

Fundamentals Level – Skills Module

Taxation (Hong Kong)

Tuesday 4 June 2013



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	
	2011/12	2012/13
	\$	\$
Basic allowance	108,000	120,000
Married person's allowance	216,000	240,000
Single parent allowance	108,000	120,000
Child allowance – 1st to 9th child (each)	60,000	63,000
– additional allowance in the year of birth (each)	60,000	63,000
Dependent parent/grandparent allowance – basic	18,000/36,000	19,000/38,000
– additional	18,000/36,000	19,000/38,000
Dependent brother/sister allowance	30,000	33,000
Disabled dependant allowance	60,000	66,000

	Deductions	
	\$	\$
Self-education expenses (maximum)	60,000	60,000
Home loan interest (maximum)	100,000	100,000
Elderly residential care expenses (maximum)	72,000	76,000
Mandatory provident fund contributions (maximum)	12,000	14,500

Tax rates (for both 2011/12 and 2012/13)

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%

Depreciation allowance rates (for both 2011/12 and 2012/13)

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

**This is a blank page.
Question 1 begins on page 4.**

ALL FIVE questions are compulsory and MUST be attempted

- 1 Eric Johnson, an American resident, is employed by Golden Inc (Golden), a multinational corporation based in the United States (US). According to his employment contract, which is enforceable in the US, Eric's duties are performed exclusively to oversee and supervise operations of various affiliated companies of Golden in the Far East region. However, for convenience sake, Eric performs most of his work in Hong Kong and Golden paid \$25,000 to purchase an air ticket for Eric to relocate him to Hong Kong.

Eric arrived in Hong Kong on 30 March 2011 and reported for duty to Silver Ltd (Silver), a subsidiary of Golden in Hong Kong which is listed on the Hong Kong Stock Exchange, on 1 April 2011. Eric's salary is paid in US dollars into his bank account in the US. It is Golden's policy to allocate 50% of Eric's salary to Silver. Silver also provided Eric with a flat in Hong Kong up to 31 July 2012; and \$3,000 was deducted from Eric's salary each month as rent.

Following a reorganisation of the management of Silver on 1 April 2012, Eric was appointed a director by Silver's board. However, Eric has not attended any of Silver's board meetings.

The following information in respect of Eric is available:

- (1) Eric's travelling schedule for the years 2011/12 and 2012/13 shows the following visits:

	1 April 2011 to 31 March 2012	1 April 2012 to 31 March 2013
Hong Kong	219	210
US (including 15 days leave)	–	25
China	67	80
Other Asian countries	80	50
Total	<u>366 days</u>	<u>365 days</u>

- (2) The following sums were received:

	1 April 2011 to 31 March 2012	1 April 2012 to 31 March 2013
From Golden:		
Salary	\$1,300,000	\$1,600,000
From Silver:		
Directors' fees	–	\$30,000

- (3) On 1 August 2012, Eric moved into a flat in Hong Kong which he had purchased at a price of \$4 million, and mortgaged it to a bank for \$3 million. The balance of the purchase price, \$1 million, was funded by a staff loan obtained from Golden at a below-market interest rate. During the year ended 31 March 2013, Eric paid interest of \$120,000 to the bank and \$12,000 to Golden. If a market interest rate had been charged by Golden, his interest cost would have been \$25,000.
- (4) On becoming a director of Silver, Eric was granted an option to buy 50,000 shares in Silver. He paid a nominal amount of \$5,000 for the option, which is transferable, but is valid only up to the end of June 2013. On 1 February 2013, Eric sold the option to buy 10,000 shares for \$48,000 and exercised the option to take up 30,000 shares for \$45,000. The 30,000 shares were all sold on 15 March 2013. The fair market values per share were as follows:

1 January 2012	\$5
1 February 2013	\$7
15 March 2013	\$10
31 March 2013	\$9

- (5) Eric contributed \$12,000 to the mandatory provident fund in the year 2011/12 and \$14,500 in the year 2012/13.

All currency amounts are given in Hong Kong dollars.

Required:

- (a) For Hong Kong salaries tax purposes, explain the factors used in determining the source of income from employment and from office. (6 marks)
- (b) Advise Eric Johnson as to the extent to which he is liable to Hong Kong salaries tax for each of the years of assessment 2011/12 and 2012/13. (5 marks)
- (c) Calculate the Hong Kong salaries tax payable by Eric Johnson, if any, for each of the years of assessment 2011/12 and 2012/13.

Notes:

- (1) You should ignore provisional taxes.
- (2) No written explanations are required. (14 marks)

(25 marks)

- 2 International Intelligence Ltd (IIL) is a Hong Kong incorporated company carrying on a trading business in Hong Kong in baby safety products. IIL develops its new products in its own brands and sub-contracts the manufacturing process to a factory located in Mainland China (China factory). All patents and trademarks are registered by IIL in Hong Kong. IIL operates nine sales outlets in Hong Kong and one sales outlet in Mainland China for its own products.

IIL makes up its accounts to 31 March. The following is IIL's income statement for the year ended 31 March 2013:

	Notes	\$	\$
Sales – Hong Kong outlets	(1)		14,000,000
– China outlet			1,000,000
Cost of sales	(1)		(6,422,000)
Gross profit			8,578,000
Interest income	(2)	122,000	
Commission income	(3)	430,000	
Compensation	(4)	200,000	
Profit on the disposal of fixed assets	(13)	2,000	
Sundry income	(5)	740,000	1,494,000
			10,072,000
Salaries and wages	(6)	1,800,000	
Rent and rates	(7)	3,550,000	
Directors' fees		220,000	
Travelling and entertainment expenses	(8)	280,000	
Donations	(9)	260,000	
Legal and professional fees	(10)	962,000	
Depreciation	(11)	1,060,000	
Interest expense	(12)	110,000	
Sundry expenses (all allowable)		120,000	(8,362,000)
Net profit			1,710,000

Notes:

- (1) Sales and cost of sales are broken down as follows:

	Hong Kong outlets	China outlet
	\$	\$
Sales	14,000,000	1,000,000
Cost of sales – purchased from the China factory	(5,122,000)	(500,000)
Cost of sales – purchased from Hong Kong suppliers	(800,000)	–
Gross profit	8,078,000	500,000

- (2) Interest income comprises the following:

	\$
Interest on HK\$ deposit with a bank in Hong Kong	10,000
Interest on RMB deposit with a bank in Hong Kong	25,000
Interest on US\$ deposit with the New York branch of a Hong Kong bank	28,000
Interest on the US\$ loan to a Hong Kong resident director (the initial loan amount was directly remitted to the director's bank account in the US)	38,000
Interest from a HK customer on a long overdue trade amount	20,000
Interest on tax reserve certificates bought from HKSAR government	1,000
Total per accounts	122,000

(3) Commission income comprises:

	\$
Commission received from Hong Kong customers for after-sale services	200,000
Commission received from the China factory on special services performed by IIL staff in China	230,000
Total per accounts	<u>430,000</u>

- (4) In May 2010, significant defects were found in the products manufactured by the China factory. These products were made according to the order of a Hong Kong customer. The dispute between IIL and the China factory was finally settled during the year for an agreed compensation of \$200,000, payable by the China factory. The amount was not received by IIL until after the accounting year end.

(5) Sundry income comprises:

	\$
Dividend income from Hong Kong listed securities	120,000
Dividend income from China listed securities	220,000
Profit on sales of Hong Kong listed securities	570,000
Loss on sales of China listed securities	(240,000)
Exchange gain from China customers' trade accounts	30,000
Exchange gain from foreign currency bank deposits – unrealised	40,000
Total per accounts	<u>740,000</u>

(6) Salaries and wages comprise:

	\$
Salaries and bonuses to staff – Hong Kong	600,000
Salaries and bonuses to staff – China	200,000
MPF contribution for Hong Kong staff – ordinary	600,000
MPF contribution for Hong Kong staff – special (per actuarial report)	400,000
Total per accounts	<u>1,800,000</u>

- (7) The rent and rates comprise \$3,200,000 for the retail outlets in Hong Kong and \$350,000 for the retail outlet in Mainland China.

(8) Travelling and entertainment expenses comprise:

	\$
Cost of trips by IIL's directors and staff to the China factory discussing China business	8,000
Cost of trips by IIL's directors and staff to the China factory discussing Hong Kong business	72,000
Cost of trips by IIL's lawyer to China re the dispute referred to in note (4)	200,000
Total per accounts	<u>280,000</u>

(9) Donations comprise:

	\$
Cash donation to Hong Kong Red Cross	180,000
Cash donation to China Red Cross (not registered in Hong Kong)	30,000
Baby products donated to Hong Kong Red Cross	50,000
Total per accounts	<u>260,000</u>

(10) Legal and professional fees comprise:

	\$
Audit and taxation fee	92,000
Tax advisory fee for tax appeals	40,000
Legal fee re dispute with the China factory	30,000
Legal fee for a capital injection in a new subsidiary in Hong Kong	100,000
Patent registration fee in Hong Kong	300,000
Trademark registration fee in Hong Kong	400,000
Total per accounts	<u>962,000</u>

(11) The total accounting depreciation charge for the year comprises:

	\$
Land and buildings	1,000,000
Furniture and fixtures	15,000
Plant and machinery	25,000
Motor vehicles	20,000
Total per accounts	<u>1,060,000</u>

(12) Interest expense comprises:

	\$
Interest paid on a HK\$ loan from a Hong Kong resident shareholder	73,000
Interest paid on a bank overdraft facility secured by a HK\$ deposit placed by one of IIL's directors	30,000
Finance charge on assets under hire purchase	7,000
Total per accounts	<u>110,000</u>

(13) During the year ended 31 March 2013, IIL has the following movements in fixed assets:

Date	Particulars
1 May 2012	Bought a photocopier at a cost of \$40,000 under hire purchase. A down payment of \$5,000 was made and monthly instalments of \$6,000 for seven months started from 1 May 2012. Sold the old photocopier for \$10,000, making a profit of \$2,000.
1 June 2012	Acquired a trademark registered in Hong Kong at a cost of \$300,000. The trademark has not been registered in any place other than Hong Kong, and is being used by the China factory to manufacture IIL's products for sale in Hong Kong.
1 August 2012	Renovated one retail outlet at a cost of \$400,000, including \$200,000 being refurbishment and \$200,000 being a new reception area.
1 February 2013	Bought an energy saving electric motor car for \$400,000.
1 March 2013	Bought a computer system with software for \$800,000.

(14) The tax depreciation schedules of IIL's 2011/12 tax computation contain the following information:

Plant and machinery pools:	
20% – tax written down value brought forward	\$200,000
30% – tax written down value brought forward	\$300,000
Commercial building allowance:	
– Initial construction cost incurred in 1988/89	\$1,500,000
– Qualifying expenditure brought forward	\$1,200,000
– Written down value brought forward	\$528,000

- (15) IIL has been filing its Hong Kong profits tax return on the basis that all sales made by the China retail outlet are offshore and non-taxable. Related expenses are disallowed only to the extent that they are specifically identified as relating to China sales. Other non-specified expenses are not adjusted for tax purposes due to immateriality.

Required:

Assuming that the same basis of offshore claim is made by International Intelligence Ltd, prepare International Intelligence Ltd's profits tax computation for the year ended 31 March 2013, showing the net assessable profits/adjusted loss and profits tax payable, if any. Clearly identify both the year of assessment and the basis period and show all your workings, including the hire purchase depreciation allowance calculation.

Notes:

- (1) You should ignore provisional tax and overseas tax.
- (2) No written explanations are required.

(30 marks)

- 3 ABC Co is a partnership between Adrian, Beatrice and Champion Ltd. The partnership commenced business in 2006 and makes up its accounts to 31 December. The partners shared profits and losses equally up to 30 April 2011, but with effect from 1 May 2011, the profit and loss sharing ratio became 1:1:2 (Adrian:Beatrice:Champion Ltd respectively).

There were disputes between the partners and the partnership ceased business on 30 April 2012. The partnership's final income statement drawn up for the 16 months from 1 January 2011 to 30 April 2012 was as follows:

	Notes	\$	\$
Turnover			12,000,000
Cost of goods sold			(7,955,000)
Gross profit			4,045,000
Rent	1	900,000	
Salaries	2	1,275,000	
Contributions to mandatory provident fund (MPF) schemes	3	126,000	
Other expenses	4	405,000	
Depreciation		120,000	
Loan interest to Champion Ltd		90,000	(2,916,000)
Net profit			1,129,000

Notes:

- (1) Rent of \$900,000 was paid to Champion Ltd, the landlord of the premises in which the business operated. The rateable value of the premises is \$810,000.
- (2) Salaries included \$270,000 paid to Adrian, \$225,000 paid to Beatrice and \$180,000 paid to Beatrice's daughter.
- (3) Contributions to MPF schemes included \$13,500 paid for Adrian, \$11,250 paid for Beatrice and \$9,000 paid for Beatrice's daughter.
- (4) Other expenses included severance payments of \$300,000. All the other items under this category are deductible.
- (5) The tax written down values as at 31 December 2010 are: 20% pool \$30,000; 30% pool \$45,000. All assets were sold in May 2012 for \$27,750, except for a computer, which had an estimated open market value of \$5,000. The cost of this computer had been fully deducted in the tax return filed in the year of purchase.

Other information:

- (i) Adrian elected for personal assessment in all relevant years. Beatrice had no other sources of income and so did not elect for personal assessment.
- (ii) Champion Ltd carries on another business in Hong Kong, for which it had assessable profits of \$37,500 for the year ended 30 June 2011 and an adjusted loss of \$52,500 for the year ended 30 June 2012.

Required:

- (a) **Compute the assessable profits/adjusted loss of the partnership for all relevant years of assessment, clearly identifying the basis periods.** (9 marks)
- (b) **Compute the allocation of profits to each of the partners and the tax payable by the partnership, if any, for all relevant years of assessment, claiming any reliefs available to Champion Ltd.**

Note: You should ignore provisional tax. (11 marks)

(20 marks)

- 4 (a) Company A's income statement contains the following taxation expenses:
- (i) Salaries tax paid for one of the company's directors.
 - (ii) Property tax paid on the rental income received by the company on the property owned by the company.
 - (iii) Overseas tax withheld by the payer of the income before remittance to the company for its overseas activities.

Required:

State, giving reasons, the tax treatment of each of the above items in Company A's profits tax return.

The following marks allocation is provided as guidance for this requirement:

- (i) 2 marks
- (ii) 4 marks
- (iii) 3 marks

(9 marks)

- (b) Senior Citizen Club has the following receipts during the year:

	From members	From non-members
Annual subscriptions	125,000	–
Entrance fees	100,000	–
Rental income from the club's property	–	350,000
Other receipts	300,000	150,000

Required:

- (i) **Ascertain, giving reasons, whether or not Senior Citizen Club is subject to profits tax in respect of the receipts collected during the year.**

Note: Tax calculations are not required.

(3 marks)

- (ii) **Explain whether Senior Citizen Club is eligible to claim back the property tax in respect of the rental income earned from the club's property.**

Note: Calculations are not required.

(3 marks)

(15 marks)

- 5 (a) Magic Ltd (Magic) commenced business in 1976 and is carrying on business in Hong Kong. Until 2013 Magic made up its accounts to 31 December annually, when it was requested by its UK parent company to change its accounting date to 30 June. To give effect to this request, Magic proposes to draw up its next accounts for the 18 months from 1 January 2013 to 30 June 2014. The management of Magic understands that it is the normal practice of the Hong Kong Inland Revenue Department to adopt a basis period of 12 months for a year of assessment, and is concerned about the implications of the change to the company's assessable profits.

Required:

Explain the position likely to be taken by the Inland Revenue Department in assessing Magic Ltd and determine the basis period for each of the affected years of assessment as a result of the change of accounting date required by the UK parent company. (7 marks)

- (b) Magic Ltd has received a notice of assessment dated 1 April 2013 which included an amount of profit arising from its activities carried out in Mainland China. The management believes that the profits should be offshore in nature and not taxable in Hong Kong and wishes to lodge an objection.

Required:

Explain the conditions which Magic Ltd must observe to ensure the objection is valid.

Note: Holdover options are not required.

(3 marks)

(10 marks)

End of Question Paper