
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.

| | | <i>Marks</i> |
|--|---|--------------|
| 1 (a) | Roger's salaries tax computation for 2010/11 | |
| | \$ | |
| Salary | 600,000 | 0·5 |
| Housing allowance (15,000*12) | 180,000 | 0·5 |
| Cash prize | 5,000 | 0·5 |
| Overtime pay related back From 1 April 2010 to 31 March 2011 (36,000*12/36) | 12,000 | 1 |
| Balancing charge (see working) | <u>2,600</u> | 0·5 |
| Net assessable income | 799,600 | |
| Concessionary deductions | | |
| Provident fund contributions (maximum) | <u>(12,000)</u> | 1 |
| | 787,600 | |
| Part V allowances | | |
| Basic allowance | (108,000) | 0·5 |
| Child allowance | <u>(50,000)</u> | 0·5 |
| Net chargeable income | <u>629,600</u> | |
| Tax payable at progressive rates | <u>95,032</u> | 0·5 |
| Tax payable at standard rate (\$787,600*15% = \$118,140) is not applicable | | 0·5 |
| Working: Depreciation allowance schedule | | |
| | \$ | |
| 2009/10 | | |
| Cost | 20,000 | 0·5 |
| Initial allowance (60%) | <u>(12,000)</u> | 0·5 |
| | 8,000 | |
| Annual allowance (20%) | <u>(1,600)</u> | 0·5 |
| Written down value | 6,400 | |
| 2010/11 | | |
| Sales proceeds | <u>(9,000)</u> | 0·5 |
| Balancing charge | <u>2,600</u> | |
| Rebecca's salaries tax computation for 2010/11 | | |
| | \$ | |
| Salary | 120,000 | 0·5 |
| Self-education expenses | <u>(12,000)</u> | 0·5 |
| Net assessable income | 108,000 | |
| Concessionary deductions | | |
| Mandatory provident fund contributions (maximum) | <u>(6,000)</u> | 1 |
| | 102,000 | |
| Part V allowances | | |
| Basic allowance | (108,000) | 0·5 |
| Net chargeable income | <u>Nil</u> | |
| Tax payable at progressive rates | <u>Nil</u> | 0·5 |
| | | <u>11</u> |

(b) Brief explanations of the tax treatment:

Item:

- | | |
|--|-----------|
| (2) Roger's employment is a Hong Kong employment. Unless Roger renders all his services outside Hong Kong in a year of assessment [s.8(1A)(b)] or pays individual income tax in respect of his portion of employment income attributable to the services rendered in China [s.8(1A)(c)], all of his employment income will be subject to salaries tax. Therefore, the exemptions [under s.8(1A)(b) and (c)] are not applicable to Roger's case. | 1.5 |
| (3) The housing allowance is a cash allowance taxable in full. The exemption to exclude rent paid or refunded by the employer [s.9(1A)(a)] does not apply even though part of the allowance was actually used to pay for rent [D62/92]. On the other hand, the rent paid by Roger, being a private expense, is not deductible. | 1.5 |
| (4) The medical benefit is exempt as the liability is that of the employer. The contract was made between the employer and the doctor, so the employer was discharging its own liability. | 1 |
| (5) The cash prize for being the best teacher was received for his services and is, thus, taxable [<i>Hochstrasser v Mayers</i>]. | 1 |
| (6) The lump sum was paid as compensation for his early retirement. It is likely to be exempt as not being income derived from the employment [<i>Clayton v Lavender</i>]. However, further details are needed to determine its taxability, e.g. if the contract of employment provides for any compensation for early termination of contract or retirement, the lump sum could be taxable. | 1.5 |
| A lump sum payment upon retirement from a recognised occupational retirement scheme is exempt [s.8(2)(c)]. | 0.5 |
| (7) The value of the retirement gift is exempt as a voluntary gift for a personal relationship, being given in consideration of the students' affection towards Roger, and not because of the services rendered by him as a teacher [<i>Reed v Seymour</i>]. | 1 |
| (8) The payment for overtime received after Roger ceased his employment is deemed to have accrued to Roger on the last day of his employment [s.11D(b) proviso (ii)]. A lump sum payment paid upon termination of employment can be related back at a constant rate over a maximum period of three years ending on the last day of employment. The application must be made in writing within two years of the end of the year of assessment 2010/11 [s.11D(b) proviso (i)]. | 1.5 |
| (10) The self-education expense (half of the tuition fee) is deductible as the course is offered by a university and is an approved course [s.12(6)]. Reimbursement of a deductible expense (half of the tuition fee) is not taxable. | 1 |
| (11) Although his younger son was studying full-time, he is married and therefore Roger is not entitled to any child allowance. Since Rebecca's income is below her basic allowance, the child allowance in respect of the elder son should be claimed by Roger. | 1.5 |
| | <u>12</u> |

(c) Roger and Rebecca's salaries tax computation under joint assessment
Year of assessment 2010/11

| | | |
|---|-----------|-----|
| | \$ | |
| Aggregate net assessable income (799,600 + 108,000) | 907,600 | |
| Concessionary deduction | | |
| Provident fund contributions (maximum) | (18,000) | |
| | 889,600 | 0.5 |
| Part V allowance | | |
| Married person's allowance | (216,000) | |
| Child allowance | (50,000) | |
| Aggregate net chargeable income | 623,600 | 0.5 |
| Tax payable at progressive rates | 94,012 | 0.5 |
| Total tax payable under separate taxation | 95,032 | |

Conclusion: Roger and Rebecca should elect for joint assessment as this will reduce their aggregate salaries tax liabilities by \$1,020 (\$95,032 – \$94,012).

Alternatively, the tax saving can be calculated by applying the applicable progressive rate to the unused basic allowance of Rebecca = (\$108,000 – \$102,000)*17% = \$1,020.

Marks

0.5

2

25

2 (a)

Computation of partnership's assessable profit

| Year ended 31 December | 2009 | 2008 | |
|------------------------------------|----------------|------------------|-----|
| | \$ | \$ | |
| Profit/(loss) per account | 374,500 | (231,000) | 0.5 |
| Salaries to partner | 95,000 | 130,000 | 0.5 |
| Depreciation | 18,000 | 14,000 | 0.5 |
| | <u>487,500</u> | <u>(87,000)</u> | |
| Depreciation allowance | (58,000) | (42,000) | 0.5 |
| Assessable profits/(Adjusted loss) | <u>429,500</u> | <u>(129,000)</u> | |

Partnership allocation
Year of assessment 2008/09

| | Andy | Bobbie | Champion | Total | |
|-----------------------------|-------------|---------------|-----------------|--------------|-----|
| | \$ | \$ | \$ | \$ | |
| Salaries | 60,000 | 70,000 | – | 130,000 | 0.5 |
| Balance (2:1:2) | (103,600) | (51,800) | (103,600) | (259,000) | 0.5 |
| Share of profit/(loss) | (43,600) | 18,200 | (103,600) | (129,000) | |
| Reallocation of profit | 5,391 | (18,200) | 12,809 | – | 0.5 |
| Adjusted loss | (38,209) | – | (90,791) | (129,000) | |
| Loss transferred [s.19C(5)] | – | – | 80,000 | 80,000 | 0.5 |
| Loss carried forward | (38,209) | Nil | (10,791) | (49,000) | 0.5 |
| Profits tax payable | | | | Nil | 0.5 |

Year of assessment 2009/10

1 January 2009 to 30 June 2009 (\$429,500 x 6/12 = \$214,750) 0.5

| | Andy | Bobbie | Champion | Total | |
|--------------------|---------------|---------------|-----------------|----------------|-----|
| | \$ | \$ | \$ | \$ | |
| Salaries | 30,000 | 35,000 | – | 65,000 | 0.5 |
| Balance (2:1:2) | 59,900 | 29,950 | 59,900 | 149,750 | 0.5 |
| Assessable profits | <u>89,900</u> | <u>64,950</u> | <u>59,900</u> | <u>214,750</u> | |

1 July 2009 to 31 December 2009 (\$429,500 x 6/12 = \$214,750)

| | Andy | Champion | Total | |
|--------------------|----------------|-----------------|----------------|-----|
| | \$ | \$ | \$ | |
| Salaries | 30,000 | – | 30,000 | 0.5 |
| Balance (1:1) | 92,375 | 92,375 | 184,750 | 0.5 |
| Assessable profits | <u>122,375</u> | <u>92,375</u> | <u>214,750</u> | |

Total allocation for 1 January 2009 to 31 December 2009

| | Andy \$ | Bobbie \$ | Champion \$ | Total \$ | |
|------------------------------------|------------|--------------|----------------|-------------|-----------|
| Share of profit | 212,275 | 64,950 | 152,275 | 429,500 | |
| Loss brought forward | (38,209) | – | (10,791) | (49,000) | 0.5 |
| Transferred to personal assessment | – | (64,950) | – | (64,950) | 0.5 |
| Loss set-off [s.19C(4)] | – | – | (120,000) | (120,000) | 0.5 |
| Net assessable profits | 174,066 | – | 21,484 | 195,550 | |
| Tax payable at 15%/16.5% | 26,109 | – | 3,545 | 29,654 | 1.0 |
| | | | | | <u>10</u> |

(b) Legal and professional fees

It will be necessary to obtain a breakdown of the legal and professional fees. Legal expenses of a revenue nature incurred in the course of business would normally be allowed. Legal expenses of a capital nature, particularly in the case of the formation of the company and the purchase of fixed assets, are not allowable deductions. However, legal fees in connection with the borrowing of money used for the purpose of producing chargeable profits are specifically allowed [s.16(1)(a)].

2

Scientific research

Care should be taken to ensure that:

- (1) The expenditure is incurred on any activities in the fields of natural or applied science for the extension of knowledge; and any systematic, investigative or experimental activities in respect of any feasibility study, or any market, business or management research.
- (2) The scientific research is related to the taxpayer's trade or class of trade.

0.5

0.5

Capital expenditure on plant and machinery which is required for scientific research is deductible in full, but no deduction is allowed for capital expenditure on land or buildings (depreciation allowance may be granted).

1

Technical education

It should be ensured that the charge represents a payment to be used for technical education related to the trade of the taxpayer, and that it is used at any university, university college or other similar educational institution wherever situated, which has been approved by the Director of Education in writing. It is important to note that the technical education concerned must be of a kind which is especially required for persons employed in the class of trade to which the taxpayer's trade belongs [s.16C(1)].

2

6

(c)

ToyStory Ltd

Profits tax computation for the year of assessment 2010/11

Basis period: year ended 31 December 2010

0.5

| | \$ | \$ | |
|---|---------|------------------|-----|
| Profit per accounts | | 191,000 | 0.5 |
| Add: Exchange loss | 40,000 | | 0.5 |
| Payment to retired staff member | 100,000 | | 0.5 |
| Depreciation | 30,000 | 170,000 | 0.5 |
| | | <u>361,000</u> | |
| Less: Interest income (20,000 + 26,000) | 46,000 | | 0.5 |
| Prescribed fixed asset | 100,000 | | 1 |
| Depreciation allowance | 375,600 | (521,600) | 0.5 |
| Adjusted loss | | <u>(160,600)</u> | |
| Profits tax payable | | <u>Nil</u> | 0.5 |

| | Depreciation allowance schedule for 2010/11 | | | Marks |
|------------------------------------|---|-----------|----------|-------|
| | 20% | HP – 30% | Total DA | |
| | \$ | \$ | \$ | |
| Cost | 150,000 | 450,000 | | 0.5 |
| IA (60%) | (90,000) | | 90,000 | 0.5 |
| | | (198,000) | 198,000 | 1 |
| | 60,000 | 252,000 | | |
| Annual allowance | (12,000) | (75,600) | 87,600 | 1 |
| Written down value carried forward | 48,000 | 176,400 | 375,600 | 8 |

(d) Interest income

The Exemption Order issued under s.87 exempts from profits tax all interest accrued on deposits with financial institutions in Hong Kong. Therefore, the interest would be exempt from profits tax. 1

The interest earned on money placed on deposit with a bank in Singapore is considered to be offshore, i.e. not derived from Hong Kong [s.15(1)(g)]. Hence, the interest is not taxable. 1

Compensation received

The compensation received is revenue in nature as it represents compensation for the loss of a trading contract, the income from which is revenue in nature. 1

Exchange loss

Though the source of the deposit came from trading receipts, the placing of it as a time deposit changed the nature of the receipt from revenue to capital. Hence, the subsequent exchange loss is capital in nature and disallowed [s.17(1)(c)]. 1

Tutorial note: *this principle is well supported in the Li & Fung case.*

Compensation payment

A payment to induce an unsatisfactory director to leave is one made in the ordinary course of business dealing with ongoing personal matters. It therefore qualifies for deduction, notwithstanding its non-recurrent nature [*Mitchell v Noble*]. 1

However, compensation payment made to a leaving staff member in return for a promise not to compete in the same field brings an enduring benefit to the company. The lump sum is therefore capital in nature and disallowed [s.17(1)(c)]. 1

6

30

3 (a) The following conditions must be satisfied before personal assessment can be elected:

- (1) The taxpayer is 18 years of age or over (or if under 18, both parents are deceased). 1
- (2) The taxpayer is a permanent or temporary resident in Hong Kong, or his or her spouse is a permanent or temporary resident. 1
- (3) In the case of a husband and wife, both must elect for personal assessment as the personal assessment scheme does not allow for a husband and wife to be assessed separately. 1
- (4) The election must be made in writing and lodged with the Commissioner within two years after the year of assessment for which the election is made ends, or within one month after an assessment of income or profits forming part of the taxpayer's total income for the relevant year of assessment becomes final and conclusive, whichever is later. 2

5

| | | | | Marks |
|---|----------|--|---------------|-----------|
| (b) | | Personal assessment computation for Mr and Mrs Siu Year of assessment 2010/11 | | |
| | | Mr Siu \$ | Mrs Siu \$ | |
| Assessable profits | \$ | | | |
| Profits from sole proprietorship business | 166,000 | | | 0.5 |
| Approved charitable donations (ACD) 35% | (58,100) | 107,900 | | 1 |
| Share of partnership profits | 92,000 | | | 0.5 |
| ACD (35%) | (32,200) | | 59,800 | 1 |
| Net assessable income | | | | |
| Director's fee | | 120,000 | | 0.5 |
| Salary | | | 300,000 | 0.5 |
| Net assessable value (NAV) | | | | |
| Rental received (15,000*10) | 150,000 | | | 0.5 |
| Premium (180,000*10/24) | 75,000 | | | 1 |
| | 225,000 | | | |
| 20% statutory deduction | (45,000) | 180,000 | | 0.5 |
| | | 407,900 | 359,800 | |
| Less: Mortgage interest (restricted to NAV) | | (46,000) | | 1 |
| ACD | | | | |
| (407,900 + 58,100 – 46,000)*35% – 58,100 | | (88,900) | | 1 |
| (80,000 – 32,200) | | | (47,800) | 1 |
| Unabsorbed ACD transferred from spouse, limited to (359,800 + 32,200)*35% – 80,000 | | | (57,200) | 1 |
| Share of partnership loss | | (48,000) | | 0.5 |
| Loss from property dealing business | | (36,000) | | 0.5 |
| Unabsorbed partnership loss brought forward | | | (76,000) | 0.5 |
| Reduced total income | | 189,000 | 178,800 | |
| Joint total income | | | 367,800 | 0.5 |
| Less: Married person's allowance | | 216,000 | | 0.5 |
| Child allowance | | 100,000 | | 0.5 |
| Dependent parent allowance | | 30,000 | (346,000) | 0.5 |
| Net chargeable income | | | 21,800 | |
| Tax payable at progressive rates | | | 436 | 0.5 |
| By Mr Siu $\$436 \times 189,000 / 367,800$ | | | 224 | 0.5 |
| By Mrs Siu $\$436 \times 178,800 / 367,800$ | | | 212 | 0.5 |
| | | | | 15 |
| | | | | 20 |

4 (a) In relation to his employment in Hong Kong, David has the following obligations under the IRO:

(1) Notification of chargeability to tax

A person who is liable to tax for any year of assessment is required to inform the Commissioner in writing that he is chargeable to tax not later than four months after the end of the basis period of that year of assessment, unless he is already required to furnish a return [s.51(2)].

1

As David started work in February 2009 with a monthly salary of \$70,000, he is liable to salaries tax for the year of assessment 2008/09. So he should have informed the Commissioner in writing not later than 31 July 2009 that he was chargeable to salaries tax for that year if he did not receive any tax return.

1

(2) Submission of tax return

If David has received a tax return issued to him, he is required to submit the return within the time specified in the return (normally one month).

1

(3) Notification of cessation of income

Every person whose source of chargeable income ceases is required to inform the Commissioner in writing within one month of the cessation of income [s.51(6)].

1

(4) Notification of departure from Hong Kong

A person chargeable to tax and who is about to leave Hong Kong for a period of over one month (except for business purposes) is required to inform the Commissioner in writing of his expected date of departure not later than one month before the expected date of departure.

1

As David tendered his resignation and left Hong Kong on 25 May 2010, he should have informed the Commissioner of his cessation of income and departure from Hong Kong.

1

6

(b) An assessor can issue an estimated assessment under the following circumstances:

- (1) The returns are not furnished but the assessor thinks that the taxpayer is chargeable to tax under the IRO [s.59(3)]

If a taxpayer fails to file the required return after the expiry of the specified period and the assessor is of the opinion that such person is chargeable to tax, he may estimate an assessment.

1

- (2) The returned profits furnished by the taxpayer are not accepted [s.59(2)]

Such a return may be considered insufficient to establish the tax payable based on the information given or the assessor may be in disagreement with certain aspects of the tax return. The assessor may then make an estimate based on the information available or by reference to his/her past experience or according to the results of similar taxpayers.

2

- (3) The assessor finds that business accounts or books have not been satisfactorily kept [s.59(4)]

When the assessor is of the opinion that the accounts or books maintained by a trade or business are inadequate such that the tax returns are unreliable, the assessor may assess the profits or income of such trade or business on the basis of the usual rate of net profit on turnover of such trade or business. The usual rate of net profit on turnover may be that prescribed by the Board of Inland Revenue for particular classes of trade or business or an estimated rate as thought fit by the assessor.

2

5

- (c) David Brown is able to hold over the provisional salaries tax in respect of 2010/11 if it is anticipated that his assessable income for 2010/11 will be, or is likely to be, less than 90% of the amount assessed to provisional tax. This may be as a result of his unemployment since 25 May 2010. The application for holdover must be made in writing and lodged with the Commissioner 28 days before the due date, i.e. 18 December 2010.

2

If no holdover of provisional salaries tax is made, David is required to pay the tax as required at the amount demanded on the date specified. However, should it ultimately be determined that his 2010/11 salaries tax liability is lower, any excess provisional salaries tax paid would be offset against the provisional salaries tax payable for 2011/12 (if any) and any remaining excess will be refunded.

2

4

15

- 5 (a) Under s.14(1) of the IRO, every person is chargeable to profits tax if that person carries on a trade, profession or business in Hong Kong and the profits from that trade, profession or business (excluding profits from the sale of capital assets) are arising in or derived from Hong Kong.

1

Generally speaking, a business is regarded as being carried on in Hong Kong if the central management and control of the business is located in Hong Kong. This is usually so determined if the board of directors meets and makes business decisions in Hong Kong [*De Beers* case and *Koitaki Para Rubber Estates* case].

1

However, it has also been held that the place of placing bank deposits and keeping accounting records would also be taken into account in determining the place where the business is being carried on [*Bartica Investment* case].

Bonus

1

In the case of O/S Ltd, the question does not give enough information as to whether the company's central management and control is being exercised in Hong Kong, e.g., whether the directors' meetings are held in Hong Kong. If O/S Ltd is regarded as carrying on a business in Hong Kong, it will be subject to Hong Kong profits tax if the profits are arising in or derived from Hong Kong. In the case of O/S Ltd, profits are earned from the sale and purchase of products. Based on the *Hang Seng Bank* case and DIPN No. 21 (Revised 2009), the source of a trading profit is determined by the place(s) where the sale and purchase contracts are 'effected'. 'Effected' cannot mean legally executed; and the IRD agrees with the approach in the *Magna* case that this will contemplate all the relevant operations carried out to earn the profits, including the solicitation of orders, negotiation, conclusion, trade financing, shipment and performance of the contracts.

2

Marks

Based on the information provided, the sales contracts are negotiated and concluded by HK Ltd in Hong Kong as an agent of O/S Ltd. Although the question does not give enough details about the purchase arrangements, the position of the IRD as per DIPN No. 21 is that the profits from a trading transaction would be taxable if either the sale or purchase contract is effected in Hong Kong. As a result, if O/S Ltd is regarded as carrying on a business in Hong Kong it is likely to be taxed in Hong Kong in respect of 100% of the profits arising from the trading transactions conducted in Hong Kong.

2
6

- (b) HK Ltd is incorporated and carrying on business in Hong Kong. It will be subject to profits tax in Hong Kong in respect of its profits arising in or derived from Hong Kong. The source of the profits is determined by the nature of the profits earned and the general principle derived from the *Hang Seng Bank* case is that 'one looks to see what the taxpayer has done to earn the profit in question and where he has done it'.

1.5

In HK Ltd's case, it earns an agency fee from O/S Ltd in compensation for its agency services rendered. In ascertaining whether or not the agency fee is sourced in Hong Kong, the critical factor is to determine whether or not the services that give rise to the fee income are rendered in Hong Kong. Based on the information given in the question, HK Ltd provides all the services in Hong Kong. As a result, the agency fee income would be taxable in Hong Kong.

1.5
3

- (c) Based on the question, the sales transaction with the customer in Taiwan was being carried out in Taiwan, including the negotiation and conclusion of the contract.

In the context of HK Ltd which earns an agency fee which is in the nature of service income, if it can prove to the satisfaction of the IRD that the services of its Sales Director were rendered in Taiwan, the portion of the agency fee attributable to the contribution made by the Sales Director may be regarded as not sourced in Hong Kong and thus not taxable in Hong Kong.

1
10