

Fundamentals Level – Skills Module

Taxation (Hong Kong)

Monday 2 June 2008

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 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)

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

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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 2007/08 tax rates and allowances are to be used in answering the questions

Allowances

| | \$ |
|--|---------------|
| Basic allowance | 100,000 |
| Married person's allowance | 200,000 |
| Single parent allowance | 100,000 |
| Child allowance – 1st to 9th child (each) | 50,000 |
| – additional allowance in the year of birth (each) | 50,000 |
| 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) | 60,000 |
| Home loan interest (maximum) | 100,000 |
| Elderly residential care expenses (maximum) | 60,000 |

Tax rates

| | |
|-----------------------------------|-------|
| Salaries tax rates: | |
| First \$35,000 | 2% |
| Next \$35,000 | 7% |
| Next \$35,000 | 12% |
| Remainder | 17% |
| Standard rate | 16% |
| Profits tax rate for corporations | 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% |
| Machines | 20% |
| Industrial buildings | 4% or formula |
| Commercial buildings | 4% or formula |

ALL FIVE questions are compulsory and MUST be attempted

- 1** Frank Ko is the general manager of Zitech (HK) Ltd (Zitech), a company carrying on business in Hong Kong. Frank is in charge of Zitech's office in Beijing and travels to Hong Kong on a regular basis. The following information is available in respect of Frank for the year ended 31 March 2008:
- (1) Frank's basic salary is \$60,000 per month.
 - (2) During the year, Frank spent eight months in China. Two-thirds of his salary was attributable to services rendered in China, upon which he was required to pay \$140,000 income tax to the Chinese authority. The Chinese income tax was paid and borne by Zitech.
 - (3) For the month of April 2007, Frank was given a cash allowance of \$15,000 to cover his accommodation costs. From 1 May 2007 to 28 February 2008, he was provided with a house owned by Zitech in Beijing, rent-free. On 1 March 2008, he purchased the house from Zitech for \$800,000. The market value of the house at that date was \$1 million.
 - (4) Zitech gave Frank an allowance of \$30,000 to spend during his holidays in France. He actually spent \$26,000 and retained the balance.
 - (5) On 1 September 2007, Frank was given an option to purchase 10,000 shares in Zitech (International) Ltd, a company listed on the London Stock Exchange, at a price equivalent to \$15 per share. The market price on 1 September 2007 was \$15.50 per share. He exercised the option on 30 December 2007 when the share price reached \$18 per share.
 - (6) Frank is studying for the MBA degree at the Tsinghua University, Beijing. During the year, he paid a tuition fee of \$80,000, half of which was reimbursed by Zitech.
 - (7) Frank's wife is a Chinese resident employed by a Chinese company. Her salary is \$10,000 per month.
 - (8) Frank has two children, aged 10 and 12.
 - (9) Frank maintains his mother, aged 68, who lives with his family in Beijing. His mother has a Hong Kong identity card and travels frequently to Hong Kong.
 - (10) During the year, Frank contributed \$15,000 to the Mandatory Provident Fund.

All currency amounts are given in Hong Kong dollars.

Required:

- (a) Advise Frank Ko on the extent to which he is liable to Hong Kong salaries tax for the year of assessment 2007/08.** (4 marks)
- (b) Calculate the Hong Kong salaries tax payable by Frank Ko for the year of assessment 2007/08, giving explanations of the treatment you have accorded for tax purposes to items (3) to (8) above.** (16 marks)
Note: you should ignore provisional taxes.
- (c) Zitech has a wholly owned subsidiary, Zitech (Cayman) Ltd. The subsidiary is incorporated in the Cayman Islands and carries on its business in Hong Kong. The management of Zitech has suggested transferring Frank Ko's employment to this subsidiary.**

Discuss the tax implications for Frank Ko if his contract of employment is transferred to Zitech (Cayman) Ltd. (5 marks)

(25 marks)

- 2 Clean and Clear Ltd (C&C) carries on the business of providing cleaning and hygienic treatment services to major hospitals in Hong Kong. C&C's profit and loss account for the year ended 31 March 2008 is as follows:

| | \$ | \$ |
|------------------------------|-----------|------------------|
| Income: | | |
| Revenue | 5,000,000 | |
| Interest income | 25,000 | |
| Compensation | 1,000,000 | 6,025,000 |
| Expenses: | | |
| Directors' fees | 2,000,000 | |
| Staff salaries and benefits | 800,000 | |
| Rent and rates | 1,200,000 | |
| Interest | 30,000 | |
| Finance charge | 35,000 | |
| Depreciation | 140,000 | |
| MPF contribution | 23,000 | |
| Repairs and maintenance | (10,000) | |
| Loss on fixed asset disposal | 25,000 | |
| Other expenses | 120,000 | (4,363,000) |
| Net profit/(loss) | | <u>1,662,000</u> |

Extracts from the auditors' working papers for the same year are as follows:

| Ref | Account name | Notes and comments | 2007/08 \$ | 2006/07 \$ |
|-----|-----------------|--|---------------|---------------|
| 01 | Revenue | Comprising cleaning service fees received from customers, two types: (a) monthly retainer ranging from \$30,000 to \$200,000, (b) \$10 per 1kg for special items; charges generally up by 2% from July 2007. | 5,000,000 | 4,300,000 |
| 02 | Interest | Bank deposit interest \$2,000. Loan interest from a director \$23,000; company made a loan to a director in 2001 at 3.5% per annum (market rate 5%); loan balance reduced to \$800,000 at the year end. | 25,000 | 80,000 |
| 03 | Sundry income | Compensation of \$1 million as settlement of a legal case, company sued a customer in 2004 for cancelling a five-year contract at short notice; total contract revenue approximately \$5 million, commercial deal, no issue. | 1,000,000 | – |
| 04 | Directors' fees | Fee to Mr Chan \$1.5 million (\$1.3 million last year), fee to Mrs Chan \$500,000 (\$200,000 last year); board approval minuted; both are residents of Canada, personnel manager said no reporting was made to the Inland Revenue Department as the fees were taxed in Canada. | 2,000,000 | 1,800,000 |
| 05 | Staff costs | Five (5) general staff, no change this year, total salaries of \$600,000; salaries tax of \$80,000 paid on behalf of the general manager (Mrs Chan's brother); four (4) return tickets HK/Canada and HK/Tokyo totalling \$120,000 purchased for Mr and Mrs Chan. | 800,000 | 600,000 |

| | | | | | | | | | | | | | | | | | | | | |
|--------------------------------|--------------------------|---|-----------|-----------|-----------|-------|--------------------------------|--------|---------------------------|--------|-----------|--------|-------------|--------|--|----------------|-------|-----------------------|---------|--------|
| 06 | Rent and rates | Company moved its factory during the year and signed a new lease contract with effect from 1 April 2007 for a term of five (5) years; annual rental is \$1,000,000; company paid factory moving costs of \$200,000; removal is due to the refusal of the landlord to renew the contract, probably due to the possible redevelopment of the site. | 1,200,000 | 1,100,000 | | | | | | | | | | | | | | | | |
| 07 | Interest | Bank loan \$600,000 obtained in 2003 at 5% per annum; guaranteed by Mr Chan on a personal basis on his property. | 30,000 | 24,000 | | | | | | | | | | | | | | | | |
| 08 | Finance charge | Washing machines leased in April 2005 for a term of ten (10) years; company has an option to purchase the machines at the end of the lease term at a notional amount of \$100. Annual lease rental is \$100,000, including a finance charge of \$35,000. The capital value has been capitalised in the accounts. | 35,000 | 35,000 | | | | | | | | | | | | | | | | |
| 09 | Mandatory provident fund | Ordinary contribution to mandatory provident fund (MPF) per advice. | 23,000 | 20,000 | | | | | | | | | | | | | | | | |
| 10 | Repairs and maintenance | Comprising annual maintenance for the year \$20,000, write-back of an over-accrual made in last year \$30,000, net credit balance (\$10,000); last year over-accrual due to over-quotation and extra discount in final billing. | (10,000) | 44,000 | | | | | | | | | | | | | | | | |
| 11 | Fixed asset disposals | Miscellaneous furniture with carrying value of \$18,000 was scrapped during the factory move. A lap-top computer acquired in 2005 was sold to a member of staff for \$2,000 – the carrying value of this computer was \$9,000. | 25,000 | – | | | | | | | | | | | | | | | | |
| 12 | Sundries | Comprising: <table style="margin-left: 40px; border-collapse: collapse;"> <tr> <td></td> <td style="text-align: right;">\$</td> </tr> <tr> <td>Insurance</td> <td style="text-align: right;">6,000</td> </tr> <tr> <td>Legal costs for suing customer</td> <td style="text-align: right;">18,000</td> </tr> <tr> <td>Legal costs for new lease</td> <td style="text-align: right;">22,000</td> </tr> <tr> <td>Utilities</td> <td style="text-align: right;">24,000</td> </tr> <tr> <td>Advertising</td> <td style="text-align: right;">50,000</td> </tr> <tr> <td></td> <td style="text-align: right;"><u>120,000</u></td> </tr> <tr> <td>Total</td> <td style="text-align: right;"><u><u>120,000</u></u></td> </tr> </table> | | \$ | Insurance | 6,000 | Legal costs for suing customer | 18,000 | Legal costs for new lease | 22,000 | Utilities | 24,000 | Advertising | 50,000 | | <u>120,000</u> | Total | <u><u>120,000</u></u> | 120,000 | 90,000 |
| | \$ | | | | | | | | | | | | | | | | | | | |
| Insurance | 6,000 | | | | | | | | | | | | | | | | | | | |
| Legal costs for suing customer | 18,000 | | | | | | | | | | | | | | | | | | | |
| Legal costs for new lease | 22,000 | | | | | | | | | | | | | | | | | | | |
| Utilities | 24,000 | | | | | | | | | | | | | | | | | | | |
| Advertising | 50,000 | | | | | | | | | | | | | | | | | | | |
| | <u>120,000</u> | | | | | | | | | | | | | | | | | | | |
| Total | <u><u>120,000</u></u> | | | | | | | | | | | | | | | | | | | |
| 13 | Tax | 2006/07 tax return shows a tax loss carried forward of \$300,000, statement of loss issued per tax return; tax estimate $17.5\% \times (\$1,537,000 - \$300,000) = \$216,475$; tax provision of \$200,000 considered adequate. 2006/07 tax return also shows: tax written down values: 20% pool \$320,000; 30% pool \$36,000; hire purchase 20% \$359,840. | 200,000 | – | | | | | | | | | | | | | | | | |

An extract of C&C's fixed asset movements for the year ended 31 March 2008 is as follows:

| | Machines \$ | Furniture \$ | Motor Car \$ | Computers \$ |
|---------------------------------|-----------------------|-----------------------|----------------------|----------------------|
| Cost at 1 April 2007 | 650,000 | 200,000 | 220,000 | 80,000 |
| Additions | – | 40,000 | – | 20,000 |
| Disposals | – | (30,000) | – | (30,000) |
| Balance at 31 March 2008 | <u>650,000</u> | <u>210,000</u> | <u>220,000</u> | <u>70,000</u> |
| Depreciation at 1 April 2007 | (130,000) | (80,000) | (140,000) | (50,000) |
| Charge for the year | (65,000) | (20,000) | (35,000) | (20,000) |
| Disposals | – | 12,000 | – | 21,000 |
| Balance at 31 March 2008 | <u>(195,000)</u> | <u>(88,000)</u> | <u>(175,000)</u> | <u>(49,000)</u> |
| Carrying value at 31 March 2008 | <u><u>455,000</u></u> | <u><u>122,000</u></u> | <u><u>45,000</u></u> | <u><u>21,000</u></u> |

Required:

- (a) **Compute Clean and Clear Ltd's Hong Kong profits tax liability in respect of the year ended 31 March 2008, clearly identifying both the year of assessment and the basis period and showing the hire purchase depreciation allowance calculation since 2005/06.**

Notes:

(1) You should ignore provisional tax and overseas tax.

(2) No detailed explanations are required in this part.

(19 marks)

- (b) **Explain the principles and the underlying reasoning relevant to the tax treatment of the rent and rates under reference number 06 above.**

(6 marks)

- (c) The auditors of Clean and Clear Ltd have raised a concern over the non-reporting to the Inland Revenue Department in respect of the directors' fees, as mentioned under reference number 04 above.

Advise Clean and Clear Ltd with regard to (1) whether it has any statutory reporting obligation in respect of the fees under the current tax law; and (2) whether they are taxable in Hong Kong.

(5 marks)

(30 marks)

3 French Restaurant is a partnership between Alex, Barbara, and Cheerful Ltd. The partners share profits and losses in the ratio of 2:1:1 respectively. The partnership commenced business on 1 January 2007 and makes up its accounts to 31 March.

The first profit and loss account of the partnership drawn up for the 15 months from 1 January 2007 to 31 March 2008 is as follows:

| | Notes | \$ | \$ |
|--------------------------|-------|----------------|-----------------------|
| Revenue | | | 6,000,000 |
| Less: Cost of goods sold | | | <u>(2,700,000)</u> |
| | | | 3,300,000 |
| Less: Wages | 1 | 975,000 | |
| Other direct expenses | 2 | <u>147,000</u> | <u>(1,122,000)</u> |
| Gross profit | | | 2,178,000 |
| Less: Rent | 3 | 900,000 | |
| Salaries | | 420,000 | |
| Other expenses | 4 | 70,500 | |
| Depreciation | | 168,750 | |
| Loan interest to Can Ltd | | <u>45,000</u> | <u>(1,604,250)</u> |
| Net profit | | | <u><u>573,750</u></u> |

Notes:

- (1) Wages included \$225,000 paid to Alex and \$270,000 paid to Barbara's husband.
- (2) Included in other direct expenses was \$31,500 being the cost of purchase of knives, forks, bowls and cups of which \$4,500 was the cost of replacement and \$27,000 was the cost of purchase of new items.
- (3) Rent of \$900,000 was paid to Cheerful Ltd, the landlord of the premises in which the business was operated.
- (4) Other expenses included:
 - (i) a legal fee for drafting the lease agreement of \$2,250; and
 - (ii) accountancy fees of \$4,500.

All other items under this category are deductible.

Other information:

- (i) Tax depreciation allowances as agreed with the Inland Revenue Department for 2006/07 and 2007/08 are \$315,000 and \$225,000 respectively.
- (ii) Apart from the above, Alex and his wife, Doris, also had the following income and outgoings for the year ended 31 March 2008:

| | Alex \$ | Doris \$ |
|---|------------|-------------|
| Salary | – | 200,000 |
| Profit from proprietorship business (before deduction of \$40,000 approved charitable donations) | 120,000 | – |
| Contributions to mandatory provident fund (MPF) | – | 15,000 |
| Total approved charitable donations (including those already deducted from the proprietorship business) | 95,000 | 60,000 |

- (iii) Only Alex and Doris elected for personal assessment in 2007/08.
- (iv) Cheerful Ltd also carries on another business in Hong Kong, for which it had assessable profits of \$15,000 for the year ended 30 June 2006 and an adjusted loss of \$30,000 for the year ended 30 June 2007.

Required:

- (a) **Compute the assessable profits/adjusted loss of the partnership for all relevant years of assessment and the tax payable thereon, if any, claiming any relief which is available to Cheerful Ltd.**

Note: you should ignore provisional tax.

(15 marks)

- (b) **Compute the tax payable by Alex and Doris under personal assessment for the year of assessment 2007/08.**

(5 marks)

(20 marks)

4 Mr Robinson purchased a property in North Point three months ago. He managed to find a tenant before he returned to Canada last month. A lease was signed with Miss Kan for two years. Details of the terms of the lease agreement are as follows:

1. Term of lease: Two years from 1 April 2007.
2. Monthly rental: \$20,000, payable in advance on the first day of each month.
3. Rent-free period: One month from 1 April 2007.
4. Rental deposit: \$40,000, payable on 1 April 2007.
5. Rates: \$3,000 per quarter, payable by Mr Robinson.
6. Management fee: \$2,000 per month, payable by Miss Kan directly to the management company.
7. Repairs: On the account of Mr Robinson.
8. Subletting: Miss Kan is allowed to sublet the property.

Mr Robinson obtained a bank mortgage loan to fund the purchase price of the property. During the year ended 31 March 2008, monthly loan interest of \$25,000 was paid. In addition, he paid an agency fee of \$10,000 for letting the property and an annual agency management fee of 0.2% of the rentals received.

In February 2008, Miss Kan tried to claim back the sum of \$7,000 being repair costs spent on the toilet system, but Mr Robinson did not respond.

Required:

- (a) Explain whether or not Mr Robinson is subject to tax in Hong Kong in respect of the property income. (2 marks)
- (b) Assuming that Mr Robinson is subject to Hong Kong property tax, calculate the property tax liability for the year of assessment 2007/08, giving explanations for the items included in and excluded from, your computation. (7 marks)
- (c) State, based on the Hong Kong Inland Revenue Ordinance, under what circumstances an individual earning property income is able to deduct bank mortgage loan interest from that property income; and advise Mr Robinson as to whether these circumstances apply to him. (6 marks)

(15 marks)

5 Baby Ltd runs a spa in Hong Kong. Parent Pte Ltd, the shareholder company of Baby Ltd, carries on business in Singapore. During the year ended 31 March 2008, Parent Pte Ltd has sent an invoice to Baby Ltd for an amount of HK\$500,000 with the description of:

‘Recovery of head office costs incurred in Singapore in respect of support services provided to the company during the year.’

Required:

Explain the principles relevant to the deduction of the payments made to Parent Pte Ltd and indicate the criteria that will need to be satisfied if a tax deduction is to be secured for the payment made by Baby Ltd.

(10 marks)

End of Question Paper