the year of assessment 2008/09, David visited Hong Kong for a total of 193 days:

1 April 2008 to 21 April 2008	21
1 May 2008 to 30 July 2008	91
8 August 2008 to 31 August 2008	24
1 October 2008 to 21 October 2008	21
15 November 2008 to 20 December 2008	36
Total	<u>193</u> days

As David's total number of days of visits in Hong Kong for the year of assessment 2008/09 is more than 60 days, he would be subject to Hong Kong salaries tax by reference to the proportion of the number of days spent in Hong Kong in the assessment year to the total number of days in that year. This is the so-called 'time-in-time-out' basis.

(b)

As explained above, David is not subject to Hong Kong salaries tax for the year of assessment 2007/08.

For the year of assessment 2008/09, David is subject to Hong Kong salaries tax in respect of his employment and services rendered in Hong Kong, based on the time apportionment basis as follows:

1 April 2008 to 21 April 2008	20
1 May 2008 to 30 July 2008	90 (including 10 leave days)
8 August 2008 to 31 August 2008	23
1 October 2008 to 21 October 2008	20
15 November 2008 to 20 December 2008	35
Total days spent in Hong Kong	188
Less: leave days in Hong Kong	(10)
Total business days spent in Hong Kong	178 (A)
Total business days in the year	355
Leave days attributable to Hong Kong service	5 (B)
[10 x (178/(365 – 10))]	
Total attributable days in Hong Kong	183 (A + B)
Time apportionment basis	183/365

Note that in calculating the number of days for time apportionment purposes, either the day of arrival or day of departure is included, but not both. This is different from calculating the number of days in Hong Kong for the 60-day rule purposes.

1

Moreover, he is also subject to property tax in respect of the rental income received from leasing the flat. Property tax in Hong Kong is imposed on rental consideration from the leasing of property situated in Hong Kong, regardless of whether the landlord is resident in Hong Kong or not. Since the rental is first received in July 2008, the relevant year of assessment for property tax purposes is 2008/09; and the property tax payable is calculated as follows:

1

	\$
Assessable value (15,000 x 9)	135,000
Less: 20% statutory deduction	(27,000)
Net assessable value	<u>108,000</u>
Property tax at 15%	<u>16,200</u>

2

(Note to marker: Candidates are not required to show details of the property tax calculation, but they are required to show the workings for the 'net assessable value' of \$108,000 in the personal assessment computation below, i.e. these 2 marks will be awarded in either place.)

For property tax purposes, there are no provisions available to allow tax deductions for mortgage loan interest, renovation costs, furniture/air-conditioners costs, or management fees. However, for mortgage loan interest, David may elect for personal assessment on the basis that he stays in Hong Kong for more than 180 days in the year of assessment and thus is a 'temporary resident' in Hong Kong. By electing for personal assessment, his property income and other taxable income such as salary will be aggregated together; but he is able to deduct the mortgage loan interest against the net assessable value of the property. The personal assessment calculation is as follows:

Computation of David's Hong Kong tax liability under personal assessment
Year of Assessment 2008/09

	\$	\$	
Salaries	1,200,000		1
Housing allowance	240,000		1
Total subject to time apportionment	<u>1,440,000</u>		
Net assessable income (x 183/365)		721,972	1
Net assessable value of property		108,000	0.5
Less: Mortgage interest (80,000 + 12,000)		(92,000)	1
Total assessable income		<u>737,972</u>	
Less: Personal allowance		(108,000)	0.5
Net chargeable income		<u>629,972</u>	
Tax payable at progressive rates on 629,972		<u>95,095</u>	0.5
Tax payable at standard rate of 15% on 737,972		<u>110,695</u>	0.5
Therefore, tax payable is		<u>95,095</u>	0.5

Non-taxable/Non-deductible items for which marks are allocated:

1. Bank deposit interest is not taxable.
2. Rental paid for the serviced apartment is not taxable.
3. Property management fee paid for the leased property is not deductible.
4. Renovation and air-conditioning/furniture expenditure are also not deductible.
5. Interest savings of \$38,000 (50,000 – 12,000) on the Company's staff loan is not taxable.
6. Share option cost of \$2,000 is not deductible.

0.5 mark each, max

3

16

- (c) The tax concession as per the Revenue Ordinance 2008 is granted to all Hong Kong taxpayers by reducing 75% of tax payable under salaries tax, profits tax, property tax and personal assessment in respect of 2007/08 final tax payment. This is also applicable to David. However, since the reduction applies only to 2007/08 final tax payment, David is not able to enjoy the benefit for the reason that he has no tax payable for 2007/08. The tax concession does not have an impact on his 2008/09 tax payable.

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2 (a) PP Ltd

(i)

Depreciation allowance schedule

	20%	30%	Total	
	\$	\$	\$	
Written down value brought forward	300,000	120,000		0.5
Addition	200,000	220,000		0.5
Initial allowance at 60%	(120,000)	(132,000)	252,000	1
	<u>380,000</u>	<u>208,000</u>		
Annual allowance	(76,000)	(62,400)	138,400	1
Written down value carried forward	<u>304,000</u>	<u>145,600</u>		
			<u>390,400</u>	

Hire purchase schedule for cabinets

	20%	Allowance	
	\$	\$	
Additions (65,000 x 5)	325,000		1
Initial allowance (65,000 x 60%)	(39,000)	39,000	1
	<u>286,000</u>		
Annual allowance	(57,200)	57,200	1
	<u>228,800</u>		
		<u>96,200</u>	
			6

(ii)

Profits tax computation for the year of assessment 2008/09

Basis period: year ended 31 December 2008

	\$	\$	
Loss before tax		(2,360,000)	0.5
Add: Depreciation	220,000		0.5
Compensation payment	1,100,000		1
Legal fee – warehouse lease (new)	15,000		1
Bad debt – general provision	20,000	1,355,000	0.5
		<u>(1,005,000)</u>	
Less: Depreciation allowance (390,400 + 96,200)	486,600		0.5
Prescribed fixed asset – computer	80,000		1
Interest income	12,000		0.5
Tradenname registration cost	100,000	(678,600)	1
Adjusted loss for the year		<u>(1,683,600)</u>	
Profits tax payable		<u>0</u>	0.5
Statement of loss			
Loss brought forward from 2007/08		1,200,000	0.5
Loss for current year 2008/09		1,683,600	
Total loss carried forward to 2009/10		<u>2,883,600</u>	0.5

Correct treatments 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	\$
Business income	3,000,000	Director's fee	1,000,000
Lease income	120,000	Salaries tax paid	400,000
Interest from director	8,000	Air tickets	80,000
		Lease rental – office	360,000
		Lease rental – warehouse	240,000
		Bank interest	32,000
		Finance charge	35,000
		Transportation cost	500,000
		MPF contribution	53,000
		Bad debt – AA Ltd	40,000
		Legal fee – office lease	13,000
		Legal fee – office sub-lease	6,000
		Legal fee – transportation	7,000
		Legal fee – tradename	8,000

0.5 mark each, max

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- (b) **Note (2)** – ‘Sub-letting’ of part of the office space by PP is regarded as a ‘business’ carried on by the company: s.2(1). Since the office is located in Hong Kong, the rental income derived from the sub-letting business is sourced in Hong Kong and taxable under profits tax: s.14(1). PP is not subject to property tax in Hong Kong as it is not the owner of the office space. Property tax is only levied on the owner of land or buildings situated in Hong Kong.

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The rental failed to be paid by the lessee, AA Ltd, is regarded as a bad debt arising from the sub-letting business. Under s.16(1)(d), a bad debt is deductible if (a) it was incurred in the business; (b) the debt has been included as a taxable receipt; and (c) it is proved to the satisfaction of the assessor that it has become bad during the assessment year. In respect of the last factor, the assessor usually requires that some positive recovery actions have been taken to recover the debt but these actions have failed. In the case of PP, reminders have been sent to recover the outstanding rental but failed, and AA Ltd has asked PP to offset its rental deposit against the rental in arrears. These would be sufficient evidence to claim that any rental in arrears after offsetting the rental deposit would be bad and irrecoverable. Tax deduction should be allowed.

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Note 3 – Interest on a bank deposit is specifically exempt under the Exemption from Profits Tax (Interest Income) Order 1998. The fact that the money represents deposits from customers is not relevant. The deposit money should have been capitalised by PP if it is refundable. However, when PP placed the money into bank as deposit and earned interest from the deposit, the deposit becomes the asset of PP, and the interest becomes income of PP; unless it is agreed between PP and the customers that any interest derived from the deposit is for the account of the customers or both. In the absence of such information in the question, it is reasonable to assume that there is no such arrangement in place.

1

Interest arising from the loan is taxable if the loan is first made available to the director in Hong Kong (‘provision of credit’ test). Although the question does not specify the place where the director first received the loan, it was given that the director used the loan to acquire property in Hong Kong. It is therefore reasonable to assume that the loan was first made available to the director in Hong Kong. The interest is therefore sourced in Hong Kong and taxable. The absence of loan agreement has no impact on the taxability of the interest income.

1

Note 9 – The deductibility of the compensation paid depends on the nature of the payment. If the payment is capital in nature, s.17(1)(c) disallows the tax deduction. A capital payment generally is a non-recurrent payment and is normally spent ‘once and for all’, although this is not the sole determinant on its own. Other criteria include whether the payment brings into existence an asset or advantage for the enduring benefit of a trade or business; and whether the payment relates to the company’s profit yielding structure or to its fixed capital or assets.

1

In the question, the reason for paying the compensation is two-fold: (a) to preserve PP’s right to continue to use the tradename; and (b) to deprive the businessman from the use of the tradename. Both reasons would bring to PP an enduring benefit to continue to trade its business under the tradename without further threat or interference. Accordingly, it would be obvious that the compensation is capital in nature and non-deductible for tax purposes.

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3 (a)

J, K and L Co Ltd
Partnership allocation
Year of assessment 2007/08

1 April 2007 to 31 January 2008 (\$156,000 x 10/12 = \$130,000 loss)

0.5

	Partnership \$	J \$	K \$	L \$	
Salaries to partners (360,000 x 10/12)	600,000	300,000	300,000	–	0.5
Salaries to K's wife (144,000 x 10/12)	120,000	–	120,000		0.5
Interest to J's wife (240,000 x 10/12)	200,000	200,000	–		0.5
Interest on capital (1.5m x 12% x 10/12)	150,000	–	–	150,000	0.5
	<u>1,070,000</u>	<u>500,000</u>	<u>420,000</u>	<u>150,000</u>	
Balance (1:1:1)	(1,200,000)	(400,000)	(400,000)	(400,000)	0.5
Allowable loss	<u>(130,000)</u>	<u>100,000</u>	<u>20,000</u>	<u>(250,000)</u>	

1 February 2008 to 31 March 2008 (\$156,000 x 2/12 = \$26,000 loss)

0.5

	Partnership \$	J \$	K \$	L \$	
Salaries to partners (J 360,000/K 180,000 x 2/12)	90,000	60,000	30,000	–	0.5
Salaries to K's wife (144,000x2/12)	24,000	–	24,000	–	0.5
Interest to J's wife (240,000 x 2/12)	40,000	40,000	–	–	0.5
Interest on capital (1.5m x12% x 2/12)	30,000	–	–	30,000	0.5
	<u>184,000</u>	<u>100,000</u>	<u>54,000</u>	<u>30,000</u>	
Balance (2:1:2)	(210,000)	(84,000)	(42,000)	(84,000)	0.5
Allowable loss	<u>(26,000)</u>	<u>16,000</u>	<u>12,000</u>	<u>(54,000)</u>	

Full year allocation for year of assessment 2007/08 (1 April 2007 to 31 March 2008)

	Partnership \$	J \$	K \$	L \$	
Share of profit/(loss)	(156,000)	116,000	32,000	(304,000)	1
Reallocation	0	(116,000)	(32,000)	148,000	1
	<u>(156,000)</u>	<u>0</u>	<u>0</u>	<u>(156,000)</u>	
Loss set off against L's profits	130,000	–	–	130,000	1
	<u>(26,000)</u>	<u>0</u>	<u>0</u>	<u>(26,000)</u>	0.5
Tax payable	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	<u>Nil</u>	0.5

Partnership allocation
Year of assessment 2008/09

	Partnership \$	J \$	K \$	L \$	
Salaries to partners	540,000	360,000	180,000	–	0.5
Salaries to K's wife	144,000	–	144,000	–	0.5
Interest on capital (1,500,000 x 12%)	180,000	–	–	180,000	0.5
	<u>864,000</u>	<u>360,000</u>	<u>324,000</u>	<u>180,000</u>	
Balance (2:1:2)	1,026,000	410,400	205,200	410,400	0.5
Share of profits	1,890,000	770,400	529,200	590,400	
Loss brought forward and set off	(26,000)	–	–	(26,000)	1
Profits transferred to personal assessment	(770,400)	(770,400)	–	–	1
Loss set off – s.19C(5)	(46,000)	–	–	(46,000)	1
	<u>1,047,600</u>	<u>0</u>	<u>529,200</u>	<u>518,400</u>	
Net assessable profits	<u>1,047,600</u>	<u>0</u>	<u>529,200</u>	<u>518,400</u>	
Tax payable at 15%/16.5%	<u>164,916</u>		<u>79,380</u>	<u>85,536</u>	1

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(b)

L Co Ltd

Profits tax computations for years of assessment 2007/08 and 2008/09

	2007/08 Year ended 31 December 2007	2008/09 Year ended 31 December 2008	
Assessable profits/(losses)	130,000	(46,000)	1
Loss transferred from partnership	(130,000)		1
Loss transferred to partnership		(46,000)	1
Net assessable profits	0	0	
Tax payable at 17.5%	Nil		0.5
Tax payable at 16.5%		Nil	0.5
			4
			20

4 Short answers to Mr New's questions in relation to tax filing requirements in Hong Kong:

(a) Who should file and sign the profits tax return?

Under s.51(1) of the Inland Revenue Ordinance (IRO), an assessor has the power to issue a return to any person and to require him to complete and submit the return within a reasonable time. In the case of New Co Ltd, as it is an incorporated body and the taxpayer is the company itself, the profits tax return is normally issued to New Co Ltd instead of Mr New. New Co Ltd may prepare the tax return itself, or appoint a tax representative to prepare the tax return, but the return should be signed by the company's secretary, manager or director (or liquidator in the event of liquidation).

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(b) When should the profits tax return be filed?

In practice, a profits tax return is normally issued around 1 April each year (unless in exceptional cases, e.g. year of commencement or cessation) and the taxpayer is usually allowed one month to submit the return. However, for companies with accounting periods ending in December, upon applications by the company or its tax representatives, the Inland Revenue Department (IRD) is prepared to grant an extension to mid-August. This is applicable to New Co Ltd. Unless in exceptional circumstances, the extended due date for filing the profits tax return for 2008/09 should be mid-August 2009. (For information, for other companies with accounting periods ending between 1 January and 31 March, the due date is extended to a later date up to mid-November.)

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(c) How can I obtain the profits tax return form and how should it be filed?

Normally, he should expect to receive the company's profits tax return form around 1 April each year. However, this in practice may not be the case in the first year of assessment. When no return form is received in any year of assessment, it is not sufficient excuse for failure to comply with the tax filing requirement. Under s.51(2), any person chargeable to tax (i.e. has earned chargeable income) for a year of assessment is obliged to inform the Commissioner in writing that he is so chargeable within four months after the end of the basis period for the relevant year of assessment, unless he has already received a specified return form. In the case of New Co Ltd, if no tax return is received before 30 April 2009, New Co Ltd should write to the Commissioner and report the chargeable income earned for the year ended 31 December 2008. A profits tax return form will then be issued to New Co Ltd. Returns to be used are issued on printed paper forms, and taxpayers are expected to complete the printed forms and have them sent back (by mail or in person) to the IRD. There are now provisions that allow returns to be made in electronic forms which can be filed electronically or through telefiling system, but these methods are only limited to cases specified by the Commissioner.

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(d) What documents are needed when filing the profits tax return?

In practice, a profits tax return requires the return to be completed, signed and submitted, together with the audited accounts for the relevant basis period, unless the company is exempt from preparing audited accounts under the Companies Ordinance in Hong Kong or the company is incorporated in a jurisdiction that does not require accounts to be audited. A tax computation with supporting schedules is not statutorily required but is usually filed to facilitate the assessment of the tax return. There may be some other additional forms or returns required for specified circumstances, and these are stipulated in the tax return form. Upon submission of the tax return, if the assessor is not satisfied with the information provided, he may require the taxpayer to submit further information.

3

(e) What will be the consequences if the profits tax return is not filed?

If New Co Ltd fails to file its profits tax return without reasonable excuse, it is guilty of an offence under s.80(2) and the penalty is a fine at level 3 (i.e. \$10,000) plus treble the amount of the tax that was either underpaid or would have been underpaid. However, the Commissioner may compound the penalty to a smaller figure depending on the circumstances. Alternatively, instead of prosecuting via the court, the Commissioner or a deputy Commissioner may personally raise an assessment of 'additional tax' and demand such payment from New Co Ltd up to treble the amount of tax that was either underpaid or would have been underpaid had the offence not been detected. Before the penalty or additional tax is raised, the Commissioner may issue an estimated assessment based on its estimation of profits or income and demand tax payment accordingly. If New Co Ltd considers the estimated assessment excessive, it would need to lodge an objection in writing within the specified time limit. Objection in this case will only be considered valid if a properly completed tax return is filed together with the objection or within such further time allowed by the IRD. Regardless of whether an objection is lodged against an estimated assessment, the Commissioner may still at a later stage issue additional assessments to demand further tax if he considers it reasonable and necessary. If New Co Ltd still fails to file the tax return, a court order may be issued to direct or require certain information to be filed. In the extreme case, the Commissioner may obtain a search warrant and enter the office of New Co Ltd to seize and retain possession of relevant information.

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- 5 (a)** The charge to Boy HK Ltd (Boy) by the US company is a service fee charged as a result of the referral and after-sales services provided by the US company for the benefit of Boy. From the perspective of Boy, 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 that the payment is tax deductible against its assessable profits.

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The general tax deduction rule under s.16(1) is that the expense or outgoing must have been incurred in the production of assessable profits. Where this is not the case, a deduction will be denied. In the case of Boy, it must be able to prove that the services were genuinely rendered by the US company; and the payment made for the services was in the production of Boy's assessable profits. It is unclear whether or not the income earned from sales to the customers referred by the US company has been returned as Hong Kong taxable profit by Boy. If the related income has been claimed as offshore and non-taxable in Hong Kong, the related payment would not be tax deductible, regardless of the recipient and the amount paid.

2

In the case that the related sales income has been treated as taxable profit by Boy in Hong Kong, the fundamental test of 'in the production of assessable profits' is considered satisfied. However, there are other general requirements which must also be met 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. Boy should be able to explain the basis of the amount charged, i.e. why it is US\$100,000 and not more or less, and to prove that the quantum is reasonable and not excessive if the same services had been rendered by an unrelated party and a fee had been charged. The basis should be consistently applied each year and should not represent a repatriation of profit out of Hong Kong.

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There should also be proper documentation including an agreement in place between Boy and the US company 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.

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Tutorial note: If the transaction does not satisfy these criteria, the IRD may regard the transaction as an act carried out for the purpose of avoiding/reducing tax in Hong Kong, and 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.

- (b)** Assuming that the US company does not carry on business in Hong Kong nor has a permanent establishment in Hong Kong, it is still possible that part or all of its fee income is regarded as Hong Kong taxable income and taxed in Hong Kong. Under s.20(2), in a situation where a payment is made by a Hong Kong resident (i.e. Boy) to a closely connected person outside Hong Kong (i.e. the US company), 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 produce less profits to the resident than might normally be expected. In other words, if the amount charged by the US company is considered excessive so that it has the effect of reducing the assessable profits of Boy, the US company may be deemed to be carrying on business in Hong Kong and subject to tax in Hong Kong. The relevant tax may be collected via Boy as the agent of the US company. Alternatively, the IRD in Hong Kong may seek to disallow part or all of the fee payment.

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