Fundamentals Level – Skills Module

Taxation (Hong Kong)

Monday 3 December 2007

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 (HKG)

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The question paper begins on page 3.

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

	2005/06 and 2006/07
	$
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

	2005/06	2006/07
Salaries tax rates:		
First $30,000	2%	2%
Next $30,000	8%	7%
Next $30,000	14%	13%
Remainder	20%	19%
Standard rate	16%	16%
Profits tax rate for corporations	17.5%	17.5%

Depreciation allowance rates

Initial allowance:	
Plant and machinery	60%
Industrial buildings	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 Eric Smith, an American citizen, was employed by Diamond Corporation (Diamond), a multinational corporation based in the United States (US). According to his employment contract, which was enforceable in the US, Eric's duties were performed exclusively to oversee and supervise operations of various affiliated companies of Diamond in the Far East region. However, for convenience, most of his work was performed in Hong Kong and Diamond paid $60,000 to purchase air tickets for Eric, his wife and two children to relocate them to Hong Kong.

Eric arrived in Hong Kong on 28 March 2005 and reported for duty on 1 April 2005 to Gold Ltd (Gold), a wholly owned subsidiary of Diamond in Hong Kong. His salary was paid in US dollars into his bank account in the US. It was Diamond's policy to allocate to Gold 50% of Eric's salary. Gold also provided Eric with a flat in Hong Kong and $2,000 was deducted from Eric's monthly salary as rent.

Following a reorganisation of the management of Gold on 1 January 2007, Eric was appointed a director by Gold's board. However, Eric has not attended any of Gold's board meetings.

The following information in respect of Eric is available:

(i) Places visited:

	1 April 2005 to 31 March 2006	1 April 2006 to 31 March 2007
Hong Kong	200	140
US (including 15 days leave)	–	25
China	65	190
Other Asian countries	100	10
Total	365 days	365 days

(ii) The following sums were received:

	1 April 2005 to 31 March 2006	1 April 2006 to 31 March 2007
From Diamond:		
Salary	$1,400,000	$1,800,000
From Gold:		
Directors' fees	–	$60,000

(iii) $800,000 of Eric's salary for the year ended 31 March 2007 was attributable to services rendered in China, upon which Eric was required to pay $160,000 income tax to the Chinese authority. The Chinese income tax was borne by Diamond (not Eric).

(iv) During the year ended 31 March 2007, Eric took a ten-day business trip to the US and extended his stay for a further fifteen days to visit his parents. Diamond purchased a business class ticket for $24,000 for Eric, but he paid the airline company $4,000 to exchange the ticket for two economy class tickets. His wife travelled with him on one of the economy tickets and shared the hotel room with him at no extra charge. Diamond approved this arrangement and paid the hotel room charges totalling $30,000 for the entire trip of twenty-five days.

(v) On becoming a director of Gold, Eric was granted an option to buy 40,000 shares in Gold Ltd. He paid a nominal amount of $4,000 for the option, which is transferable, but is valid only up to the end of June 2007. On 1 February 2007, he sold the option to buy 10,000 shares for $35,000 and exercised the option to take up 20,000 shares for $40,000. The 20,000 shares were all sold on 15 March 2007. The fair market values per share were as follows:

1 January 2007	$4
1 February 2007	$6
15 March 2007	$9
31 March 2007	$8

(vi) Eric's wife does not work. His two sons are studying in a primary school in Hong Kong.

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 an employment and from an office. (6 marks)

(b) Advise Eric Smith on the extent to which he is liable to Hong Kong salaries tax for the years of assessment 2005/06 and 2006/07. (5 marks)

(c) Calculate the Hong Kong salaries tax payable by Eric Smith for each of the years of assessment 2005/06 and 2006/07.

Notes:

You should ignore provisional taxes.

Written explanations for the treatment of each item are not required. (14 marks)

(25 marks)

2 TT Ltd (TT) has been carrying on business in Hong Kong as an importer and exporter of electronic parts since 1994. The company's management accounts for the year ended 31 March 2007 are reproduced in the Appendix on page 9.

The following information, extracted from the audit working papers, gives further details of TT's operations during the year:

1. Turnover $11,175,000 (2006: $9,075,000) – increased by 23%; orders received from German customers up by 20%; summary of sales orders by area:

	%
US	35
Germany	30
PRC	15
HK	20
Total	100

The sales team is based in Hong Kong but frequently travels overseas to attend trade fairs and meet customers. Most customers are old, having done business with TT for more than ten years. All sales orders must be approved and processed in Hong Kong.

2. Interest income $90,000 (2006: $120,000) – decreased by 25%; mainly due to a decrease in bank deposits in the US:

Currency	**Banker**	**Interest**
Euro$	ABN	$30,000
US$	Citibank	$35,000
HK$	HSBC	$20,000

Another $5,000 was received from a US customer on his overdue account.

3. Compensation $400,000 (2006: $0) – received from a German customer after litigation due to the cancellation of a five-year sales contract without prior notice.

4. Legal and professional fees $210,000 (2006: $110,000):

	$
Collection of trade debts – HK customers	15,000
– overseas customers	10,000
Litigation (as referred to in note 3 above)	35,000
Office lease renewal	25,000
Audit fee	70,000
Tax filing in Hong Kong	55,000
Total	210,000

5. Retirement fund expense $400,000 (2006: $340,000); comprised of a $20,000 lump sum payment specially requested by the actuary; and a balance of $380,000 due per the actuarial report.

Based on representation by the management, the agreement reached with the actuary is that a special formula is applied to equate (to a large extent) the profit/loss charge with the cash contribution. Under the scheme, staff contribute 5% and the company contributes 10%. The company's contribution is normally due for payment in February.

6. Finance charges $30,000 (2006: $28,000) – increased by 7%:

	$
Bank charges on daily operations	12,000
Finance charges on hire purchase	2,000
Interest on a bank overdraft secured by a HK$ deposit with HSBC (see note 2 above)	16,000
Total	30,000

7. Exchange loss $12,000 (2006: $20,000 gain) – decreased by 160%; mainly due to the fluctuation of the Euro$ rate during the year:

	$
Gain from conversion of bank deposits	(78,000)
Loss from conversion of trade receivables	90,000
Net loss	12,000

8. Commission $410,000 (2006: $500,000) – decreased by 18%; due to a better deal with agents, including an agent in Germany under a non-disclosure agreement with TT; the commission paid to this agent was $90,000.

9. Provision for trade receivables $20,000 (2006: $13,000) – increased by 54%; mainly due to the insolvency of a German customer:

	$
Opening balance	(76,000)
Balances written off – DD Co, Hong Kong	5,000
– ZZ Ltd, Germany	25,000
Amount recovered from Hong Kong customers written off in 2004	(15,000)
Amount charged to profit and loss account	(20,000)
Closing balance	(81,000)

10. Sundry expenses $47,000 (2006: $58,000) – decreased by 19%:

	$
Repairs	6,000
Stock loss	5,000
Tax surcharge (late payment)	12,000
Subsidy for director's salaries tax	10,000
Other allowable office consumables	14,000
Total	47,000

11. As per 2005/06 profits tax computation:

	$
Assessable profits for the year	Nil
Loss for the year	550,000
Loss brought forward	630,000
Depreciation allowance:	
WDV carried forward: 20% pool	20,000
30% pool	30,000
Rebuilding allowance	0
Industrial building allowance	0

12. Fixed asset movements:

	Furniture/fixtures	Computers	Motor car
	$	$	$
Cost	200,000	610,000	400,000
New additions	0	40,000*	100,000
Disposals	0	(120,000)	(80,000)
	200,000	530,000	420,000
Depreciation			
Balance at 1 January 2007	25,000	240,000	160,000
Additions/charge	10,000	200,000	26,000
Disposals	0	(80,000)	(40,000)
Balance	35,000	360,000	146,000
Net book value (NBV)	165,000	170,000	274,000
NBV of disposal	0	40,000	40,000
Disposal proceeds	0	30,000 **	56,000
Profit/(loss)	0	(10,000)	16,000

* Including a $20,000 system purchased under a hire purchase agreement of six months, with a down payment of $2,000, monthly instalments of $4,000 and an invoice date of 1 February 2007.

** The cost of the computer had been 100% written off in the previous year's tax computation.

Required:

(a) Compute TT Ltd's Hong Kong profits tax liability in respect of the year ended 31 March 2007, clearly identifying both the year of assessment and the basis period.

Notes:

You should ignore provisional tax and overseas tax.

No detailed explanations are required in <u>this</u> part. (23 marks)

(b) Give explanations to illustrate the correct tax treatment and the underlying reasoning in respect of the compensation of $400,000 received by TT Ltd as per the auditor's note 3. (3 marks)

(c) Since TT Ltd has incurred tax losses for several years, no profits tax return was issued for either 2005/06 or 2006/07.

Advise TT Ltd of its statutory reporting obligation as required under the Inland Revenue Ordinance. (4 marks)

Appendix to Question 2

TT Ltd

Draft management accounts for the year ended 31 March 2007

	$	$
Sales	11,175,000	
Interest income	90,000	
Compensation	400,000	
Profit on disposal	6,000	11,671,000
Directors' fees	200,000	
Salaries and wages	2,930,000	
Legal and professional fees	210,000	
Retirement fund expense	400,000	
Depreciation charge	116,000	
Insurance	12,000	
Finance charges	30,000	
Exchange loss	12,000	
Office rent and rates	2,015,000	
Travelling and entertainment	1,222,000	
Commission	410,000	
Printing and stationery	8,000	
Provision for trade receivables	20,000	
Donation to HK Community Chest	60,000	
Sundry expenses	47,000	(7,692,000)
Net profit		3,979,000

(30 marks)

3 Messrs Sze and To have been in partnership business since 1999. Their partnership agreement states that Messrs Sze and To will each receive an annual salary of $120,000 and that the balance of profits or losses is shared equally. On 1 January 2006 Mr To retired from the partnership and his share was taken up by Z Ltd. The new partners agreed that Mr Sze would continue to receive the same salary and that Z Ltd would be paid interest at the rate of 10% on its capital contribution of $1,000,000. The profit sharing ratio was then changed to 1:2 (Sze:Z Ltd).

Recent results of the partnership are as follows:

Year ended 31 December 2005	Allowable loss	($450,000)
Year ended 31 December 2006	Assessable profits	$670,000

The partners also provide you with the following information:

1. During the years ended 31 December 2005 and 2006 the partnership employed Mr To's wife as a bookkeeper and paid her an annual salary of $108,000 in both years.

2. Mrs Sze (Mr Sze's wife) owns an office in Central. From 1 April 2006, she leased the office to Z Ltd for two years at a monthly rent of $20,000 plus a premium (received on 1 April 2006) of $120,000. For the year ended 31 March 2007, Mrs Sze paid rates of $3,000 per quarter and Z Ltd paid management fees of $2,000 per month. In September 2006, the office was repaired for $40,000, which was paid equally by Mrs Sze and Z Ltd. To finance the acquisition of the office, Mrs Sze borrowed $2,000,000 from her brother, a resident in Singapore. Interest paid on the loan for the year ended 31 March 2007 amounted to $140,000.

3. Apart from the above, Mr and Mrs Sze also had the following income and outgoings for the year ended 31 March 2007:

	Mr Sze $	Mrs Sze $
Salary	–	96,000
Profit from proprietorship business (before deduction of approved charitable donations)	160,000	–
Loss from property trading	–	(170,000)
Contributions to mandatory provident fund	–	15,000
Total approved charitable donations (including those already deducted from the proprietorship business)	130,000	–

4. Mr and Mrs Sze elected to be personally assessed in 2006/07. Mr To had no other sources of income and he did not elect for personal assessment.

5. Z Ltd carries on a trading business. For the year ended 31 March 2007, its profit and loss account contained the following particulars:

	$
Sales	3,500,000
Cost of sales	(2,800,000)
	700,000
Interest income from partnership	100,000
Distribution of partnership profits	250,000
	1,050,000
Revenue expenses	(950,000)
Net profit	100,000

Required:

(a) Compute the allocation of profits for the partnership business together with the profits tax payable, if any, by the partnership for each of the years of assessment 2005/06 and 2006/07.

Note: You should ignore provisional tax. (7 marks)

(b) Compute the tax payable by Mr and Mrs Sze under personal assessment for the year of assessment 2006/07. (10 marks)

(c) Prepare the profits tax computation for Z Ltd for the year of assessment 2006/07.

Note: You should ignore provisional tax. (3 marks)

(20 marks)

4 **(a)** PP Ltd is a Hong Kong company carrying on a trading business in Hong Kong. The director of PP Ltd is proposing to borrow money to acquire trading stock from a supplier. He has the following choices of funding:

(i) A loan from a Hong Kong bank;

(ii) A loan from a PRC company which is owned by a friend of the director.

Required:

Explain the principles governing the tax deductibility of the loan interest which will be incurred by PP Ltd under each of the respective choices. (10 marks)

(b) LL Ltd carries on business in Hong Kong as a manufacturer. It owns a patent 'L2' for its manufacturing activities. Due to financial difficulties, it intends to sell this patent right to a Singapore company and license it back for use in its factory in Hong Kong. LL Ltd will pay an annual royalty to the Singapore company at an agreed percentage based on annual sales. The Singapore company is an independent party to LL Ltd.

Required:

Explain the Hong Kong tax implications for the Singapore company as a consequence of the receipt of the royalty income from LL Ltd. (5 marks)

(15 marks)

5 **(a)** **Explain the meaning of plant and machinery and the basis on which it is distinguished from a building for tax purposes.** (4 marks)

(b) **State the tax treatment accorded to expenditure on implements, utensils and articles.** (2 marks)

(c) In July 2006 QQ Ltd purchased a roof of a building with a neon advertising sign erected thereon for a consideration of $2,000,000. In its profits tax return for the year of assessment 2006/07, QQ Ltd claimed depreciation allowances in respect of the entire roof, including the neon advertising sign on the ground that it constituted plant and machinery. It further submitted that the rooftop performed the function of allowing the sign to be erected and had no other value. However, in the 2006/07 profits tax assessment, the assessor only allowed a commercial building allowance calculated on the entire cost of the roof on the ground that 'a roof is an integral part of a building and does not qualify as machinery or plant'.

Required:

State, giving reasons, whether or not the 2006/07 profits tax assessment issued to QQ Ltd is correct. (4 marks)

(10 marks)

End of Question Paper