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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
1 (a)	John Ellis's salaries tax computation for 2010/11		
		\$	
	Salary	1,200,000	0.5
	Entertainment allowance	96,000	0.5
	Reimbursement of club subscription	6,000	0.5
	Holiday journey benefit		
	– air ticket for wife (28,000 + 4,000)/2 – 4,000	12,000	1
	– hotel room charges (30,000*15/25)	18,000	1
		<u>1,332,000</u>	
	Time-apportionment:		
	HK: 140 + 15*140/(365 – 15) = 146 days		1.5
	Taxable: 1,332,000 x 146/365	532,800	1
	HK salaries tax paid by employer	30,000	1
		<u>562,800</u>	
	Rental value at 4%	22,512	1
	Less: rent suffered (120,000*5%)	(6,000)	1
		<u>16,512</u>	
	Gain on share option		
	– gain on sale of option (40,000 – 2,000)	38,000	1
	– gain on exercise of option [25,000*(8 – 5) – 2,500]	72,500	1
		<u>110,500</u>	
	Apportioned on the no. of days: 110,500*146/365	44,200	1
	Assessable income	623,512	
	Mandatory provident fund contributions (maximum)	(12,000)	0.5
		<u>611,512</u>	
	Married person's allowance	(216,000)	0.5
	Net chargeable income	<u>395,512</u>	
	Tax payable at progressive rates	<u>55,237</u>	0.5
	Tax payable at standard rate (\$611,512*15% = \$91,726) is not applicable		0.5
	Correct treatment of:		
	Overseas tax paid by employer		0.5
	Gain on sale of shares		0.5
			<u>15</u>
(b) (i)	A concessionary deduction for home loan interest is available to taxpayers under salaries tax. The following are the conditions that must be satisfied for such a deduction (s.26E):		
	(1) The person is the owner of the dwelling (sole owner, joint tenant or tenant in common).		0.5
	(2) The dwelling is situated in Hong Kong and is used exclusively or partly for residential purposes.		0.5
	(3) The dwelling is wholly or partly used by the person as his place of residence (or as the principal place of residence if there is more than one place of residence at the same time in the year of assessment).		0.5
	(4) Home loan interest is paid by the person on a loan applied wholly or partly for the acquisition of the dwelling.		0.5
	(5) The loan is secured by a mortgage or charge over the dwelling or over any other property in Hong Kong.		0.5
	(6) The lender is the government, a financial institution, a registered credit union, a licensed money lender, the Hong Kong Housing Society, the person's employer, or any organisation or association approved by the Commissioner of Inland Revenue (CIR).		0.5
			<u>3</u>

(ii) The salaries tax treatments of options (1) to (3) are as follows:

- |   |                  |
|---|------------------|
| (1) A monthly housing allowance, paid by Sun Ltd as a cash allowance, is treated as assessable income arising from employment and it will be added to the other assessable income of John and taxed accordingly.  | 1                |
| <p>However, if John uses the property as his principal place of residence in Hong Kong, the conditions for a home loan interest deduction are satisfied, and John can get a deduction for the home loan interest against his total assessable income, subject to a maximum allowance of \$100,000 in any year of assessment for ten years.</p>  | 1.5              |
| (2) The mortgage loan is made between John and the Hong Kong bank directly. The loan repayment, including interest repayment, becomes the personal liability of John. If Moon Ltd subsidises any amount for John, the subsidised amount is an employee benefit and would become his assessable income for salaries tax purposes. This is because the subsidy is convertible into cash and, more importantly, it discharges John's personal liability. | 1.5              |
| <p>However (as in (1) above), if John uses the property as his principal place of residence in Hong Kong, the conditions for home loan interest deduction are satisfied, and John can get a deduction for the home loan interest against his total assessable income, subject to a maximum allowance of \$100,000 in any year of assessment for ten years.</p>  | 0.5              |
| (3) Although a low-interest loan provided by Moon Ltd is an employee benefit, it is not assessable for salaries tax purposes. Since the loan is made between John and Moon Ltd, the benefit does not discharge any personal liability of John. Moreover, the benefit is not convertible into cash. John will not be assessed on the interest rate differential.   | 1                |
| <p>However, even if John uses the property as his principal place of residence in Hong Kong, he is not eligible for the home loan interest deduction. Although the first five conditions for home loan interest deduction are satisfied, the last condition is not, as the lender, being the employer's subsidiary, does not fall within the definition of 'lender'.</p>  | 1.5              |
|   | <u>7</u>         |
|   | <u><b>25</b></u> |

2 (a)

Hope Ltd

Profits tax computation for the year of assessment 2010/11

Basis period: year ended 31 December 2010

	\$	\$	
Loss for the year per accounts		(811,000)	0.5
Add: Depreciation	1,060,000		0.5
Loss on asset disposal	20,000		0.5
Legal fee for new office lease	4,000		0.5
Interest on loan from director	5,000		0.5
Sales proceeds of prescribed fixed asset – computer	20,000		0.5
Commercial building allowance – balancing charge	6,000,000		0.5
Loss from securities trading – China	540,000		0.5
Charitable donations	100,000	7,749,000	0.5
		<u>6,938,000</u>	
Less: Depreciation allowance (\$88,160 + \$2,000,000)	2,088,160		0.5
Profit from disposal of Property A	3,700,000		0.5
Prescribed fixed asset – computer	40,000		0.5
Dividends (700,000 + 100,000)	800,000		0.5
Interest income	300,000	6,928,160	0.5
		<u>9,840</u>	
Less: Approved charitable donations (restricted to 35%)		(3,444)	0.5
Assessable profits		<u>6,396</u>	
Profits tax payable at 16.5%		<u><u>1,055</u></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/non-deductible items	\$	Deductible/non-taxable items	\$
Consultancy fee from China	400,000	Travelling and entertainment in China	400,000
Profit from securities trading – HK	2,000,000	Accommodation in China	80,000
Currency trading gain	240,000	(400,000*20%)	
Profits from sale of Property C	2,000,000	Severance payment	100,000
		Legal fee – staff quarter lease renewal	6,000
		Interest on bank mortgage loan	70,000
		Interest on bank overdraft line	12,000
(0.5 mark each maximum)			
4			

Depreciation allowance schedule				
	20%	30%	HP – 30%	Allowance
	\$	\$	\$	\$
Written down value brought forward	50,000	60,000		
Additions				
Furniture/fixtures	40,000			
Computers			40,000	
Motor vehicle		20,000		
	90,000	80,000		
Initial allowance (IA) at 60%	(24,000)	(12,000)		36,000
IA – HP (7,000 + 5,500*2)*60%			(10,800)	10,800
Disposals	(5,000)	–	–	
	61,000	68,000	29,200	
Annual allowance	(12,200)	(20,400)	(8,760)	41,360
Written down value carried forward	48,800	47,600	20,440	
Total for plant and machinery				88,160
Commercial building allowance:				
Property A – balancing charge (restricted to CBA claimed before, i.e. \$15,000,000*4%*10 years)				6,000,000
Property B at cost	50,000,000			
Annual allowance at 4%	2,000,000			2,000,000
				1
				20

- (b) (i) Securities trading – Under s.14(1), profits tax is imposed on every person carrying on a trade, profession or business in Hong Kong in respect of the assessable profits arising in or derived from Hong Kong. When a company carrying on business in Hong Kong derives income from a transaction, such income would be taxable in Hong Kong only if the income is sourced in Hong Kong. When dealing with the source of profits, the broad guiding principle is that one looks to see what the taxpayer has done to earn the profits in question and where he has done it (*Hang Seng Bank* and *HKTVB-I*). This is generally referred to as the 'operations test'.

In the case of trading profits, the place where the contracts of buying and selling are concluded and effected would be the relevant factor. Therefore, the appropriate test to apply would depend on the nature of the income. In the case of Hope, the profit/loss arises from trading in securities on both the Hong Kong and China Stock Exchanges. Based on the Privy Council's decision in *Hang Seng Bank*, the general rule for determining the source of profit from dealing in commodities or securities is the place where the contracts of purchase and sale are effected. In the event that the securities are listed, the place of the stock exchange at which the securities are listed would generally be regarded as the place where the 'bought' and 'sold' notes are effected.

On this basis, the profits arising from the securities trading at the Hong Kong Stock Exchange would be sourced in Hong Kong and thus taxable. Whereas the loss arising from the securities trading at the China Stock Exchange would be sourced outside Hong Kong, and thus non-deductible.

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(ii) Approved charitable donation – Under s.16D, donations made to charitable organisations would be tax deductible if the following conditions are fulfilled:

- (a) the payment must be a donation of money;
- (b) the donation is made to a charitable institution or trust of a public character which is exempt from tax under s.88 of the Inland Revenue Ordinance (IRO), or to the Government for charitable purposes;
- (c) the payment must be a pure donation and not confer any benefit at all upon the donor;
- (d) the aggregate of allowable donations must be not less than \$100;
- (e) the deduction is limited to 35% of assessable profit after depreciation allowance but before charitable donations; and
- (f) the sum must not qualify for deduction under any other profits tax provision or as a concessionary deduction for salaries tax and personal assessment purposes.

2.5

As the donation, if deductible, is restricted to 35% of assessable profit after depreciation allowance but before charitable donations, the donation sum must first be added back to the assessable profits so that the 35% limit can be calculated and ascertained. If the donation sum exceeds the 35% limit, any excess is not available for deduction, thus in the case where a loss is incurred, no donation would be allowed.

0.5

3

(iii) Bank loan interest cost – Interest incurred on a loan borrowed is tax deductible if (i) the interest is incurred in the production of assessable profits (s.16(1) and s.16(1)(a)); and (ii) 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 or an overseas financial institution would be allowed provided that the restrictions under s.16(2A) and s.16(2B) are not applicable.

1

In general, the conditions under s.16(2A) and s.16(2B) include:

- (a) 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
- (b) 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) which is not taxed on such interest received (s.16(2B)).

1

In the case of Hope Ltd, the bank mortgage loan was used to fund its acquisition of Property A which was leased out for taxable rental income, while the bank overdraft was used to finance the foreign currencies trading. Also, neither the bank loan nor the bank overdraft were secured by deposits. As such, the interest incurred on both the bank loan and the overdraft would satisfy s.16(1). As regards s.16(2), the interest would be tax deductible under s.16(2)(d), provided that s.16(2A) and s.16(2B) are not applicable.

2

4**30**

3 (a)

**Mr Li's sole proprietor business**  
**Profits tax computation for the year of assessment 2010/11**  
**Basis period: year ended 31 March 2011**

	\$	\$	
Net profit		5,000	0.5
Add: Drawings	90,000		0.5
Charitable donations	<u>70,000</u>	160,000	0.5
		165,000	
Less: Approved charitable donations (ACD) (restricted to 35%)		<u>(57,750)</u>	0.5
Assessable profits		<u>107,250</u>	
Profits tax payable at 15%		<u><u>16,087</u></u>	0.5

				Marks
<b>Mr Li's property tax computation for the year of assessment 2010/11</b>				
		\$		
Rental (\$10,000*12)		120,000	0.5	
20% statutory allowance		(24,000)	0.5	
Net assessable value		<u>96,000</u>		
Property tax payable at 15%		<u>14,400</u>	0.5	
<b>Mrs Li's salaries tax computation for 2010/11</b>				
		\$		
Salary		670,000	0.5	
Less: Mandatory provident fund contributions (maximum)		(12,000)	0.5	
ACD (70,000 – 57,750)		<u>(12,250)</u>	1	
		645,750		
Less: Married person's allowances		<u>(216,000)</u>	0.5	
Net chargeable income		<u>429,750</u>		
Salaries tax payable at progressive rates		<u>61,057</u>	0.5	
Salaries tax payable at standard rate (\$645,750*15% = \$96,862) is not applicable			0.5	
<b>Total tax liabilities:</b>				
Profits tax payable by Mr Li		16,087		
Property tax payable by Mr Li		14,400		
Salaries tax payable by Mrs Li		<u>61,057</u>		
		<u>91,544</u>	0.5	
			8	
<b>(b) Partnership profits tax computation for the year of assessment 2010/11</b>				
<b>Basis period: year ended 31 March 2011</b>				0.5
		\$	\$	
Net loss			(80,000)	0.5
Add: Salaries to partners – Mrs Li	50,000			0.5
Salaries to partners – June	<u>80,000</u>		<u>130,000</u>	0.5
Assessable profits			<u>50,000</u>	
<b>Partnership allocation for the year of assessment 2010/11</b>				
	Mrs Li	June	Total	
	\$	\$	\$	
Salaries	50,000	80,000	130,000	0.5
Balance (1:1)	<u>(40,000)</u>	<u>(40,000)</u>	<u>(80,000)</u>	0.5
Assessable profits	10,000	40,000	50,000	
Loss brought forward	<u>(10,000)</u>	<u>(33,000)</u>	<u>(43,000)</u>	0.5
Net assessable profits	<u>–</u>	<u>7,000</u>	<u>7,000</u>	0.5
Profits tax payable at 15%		<u>1,050</u>	<u>1,050</u>	0.5
Loss carried forward	(34,000)	–	(34,000)	0.5
				5

				Marks
<b>(c) Personal assessment computation for Mr and Mrs Li</b>				
<b>Year of assessment 2010/11</b>				
	<b>Mr Li</b>	<b>Mrs Li</b>	<b>Total</b>	
	<b>\$</b>		<b>\$</b>	
Assessable profit	107,250	–		0.5
Net assessable income	–	670,000		0.5
Net assessable value (NAV)	96,000			0.5
	<u>203,250</u>			
Less: Mortgage interest (restricted to NAV)	(96,000)			0.5
MPF (maximum)		(12,000)		0.5
ACD (107,250 + 57,750)*35% – 57,750	0			0.5
Unabsorbed ACD transferred from spouse (70,000 – 57,750)		(12,250)		0.5
	<u>107,250</u>	<u>645,750</u>		
Reduced total income			753,000	
Joint total income			(216,000)	0.5
Less: Married person's allowance			537,000	
Net chargeable income			<u>79,290</u>	0.5
Tax payable at progressive rates				
Tax payable at standard rate (753,000*15% = 112,950) is not applicable				0.5
Tax payable by Mr Li \$79,290*107,250/753,000			11,293	0.5
Tax payable by Mrs Li \$79,290*645,750/753,000			<u>67,997</u>	0.5
If no personal assessment is elected, the total tax liabilities of Mr and Mrs Li is \$91,544. Therefore, personal assessment will result in a tax saving of \$12,254 (91,544 – 79,290); and so an election for personal assessment is advantageous for them.				1
				<u>7</u>
				<b><u>20</u></b>

- 4 (a) Although First Real Estate Ltd (FREL) carries on a real estate agency business, the letting of half of Property A results in a second business being carried on by FREL. Under s.2, the definition of 'business' includes 'letting or sub-letting by any corporation to any person of any premises or portion thereof'. As such, FREL is also regarded as carrying on a property letting business, and any rental income arising therefrom would be subject to profits tax under s.14(1). 1
- On the other hand, FREL would also be subject to property tax under s.5, on the basis that Property A is situated in Hong Kong and FREL, as the owner of the property, receives consideration arising from the letting of Property A. 1
- To avoid double taxation of the same rental income under both profits tax and property tax, FREL is entitled, under s.5(2)(a), to apply for an exemption from property tax (s.5(2)(a)). The conditions for exemption are either (a) the profits from the property are part of the profits of the business carried on by the corporation; or (b) the corporation occupies the property for the purposes of producing profits subject to profits tax. In FREL's case, the exemption should apply. 1.5
- In the event that FREL has been assessed to property tax on the rental income and has paid the tax accordingly, it can set off the property tax paid against its profits tax liability (s.25). Any excessive property tax paid would be refunded. 0.5
- (b) Property B has been held and classified in the 2010 accounts as 'property held for resale'. In general, any property held for resale would be interpreted in accounting terms as 'trading stock'. The IRO does not contain any provision or guideline as to the valuation of trading stock other than s.15C which applies only in the case of the cessation of a business. However, where trading stock has been used by a taxpayer for his or her own personal purposes; converted into assets for use in the business; or disposed of outside the ordinary course of business; the taxpayer is required to account for the stock as if it had been sold in the due course of trade (*Sharkey v Wernher*). 4
- 2

In FREL's case, Property B is not sold, but its usage is changed from trading stock to a non-current asset. It is obvious that the reason for the change in accounting presentation is that Property B is now being occupied by the director as a kind of accommodation benefit offered to the director. This implies that the intended use of the property is changed.

1

By applying the above principle, FREL could be regarded as having sold Property B, the trading stock, back to itself at the market price at the time of the change in usage. If the market price exceeds the original cost of Property B, FREL would be deemed to have made a profit which, in principle, is taxable. Having said that, it has not been well determined whether the above principle is applicable in Hong Kong. More importantly, in FREL's case, if there is no revaluation of property in the accounts, the profit remains as an unrealised deemed profit which is not taken up in the accounts. Without specific authority given in the IRO to assess such deemed profits, the IRD may find it difficult to enforce the principle and assess the profits due to the change in usage of the property.

2

5

- (c) Property C was acquired in April and sold in August of the same year, giving rise to a profit of \$300,000. Whether or not the profit is taxable under s.14 depends on the nature of the profit. Should the profit be capital in nature, it could be excluded from the scope of profits tax charge.

1

Whether the profit from sale of properties is capital or revenue in nature has been an area of major dispute and there is no rule of thumb. The test most commonly applied by the IRD is the so-called 'badges of trade' and the following factors would be considered:

- (1) The subject matter is a residential unit, which is a common form of asset in a trade.
- (2) The length of the period of ownership, which is only four months, is too short to demonstrate a long-term intention to hold the property.
- (3) The frequency or number of similar transactions in the past, which is relevant to illustrate FREL's intention, although this information is not provided in the question.
- (4) Any supplementary work on the property being disposed of, which helps determine the intention of FREL, although this information is also not provided in the question.
- (5) The circumstances responsible for the disposal, whether due to an increase in property price or other non-profit-making reason. Again, the information provided in the question is not sufficient but the fact that the disposal did generate a profit and FREL also held Property B for resale is obvious enough to imply FREL's intention in this transaction.
- (6) The motive for disposal, whether profit-making or other non-profit related motive. Again, further information is required.

3

Due to the complexity of transactions nowadays, the above six factors could not be conclusive and usually all other relevant factors will be taken into consideration, including the purpose of acquisition, the method of financing, the history or expertise of the taxpayer and usage of the sales money, etc.

1

Although the information provided in the question is insufficient to be conclusive, it is likely that the profit would be assessed by the IRD on the basis that the property was only held for four months and FREL has expertise in the property market, unless there is other evidence sufficient to prove that the gain from the disposal of Property C was capital in nature.

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**15**

- 5 (a) The provisions relating to the prosecution of, and the respective penalties for, a taxpayer who has committed an offence in understating or omitting the amount of chargeable income are contained in ss.80(2), 82 and 82A of the IRO.

Any person who, without reasonable excuse, makes an incorrect return by omitting or understating the taxable income is guilty of an offence (s.80(2)). If the CIR institutes proceedings, the court may impose a fine of \$10,000 plus treble the amount of tax that has, or would have been, undercharged as a result of the omission or understatement. The CIR may compound the offence (s.80(5)).

1

Where the taxpayer is suspected of having evaded tax with fraud and wilful intention, the CIR can prosecute him (s.82). Fraud and wilful evasion include:

- (1) an omission from a return;
- (2) a false entry or statement in a return;
- (3) a false statement in a claim for a deduction or allowance; and
- (4) signing a statement or return without reasonable grounds for believing that it is true.

2



Any person who is prosecuted for fraud and wilful evasion is guilty of a misdemeanour with the following maximum penalties:

- (1) On summary conviction: a fine of \$10,000, an additional fine of three times the tax that was, or would have been, underpaid, and imprisonment of six months.
- (2) On indictment: a fine of \$50,000, an additional fine of three times the tax that was, or would have been, underpaid, and imprisonment of three years.

2

There is an alternative penal section whereby the CIR or Deputy Commissioner of Inland Revenue (DCIR) may impose a penalty in the form of an additional tax on the amount of tax understated (s.82A) as a result of the taxpayer's non-compliance without a reasonable excuse. The maximum amount of additional tax is treble that of the amount of tax undercharged. Assessment to additional tax is only applicable if no proceedings have been instituted for making an incorrect return without reasonable excuse and the person has not been prosecuted for fraud or wilful evasion. If additional tax is raised, the taxpayer cannot be prosecuted on the same facts with an offence.

2

Before issuing an assessment to additional tax, the CIR or DCIR shall send a notice of intention to assess additional tax to the person concerned, and advise the person to submit written representation in respect of the offence for his consideration. The notice shall specify the offence in respect of which the additional tax is being assessed. After the CIR or DCIR issues the notice of additional tax under s.82A, the taxpayer, if he disagrees, may appeal against such notice to the Board of Review.

Bonus 1  
7

- (b) In *D31/85*, the Board of Review explained 'reasonable excuse' as follows: 'We consider that the correct test to be applied in determining reasonable excuse is what one would expect a reasonable person to do in all of the circumstances.'

1

Illiteracy and ignorance of the law are not acceptable defences in a criminal prosecution. Reliance on professional advice is a reasonable excuse (*BR 80/76*), but that reliance must be reasonable in the circumstances (*D28/84*). Reliance on the bookkeeper's belief that the profits from the sale of goods to customers in China might not be subject to profits tax hardly seems to be a reasonable reliance. If the bookkeeper and Mr Young considered there was doubt as to the tax position, full details should have been given in the return.

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**10**