

## **SECTION A – CASE QUESTIONS**

### **Answer 1(a)**

The broad guiding principle for determining the source of profits, as laid down by Lord Bridge in *Commissioner of Inland Revenue v Hang Seng Bank Ltd.* [1991] 1 AC 306 and expanded by Lord Jauncey in *Commissioner of Inland Revenue v HK-TVB International Ltd.* [1992] 2 AC 397, is “one looks to see what the taxpayer has done to earn the profit in question and where he has done it”.

In the present case, Dr. A earned the Consultation Fees by providing medical treatment to a patient in the Mainland. Applying the above broad guiding principle, the Consultation Fees did not arise in or were not derived from Hong Kong.

The fact that Dr. A prepared the medical report for the patient in Hong Kong was merely an antecedent or incidental matter which did not determine the source of the consultancy income: see *Kwong Mile Services Limited v. Commissioner of Inland Revenue* [2004] 3 HKLRD 168. Indeed, there is no evidence suggesting that part of the Consultation Fees arose from the preparation of the medical report and had a locality separate from the part attributable to the provision of medical treatment.

### **Answer 1(b)**

The Compensation Payment should be revenue in nature because of the following:

- (1) Dr. A entered into the service contract with Company B in the ordinary course of his medical practice. Being a sum to compensate for the termination of such a contract, the Compensation Payment should be regarded as a normal trading receipt.
- (2) The service contract with Company B only contributed to 10% of Dr. A's annual income. It is unlikely that the termination of the service contract would affect the entire framework of Dr. A's business.
- (3) The Compensation Payment was computed with reference to the consultation fees that Dr. A would have earned from the contract. It was more akin to compensation for the loss of profits rather than the loss of capital assets.

### **Answer 2(a)**

The medical expenses are not deductible because of the following:

- (1) They were incurred by Dr. A for the benefit of his health. Plainly, they are of a private nature and are prohibited from deduction under s.17(1)(a) of the IRO.
- (2) Although the expenses could also enable Dr. A to continue to carry on his business, there is no sensible way of apportioning them between private and business purposes.

Relevant authority: *Fahy v CIR* (1992) 3 HKTC 695

### **Answer 2(b)**

The additional tax is not deductible because of the following:

- (1) Additional tax is a kind of fine or penalty. It was imposed due to a wrongdoing on the part of Dr. A, i.e. late submission of his tax return. It was not incurred for the purpose of earning profits from his medical practice and was thus not allowable for deduction by virtue of s.17(1)(b) of the IRO.
- (2) Moreover, the purpose of a fine or penalty is to punish the wrongdoer, and the legislative policy would be diluted if the wrongdoer is allowed to share the burden with the rest of the community.

Relevant authority: *CIR v Chu Fung Chee* 6 HKTC 743

### **Answer 2(c)**

The expenditure on renovation of the existing clinic is deductible under s.16F of the IRO because of the following:

- (1) The relevant unit of building has not been used as a domestic building or structure;  
and
- (2) The expenditure was incurred in production of chargeable profit.

The renovation expenditure is allowed for deduction by five equal instalments, the first of which is allowed in the basis period during which the expenditure was incurred and the remaining four instalments in the basis periods of the next four succeeding years of assessment.

Therefore, the deduction of expenditure on renovation of the existing clinic for the year of assessment 2011/12 should be computed as  $\text{HK\$}300,000 \times 1/5 = \text{HK\$}60,000$ .

By virtue of s.16F(3) of the IRO, Dr. A is not entitled to Commercial Building Allowance ("CBA") in respect of the expenditure which has been allowed under s.16F.

As for the expenditure for the initial decoration of the new branch clinic, it was incurred to enable the unit of building to be first used by Dr. A for the production of profits, so does not qualify for deduction under s.16F.

However, CBA can be granted in respect of such initial decoration expenditure under s.33A of the IRO for the year of assessment 2011/12 as follows:

Annual Allowance:  $\text{HK\$}500,000 \times 4\% = \text{HK\$}20,000$

### **Answer 3**

Home loan interest deduction is allowable to a person who has paid interest on a mortgage loan obtained to purchase a residential property if, among others,

- (1) the person who claims the deduction is the owner of the property; and
- (2) the property is used by the person as his place of residence.

In *D108/02*, 18 IRBRD 45, *D70/05*, (2006-07) 21 IRBRD 1, *D80/05*, (2006-07) 21 IRBRD 93 and *D3/10*, (2010-11) 25 IRBRD 162, the Board of Review held that no one can claim deduction of home loan interest unless he is a legal or registered owner of the property, not just a beneficial owner of an interest in the property.

Although Dr. A commenced to pay mortgage interest in respect of Flat C from April 2011, he had not used the flat as his place of residence until 1 June 2011. Furthermore, he only became a legal owner of the flat on 1 November 2011. In the circumstances, Dr. A is not entitled to any home loan interest deduction for the period from April 2011 to October 2011.

For the period from November 2011 to March 2012, Flat C was held by Dr. A and Mrs. A as joint tenants. By virtue of s.26E(2)(b)(i) of the IRO, Dr. A and Mrs. A should each be allowed deduction of home loan interest in proportion to the number of joint tenants, i.e.  $\text{HK\$}10,000 \times 5 \text{ months} \times 1/2 = \text{HK\$}25,000$ .

Since Mrs. A did not have any income chargeable to tax for the year of assessment 2011/12, she can nominate Dr. A to claim deduction of her share of home loan interest deduction pursuant to s.26F of the IRO.

To sum up, the amount of home loan interest deduction to which Dr. A is entitled should be computed as follows:

His share of deduction (HK\$25,000) + The share of deduction nominated by Mrs. A (HK\$25,000) = HK\$50,000

#### **Answer 4(a)**

Under this nomination agreement, the nominee (i.e. Mrs. A) is the wife of the nominator (i.e. Dr. A).

By virtue of s.29CA(10) of the Stamp Duty Ordinance ("SDO"), the nomination agreement is exempted from special stamp duty.

#### **Answer 4(b)**

Dr. A entered into an agreement to purchase Flat D on 1 March 2011.

By entering into the nomination agreement on 1 October 2011, Dr. A is regarded as having sold the flat to Company E on that date.

The period between 1 March 2011 and 1 October 2011 is 7 months and 1 day.

Since the holding period is more than 6 months but less than 12 months, the nomination agreement will be chargeable with special stamp duty at 10% of the consideration stated therein (if any) or the market value of Flat D on 1 October 2011, whichever is the higher, under head 1(1B)(b) in the First Schedule to the SDO.

#### **Answer 5(a)**

Dr. A can be granted child allowance in respect of his son because:

- (1) the son is under the age of 18; and
- (2) he has maintained the son by supporting his living expenses in the US.

#### **Answer 5(b)**

Mrs. A's parents emigrated to the US more than 20 years ago and have not visited Hong Kong during the year of assessment 2011/12.

As Mrs. A's parents were not ordinarily resident in Hong Kong during the relevant year, Dr. A cannot be granted the related dependent parent allowances.

### **Answer 6(a)**

By carrying on his medical practice through Company E, Dr. A may reduce his tax liabilities as follows:

- (1) As Company E becomes the person carrying on the medical practice, Dr. A will no longer be liable to profits tax in respect of the profits of the clinics. Instead, he, being the director of Company E, will provide medical services at the clinics in return for his director's remuneration. His remuneration package can be arranged to include a lot of fully or partially non-taxable fringe benefits (e.g. provision of quarters, domestic helper employed by Company E, etc.), whereas Company E will be able to claim deduction of those benefits as business expenses. By such arrangement, although the profits tax rate for a corporation (16.5%) is higher than the standard tax rate for individual (15%), the overall tax liabilities of both Dr. A and Company E can be reduced.
- (2) The substantial loss sustained by Company E from share dealing has not yet been utilised due to its dormancy since 1997. In the circumstances, by injecting the medical practice into Company E, the aforesaid loss can be utilised to set off against the profits of the clinics.

### **Answer 6(b)**

In advising Dr. A on his tax planning idea, the accountant should be aware of the following:

- (1) Tax is a major source of the government's income. To preserve the welfare of the community, the accountant should act honestly in advising Dr. A on his tax planning idea.
- (2) The accountant is entitled to put forward tax advice as to the best position for Dr. A, provided that he does so within his professional competence and it does not in any way impair his standard of integrity and objectivity, and is in his opinion consistent with the law.
- (3) The accountant should not hold out to Dr. A the assurance that the tax advice he offers is beyond challenge. Instead, the accountant should ensure that Dr. A is aware of the limitations attaching to the advice (such as the possibility that the Commissioner may invoke ss.61 and 61A of the IRO to deny any tax benefit obtained from the tax plan), so that he does not misinterpret an expression of opinion as an assertion of fact. Moreover, the accountant should remind Dr. A of his exposure to penalty provided under the IRO if the tax plan fails eventually.
- (4) If the accountant also assists Dr. A in preparing his tax return in accordance with the tax advice, he should advise Dr. A that the responsibility for the content of the return rests primarily with Dr. A.

- (5) The accountant should not disclose any information acquired in the course of advising Dr. A to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose.

\* \* \* END OF SECTION A \* \* \*

## **SECTION B – ESSAY / SHORT QUESTIONS**

### **Answer 7(a)**

Under s.20AC of the IRO, profits derived by Newco are exempt from being chargeable to profits tax if it is structured and participates in Hong Kong securities market in the following manner:

- (a) Newco is a non-resident person; and
- (b) Newco does not carry on any trade, profession or business in Hong Kong involving transactions other than
  - (i) the Specified Transactions carried out through or arranged by a Specified Person; and
  - (ii) Transactions incidental to the carrying out of the Specified Transactions and the trading receipts from the Incidental Transactions do not exceed 5% of the total trading receipts from both the Specified Transactions and the Incidental Transactions.

In determining residency status, a corporation is considered to be a resident person if the central management and control of the corporation is exercised in Hong Kong (s.20AB(2)(b) of the IRO). The location of central management and control is wholly a question of fact. In general, if the central management and control of a company is exercised by the directors in board meetings, the relevant locality of central management and control is where those directors' board meetings are held. (Para 15 of DIPN 43 (Revised February 2010)).

Specified Transactions are specified in Schedule 16 of the IRO as transactions in (i) securities, (ii) future contracts; (iii) foreign exchange contracts; (iv) consisting in the making of deposit other than by way of a money lending business, (v) foreign currencies and (vi) exchange-trade commodities.

Specified Person normally is a corporation licensed or an authorised financial institution registered under the Securities and Futures Ordinance for carrying on a business in any regulated activity within the meaning of the Securities and Futures Ordinance (Para 39 of DIPN 43 (Revised February 2010)).

Incidental Transactions refer to various modes of operation of different offshore funds, including custody of securities, and receipt of interest or dividend on securities acquired through the Specified Transactions (Para 37 of DIPN43 (Revised February 2010)).

### **Answer 7(b)**

A resident person will be deemed to have derived assessable profits in respect of profits derived by the offshore fund from both Specified and Incidental Transactions if the resident person (i) alone or jointly with other associates holds direct and / or indirect beneficial interest of 30% or more in a tax-exempt offshore fund; or (ii) holds any percentage if the offshore fund is the resident person's associate (s.20AE of the IRO).

### **Answer 7(c)**

IRO does not have any provisions on the statutory requirements for offshore fund profits tax exempt application or registration. However, a resident person with deemed assessable profits derived under s.20AE of the IRO bears the legal obligation of complying with other provisions of the IRO on reporting chargeability, lodgment of returns, providing information, payment of tax etc. (Para 67 of DIPN 43 (Revised February 2010)).

### **Answer 8(a)**

Under s.14(1) of the IRO, profits tax is charged for each year of assessment. Therefore, the taxpayer cannot claim that the tax reporting is correct if the overall tax liabilities for two years were computed as a single assessment.

As a matter of fact, as there is an underpayment of tax for the year of assessment 2010/11, Mr. Chan should immediately inform IRD about the error and request a revision of his tax position for 2010/11 by issuing an additional assessment under s.60(1) of the IRO.

IRD may seek to impose a penalty in the form of additional tax under s.82A of the IRO for the undercharge of tax for 2010/11 if there is no reasonable excuse for making an incorrect return leading to the undercharge of tax.

Mr. Chan should lodge an objection against the 2011/12 assessment notice if the one month objection period stipulated under s.64(1) of the IRO has not yet lapsed. Otherwise, Mr. Chan should lodge a claim under s.70A of the IRO against the assessment based on the grounds that there is an error found in the respective tax return and statement submitted thereof.

If the taxpayer voluntarily provides full disclosure on the income received, the IRD may in practice or on a discretionary basis accept the taxpayer's tax position as reported or may revise the tax assessments for the relevant years.

### **Answer 8(b)**

Under s.63E(2)(b) or (c) of the IRO, Mr. Wong is eligible to apply for the holdover of 2011/12 provisional tax as he has retired since 1 April 2011, and the net chargeable income during the year of assessment assessed to provisional salaries tax is likely to be less than 90% of the net chargeable income for the year preceding the year of assessment or he has ceased to derive income chargeable to salaries tax. However, under s.63E(1)(a), the deadline for Mr. Wong to lodge the holdover of the tax due on 3 January 2012 has lapsed as the holdover application had to be lodged 28 days before the payment due date of 3 January 2012.

The Commissioner of Inland Revenue has no discretionary power to extend the time limit for a holdover application. Therefore, Mr. Wong can no longer make a valid application for holding over the provisional salaries tax due on 3 January 2012 after the application deadline.

However, on the basis that Mr. Wong settled the tax liability due on 3 January 2012, he can apply to hold over the second tax payment due on 2 April 2012 by lodging the application 28 days before the due date i.e. to be lodged on or before 5 March 2012.

If Mr. Wong does not settle the tax liability due on 3 January 2012, the full amount of tax (both in the first and second instalments) becomes due and payable immediately.

### **Answer 8(c)**

From the PRC turnover tax perspective, income derived from services received by the PRC client in the PRC are subject to PRC business tax (Article 1 of the Provisional Regulations of the People's Republic of China on Business Tax).

As business consultancy is in the scope of service industry, the applicable rate for business tax is 5%.

The business tax liability is therefore  $\text{RMB}101,800 \times 5\% = \text{RMB}5,090$ , as taxable income includes turnover and expenses reimbursement.

There is no business tax exemption provision with respect to income threshold and services duration and accordingly Prince Limited is liable to the abovesaid PRC business tax.

**Answer 9(a)**

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<u>Mr. Lip</u>	
<u>Net Assessable Income – 2011/12</u>	
	HK\$
Director remuneration	1,350,000
Add: Rental value (\$1,350,000 x 10%)	<u>135,000</u>
	1,485,000
Add: Share option gain (Note)	<u>164,000</u>
Net assessable income	<u>1,649,000</u>

Note:

$$\$20,000 + (10,000 \times (\$7 - \$2)) + \$100,000 - \$6,000 = \$164,000$$

**Answer 9(b)**

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<u>Mrs. Lip</u>	
<u>Net Assessable Value – 2011/12</u>	
	HK\$
Rent (\$12,000 x 11)	132,000
Less: Rates (\$1,800 x 4)	<u>7,200</u>
	124,800
Less: 20% statutory allowance	<u>24,960</u>
Net assessable value	<u>99,840</u>

**Answer 9(c)**

Mr. and Mrs. Lip  
Tax liabilities under Personal Assessment  
Year of assessment 2011/12

	Mr. Lip HK\$	Mrs. Lip HK\$	Total HK\$
Net assessable income (Note)	1,649,000	---	1,649,000
Net assessable value of the property	<u>---</u>	<u>99,840</u>	<u>99,840</u>
	1,649,000	99,840	1,748,840
Less: interest on mortgage loan re the property (restricted to net assessable value)	<u>---</u>	<u>99,840</u>	<u>99,840</u>
	1,649,000	---	1,649,000
Less: Concessionary deductions			
Approved Charitable Donations	10,000	---	10,000
Elderly Residential Care Expenses	72,000	---	72,000
MPF Contribution	<u>12,000</u>	<u>---</u>	<u>12,000</u>
	<u>1,555,000</u>	<u>---</u>	1,555,000
Less: Business loss incurred by Mrs. Lip			<u>150,000</u>
			1,405,000
Less: Married Person's Allowance			216,000
Dependent Parent Allowance			36,000
Additional Dependent Parent Allowance			<u>36,000</u>
Net chargeable income			<u>1,117,000</u>
Lower of :-			
- Tax thereon at standard rate (\$1,405,000 x 15%)			<u>210,750</u>
or			
- Tax thereon @ progressive rate (\$8,400 + ((\$1,117,000 - \$120,000) x 17%)			<u>177,890</u> (applicable)
Total tax payable by Mr. Lip			
\$177,890 x 1,555,000/1,555,000	=		<u>\$177,890</u>
Total tax payable by Mrs. Lip			
\$177,890 x 0/1,555,000	=		<u>\$0</u>

**Note:**

Self-education expenses for Mrs. Lip are deductible under salaries tax (s.12(1)(e) of the IRO) only, and the expenses cannot be allowed for deduction in computing tax liabilities under personal assessment.

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