Fundamentals Level – Skills Module

Taxation (Hong Kong)

Tuesday 6 December 2011

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 for 2009/10 and 2010/11 are to be used in answering the questions.

Allowances

	$
Basic allowance	108,000
Married person's allowance	216,000
Single parent allowance	108,000
Child allowance – 1st to 9th child (each)	50,000
– additional allowance in the year of birth (each)	50,000
Dependent parent/grandparent allowance – basic	15,000/30,000
– additional	15,000/30,000
Dependent brother/sister allowance	30,000
Disabled dependant allowance	60,000

Deductions

	$
Self-education expenses (maximum)	60,000
Home loan interest (maximum)	100,000
Elderly residential care expenses (maximum)	60,000
Mandatory provident fund contributions (maximum)	12,000

Tax rates

Salaries tax rates:	
First $40,000	2%
Next $40,000	7%
Next $40,000	12%
Remainder	17%
Standard rate	15%
Profits tax rate for corporations	16·5%

75% of salaries tax and tax under personal assessment for the year of assessment 2009/10 will be waived subject to a ceiling of $6,000.

Depreciation allowance rates

Initial allowance:		
Plant and machinery	60%	
Industrial buildings	20%	
Annual allowance:		
Computers	30%	
Motor cars	30%	
Furniture and fixtures	20%	
Machines	10%–30%	
Industrial buildings	4%	or formula
Commercial buildings	4%	or formula

ALL FIVE questions are compulsory and MUST be attempted

1 John Ellis is a British resident. On 1 April 2009, he was appointed as the Asian sales manager of Sun Ltd (Sun), a company carrying on business in London, and became responsible for sales promotion of Sun's products in the Asian region. His employment contract was negotiated and concluded in London, and his salary is paid directly into his bank account in London. John's travelling schedule for the year ended 31 March 2011 was as follows:

Hong Kong	140 days	
China	190 days	
Other Asian countries	10 days	
United Kingdom (UK)	25 days	(including 15 days annual leave)
	365 days	

In relation to the year ended 31 March 2011, John has the following income and expenditure (all amounts are denominated in Hong Kong dollars):

(1) Annual salary of $1,200,000.

(2) An entertainment allowance of $96,000.

(3) John lived in a hotel room during his stays in Hong Kong. Total hotel charges of $120,000 were paid by Sun, and 5% of these hotel charges would be deducted from John's salary.

(4) During the year, Sun received and paid the following tax bills in respect of John:

Hong Kong salaries tax	$30,000
China individual income tax	$50,000
Other Asian countries' income tax	$35,000

(5) John took a ten-day business trip to the UK and extended his stay for a further 15 days to visit his parents. Sun purchased a business class ticket for $28,000 for John, but he paid the airline company $4,000 to exchange the ticket for two economy class tickets. His wife travelled with him on one of the economy tickets and shared the hotel room with him at no extra charge. Sun approved this arrangement and paid the hotel room charges totalling $30,000 for the entire trip of 25 days.

(6) John joined the Hong Kong Business Club with effect from 1 December 2010. He paid an annual subscription of $12,000 and obtained a reimbursement of half of this amount from Sun. John often met with clients in the Club.

(7) On 1 February 2011, John was granted an option to acquire 50,000 shares in Moon Ltd (Moon), a Hong Kong subsidiary of Sun, at $5 each. He paid $5,000 for this option. On 1 March 2011, he sold the option in respect of 20,000 shares for $40,000; and exercised the option to take up 25,000 shares. The 25,000 shares were all sold on 20 March 2011. The fair market values per share were as follows:

1 February 2011	$7
1 March 2011	$8
20 March 2011	$9
31 March 2011	$10

(8) John made voluntary contributions totalling $18,000 to the recognised occupational retirement scheme maintained by Moon in Hong Kong.

Required:

(a) Compute the salaries tax payable by John Ellis for the year of assessment 2010/11.

Note: you should ignore provisional tax. (15 marks)

(b) John has learnt that interest incurred on a loan to acquire a residential property in Hong Kong can be deducted against his income. He is therefore thinking of buying a flat in Hong Kong for use as his place of residence, using one of the following options:

(1) John will enter into a mortgage loan with a Hong Kong bank at a market interest rate. Sun will pay John a monthly housing allowance in cash, and he will use all or part of the allowance for the monthly mortgage repayment.

(2) John will enter into a mortgage loan with a Hong Kong bank at a market interest rate. Moon, the Hong Kong subsidiary of Sun, will guarantee a maximum interest repayment of 2% per annum. Any excess interest charged by the bank above 2% will be subsidised by Moon by paying the difference into John's bank account each month.

(3) Moon will provide a low-interest mortgage loan to John. The interest rate will be fixed at 2% irrespective of the market rate.

Required:

(i) List the conditions necessary for the deduction of home loan interest for salaries tax purposes; and (3 marks)

(ii) Advise John Ellis of the different treatments of options (1) to (3) for salaries tax purposes. (7 marks)

(25 marks)

2 Hope Ltd (Hope), a Hong Kong incorporated company, carries on investment activities as well as consultancy business in Hong Kong and China. It only maintains an office in Hong Kong and has engaged a team of executives who are required to travel between Hong Kong and China. For the year ended 31 December 2010, Hope has the following trading results:

	Note	$	$
Income			
Consultancy fee	(1)	1,000,000	
Property rental income	(2)	2,000,000	
Profit from sale of property	(3)	5,700,000	
Profit from sale of securities	(4)	1,460,000	
Dividend from securities	(4)	800,000	
Interest income	(5)	300,000	
Currency trading gain	(6)	240,000	11,500,000
Expenses			
Directors' fees		3,150,000	
Staff costs	(7)	5,200,000	
Travelling and entertainment			
– Hong Kong		500,000	
– China		400,000	
Office rent and rates – Hong Kong		1,600,000	
Depreciation	(8)	1,060,000	
Loss on asset disposal	(8)	20,000	
Legal and professional fees	(9)	90,000	
Interest expenses	(10)	88,000	
Insurance		40,000	
Office consumables		63,000	
Donations	(11)	100,000	(12,311,000)
Loss for the year			(811,000)

Notes:

(1) Included in the consultancy fee of $1,000,000 was a billing of $400,000, derived from services rendered by the executives during their business trips in China.

(2) Hope owned and leased the following properties located in Hong Kong:

(i) Property A had been acquired in January 2000 from a property developer at a cost of $15,000,000 (land value excluded), 50% of which was funded by a bank mortgage loan. The property has been leased out since 1 April 2000. On 1 November 2010, Hope sold the property for $16,000,000 (land value excluded). The total rental income earned during the year was $600,000.

(ii) Property B was acquired in January 2010 from a property developer at a cost of $50,000,000 (land value excluded). It was leased out and total rental income earned during the year was $1,400,000.

(3) Hope disposed of the following properties during the year (land value excluded):

	Cost	Depreciation	Net book value	Proceeds	Profit
	$	$	$	$	$
Property A	15,000,000	2,700,000	12,300,000	16,000,000	3,700,000
Property C	6,000,000	–	–	8,000,000	2,000,000

Property C was acquired on 1 May 2010 from a property developer and subsequently sold at the market price of $8,000,000.

(4) Hope was involved in holding and trading in listed securities in Hong Kong and China. Investment returns earned during the year are:

	$
Profit from securities trading on the HK Stock Exchange	2,000,000
Loss from securities trading on the China Stock Exchange	(540,000)
Dividends from securities listed in HK	700,000
Dividends from securities listed in China	100,000

(5) Interest income includes the following:

	$
Interest on HK$ deposit with a bank in Hong Kong	50,000
Interest on A$ deposit with a bank in Hong Kong	100,000
Interest on NZ$ deposit with a bank in Hong Kong	80,000
Interest on RMB deposit with a bank in Hong Kong	50,000
Interest on RMB deposit with a bank in China	18,000
Tax Reserve Certificates bought from HKSAR government	2,000
Total per accounts	300,000

(6) During the year, Hope made a net profit of $240,000 from the buying and selling of foreign currencies, including A$ (profit $80,000), NZ$ (profit $460,000), Euro (loss $300,000). The entire fund used for foreign currency trading was sourced from Hope's bank overdraft line.

(7) Staff costs include the following:

	$
Salaries and allowances	4,700,000
Accommodation (20% in China)	400,000
Severance payment (per Employment Ordinance)	100,000
Total per accounts	5,200,000

(8) The depreciation charge for the year was determined as follows:

	Building	Furniture/ fixtures	Computer	Motor vehicle
	$	$	$	$
Cost at 1 January 2010	15,000,000	150,000	80,000	220,000
Additions	50,000,000	40,000	80,000	20,000
Disposals	(15,000,000)	(35,000)	(40,000)	0
Balance at 31 December 2010	50,000,000	155,000	120,000	240,000
Depreciation at 1 January 2010	2,700,000	45,000	40,000	60,000
Charge for the year	1,000,000	15,000	25,000	20,000
Disposals	(2,700,000)	(10,000)	(20,000)	0
Balance at 31 December 2010	1,000,000	50,000	45,000	80,000
Net book value at 31 December 2010	49,000,000	105,000	75,000	160,000
Net book value of disposal	12,300,000	25,000	20,000	
Proceeds from disposal	16,000,000	5,000	20,000	
Profit/(loss) on disposal	3,700,000	(20,000)	0	

Additional information:

(i) The additions of buildings relate to Property B and disposals of buildings relate to Property A.

(ii) All the additions to furniture/fixtures qualify for a 20% annual allowance.

(iii) Two computers, costing $40,000 each, were purchased during the year. One of these two computers was acquired under hire purchase. The hire purchase agreement required Hope to make a down payment of $7,000 at the time of the initial purchase of this computer, followed by monthly instalments of $6,000 each for six months from 1 November 2010.

(iv) The full cost of the computer disposed of in the year had been fully deducted in the tax return filed in the year of purchase.

(9) Legal and professional fees include:

	$
Audit and accountancy fees	80,000
Legal fees for new office lease	4,000
Legal fees for staff quarters lease renewal	6,000
Total per accounts	90,000

(10) Interest expenses include:

	$
Hire purchase finance charge on computer	1,000
Interest on a loan from a company director to finance the renovation of the staff quarters	5,000
Interest on bank mortgage loan	70,000
Interest on bank overdraft line	12,000
Total per accounts	88,000

The bank mortgage loan and the bank overdraft facility were secured by the properties held by Hope and the directors' personal guarantee.

(11) Hope made donations, totalling $100,000, to the Community Chest.

(12) Hope has been filing its Hong Kong profits tax return on the basis that all of its income is subject to Hong Kong profits tax. The tax written down values brought forward from the previous year in respect of fixed assets are:

10% – nil
20% – $50,000
30% – $60,000

Required:

(a) Compute Hope Ltd's Hong Kong profits tax liability in respect of the year ended 31 December 2010. Show all your workings, including the hire purchase depreciation allowance calculation. Clearly identify both the year of assessment and the basis period.

Notes:
(1) You should ignore provisional tax and overseas tax.
(2) No detailed explanations are required in this part. (20 marks)

(b) Give explanations to illustrate the correct tax treatment, including the underlying reasoning in respect of:

(i) the profit from securities trading; (3 marks)

(ii) the donations made to the Community Chest; and (3 marks)

(iii) the bank interest cost (mortgage loan and overdraft facility). (4 marks)

(30 marks)

3 Mr Li runs a sole proprietorship business in Hong Kong. For the year ended 31 March 2011, the business recorded the following income and expenditure:

	$
Service fee collected	333,000
Bank loan interest (half of total $200,000)	(100,000)
Office utilities	(20,000)
Drawings	(90,000)
Wages to staff	(48,000)
Charitable donations in cash to Hong Kong Red Cross	(70,000)
Net profit	5,000

The office is owned by Mr Li in his own name. He leased half of the office space for rent under a term of two years, commencing on 1 April 2009. The monthly rent is $10,000, payable in advance and it was agreed that the rates and property management fee are to be for the account of the tenant. During the year ended 31 March 2011, Mr Li paid a total of $200,000 as interest on the bank mortgage loan obtained to finance the purchase of the office.

Mr Li's wife is a registered nurse at a private hospital. During the year ended 31 March 2011, Mrs Li's total income from employment was $670,000; and she made a contribution of $18,000 to the mandatory provident fund (MPF).

Three years ago, Mrs Li commenced a partnership business with her sister, June, to trade in second-hand clinical equipment. They agreed to share the profits and losses equally. During the year ended 31 March 2010, the partnership made a tax loss; Mrs Li's share of this partnership tax loss is $44,000 and June's share of this partnership tax loss is $33,000. For the year ended 31 March 2011, the partnership had the following trading results:

	$
Gross profit	220,000
Rent and rates	(130,000)
MPF contributions for Mrs Li	(10,000)
MPF contributions for June	(12,000)
Salary to Mrs Li	(50,000)
Salary to June	(80,000)
Other allowable expenses	(18,000)
Net loss	(80,000)

Required:

(a) Compute the total tax payable by Mr and Mrs Li for the year of assessment 2010/11, assuming that no personal assessment is elected. (8 marks)

(b) Compute the assessable profit/adjusted loss, the allocation of profit/loss and the tax payable by the partnership, if any, for the year of assessment 2010/11, assuming that no personal assessment is elected. Clearly identify the applicable basis period. (5 marks)

(c) Compute the tax payable by Mr and Mrs Li for the year of assessment 2010/11 under personal assessment and advise whether or not an election for personal assessment would be advantageous for them. (7 marks)

(20 marks)

4 First Real Estate Ltd (FREL) carries on a real estate agency business in Hong Kong. Its accounts for the year ended 30 September 2011 contain the following properties:

(1) Property A, a commercial unit in Central. Half of Property A is occupied by FREL as its office, and is shown as a 'non-current asset'; the other half is let out for rental income, and is shown as an 'investment property'.

(2) Property B, a residential unit in Causeway. Property B had been acquired in June 2010, and shown as a 'property held for resale' in the accounts for the year ended 30 September 2010. Starting from 1 January 2011, Property B was occupied by a director of FREL; and was reclassified and shown as a 'non-current asset'.

(3) Property C, a residential unit in Kowloon Tong. Property C was acquired in April 2011, and sold in August 2011 at a profit of $300,000.

Required:

(a) In respect of the rental income from Property A, explain First Real Estate Ltd's overall tax positions in relation to profits tax and property tax. (4 marks)

(b) Advise First Real Estate Ltd on any profits tax implications arising from the consequence of Property B being occupied by one of its directors. (5 marks)

(c) Advise First Real Estate Ltd on whether or not the profit from the sale of Property C will be taxable. (6 marks)

(15 marks)

5 Mr Young is the sole owner of a trading company in Hong Kong. The company purchases goods in Hong Kong and sells them to customers in Hong Kong and China. In a recent field audit, the officers from the Inland Revenue Department (IRD) found that Mr Young had not included the profits from the sale of goods to customers in China in his tax returns submitted to the IRD.

Mr Young told the IRD officers that he was illiterate and he relied on his bookkeeper for all accounting and tax matters. His bookkeeper explained that he did not include the profits from the sale of goods to customers in China as he thought that the profits might be offshore and not taxable.

Required:

(a) Explain the power of the Commissioner under the Inland Revenue Ordinance to penalise a taxpayer for understating her/his taxable profits, together with the respective penalties. (7 marks)

(b) Advise Mr Young what constitutes a 'reasonable excuse' and whether he has a reasonable excuse for omitting the profits from the sale of goods to customers in China. (3 marks)

(10 marks)

End of Question Paper