

Fundamentals Pilot Paper – Skills module

Taxation (Hong Kong)

Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

ALL FIVE questions are compulsory and MUST be attempted.
Rates of tax and tables are printed on page 3.

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 (HKKG)

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black square.

ACCA

**This is a blank page
The question paper starts on page 3**

The following tax rates and allowances are to be used in answering the questions

	2006/07 \$
Allowances	
Basic allowance	100,000
Married person's allowance	200,000
Single parent allowance	100,000
Child allowance – 1st to 9th child (each)	40,000
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)	40,000
Home loan interest (maximum)	100,000
Elderly residential care expenses (maximum)	60,000
Tax rates	
Salaries tax rates:	
First \$30,000	2%
Next \$30,000	7%
Next \$30,000	13%
Remainder	19%
Standard rate	16%
Profits tax rate for corporations	17.5%
Depreciation allowance rates	
Initial allowance:	
Plant and machinery	60%
Industrial building	20%
Annual allowance:	
Computers	30%
Motor cars	30%
Furniture and fixtures	20%
Industrial buildings	4% or formula
Commercial buildings	4% or formula

ALL FIVE questions are compulsory and MUST be attempted

- 1 Howard has been employed by Digital Inc (Digital), a computer software company in the USA, as a project manager since 1998. In April 2006, he was sent to Hong Kong to work for the Hong Kong branch of Digital for two years, but he was also required to travel to the PRC as necessary. In consideration of his assignment to Hong Kong, Digital revised Howard's employment contract such that he enjoyed longer annual leave and provision of housing benefit in Hong Kong. During the year ended 31 March 2007, he worked for 170 days in Hong Kong, 160 days in the PRC, and 35 days (including 25 days annual leave) in the USA.

During the year ended 31 March 2007, Howard received the following remuneration from the Digital-HK branch:

- (1) Salary for the year: \$1,500,000.
- (2) Monthly cost of living allowance: \$3,000.
- (3) Monthly entertainment allowance: \$2,000. Total meal vouchers of \$16,000 were submitted.
- (4) Air tickets for Howard, his wife and daughter to relocate them from the USA to Hong Kong were purchased by Digital at a cost of \$32,000.
- (5) During the month of April 2006, Howard lived in two hotel rooms. The bill for the account of Digital was \$30,000. From 1 May 2006, Howard moved into a leased flat at a monthly rental of \$24,000. The lease with the landlord was signed by Digital and the monthly rental was paid by Digital directly to the landlord. Since the rental exceeded Howard's eligibility limit, Howard paid back \$4,000 per month to Digital for the flat.
- (6) Howard sent his daughter for exchange study in France. Digital reimbursed \$30,000 to him for part of the school fees incurred. Digital also reimbursed him the cost of his daughter's air ticket in the amount of \$9,000.
- (7) On 1 June 2006, Howard bought a second-hand car from a friend in Hong Kong for \$70,000. Digital provided him with a corporate credit card which he used to pay for his private car expenses in the amount of \$12,000. The credit card balance was settled by Digital.
- (8) During the year, Howard paid \$8,500 to his family doctor for medical consultations in respect of his family. Howard produced all the medical receipts but Digital only approved and reimbursed \$6,000. Digital has not established any medical insurance scheme but has made adequate provision in its annual accounts to cover potential medical claims from staff.
- (9) In January 2006, Howard had been granted the right to subscribe for 5,000 shares in Digital, at a price of \$10 per share. On that date Digital's shares were traded at \$12 each. On 1 August 2006, when the market value per share was \$18 Howard exercised the options in Hong Kong and acquired the full 5,000 shares. On 3 January 2007, he sold all of the shares allotted for \$23 each.
- (10) On 1 February 2007, upon successful partial completion of the project, Howard was granted a further right to subscribe for 8,000 shares in Digitalworks Ltd, a UK subsidiary of Digital, at a price equivalent to \$16 per share. On that date the shares were traded at \$20 each. On 1 March 2007, when the market value per share was \$25 Howard exercised the options in Hong Kong and acquired the full 8,000 shares. On 28 March 2007, he sold all the shares allotted for \$30 each.
- (11) During the year, Howard enrolled onto a Putonghua course offered by a local educational institute. He spent a total of \$8,000 on tuition fees for which he did not obtain any reimbursement from Digital.
- (12) In January 2007, Howard donated \$40,000 to the Hong Kong Red Cross, an approved charitable organisation in Hong Kong. The donation was exclusively for the benefit of countries suffering from tsunami disasters.
- (13) Howard paid individual income tax of \$28,000 in the PRC on the income attributable to his services rendered in the PRC. The Assessor has agreed that such income tax was comparable to salaries tax in Hong Kong.
- (14) Howard's wife does not work. He maintained both his daughter (aged 16) and his brother (aged 13), who is the step son of his father and living in the USA.

All currency amounts are in Hong Kong dollars.

Required:

- (a) Explain whether, and if so to what extent Howard’s income should be assessed to Hong Kong salaries tax for the year of assessment 2006/07. (6 marks)
- (b) Compute Howard’s Hong Kong salaries tax liability for the year of assessment 2006/07. (14 marks)
- (c) Briefly explain the tax treatment of the items referred to in 4 and 6 to 13 inclusive. (5 marks)

(25 marks)

2 RR Ltd (RR) is a trading company carrying on business in Hong Kong. RR also owns properties for both resale and leasing purposes. The management accounts for the year ended 31 December 2006 are reproduced below.

RR Ltd’s Management Accounts for the year ended 31 December 2006

	\$	\$
Profit from trading	2,420,000	
Profit from property sale	400,000	
Rental income	380,000	
Compensation	200,000	
Interest income	57,000	3,457,000
	<hr/>	
Directors’ fees	120,000	
Staff salaries	420,000	
Bank interest	15,000	
Other interest	370,000	
Legal fees	140,000	
Rent and rates	43,000	
Termination payment	128,000	
Taxation expenses	100,000	
Retirement contribution	130,000	
Research	250,000	
Depreciation	48,000	
Sundries (all allowable)	34,000	
Insurance	22,000	(1,820,000)
	<hr/>	<hr/>
Net profit		<u>1,637,000</u>

The supplementary information in support of these accounts is as follows:

- (1) All RR’s trading profits arise in Hong Kong.
- (2) Profits arising from the sale of properties held for resale are returned as taxable for Hong Kong profits tax purposes.
- (3) During the year, RR has sold two properties which were acquired during 2001 and classified as ‘Property held for resale’ in RR’s balance sheet as at 31 December 2005. Property A was sold to a third party but Property B was sold to one of the directors at cost. The market value of this property at the time of sale was \$2,500,000.

	Cost	Sale	Profit
	\$	\$	\$
Property A	3,400,000	3,800,000	400,000
Property B	2,000,000	2,000,000	–

- (4) During the year, RR received compensation of \$200,000 from a PRC customer who terminated a sales contract without reasonable cause. The payment was agreed by both parties as being in settlement of any further dispute.

(5) Details of interest income received during the year are:

	\$
HK\$ fixed deposit with Chartered Bank, Hong Kong	20,000
US\$ fixed deposit with Bank of America, New York	35,000
Trade customer in PRC, for debt overdue	2,000
	<u>57,000</u>

(6) The bank interest expense was incurred on the current account balance overdrawn and used solely for the trading operations. Other interest related to two loans obtained from a lender company carrying on business in the PRC. The loans were specifically used to finance the acquisitions of the following two properties:

	Classified as	Loan interest
Property C	Leased property	\$150,000
Property D	Resale property	\$220,000

The lender company is not associated with RR and the properties are used as security against the respective loans.

(7) Legal fees were incurred for a prosecution brought against one of RR's directors for an offence under the Prevention of Bribery Ordinance. The litigation is still under appeal.

(8) The termination payment was made to a leaving member of staff and comprised a severance payment of \$90,000 whose calculation was based on the Employment Ordinance, and a lump-sum payment of \$38,000 in return for which the member of staff agreed not to compete with RR within two years.

(9) Taxation expenses were made up of:

	\$
Property tax paid by RR	60,000
Salaries tax of a director, paid and borne by RR	40,000
	<u>100,000</u>

(10) Contributions to the exempted registered retirement scheme are made up of:

	\$
Provision for annual contribution (20% of each member of staff's salary)	60,000
Provision for a special contribution to the same scheme	70,000
	<u>130,000</u>

RR had also made a special contribution to the scheme during the year 2003, of \$30,000.

(11) In August 2002, RR started a project to develop a piece of land in Tai Po and spent \$250,000 in conducting an environmental research and study. Unfortunately, the project had to be abandoned due to governmental restriction.

(12) RR's tax written down values as at 31 December 2005 for plant and machinery and the qualifying cost for commercial building allowance were:

20% pool	\$20,000
30% pool	\$30,000
CBA	\$2,000,000

(13) RR's balance sheet revealed that there was no movement in fixed assets during the year.

Required:

- (a) **Compute RR Ltd's Hong Kong profits tax liability in respect of the year ended 31 December 2006. Show all your workings and clearly identify both the year of assessment and basis period. Ignore provisional tax and overseas tax. No detailed explanations are required in this part.** (21 marks)
- (b) **Give explanations to illustrate the correct tax treatment and the underlying reasoning in respect of the interest costs incurred on Properties C and D (as per 6 above).** (5 marks)
- (c) The auditor of RR Ltd has discovered that as a result of the recent implementation of a new electronic filing system, RR Ltd has discarded all supporting documents, except for its management accounts and reports, up to 2004.
Advise the directors of RR Ltd of the statutory requirements for record keeping under the current tax law. (4 marks)

(30 marks)

- 3** Mr M and S Ltd have been in partnership for several years, sharing the partnership profits and losses in the ratio of 1:2 respectively. Before this profit sharing, Mr M is entitled to an annual salary of \$120,000, and S Ltd to receive interest at the rate of 10% per annum on its capital contribution of \$500,000.

As at 31 December 2005, the partnership had an agreed tax loss of \$180,000, which was allocated to Mr M and S Ltd in the amount of \$100,000 and \$80,000 respectively. Their shares of loss were carried forward under the partnership.

The following information has been provided by Mr M in respect of the year ended 31 December 2006:

- (1) The partnership made an accounting profit of \$450,000.
- (2) S Ltd carries on a trading business which showed an adjusted loss of \$170,000 (including the interest income from partnership) for the year of assessment 2006/07.
- (3) Mr M's sister works for the partnership for an annual salary of \$70,000.
- (4) Mr M also carries on a sole-proprietorship business. The 'profit before tax and donation' from this proprietorship business for the year ended 31 December 2006 was \$180,000. Total approved charitable donations made under the name of the sole-proprietorship business were \$56,000.
- (5) Mr M received a director's fee of \$90,000 during the year.
- (6) Mrs M has been trading in Hong Kong securities, and incurred a net loss for the year of \$70,000. Mrs M has paid profits tax in previous years on the profits she has earned from such trading.
- (7) Mrs M owns a property which is leased to S Ltd for a term of three years, at a monthly rental of \$20,000. Rates were agreed to be paid by Mrs M but the building management fees were agreed to be borne by S Ltd. Quarterly rates for the property are \$3,000 whilst monthly building management fees are \$1,500. Mrs M financed the acquisition of this property by a loan from her brother on which she paid \$160,000 as interest for the year 2006.
- (8) Mr and Mrs M have no children or dependants.

Required:

- (a) **State the conditions that must be satisfied for personal assessment to be elected.** (4 marks)
- (b) **Compute the allocation of profits for the partnership business together with the profits tax payable by the partnership for the year ended 31 December 2006.** (5 marks)
- (c) **Compute the tax payable by Mr and Mrs M under personal assessment for the year of assessment 2006/07.** (11 marks)

(20 marks)

- 4 (a) Dollars Ltd is a Hong Kong company and a member of the Money Group, which collects substantial amounts in cash from its daily sales. The company's management is considering on-lending the surplus cash to the group's associates overseas at an interest rate slightly below the market rate. When necessary, it will also borrow surplus fund from other group companies and then on-lend these fund to the associates, earning a profit from the interest rate differential.

Required:

Explain the principles governing the chargeability of interest income in Hong Kong, and comment on the implications of the above proposal. (6 marks)

- (b) The director of Dollars Ltd proposes to set up a subsidiary, Coins Ltd, offshore from Hong Kong. Coins Ltd will enter into a service contract with Dollars Ltd such that a service fee would be payable by Dollars Ltd to Coins Ltd each year. The quantum of the fee is determined as 30% of the profit earned by Dollars Ltd.

Required:

Explain the principles relevant to the deduction of management fees paid to a service company and indicate the criteria which will need to be satisfied if a tax deduction is to be secured for the payment made by Dollars Ltd. (9 marks)

(15 marks)

- 5 TT Ltd (TT) has been trading in Hong Kong since 1970 and makes up its accounts to 30 June each year. In view of the large profits it made in the year ended 30 June 2004, TT changed its accounting date from 30 June to 31 January, and prepared accounts for the 19 months ended 31 January 2005. TT believed that this would lead to the exclusion of some profits from any basis period and therefore make them not subject to profits tax.

On 30 September 2006, TT went into voluntary liquidation and ceased trading. The following figures have been agreed by the Assessor and TT:

Period	Adjusted profit \$
Year ended 30 June 1973	150,000
Year ended 30 June 1974	170,000
Year ended 30 June 1975	180,000
Year ended 30 June 2003	1,800,000
1 July 2003 to 31 January 2005	2,470,000
Year ended 31 January 2006	1,100,000
1 February 2006 to 30 September 2006	800,000

Required:

- (a) **Explain the general principles to be adopted in ascertaining the basis period for cases involving a change of accounting date.** (3 marks)
- (b) **Advise on the position which will be taken by the Inland Revenue Department in assessing TT Ltd in respect of each of the years of assessment 2003/04 to 2006/07 inclusive.** (7 marks)

(10 marks)

End of Question Paper

Answers

1 (a) In Hong Kong salaries tax is charged on income from an employment, office or pension “arising in or derived from” Hong Kong. In the case of employment income, the court ruled in the Goepfert case that the correct approach is to look for the place where the income really comes to the employee, that is where the employment is located. As a consequence of this decision, the IRD issued DIPN No. 10 which accepts that an employment is located outside Hong Kong (a foreign employment) where the following three factors are present:

- (i) the contract of employment was negotiated, entered into, and enforceable outside Hong Kong;
- (ii) the employer is resident outside Hong Kong; and
- (iii) the employee’s remuneration is paid to him outside Hong Kong.

2

If not all of the above factors are outside Hong Kong, it appears that the second factor is more important than the other factors, and the place of payment of the remuneration is of least importance. If a person is recruited by an employer resident in Hong Kong, the employment is unlikely to be located outside Hong Kong, even though the contract is concluded outside Hong Kong and his remuneration is paid outside Hong Kong.

1

The IRD reserves the right to look beyond the three factors where in reality the employment is a Hong Kong employment but manipulation exists. (Bonus 1)

Howard, although assigned to Hong Kong and having a position as a project manager of the Hong Kong branch, continues to be employed by Digital, the US company. Even though the terms of employment were changed, the contract of employment was still made with the US company. Irrespective of whether the contract of employment was a new contract or a mere variation of the existing one, Howard’s employment should therefore still be a foreign one (CIR v. Goepfert).

2

However, as Howard performs some of his duties in Hong Kong, he is still subject to Hong Kong salaries tax in respect of his income derived from services rendered here under s.8(1A). In ascertaining his tax liabilities, the time apportionment basis will be used, ie the employment income will be apportioned according to the number of days that he is present in Hong Kong. As however Howard’s income is already assessed on a time-basis, the exemption under s.8(1A)(c) is not applicable.

1

6

(b) Howard’s salaries tax computation for the year of assessment 2006/07

	\$	\$	
Salary		1,500,000	0.5
Cost of living allowance		36,000	0.5
Entertainment allowance		24,000	0.5
Reimbursement of school fees		30,000	0.5
Reimbursement of air ticket		9,000	0.5
Private car expenses		12,000	0.5
Reimbursement of medical expenses		6,000	0.5
		<u>1,617,000</u>	
Time-apportionment:			
HK: $170 + 25 \times 170 / (365 - 25) = 182.5$ days			2
Taxable: $1,617,000 \times 182.5 / 365$		808,500	1
Rental value			
– $808,500 \times 1/12 \times 8\%$		5,390	1
– $808,500 \times 11/12 \times 10\%$	74,112		1
Less: rent suffered ($4,000 \times 11$)	44,000	30,112	0.5
Exercise of share option [$8,000 \times (25 - 16)$]	<u>72,000</u>		1
Apportioned on the number of days $182.5/365$		<u>36,000</u>	1
Assessable income		880,002	
Less: Approved charitable donations		(40,000)	0.5
		840,002	
Less: Married person’s allowance	200,000		0.5
Child allowance	40,000		0.5
Dependent brother allowance	30,000	(270,000)	0.5
Net chargeable income		<u>570,002</u>	
Salaries tax liability at progressive rates		<u>97,800</u>	0.5
Salaries tax at standard rate ($\$840,002 \times 16\%$) is not applicable		<u>134,400</u>	0.5
		<u>14</u>	

(c) Explanatory notes to the items:

1. The air tickets to relocate Howard's family to Hong Kong are not for holiday purposes and are therefore, not taxable. 0.5
 2. Payment for the education of an employee's children is assessable as it represents a discharge of the employee's personal liability – s.9(2A)(a). Likewise, reimbursement of the cost of the air ticket is taxable. 0.5
 3. Howard is not entitled to any tax deduction in respect of the cost of the car as this is domestic and private in nature. On the other hand, the payment of the credit card balance is assessable income as Digital is discharging Howard's personal liability. 0.5
 4. Reimbursement of the medical expense of \$6,000 is taxable as the payment is not made under any insurance contract but directly from Digital in discharge of Howard's private expense. The excess of \$2,500 incurred but not reimbursed is not deductible since medical expenses are domestic and private in nature. 0.5
 5. Section 9(1)(d) deems any gain realised on the exercise, release or assignment of a share option to be income from an employment or office. In the case of the exercise of an option, the gain is equal to the open market value of the shares at the time of exercise less the consideration paid for the option and the amount paid for the shares. The subsequent sale of the shares is irrelevant. 0.5
- The exercise of the first share option on 1 August 2006 is not taxable as the option was granted in January 2006 before Howard was assigned to the Hong Kong branch. Although the option was exercised in Hong Kong, the benefit arising from the option is not attributable to services rendered in Hong Kong. 0.5
- On the other hand, the exercise of the second share option on 1 March 2007 is taxable on a time basis on the basis that the option is granted for partial completion of the project in Hong Kong and the benefit arising from the option is partly attributable to services rendered in Hong Kong. 0.5
6. The tuition fee of \$8,000 paid for the Putonghua course is not deductible as self-education expenses since the nature of the education is not directly connected with Howard's employment. 0.5
 7. The donation, made to an approved charitable organisation in Hong Kong, is allowable even though it is not used for the benefit of Hong Kong. 0.5
 8. The individual income tax paid in the PRC is not relevant as his income for services rendered outside Hong Kong is already exempt. 0.5

5
25

2 (a) RR Ltd

Profits tax computation for the year of assessment 2006/07

Basis period: year ended 31 December 2006

	\$	\$	
Net profit for the year		1,637,000	0.5
Add: Depreciation	48,000		0.5
Profit on sale of Property B	500,000		1
Interest cost on Property C	150,000		1
Legal fees	140,000		1
Termination payment – for covenant	38,000		1
Taxation expense – property tax	60,000		1
Retirement contribution – annual (60,000 x 5/20)	15,000		1
Retirement contribution – special provision	70,000	1,021,000	1
	<hr/>	2,658,000	
Less: Depreciation allowance	93,000		0.5
Interest income – HK\$ deposit	20,000		1
Interest income – US\$ deposit	35,000		1
Retirement contribution – special payment in 2003 (30,000 x 1/5)	6,000	(154,000)	1
Assessable profit		<hr/> 2,504,000 <hr/>	
Profits tax payable @17.5%		438,200	1
Property tax paid		(60,000)	1
Net profits tax payable		<hr/> 378,200 <hr/>	

Depreciation allowance					
	20% Pool	30% Pool	CBA	Total	
	\$	\$	\$	\$	
WDV/Cost brought forward	20,000	30,000	2,000,000		1
Addition:	0	0	0		
IA	0	0	0	0	
Disposal:	0	0	0	0	
AA	(4,000)	(9,000)	(80,000)	93,000	1.5
WDV/Cost carried forward	16,000	21,000	1,920,000		

Correct treatment of items that require no adjustment (Candidates are NOT required to prepare this table in their answers. Marks will be awarded if they are not adjusted in the tax computation.)

Taxable items		Deductible items		
Profit from property sale	400,000	Bank interest	15,000	
Compensation	200,000	Other interest on Property D	220,000	
Interest from PRC customer	2,000	Severance payment	90,000	
		Salaries tax for director	40,000	
		Research	250,000	
			0.5 mark each	4
				<u>21</u>

- (b) The interest costs incurred to finance Property C and Property D may have different tax implications, given that Property C is held for leasing purpose, ie held as a 'capital asset for investment'; whilst Property D is held for resale, ie held as trading stock.

The fundamental test for an interest cost deduction is the general principle under s.16(1), ie incurred in the production of assessable profits. As both properties earn income subject to Hong Kong profits tax, ie either lease rentals or sale profit, s.16(1) is satisfied.

1

The deduction of interest costs will thus be subject to a second test, ie s.16(2). In respect of Property C which is held as a capital asset, s.16(2)(c) or s.16(2)(d) would be examined. Information indicates that the lender company is carrying on a business in the PRC. It can reasonably be assumed here that the lender company is not subject to tax in Hong Kong in respect of the interest income received from RR Ltd. As such, s.16(2)(c) would not be satisfied.

1.5

As regards s.16(2)(d), since the lender company is not a financial institution, the section is not satisfied either. As a result, the interest cost incurred for Property C is not tax deductible for Hong Kong tax purposes.

1

In respect of Property D which is held for resale, s.16(2)(e) would be satisfied on the basis that interest was incurred to finance either plant and machinery or trading stock; and the lender is not associated with RR Ltd.

1.5

- (c) Under s.51C of the IRO, any person carrying on a trade, profession or business must keep sufficient records in English or Chinese of its income and expenditure, to enable the assessable income of such trade, profession or business to be readily ascertained. These records are to be kept for a period of not less than seven years after the completion of the transactions, acts or operations.

5

'Records' include books of account, receipts and payments, income and expenditure together with vouchers, bank statements, invoices, receipts and other documents necessary to verify the entries in the accounts. It also includes records of assets and liabilities, goods purchased and sold, details of sellers and buyers, records of stocktakings, and records of services provided.

2

Since RR Ltd is the owner of land and/or a building, sufficient records of rental details are required also.

1.5

0.5

4

30

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

- (a) The taxpayer is 18 years of age or over (or if under 18, both parents are deceased).
- (b) The taxpayer is a permanent or temporary resident in Hong Kong, or his or her spouse is a permanent or temporary resident.
- (c) 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.
- (d) 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 for the relevant year becomes final and conclusive, whichever is later.

at 1 mark each

4

(b) Computation of profits tax liability for the partnership

For the year of assessment 2006/07 (based on the year ended 31 December 2006)

	\$	
Accounting profit for the year	450,000	
Add: Salary to partner (Mr M)	120,000	0.5
Interest to partner (S Ltd)	50,000	0.5
Adjusted profit for the year	620,000	

Allocation of profit/loss of the partnership

For the year ended 31 December 2006

	Mr M \$	S Ltd \$	Total \$	
Salary	120,000	–	120,000	0.5
Interest	–	50,000	50,000	0.5
Balance (1:2)	150,000	300,000	450,000	0.5
Adjusted profits	270,000	350,000	620,000	
Loss brought forward	(100,000)	(80,000)	(180,000)	0.5
Transferred to personal assessment	(170,000)	–	(170,000)	0.5
Loss transferred: s.19C(4)		270,000 (220,000)*	270,000 (220,000)	1
Net assessable profits		50,000	50,000	
Tax payable at 17.5%		8,750	8,750	0.5
				5

*Adjusted loss of S Ltd, \$170,000, deducting partnership interest income of \$50,000 which has been taxed under the partnership.

Computation of personal assessment for 2006/07 – Mr and Mrs M

	\$	Mr M \$	Mrs M \$	
Share of partnership profits		170,000		0.5
Director's fee		90,000		0.5
Sole proprietorship profit	180,000			0.5
Approved charitable donation, limited to 25% of profit	(45,000)	135,000		1
		<u>395,000</u>		
Net assessable value			182,400	0.5
Mortgage interest			(160,000)	1
			<u>22,400</u>	
Approved charitable donation (56,000–45,000)		(11,000)		1
		<u>384,000</u>		
Loss from securities trading			(70,000)	1
Excess loss transferred to Mr M		(47,600)	47,600	1
Total income		<u>336,400</u>	–	
Total joint income			<u>336,400</u>	0.5
Married person's allowance			(200,000)	0.5
Net chargeable income			<u>136,400</u>	
Tax payable at progressive rates			<u>15,416</u>	0.5
Tax payable at standard rate (336,400 x 16%)			<u>53,824</u>	0.5
Final tax payable			<u>15,416</u>	0.5
Computation of net assessable value				
Rental (20,000 x 12)			240,000	0.5
Rates (3,000 x 4)			(12,000)	0.5
			<u>228,000</u>	
Statutory allowance at 20%			(45,600)	0.5
Net assessable value			<u>182,400</u>	11
				<u>20</u>

- 4 (a)** In Hong Kong, interest income is a deemed business receipt under s.15(1)(f) or s.15(1)(g). Any interest accruing to a corporation carrying on a business in Hong Kong which arises in or is derived from Hong Kong will be taxable under s.15(1)(f). Interest is regarded as arising in or derived from Hong Kong when it is sourced in Hong Kong. Generally speaking, the factor to determine the source of interest income depends on the place where the credit or loan is first made available to the borrower. This is known as the 'provision of credit' test, and has been confirmed in the Hang Seng Bank case and included in DIPN No.21 (revised). **2**

However, in the Orion Caribbean case, the judge decided that the taxpayer earning interest income would be taxable in Hong Kong regardless of the fact that the relevant credit or loan was made outside Hong Kong. This was because the taxpayer in that case was actively involved in the borrowing and on-lending of money to associated persons with an intention to earn a profit from the rate differential. In the decision, it was emphasised that the provision of credit test should only be used for passive interest income. Interest income earned as a result of the active participation and arrangement of loans and credit will be regarded as normal trading income and subject to the principles applicable to trading income in determining the source. **2**

In Dollars Ltd's case, if it simply lends its surplus cash to earn interest income, the interest can be non-taxable if the money is provided outside Hong Kong. However, if it is actively involved in the borrowing and on-lending of surplus fund to associates, and the transaction is actively conducted in Hong Kong, it may be challenged by the IRD on the grounds that the provision of credit test may not apply. As a result, the interest income earned is likely to be taxed under profits tax as the source of the income is in Hong Kong. **2**

- (b)** The following points should be covered: **6**

Hong Kong does not have any specific transfer pricing rules thus the analysis of the situation and its implications should be based on the general arms length principle. The general requirements for the deductibility of management fees paid to a service company are as set out in DIPN 24, although this statement is targeted towards management fees paid by unincorporated businesses. **2**

The deduction of management fees is primarily governed by the general deduction rule under s.16(1), ie that the expense or outgoing has to have been incurred in the production of assessable profits. Where this is not the case, therefore a deduction will be denied.

1

Further the IRD may seek to challenge the transaction under either of the following anti-avoidance provisions in s.61 and s 61A:

0.5

- under s.61 by scrutinising the transaction to ascertain whether it is artificial and fictitious. The consequence of s.61 is that the charge would be disregarded. (Bonus 1)
- under s.61A if the transaction is regarded as conducted for the sole and dominant purposes of avoiding tax. The consequence is either to treat the transaction as if the charge has not been made, or to adjust the charge to counteract any tax benefit. (Bonus 1)

Under s.20(2) the Commissioner may deem a business to be carried on in Hong Kong where a non-resident carries on business with a resident and the business is arranged so as to produce less profits to the resident than might normally be expected. However, s.20(2) may only apply in situations where the IRD considers that the two parties are closely connected, ie in this case if it is judged that Coins Ltd is closely connected with Dollars Ltd.

1.5

A deduction may thus be secured if the following are satisfied:

1. The transaction between Dollars Ltd and Coins Ltd is on an arm's length basis, ie arranged as if both parties are unrelated third parties. 0.5
2. The transaction is commercially justified, ie not entered for the sole and dominant purpose of avoiding tax. 0.5
3. Services are provided for the benefit of Dollars Ltd in the production of Dollars Ltd's assessable profits. 0.5
4. The amount charged is substantiated with calculations and reflects the costs of Coins Ltd directly attributable to the services provided. 0.5
5. The basis of charge is commensurate with the benefits accrued to Dollars Ltd and consistently applied with no reference made to the profitability of Dollars Ltd. 0.5
6. The quantum of the fee is realistic, reasonable and not excessive. 0.5
7. Documentation is properly put in place, including service agreement, relevant board minutes or resolutions, invoices, receipts, payment records and working papers to substantiate the calculations. 0.5
8. Transaction is not artificial and fictitious. 0.5

0.5

9

15

- 5 (a) Under s.18E(1), when a taxpayer's accounts are not made up to the same day as in the previous year of assessment, or to more than one day in a year of assessment, the CIR is empowered to compute the assessable profits for the year of change, and to recompute the assessable profits for the previous year, on a basis that the CIR thinks appropriate.

1

In ascertaining the basis period for the year of change and the year preceding the year of change, the general principles are:

- (i) to adopt the new accounting date as soon as possible;
- (ii) to make sure that
 - for a new business (commencing on or after 1 April 1974), none of the profits arising during the life of the business falls out of the profits tax net; and
 - for an old business (commencing before 1 April 1974), the period left out of assessment is not one of high profit.
- (iii) to amend the basis period for the preceding year to the new accounting date only if this gives a larger profit; and
- (iv) to ensure fairness to both the IRD and the taxpayer.

2

- (b) When TT Ltd changed its accounting date from 30 June 2004 to 31 January 2005, the year of change is 2004/05. Under s.18E, for old businesses, the basis period for the year of change must be 12 months. On this basis, the basis period for the year of assessment 2004/05 will be from 1 February 2004 to 31 January 2005, and profits for the period from 1 July 2003 to 31 January 2004 will drop out of assessment .

3

1

However, if the change of accounting date was made for the sole or dominant purpose of obtaining a tax benefit through the expected drop out of profit, the tax benefit may be countered by the application of s.61A and the CIR is entitled to adopt a basis period of more than 12 months irrespective of s.18E: see Yick Fung Estate Ltd v CIR.

0.5

In this case, since the change is not for bona fide commercial reasons but for the sole or dominant purpose of avoiding tax, the CIR will likely adopt a basis period of 19 months for the year of assessment 2004/05. The basis period will be from 1 July 2003 to 31 January 2005.

0.5

Year of assessment 2004/05

Basis period: 1 July 2003 to 31 January 2005

Adjusted profits \$2,470,000

0.5

Year of assessment 2003/04

Original assessment

Basis period: year ended 30 June 2003

Adjusted profits \$1,800,000

1

Revised assessment (with new accounting date)

Basis period: 1 February 2003 to 31 January 2004

Adjusted profits (1,800,000 x 5/12 + 2,470,000 x 7/19) \$1,660,000

As the profits of the revised assessment are less than originally assessed, the IRD normally would not initiate the reassessment. (Usually if there is no drop-out period in the year of change, the IRD may not revise the assessment for the year preceding the year of change.)

1

Year of assessment 2005/06

Basis period: year ended 31 January 2006

Adjusted profits \$1,100,000

0.5

Year of assessment 2006/07 (year of cessation)

Basis period: 1 April 2006 to 30 September 2006

Adjusted profit (800,000 x 6/8) \$ 600,000

Add: profit for relevant period 1 February 2006 to 31 March 2006 (800,000x2/8) 200,000

Less: transitional amount 1 July 1974 to 31 March 1975 (18,000x9/12) (135,000)

Assessable profits for 2006/07 665,000

2

7

10