Answers

Notes to candidates:

Cases are given in the answers for educational purposes. Unless specifically requested, candidates were not required to quote specific case names to obtain the marks, only to provide the general principles involved.

Marks

1 Eric Smith

(a) Under s.8, salaries tax is charged on income from an employment, office and pension arising in or derived from Hong Kong. The phrase 'arising in or derived from Hong Kong' is not defined in the IRO, but s.8(1A) provides that income from employment includes income derived from services rendered in Hong Kong and excludes income derived from services rendered outside Hong Kong. However, this section applies only to income from employment. It does not apply to income from an office. Apart from this, no guidance is given in the IRO and the phrase 'arising in or derived from Hong Kong' is to be interpreted according to case law and BOR decisions. 1

In the case of employment income, the BOR adopted the 'totality-of-facts test' and looked at all the facts of the cases. No single factor or particular factors could determine the issue. 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 and accepts that employment is located outside Hong Kong (a foreign employment) where the following three factors are present:

1. the contract of employment was negotiated and entered into, and is enforceable outside Hong Kong;
2. the employer is resident outside Hong Kong; and
3. the employee's remuneration is paid to him outside Hong Kong.

If not all of the above factors are outside Hong Kong, it appears that the second factor is more important than the other factors. 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. 2

It must be noted that looking at these three factors only is a practice of the IRD. The *Goepfert* case did not expressly state that the question of the source of employment income is solely determined by these three factors. In fact, the IRD's interpretation was criticised in *D40/90*, which is the first BOR case on the source of income after the *Goepfert* case. The Board still preferred the totality-of-facts test. The Board considered that the question of the source of income remains a practical, hard matter of facts to be decided by looking at all relevant facts. However, the three factors accepted by the IRD must be important factors in source of income issues and should be sufficient to resolve the question for most cases. 1

In the case of income from an office, the source is the place where the office legally exists. In *McMillan* v *Guest (24 TC 190)*, it was held that the office of a director is located at the place where the control and management of the corporation is exercised. Hence, if the corporation is managed and controlled in Hong Kong, the services of the office holder are deemed to be rendered in Hong Kong and fees derived from the office are chargeable to salaries tax under the basic charge, s.8(1), irrespective of where the person resides and whether he renders any service for the company in Hong Kong. 2

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(b) In accordance with the principle in the *Goepfert* case, Eric's employment has its source outside Hong Kong as:

1. the employment contract was entered into outside Hong Kong;
2. at all material times his employer is Diamond Corporation, which is an overseas company based in the US;
3. his remuneration is paid to him outside Hong Kong; and
4. although he performs much of his work in Hong Kong, his location here is a matter of convenience and his work is for the benefit of various affiliated companies outside Hong Kong. 2

However, as Eric 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 taxable income, time apportionment basis would be used, i.e. the employment income is apportioned according to the number of days that he is present in Hong Kong. As Eric's income is already assessed on a time-basis, it is not necessary for him to claim the exemption under s.8(1A)(c). 2

Eric is a director of Gold Ltd and the company is centrally managed and controlled in Hong Kong. All his directors' fees from Gold Ltd are sourced in Hong Kong and thus, taxable under s.8(1), irrespective of whether he attended any of the directors' meetings. 1

5

Marks

(c) Eric Smith
Salaries tax assessment
Year of assessment 2005/06

	$	$	
Salary (1.4m x 200/365)		767,123	1
Air ticket re relocation		0	0·5
Rental value at 10%	76,712		0·5
Rent suffered (2,000 x 12)	(24,000)	52,712	0·5
Assessable income		819,835	
Married person's allowance		(200,000)	0·5
Child allowance (40,000 x 2)		(80,000)	0·5
Net chargeable income		539,835	
Salaries tax payable at progressive rates		97,167	0·5
Salaries tax at standard rate is not applicable (819,835 x 16%)		131,173	0·5

Year of assessment 2006/07

	$	$	
Salary		1,800,000	0·5
Holiday journey benefit			
– air ticket for wife (24,000 + 4,000)/2 – 4,000	10,000		1
– hotel room charges (30,000 x 15/25)	18,000	28,000	1
		1,828,000	
Time-apportionment:			
HK: 140 + 15 x 140/(365 – 15) = 146 days			1
Taxable: 1,828,000 x 146/365		731,200	0·5
Directors' fees		60,000	0·5
		791,200	
Rental value at 10%	79,120		0·5
Rent suffered (2,000 x 12)	(24,000)	55,120	0·5
Share option gain			
– on sale of option (35,000 – 4,000 x 1/4)	34,000		1
– on exercise of option (20,000 x 6 – 40,000 – 4,000 x 2/4)	78,000	112,000	1
Assessable income		958,320	
Married person's allowance		(200,000)	0·5
Child allowance (40,000 x 2)		(80,000)	0·5
Net chargeable income		678,320	
Salaries tax liability at progressive rates		118,380	0·5
Salaries tax at standard rate is not applicable (958,320 x 16%)		153,331	0·5
			14
			25

Marks

2 (a) TT Ltd
Profits tax computation for the year of assessment 2006/07
Basis period: year ended 31 March 2007 0·5

	$	$	Marks
Net profit for the year		3,979,000	0·5
Add: Depreciation	116,000		0·5
Donation	60,000		0·5
Retirement fund special contribution	20,000		0·5
Commission (undisclosed agent)	90,000		1
Sundry expense (tax surcharge)	12,000		1
Sale proceeds of computer (PFA)	30,000	328,000	1
		4,307,000	
Less: Interest income (30,000 + 35,000 + 4,000)	69,000		1
Retirement fund special contribution (20,000 x $^{1}/_{5}$)	4,000		1
Exchange gain	78,000		1
Gain on fixed asset disposal	6,000		0·5
Prescribed fixed asset – computers	20,000		1
Depreciation allowance	77,560	(254,560)	0·5
		4,052,440	
Less: Donation (maximum 25% of 4,056,440)		(60,000)	0·5
Adjusted profit for the year		3,992,440	
Loss brought forward		(1,180,000)	1
Net assessable profit		2,812,440	
Profits tax payable at 17·5%		492,177	0·5

Depreciation allowance

	20%	30%	HP-30%	Allowance	Marks
WDV brought forward	20,000	30,000	–		0·5
Additions	0	100,000	20,000		1
Initial allowance (IA) – 100,000 x 60%		(60,000)		60,000	0·5
IA – HP (2,000 + 3,000 x 2) x 60%	0	0	(4,800)	4,800	1·5
Disposals	0	(56,000)	0		0·5
	20,000	14,000	15,200		
Annual allowance	(4,000)	(4,200)	(4,560)	12,760	1·5
	16,000	9,800	10,640	77,560	

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	$
Sales	11,175,000	Legal fees	210,000
Interest income – customer	5,000	Retirement fund ordinary contribution	380,000
Compensation	400,000	Interest on overdraft	16,000
		Loss from conversion of receivable	90,000
		Provision for receivables	20,000
		Subsidy for director	10,000

(0·5 mark each) 5

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(b) The compensation is revenue in nature and taxable on the basis that the compensation is made to cover the revenue loss suffered from the cancellation of a trade contract. Since the income from the contract is returned (and to be returned) as taxable revenue income, the compensation made to cover the loss of such income is accordingly revenue in nature and taxable. The fact that the customer is German is not relevant. In a situation where the contract terminated constitutes the whole business of the company, the cancellation of which would lead to the closing down of the company's business, the compensation may be regarded as capital in nature and non-taxable [*Kelsall Parsons & Co* v *CIR(1938)* and *Barr Crombie & Co Ltd* v *CIR (1945)*]. Based on the information given in the question, this appears not to be the case despite the contract having a term of five years. 3

Marks

(c) Despite no tax return being issued to or received by the company, it is not a sufficient excuse not to report taxable income. Under s.51(2) of the IRO, any person chargeable to tax for a year of assessment is obliged to inform the Commissioner in writing that he is so chargeable within four months after the end of the basis period for the relevant year of assessment, unless he has already received a tax return. In the case of TT Ltd, as it has incurred a tax loss before the set-off of the 2004/05 loss for the year of assessment 2005/06, there is no obligation to notify the Commissioner under s.51(2) if no tax return was received. However, in respect of the year of assessment 2006/07, the company made an adjusted profit before set-off of the prior years' losses of $3,996,440. It is, therefore, obliged to write to the Commissioner and notify its chargeability to profits tax. The due date for this notification was 31 July 2007. Since this date has passed, it is advisable that TT Ltd should immediately send the notification to the Commissioner requesting the issuance of tax returns for both 2005/06 and 2006/07. 4

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3 Messrs Sze and To

(a) Partnership allocation for 2005/06

	Partnership $	Sze $	To $	
Salaries to partners	240,000	120,000	120,000	0·5
Salary to partner's wife	108,000	–	108,000	0·5
Balance (1:1)	(798,000)	(399,000)	(399,000)	0·5
Allowable loss	(450,000)	(279,000)	(171,000)	
Loss lapsed upon withdrawal from partnership	171,000	–	(171,000)	0·5
Loss carried forward	(279,000)	(279,000)	–	0·5

Partnership allocation for 2006/07

	Partnership $	Sze $	Z Ltd $	
Salary to partner	120,000	120,000	–	0·5
Interest on capital	100,000	–	100,000	0·5
Balance (1:2)	450,000	150,000	300,000	0·5
Assessable profits	670,000	270,000	400,000	
Loss brought forward and set off	(270,000)	(270,000)	–	0·5
Loss set off under s.19C(4)	(250,000)	–	(250,000)	1
Profit transferred to personal assessment	–	0	–	0·5
Net assessable profits	150,000	–	150,000	
Loss carried forward (279,000 – 270,000)	9,000	9,000		0·5
Tax payable at 17·5%			26,250	0·5
				7

Marks

(b) 2006/07 Personal assessment computation for Mr and Mrs Sze

	Mr Sze $	Mrs Sze $	
Salary	–	96,000	0·5
Net assessable value (see below)	–	246,400	0·5
Proprietorship business income (net of ACD limited to 25%) (160,000 – 40,000)	120,000	–	1
	120,000	342,400	
Less: Mortgage interest	–	(140,000)	0·5
	120,000	202,400	
Approved charitable donations transferred from spouse 130,000 – 40,000 = 90,000, limited to 25% of $202,400		(50,600)	1
Contributions to MPF (maximum)	–	(12,000)	0·5
	120,000	139,800	
Loss from property trading	–	(139,800)	0·5
Loss transferred from spouse (170,000 – 139,800)	(30,200)	–	1
Reduced total income	89,800	0	
Joint total income		89,800	
Married person's allowance		(200,000)	0·5
Net chargeable income		0	
Tax payable		0	0·5

Calculation of net assessable value

	$	
Rental (20,000 x 12)	240,000	0·5
Premium (120,000 x 12/24)	60,000	1
Repairs borne by tenant	20,000	1
	320,000	
Less: rates (3,000 x 4)	(12,000)	0·5
	308,000	
Less: statutory allowance (20%)	(61,600)	0·5
Net assessable value	246,400	10

(c) 2006/07 Profits tax computation for Z Ltd
Basis period: year ended 31March 2007

	$	
Net profit per accounts	100,000	0·5
Less: Interest income from partnership	(100,000)	1
Distribution from partnership profits	(250,000)	0·5
Agreed loss	(250,000)	
Loss set off against share of partnership profit	(250,000)	0·5
Loss carried forward	0	0·5
		3
		20

Marks

4 (a) The fundamental principles governing the tax deductibility of interest expense are ss.16(1), 16(1)(a) and 16(2), including s.16(2A) and s.16(2B). The general deduction principle under s.16(1) requires that the interest must be incurred in the production of assessable profits. In the case given, the intention is to use the loan money to acquire trading stock for trading purposes. If the trading profit is to be returned as assessable profits for Hong Kong tax purposes, s.16(1) would be satisfied. However, if the trading profit is to be claimed as offshore and non-taxable, s.16(1) would not be satisfied and no tax deduction will be allowed for the interest incurred. Assuming that the requirement under s.16(1) is satisfied, the interest deduction would only be allowed if any of the conditions under s.16(2) is satisfied. 2

Under the first choice, the loan would be acquired from the bank. Under s.16(2)(d), s.16(2A) and s.16(2B) where the loan is obtained from a financial institution, the interest would be deductible if (a) the repayment of the loan (principal or interest) is not secured or guaranteed, in whole or in part, directly or indirectly, by or on behalf of the borrower (i.e. PP Ltd) or its associate, against a deposit with or loan to any financial institution (or its associate) or to the lender (or its associate); where the interest on that deposit or loan is not chargeable to Hong Kong profits tax; and (b) there is no such arrangement in place such that the interest payment is ultimately paid back to the borrower or any connected person. If the above conditions are met, PP Ltd would get a tax deduction on the interest incurred on the bank loan. 3

Under the second choice, the loan would be acquired from a PRC company. The relevant conditions under s.16(2) would be either s.16(2)(c) or s.16(2)(e). Under s.16(2)(c) where the loan is obtained other than from a financial institution, the interest would be deductible if the interest in the hands of the recipient is subject to tax in Hong Kong. In this case, assuming that the PRC company does not carry on business in Hong Kong, it is not likely that the interest income would be taxed in Hong Kong. Therefore, the condition under s.16(2)(c) is not satisfied. 2

PP Ltd may be able to rely on s.16(2)(e) to claim the tax deduction on the basis that the loan is acquired wholly and exclusively for the acquisition of trading stock and the lender is not an associate of PP Ltd. The definition of 'associate' under the IRO does not include a friend of the borrower's director unless the associate is also under the control of PP Ltd. In the absence of control, PP Ltd should satisfy the condition under s.16(2)(e). So provided that the loan is not secured or guaranteed by any deposit or loan which generates non-taxable interest, nor is made under any arrangement such that the interest is paid back to PP Ltd, the interest incurred on the loan should be tax deductible. 3

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(b) Under s.14, any person carrying on business in Hong Kong and deriving profits that are sourced in Hong Kong would be subject to profits tax. In the case of a person who does not carry on business in Hong Kong but earns deemed trading receipts as identified under s.15, the receipts would also be taxed under profits tax. 1

The Singapore company receives income in the form of a royalty for the use of or right to use the patent in Hong Kong. Assuming that it does not carry on business in Hong Kong, the royalty is not taxed under s.14. However, it is deemed as a trading receipt arising in or derived from Hong Kong under s.15(1)(b) and thus, subject to profits tax. 1

In general, only 30% of the gross royalty received is taxed at the applicable profits tax rate of 17·5%. This gives an effective tax rate of 5·25% on the gross royalty income. However, in circumstances where the Singapore company is associated with LL Ltd and the patent has been owned, partly or wholly by any person carrying on business in Hong Kong, 100% of the royalty will be taxed. In the case of LL Ltd, the patent has been owned by LL Ltd before it was sold to the Singapore company. However, since the question states that the Singapore company is an independent party to LL Ltd, this exception (100% rule) would not apply. In conclusion, the Singapore company would only be assessed at 5·25% of the gross annual royalty. 3

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			Marks
5	**(a)**	Plant and machinery are not defined in the IRO. Their definition comes from tax case law. The general principle is first to identify 'plant and machinery' and then to distinguish these from 'buildings'. To determine whether an asset is plant and machinery, it is necessary to look at the function of the asset (functional test) and whether it forms part of the setting in which the business is carried on or it is an asset with which the business is carried on (setting test).	1
		In *Yarmouth* v *France (19 QBD 647)* it was held that plant includes 'whatever apparatus is used by a business man for carrying on his business, not his stock-in-trade which he buys or makes for sale, but all goods and chattels, fixed or movable, live or dead, which he keeps for permanent employment in his business'. From this and subsequent cases has developed the general principle that expenditure on plant and machinery may be identified and distinguished from expenditure on buildings in that the former relates to 'tools' with which the business is carried on, whereas the latter is the 'environment' in which the business is carried on. It has been said that plant performs an active function while the function of a building is passive. In *CIR* v *Barclay, Curle & Co Ltd (1969) (45 TC 221)* a dry dock was held to be plant, not a building structure. The dry dock held ships up for repair and its role was similar to a tool of a trader.	1·5
		The active versus passive function test was also illustrated in *CIR* v *Scottish & Newcastle Breweries Ltd (55 TC 252)*. In this case decorations, electric light fittings of hotels, were held to be plant as they carried out the function of creating atmosphere. Similarly, special decorative windows in the offices of a building society were held to be plant and machinery in *Leeds Permanent Building Society* v *Procter (56 TC 293)*. In *J. Lyons & Co Ltd* v *AG (1944) (1 All E.R. 477)* a distinction was made between the setting in which the business was carried on and the apparatus with which the business was carried on. The former is a building while the latter is plant. This principle was followed in *Jarrold* v *John Good & Sons Ltd (40 TC 681)*. Partitioning which was movable and which was required to be regularly moved because of the changing nature of the business' requirements was held to be plant, and not part of a building. However, merely being movable or demountable is not, of itself, sufficient, as demonstrated in *St. Johns School* v *Ward (49 TC 524)* wherein a portable laboratory and a gymnasium were held to be buildings.	1
		In addition, IRR 2 specifies items which are plant and machinery and items which are implements, utensils and articles not qualifying for depreciation allowances.	0·5
			4
	(b)	Implements, utensils and articles are specifically excluded from the definition of plant and machinery in IRR 2. Such items include crockery and cutlery, loose tools, soft furnishings, kitchen utensils, etc. The initial purchase of such items, being capital expenditure, is not deductible under s.17(1)(c). Expenditure incurred on the subsequent replacement of these items is, however, fully allowed on a replacement basis under s.16(1(f).	2
	(c)	Applying the principles discussed in (a) above, a roof is an integral part of a building in which business is carried on and does not qualify as 'machinery or plant'. However, the sign performs an active function and is a 'tool' with which business is carried on. The sign does qualify as 'machinery or plant' and provided that a separate cost can be attributed to the structure comprising the sign then the same qualifies for depreciation allowances as 'machinery or plant'. For this reason, the price which QQ Ltd paid to purchase the roof did not qualify for depreciation allowances but only the cost of the structure thereon, which comprised the sign, qualified for depreciation allowances. QQ Ltd should provide information to the Commissioner for her to determine the amounts to be allocated to the respective costs of the roof and the sign for the purposes of calculating the capital allowances under s.38A.	4
			10