SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1(a)

Analysis of income	**Taxable** HK$	**Non-taxable** HK$
Compensation for early termination of a business contract	152,500	-
Share of profits from an associated company	-	350,000
Exchange gain	28,300	-
Interest income from loans advanced to employees	8,100	-
Interest income from unpledged deposit placed with a local bank	-	1,300
Interest income from long outstanding business related receivable balance	6,800	-
General bad debt provision written back	-	191,200
Deposit forfeited by customers	100,000	-
Total	295,700	542,500

Answer 1(b)

Analysis of expenses	**Deductible** HK$	**Non-deductible** HK$
Interest expense on overdue account payable	2,600	-
Interest expense on a bank loan from HSBC	88,000	-
Interest expense on a bank loan from Standard Chartered Bank	-	79,500
Recognised occupational retirement scheme special contribution ($185,000 x 1/5 as deductible)	37,000	148,000
Recognised occupational retirement scheme annual contribution ($680,000 ÷ 17% x 15% as deductible)	600,000	80,000
Refurbishment expense for the residential property (expenses to be claimed for commercial building allowance)	-	280,000
Refurbishment expense for the commercial property ($700,000 x 1/5 as deductible)	140,000	560,000
Tax payment	275,000	-
Accounting depreciation	-	163,500
Total	1,142,600	1,311,000

Answer 1(c)

Depreciation allowance

	20% pool	30% pool	Total allowances
	HK$	HK$	HK$
T.W.D.V. b/fwd	89,300	111,700	
Additions-office furniture/motor vehicle	99,500	238,800	
	188,800	350,500	
Less: I.A. @60% on additions	(59,700)	(143,280)	202,980
	129,100	207,220	
Less: A.A	(25,820)	(62,166)	87,986
T.W.D.V. c/fwd	103,280	145,054	
			290,966

Commercial building allowance

	HK$
Ranking cost b/fwd	400,000
Less: Disposal	(400,000)
Add: Addition (refurbishment of residential property)	280,000
Ranking cost c/fwd	280,000

	HK$	Total allowances HK$
T.W.D.V. b/fwd	304,000	
Less: Disposal (balancing allowance)	(304,000)	304,000
Add: Addition (per above)	280,000	
Less: A.A. (@4% on ranking cost c/fwd)	(11,200)	11,200
T.W.D.V. c/fwd	268,800	
		315,200

Answer 1(d)

Anomalistic Limited
Profits Tax Computation – 2015/16

	HK$
Profit before taxation	7,239,000
Add: Non-deductible expenses (per Answer 1(b))	1,311,000
	8,550,000
Less: Non-taxable income (per Answer 1(a))	(542,500)
	8,007,500
Less: Allowances under Part 6 of the IRO (per Answer 1(c))	
- Depreciation allowances	(290,966)
- Commercial building allowance	(315,200)
	7,401,334
Deduction under S.16G of the IRO (computer equipment)	(88,800)
Assessable profits	7,312,534
Tax thereon @16.5%	1,206,568

Answer 2(a)

For simple loans of money, the taxability of interest income is determined by the place where the credit is provided to the borrower, (i.e. the place where the funds from which the interest income is derived are provided to the borrower), in accordance to the "provision of credit" test (Para. 2, DIPN No. 13 (Revised) issued in December 2004). Essentially, if the relevant loan is first made available to the borrower outside of Hong Kong (e.g. through the remittance of funds to the borrower's overseas bank account), the interest income derived thereon should be offshore in nature and should not be subject to profits tax. The place of residence of the debtor is irrelevant to the taxability of the interest income.

However, in line with the case of Orion Caribbean Limited v. CIR 4 HKTC 432, the taxability of interest income derived by a taxpayer carrying on a money lending business should be determined by the operation test (i.e. the respective activities deriving the income and the location where these activities have been done) instead of the abovesaid "provision of credit" test. In this connection, Co. A should carefully review if the envisaged money lending activities would constitute a distinctive money lending business from the profits tax perspective.

Answer 2(b)

The broad guiding principle in determining the source of profits (including service income and other income derived from various forms of business activities) is that one looks to see what the taxpayer has done to earn the profits in question, and where he has done it. Specifically the following principles are particularly relevant in determining the locality of service income (Para. 17, DIPN No. 21 (Revised) issued in July 2012):

i. The relevant operations (activities) producing the service income and where those operations took place should be ascertained.
ii. The operations in question must be the operations of the taxpayer.
iii. The operations do not comprise the whole of the activities of the taxpayer carried out in the course of its business, but only those which produce the service income.
iv. If services are performed both in Hong Kong and overseas, apportionment of the service income into onshore and offshore sourced portion may be appropriate, subject to the availability of an appropriate basis.
v. The absence of an overseas permanent establishment to facilitate the provision of the services outside Hong Kong does not of itself mean that the service income must be sourced in Hong Kong. However, in the HK-TVBI Case, Lord Jauncey said that "it can only be in rare cases that a taxpayer with a principal place of business in Hong Kong can earn profits which are not chargeable to profits tax".

With respect to the service income to be derived by Co. A from the proposed listing advisory services and in line with the above principles, Co. A should identify all the relevant activities to be conducted both within and outside Hong Kong, and evaluate what are the most important activities and critical step(s) constituting the generation of the service income, and the respective location(s) in performing the services. In conducting the evaluation, only the activities conducted directly by Co. A should be taken into account. In addition, Co. A should evaluate whether its overseas permanent establishment, if any, can facilitate the offshore claim, or alternatively Co. A should prepare the justification of having offshore profits without any permanent establishment outside of Hong Kong. Co. A should also consider the applicability of apportioning the service income into both an onshore and offshore sourced portion where an appropriate basis is available.

Answer 3

Under s.9(1)(a)(iv) and s.9(2A)(a) of the Inland Revenue Ordinance ("IRO"), income from employment assessable to salaries tax excludes any amount paid by the employer to or for the credit of a person other than the employee in discharge of a sole and primary liability of the employer to that other person, provided that the benefit is not capable of being converted into cash by the recipient. In this connection, benefits-in-kind structured and provided by Co. A to its senior executives should not be subject to salaries tax if they are structured in line with the regulatory framework as per the relevant IRO provisions.

However, Co. A and the senior executives should also note that the provision under s.9(1)(a)(iv) of the IRO shall not be applicable to the following benefits-in-kind, which are specifically excluded under other provisions in the IRO:

i. Any amount paid by an employer in connection with the education of a child of an employee (s.9(2A)(b) of the IRO); and
ii. Any amount paid by an employer in connection with a holiday journey (s.9(2A)(c) of the IRO).

Answer 4(a)

The transfer of Property X from Co. C to Co. A is chargeable to Ad Valorem Stamp Duty ("AVD") under Head 1 in the First Schedule of the Stamp Duty Ordinance ("SDO"). The chargeable instrument with respect to the transfer is the Agreement for Sale under Head 1 (1A) or, in a case without any Agreement for Sale, the Conveyance on Sale (Deed of Assignment) under Head 1(1). The time for stamping is within 30 days after the execution of the respective instrument.

As Property X is a commercial property, the transfer is subject to Scale 1 rates under Head 1(1) or Head 1(1A). The respective AVD liability is thus HK$2,975,000 (HK$35,000,000 x 8.5%).

Notwithstanding that Co. A and Co. C are entirely owned by Mr Ng, this shareholding structure cannot be regarded as "associated companies" within the meaning under s.45(2) of the SDO. In this connection, stamp duty relief under s.45 of the SDO is not applicable accordingly.

As Property X is a commercial property, Special Stamp Duty ("SSD") under Head 1 (1AA) and 1(1B), and Buyer's Stamp Duty ("BSD") under Head 1(1AAB) and Head 1(1C) are not applicable with respect to the transfer.

Answer 4(b)

On the basis that Co. C would be put into liquidation by distribution in specie, the shareholder of Co. C (i.e. Mr Ng) would be regarded as becoming a beneficial owner of Property Y previously owned by Co. C upon executing the instrument to effect the distribution in specie of Property Y to Mr Ng (Para.12, SOIPN No. 8 issued in October 2014). In this regard, the transfer should not be subject to any AVD, SSD and BSD as the beneficial owner of Property Y has not been changed with respect to the transfer.

Answer 4(c)

The transfer of Property Z from Mr Ng to his wife and his mother collectively by way of a gift is chargeable to stamp duty as a voluntary disposition inter vivos under s.27 of the SDO, and the relevant instrument effecting the transfer (i.e. Conveyance or Deed of Assignment) would be chargeable to AVD under Head 1(1) in the First Schedule of the SDO. The time for stamping is within 30 days after the execution of the instrument.

In ascertaining the relevant AVD rate for the transfer, Scale 2 rates under Head 1(1) would be applicable if all the transferees are close relatives of the transferor (i.e. Mr Ng) under s.29AL(2)(a) of the SDO, and all transferees are also close relatives amongst themselves under s.29AL(2)(b) of the SDO. As the wife of Mr Ng and the mother of Mr Ng are not close relatives within the meaning of s.29AD(b) of the SDO, Scale 2 rates are not applicable. The AVD is therefore HK$1,200,000 (HK$16,000,000 x 7.5%) in accordance to Scale 1 rates under Head 1(1) (Para.39, SOIPN No. 8 issued in October 2014).

On the same basis (i.e. the transferees are not closely related under s.29AD(b) of the SDO) and the mother of Mr Ng is a non-Hong Kong permanent resident, the exemption of BSD under s.29DB(2)(b)&(c) of the SDO is not applicable and therefore the transfer is subject to BSD at HK$2,400,000 (HK$16,000,000 x 15%) under Head 1(1AAB), payable within 30 days after the execution of the instrument.

SSD is not applicable to the transfer as Property Z was acquired by Mr Ng in year 2009, i.e. prior to the effective date of the SSD regime on 20 November 2010.

Answer 5

(i) Before accepting the tax services engagement, JOS should ensure its objectivity to Co. A by ascertaining that there is no conflict of interest for JOS in rendering the tax services to Co. A. In addition, JOS should also ensure that they have competent professional knowledge in providing the respective tax services to Co. A.

(ii) During the provision of the tax services, JOS should put forward the best position in favour of Co. A, provided that it does not impair its standard of integrity. Information provided by Co. A should be kept by JOS confidentially. The tax advice and tax computation prepared by JOS should be prepared on a fair basis. Specifically, JOS should not hold out to Co. A that they are beyond challenge.

(Any other fundamental principles from the Code of Ethics for Professional Accountants s.430 “Ethics in tax practice” relevant to the services provided to Co. A are also acceptable)

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS (Total: 50 marks)

Answer 6

(a) The owners of those 500 residential units ("the Landlords") are the owners of the common area, which includes the roofs (hereinafter collectively referred to as "the Properties"), of Honour Estate. As s.7A of the IRO provides that buildings includes any part of a building, it follows that the roofs of the residential buildings also fall into s.5(1) of the IRO – the charging section of property tax. The Receipts are the consideration paid for the use of the Properties. Hence, they are chargeable to property tax.

(b) As to the chargeable person, the Landlords are the owners of the Properties. They are the relevant chargeable persons. (Relevant authority: Board of Review Decision No. ***D80/02*** 17 IRBRD 984). Alternatively, as "owner" includes a person who, on behalf of another person, receives any consideration in respect of the right of use of any common parts (s.2 of the IRO), Excellent Service Company Limited is also the chargeable person as it receives the Receipts on behalf of the Landlords.

(c) The net assessable value of the Properties is the Receipts less (i) rates paid by the owners in respect of the Properties (s.5(1A)(b)(i) of the IRO) and (ii) 20% statutory deduction (s.5(1A)(b)(ii) of the IRO). The disbursement of the Receipts on estate management expenses other than rates has no relevance on the computation of net assessable value of the Properties.

Answer 7

Year of assessment 2009/10

Insofar as is relevant, s.26E(1) of the IRO provides that home loan interest is to be granted to any person who has paid interest on a home loan obtained to purchase a residential property which is used by the person as his place of residence. S.26E(2)(a) of the IRO further provides that a deduction allowable to a person under s.26E(1) shall be the lesser of the amount of the home loan interest paid or the amount specified in Schedule 3D in relation to that year of assessment. The amount specified in Schedule 3D for the year of assessment 2009/10 is HK$100,000. But s.26E(2)(a) of the IRO is subject to s.26E(2)(b) and (c).

S.26E(2)(b)(i) provides that where a dwelling is held by a person as joint tenant, the amount of the home loan interest shall be regarded as having been paid by the joint tenants each in proportion to the number of the joint tenants.

S.26E(2)(c)(i) further provides that where a dwelling is held by a person as a joint tenant, the relevant amount specified in Schedule 3D of the IRO in relation to home loan interest should be regarded as having been reduced in proportion to the number of the joint tenants.

In the present case, the Property is Mr Chan's place of residence. He is one of the joint tenants of the Property. For the purposes of s.26E(2)(b)(i) of the IRO, the amount of home loan interest regarded as having been paid is half of HK$160,000, i.e., HK$80,000. For the purposes of s.26E(2)(c)(i) of the IRO, the relevant amount specified in Schedule 3D will be reduced to half of HK$100,000, i.e., HK$50,000. By virtue of s.26E(2)(a) and on the authority of the Board of Review Decision No. ***D20/01*** 16 IRBRD 187 and ***D11/06*** (2006-07) 21 IRBRD 227, Mr Chan is only entitled to the deduction of home loan interest to the extent of half of HK$100,000, i.e. HK$50,000 for the year of assessment 2009/10.

Year of assessment 2014/15

With regard to Loan A, for the purposes of s.26E(2)(b)(i) of the IRO, the amount of home loan interest as having been paid is half of HK$40,000 i.e., HK$20,000.

As to Loan B, s.26E(9) of the IRO provides that a home loan means a loan of money which is applied for the acquisition of the dwelling. Loan B was taken out for the payment of premium to remove the alienation restriction in respect of the Property. It was not taken out for acquiring the Property. Hence, Loan B is not a home loan. On the authority of the Board of Review Decision No. ***D139/01*** 17 IRBRD 26, Mr Chan is not entitled to the deduction of home loan interest in respect of Loan B.

Hence, Mr Chan is entitled to the deduction of home loan interest in the amount of HK$20,000 for the year of assessment 2014/15.

Answer 8

(a) S.16(1) of the IRO provides for the deduction of outgoings and expenses which are incurred by a taxpayer in the production of its assessable profits. S.17(1)(c), however, provides that no deduction shall be allowed in respect of any expenditure of a capital nature. On the authority of the High Court decision of ***Wharf Properties Limited v Commissioner of Inland Revenue*** 1 HKLR 347, even if an expense falls within s.16, it still has to be considered whether the deduction is to be excluded under s.17. It is only when an expense qualifies for the deduction under both s.16 and s.17 that it is allowable for deduction. It was also held in ***the Wharf case*** that in determining whether an expense was of capital or revenue in nature, one has to examine not only the status of the expenditure but also the purpose or the circumstances under which the expenditure is incurred. Following the decision in ***British Insulated and Helsby Cables Limited v Atherton*** 10 TC 155, when an expenditure is made, not only once and for all, but with a view to bringing into the existence of an asset or an advantage for the enduring benefit of a trade, the expenditure is capital in nature. As to the meaning of "enduring benefit" or "permanent", it was held in ***Henriksen v Grafton Hotel, Ltd*** 24 TC 453 that they referred to enough durability to justify its being treated as a capital asset.

In the present case, the payment of the Sum enabled Gourmet Limited to obtain the right to use the factory premises for a term of 15 years. Though the Sum did not bring Gourmet Limited the title on the factory premises, the right so acquired brought into existence an advantage for the enduring benefit of the company. On the authority of ***British Insulated and Helsby Cables Limited v Atherton***, the Sum was capital in nature. Such being the case, it is not allowable for deduction under s.17(1)(c) of the IRO.

(b) Notwithstanding that the Sum was capital in nature, it does not follow that Gourmet Limited is entitled to the deduction of the industrial building allowance or commercial building allowance in respect thereof.

S.34 of the IRO provides that a person is entitled to the deduction of industrial building allowance when certain conditions are met. Where a person incurred capital expenditure on the construction of a building or structure which is an industrial building or structure and occupied it for the purposes of a trade, he is entitled to deduction of an initial allowance (s.34(1) of the IRO). Where a person is entitled to an interest in a building or structure which is an industrial building or structure and where that interest is the relevant interest in relation to the capital expenditure incurred on the construction of that building or structure, a person is entitled to the deduction of an annual allowance (s.34(2) of the IRO). As to commercial building allowance, a provision similar to s.34(2) is set out in s.33A(1) of the IRO.

In the present case, it is patently clear that the Sum was not incurred in the construction of the factory premises. Hence, Gourmet Limited is neither entitled to the deduction of industrial building allowance nor commercial building allowance.

Answer 9(a)(i)

Proviso to s.42(1) of the IRO provides that there shall be deducted from that part of the total income the amount of interest payable on money borrowed for the purpose of producing that part of the total income where the amount of such interest has not been allowed and deducted under Part 4. In the Board of Review Decision No. ***D86/99*** 14 IRBRD 581, the Board held that the proviso does not allow a global deduction for interest payable against total taxable income. It only allows a deduction for interest payable on money borrowed for the purpose of producing that part of the property income which has been included in the computation of total income under s.42(1)(a) of the IRO.

On the authority of the Board of Review Decision No. ***D86/99***, the amount of mortgage interest that is allowable for deduction is as follows:

	Mortgage interest allowable for deduction capped at net assessable value of the respective property
	HK$
Property 1	150,000
Property 2	240,000
Total	390,000

Answer 9(a)(ii)

S.30(3)(b) of the IRO provides that an additional allowance is to be granted if the parent resided, otherwise than full valuable consideration, with the person who is eligible to claim the dependent parent allowance under s.30(1) of the IRO. In the present case, although Mr Lee is entitled to the deduction of the dependent parent allowance in respect of the Mother (s.30(1) of the IRO), no deduction of additional dependent parent allowance is to be allowed. It is because the Mother did not reside with Mr Lee continuously throughout the year of assessment 2014/15. She resided at Property 4 whereas Mr Lee resided at Property 3.

Answer 9(b)

	2012/13 HK$	2014/15 HK$
Mr Lee		
Assessable profits[1]	-	200,000
Net assessable value	600,000	680,000
Mrs Lee		
Assessable income	210,000	250,000
Total income	810,000	1,130,000
Less:		
Interest payable on Loan 1 and Loan 2	(390,000)	(350,000)
	420,000	780,000
Less:		
Loss for the year	(150,000)	-
Net total income	270,000	780,000
Less:		
Married person's allowance	(240,000)	(240,000)
Child allowance	-	(140,000)
Dependent parent allowance in respect of the Mother	(19,000)	(40,000)
Net chargeable income under s.42A(1)(b) of the IRO	11,000	360,000

Note 1: Year of assessment 2014/15: HK$250,000 (being assessable profits for the year of assessment 2014/15) – HK$50,000 (being loss brought forward from the year of assessment 2013/14) (s.19C(1) and s.42(1)(c) of the IRO)

Answer 9(c)

The property tax assessment and the salaries tax assessment were issued to the Couple on 3 August 2014. They did not object to those assessments. On 4 September 2014, the assessments became final and conclusive in terms of s.70 of the IRO. If the Couple would like to have their income assessed under personal assessment for the year of assessment 2013/14, they have to write to the Commissioner of Inland Revenue not later than (a) one month after the assessments concerned become final and conclusive i.e., 4 October 2014; or (b) two years after the end of the year of assessment in respect of which the election is made, i.e., by 31 March 2016 (s.41(3) of the IRO). Hence, they have to make their application on 31 March 2016, at the latest.

Answer 10

The course fee is not allowable for deduction under s.12(1)(a) of the IRO. It is not deductible under s.12(1)(e) either.

S.12(1)(a) of the IRO provides that, other than expenses of a domestic or private nature and capital expenditure, all outgoings and expenses wholly, exclusively and necessarily incurred in the production of the assessable income are allowable for deduction. In the present case, Mary is a chemistry teacher. There is no evidence that the fine art course fee was wholly, exclusively and necessarily incurred in the production of her assessable income.

S.12(1)(e) of the IRO on the other hand provides that self-education expenses as defined in s.12(6) are allowable for deduction. S.12(6)(c) of the IRO provides that a prescribed course of education means a course undertaken to gain or maintain qualifications for use in any employment and being provided by an approved institution which includes an education provider (s.12(6)(d) of the IRO). In the present case, although the course was provided by a university which is an education provider as defined in s.12(6)(d) of the IRO, there is no evidence that the course was undertaken by Mary to gain or maintain qualifications for use in any employment.

Answer 11

With regard to the period during which John was the chief representative of the representative office ("Period A"), although John spent less than 90 days during a calendar year in mainland China ("the Mainland"), the 90-day exemption is not applicable to him because he was the chief representative of a representative office and his remuneration was deemed to have been borne by the representative office. Such being the case, the income derived by John from his acting as the chief representative of the representative office was chargeable to Individual Income Tax ("IIT") in the Mainland. The IIT would be calculated using the time apportionment method since John acted as both the General Manager of the Hong Kong company and the chief representative at the same time.

As to the period during which he acts as the General Manager of the foreign investment enterprise ("Period B"), John's income is also chargeable to IIT in the Mainland. John stayed in the Mainland for a period of around 11 months during a calendar year.

Turning to tax reporting obligations. John's annual income was more than RMB120,000 in both Period A and Period B. As such, he had to report his taxable income to the local tax bureau within three months after the end of the relevant year. John's employers should also (a) furnish IIT withholding returns to the relevant tax bureau and (b) act as the withholding agent to withhold IIT from the salaries payable to John on a monthly basis within 15 days after the end of the month.

* * * END OF EXAMINATION PAPER * * *