



Hong Kong Institute of
Certified Public Accountants
香港會計師公會



**Examination Technique Seminar on
Section B (Essay/Short Question)
for
Module D on Taxation**

**Speaker
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HKICPA Module Preparation Seminar

Module D - Taxation

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Exam Techniques Seminar on Section B (Essay/Short question)

- June and December 2012

Agenda

1. Exam Techniques

2. Review Past papers and Examiner's comment

- Part A: Tax system and Tax administration
- Part B: Profits tax
- Part C: Salaries tax, Property tax and Personal assessment
- Part D: Stamp duty
- Part G: China tax



1. Exam Techniques

Before the exam

1. Understand the important and new topics (e.g. new IRO & DIPN)
2. Practise past papers
3. Read the examination panelists' reports
4. Index your notes for examination by topics

Part A: Tax system and Tax administration

Part B: Profits tax

Part C: Salaries tax

- Computation format
- Tax rate and allowance table

In the exam

1. Read the requirement carefully
 - ✓ *'Tax exposure'* of certain activities:
Any person is liable to Property/Salaries/Profits tax/Stamp duty
 - ✓ *'Tax implication'* of certain transactions:
Any item is taxable/deductible or subject to Stamp duty
2. Draw diagram or timeline to assist your understanding of the question and the relationship between different parties
3. Plan your answer
 - i) Law and practice (IRO/SDO, Principle, Tax case, DIPN/SOIPN)
 - ii) Analyze the facts
 - iii) Draw conclusion
 - iv) Alternatives or Recommendation (make reasonable assumption)
4. New page for new question (or part)

In the exam

5. Time management

- Leave question unanswered
- Spend too much time on finding reference
- Spend too much time on copying the material

6. Only compute what is asked

E.g. Assessable income, Net assessable income, Net chargeable income or Tax liability?

7. State the applicable tax rate

8. Use correct format required

E.g. Letter, memo or report

2. Review Past papers and Examination panelist's report



➤ **Part A:**
**Tax system and
Tax administration**

Dec 2012 Q8a

Comment on the circumstances below from the Hong Kong tax or PRC turnover tax perspectives and, where appropriate, provide your recommendations. Support your answers with relevant provisions of the IRO or the PRC rules and regulations:

Dec 2012 Q8a

Required:

- (a) Mr. Chan recently received a 2011/12 assessment notice for his sole proprietorship business. After cross-checking the relevant details, he noticed that a trading receipt of \$100,000 originally derived in the year of assessment 2010/11 had been erroneously recorded in his 2011/12 books of accounts, and thereby assessed to profits tax in the 2011/12 assessment notice.

Mr. Chan decided not to do anything to rectify the tax position for both years of assessment 2010/11 and 2011/12, and intended to settle the tax demanded for the year of assessment 2011/12 as his aggregate tax position for both years would be correctly reported after the tax settlement for the year of assessment 2011/12.

(6 marks)

Examiner's comment for Dec 2012 Q8a

Performance: Fair

Common mistakes

- Could not distinguish clearly the correct treatment for the relevant years of assessment.
- Wrongly focused their discussion on anti-avoidance provisions.
- Not able to elaborate that profits tax is charged for each year of assessment under s.14(1) of the IRO.

Answer to Dec 2012 Q8a

1. S.14(1) Charge of profits tax

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.

2. S.60(1) Additional assessment

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.

3. S.82A Additional tax

IRD may seek to impose a penalty in the form of additional tax 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.

Answer to Dec 2012 Q8a

4. S.64(1) Objection

Mr. Chan should lodge an objection against the 2011/12 assessment notice if the one month objection period has not yet lapsed.

5. S.70A Power of assessor to correct error

Mr. Chan should lodge a claim against the assessment based on the grounds that there is an error found in the respective tax return and statement submitted thereof.

6. 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.

Dec 2012 Q8b

- (b) Mr. Wong received his salaries tax assessment notice (2010/11 Final and 2011/12 Provisional) in the middle of October 2011.

He simply set it aside without making any reminder of his own tax payment due dates. On 3 January 2012, Mr. Wong accidentally noted from the assessment notice that the first tax payment of his salaries tax liabilities was due on that day (3 January 2012), whilst the second tax payment was due on 2 April 2012.

He would then like to apply for a complete holdover of the 2011/12 provisional salaries tax demanded in this notice as he retired on 1 April 2011 and did not have any income chargeable to salaries tax after his retirement.

(5 marks)

Examiner's comment for Dec 2012 Q8b

Performance: Satisfactory

Common mistakes

- No further discussion on the holdover for the second instalment and the surcharge on late payment. The elaborations on these two aspects were integral parts of the whole discussion for this question

Answer to Dec 2012 Q8b

1. S.63E(2)(b) or (c) Ground for holdover

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.

2. S.63E(1)(a) Time limit for a holdover application

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.

Answer to Dec 2012 Q8b

3. Holdover of 1st installment

The CIR 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.

4. Holdover of 2nd installment

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.

5. Surcharge on late payment

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 installments) becomes due and payable immediately.

Jun 2012 Q5d

Barry Fisher is a US resident. He graduated as an MBA in 2009. Just before his graduation, Barry was invited by A Inc., a fund house incorporated in the US, to discuss an employment offer in its New York office. The employment was concluded on that occasion with the following terms: (a) Barry's annual salary was US\$100,000 payable into his bank account in the US; (b) he would be granted an option to purchase 100,000 shares in A Inc. at US\$0.10 upon the commencement of his employment, subject to a vesting period of one year; and (c) he would be paid a sum equivalent to his annual salary ("Sum A") if his employment was terminated within two years.

Barry's employment commenced on 1 September 2009. During the first half year, Barry was required to work at the New York office. With effect from 1 April 2010, A Inc. assigned Barry to work for its subsidiary in Hong Kong, A-HK Ltd. His terms of employment with A Inc. remained unchanged during the assignment. Barry came

Jun 2012 Q5d

to Hong Kong on 1 April 2010, whilst his wife stayed in the US to look after their two-year-old son. During the year of assessment 2010/11, Barry stayed in Hong Kong for 20 days each month.

As a result of group restructuring, A Inc. terminated Barry's employment on 31 March 2011 and paid him Sum A pursuant to his terms of employment. Barry also exercised his share option on that day, when the relevant share closed at US\$0.60.

A-HK Ltd. filed an employer's return reporting the full amount of Barry's remuneration for the year of assessment 2010/11 (comprising salary, Sum A and the share option gain) in May 2011. Failing to receive any tax return from Barry, the Assessor raised an estimated salaries tax assessment on Barry without granting any personal allowances in accordance with the employer's return on 14 September 2011.

Jun 2012 Q5d

Required

(d) Barry engaged C Ltd. as his tax representative and decided to object to the 2010/11 estimated salaries tax assessment. Assuming that you are the tax manager of C Ltd. who has been assigned to this engagement, draft a notice of objection for Barry.

(6 marks)

Examiner's comment for Jun 2012 Q5d

Performance: Well

Common mistakes:

- failed to recognize that the notice should be drafted in the capacity of Barry's representative, not Barry himself.
- did not set out all relevant grounds of objection
- did not mention that Barry had to submit a completed tax return to validate his objection.

Jun 2012 Q5d

1. Format of notice of objection
2. S.64(2) Ground of objection
3. Submission of completed tax return

Answer to Jun 2012 Q5d

The Commissioner of Inland Revenue
G. P. O. Box 132
Hong Kong
(Our Reference)

Dear Sir,

Mr. Barry Fisher
(IRD File No.)

Objection: Year of Assessment 2010/11

On behalf of our above-named client, we hereby object to the 2010/11 salaries tax assessment under Charge No: X-XXXXXXXX-XX-X dated 14 Sept 2011 in accordance with s.64(1) of the IRO.

Our **grounds of objection** are as follows:

- (a) The assessment is excessive.
- (b) Our client's employment had a source outside Hong Kong and

Answer to Jun 2012 Q5d

his income from employment should be assessed to salaries tax on a time apportionment basis.

- (c) He should be entitled to married person's allowance and child allowance.

As the assessment was raised in the absence of our client's tax return, to validate the objection, we enclose herewith his **duly completed tax return** for the year of assessment 2010/11 for your attention.

We should be grateful if you would agree to our objection and revise the assessment accordingly.

Yours faithfully,

For and on behalf of C Ltd.

XXX

Manager – Tax Services

c.c. Mr. Barry Fisher

Jun 2012 Q8b

Herbert has carried on an insurance agency business on his own account. Three months ago, the IRD informed Herbert that a tax audit would be conducted in respect of his business accounts for the year ended 31 March 2011. Herbert engaged J & Co. to handle the audit.

After examining the relevant accounts and records, J & Co. found that Herbert had omitted from his accounts an initial signing fee received pursuant to his service contract with the insurance company he joined on 1 July 2010. If he terminates his service contract within five years, he would be required to repay a portion of the initial signing fee. In addition, J & Co. failed to locate certain invoices and receipts in relation to the expenses claimed in the accounts.

Jun 2012 Q8b

Required

(b) Assuming that you are the partner of J & Co., evaluate, from the ethical perspective,

(i) how you will advise Herbert in light of the findings stated in the question; and

(3 marks)

(ii) what you should do if Herbert has made some fictitious invoices and receipts, and asks you to submit them to the IRD to substantiate the expense claims.

(3 marks)

Examiner's comment for Jun 2012 Q8b

Performance: Well

Common mistakes:

- Failed to point out that the representative had no obligation to IRD without Herbert's consent.
- Could not point out that the tax representative should also advise Herbert of the seriousness and consequences of his proposed act, and disassociate themselves from the fictitious documents.

Answer to Jun 2012 Q8b(i)

1. J & Co. should advise Herbert of the irregularities (i.e. the omission of the initial signing fee in the accounts and the missing invoices and receipts in relation to certain expense claims)
2. J & Co should recommend Herbert to make full disclosure to the IRD.
3. The firm is, however, not obligated to inform the IRD, nor may it do so without Herbert's consent.
4. If Herbert refuses to disclose and rectify the irregularities, J & Co. should inform Herbert that it can no longer act for him in matters of taxation.

Answer to Jun 2012 Q8b(ii)

1. J & Co. should decline Herbert's request immediately and **inform him of the seriousness of his intended act** (i.e. willful submission of incorrect information in relation to expense claims) and the possible consequences (including criminal prosecution and the possibility of imprisonment upon conviction).
2. The firm should also cease to act for Herbert and **dissociate itself from the fictitious invoices and receipts** provided by Herbert.



➤ **Part B:
Profits tax**

Dec 2012 Q7

An investor in the US would like to participate in the securities market in Hong Kong by establishing a fund in the form of a limited company (Newco) with the objective of enjoying the profits tax exemption for an offshore fund as stipulated in the IRO. Newco will be incorporated in Bermuda and will have two individuals as directors.

Required:

- (a) Elaborate on how Newco should be structured and participate in Hong Kong securities market so that it can enjoy the profits tax exemption for an offshore fund.

(11 marks)

Examiner's comment for Dec 2012 Q7a

Performance: Diverged

Common mistakes:

- elaborated their answers in the wrong direction by discussing the source of profits, permanent establishment or the badges of trade.
- did not attempt this question.
- not familiar with this topic.

Answer to Dec 2012 Q7a

1. 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.

Answer to Dec 2012 Q7a

2. 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).
3. 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)).
4. 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.

Answer to Dec 2012 Q7a

5. 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)).

6. 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)).

Dec 2012 Q7b

(b) Discuss the circumstances in which the profits derived from the abovesaid offshore fund structure and participation in accordance with the profits tax exemption provisions in the IRO for the offshore fund would still be subject to profits tax.

(3 marks)

Examiner's comment for Dec 2012 Q7b

Performance: Not satisfactory

Common mistakes:

- Not able to identify the deeming provision in the IRO.

Answer to Dec 2012 Q7b

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).

Dec 2012 Q7c

(c) Briefly state the tax reporting obligations, if any, for the offshore fund under the IRO.

(2 marks)

Examiner's comment for Dec 2012 Q7c

Performance: Below expectations

Common mistakes:

- Not explain clearly that there was no provision in the IRO relevant to the application or registration of offshore fund exemption.
- Could not discuss the reporting requirement stipulated under the deeming provision as elaborated in the DIPN 43.

Answer to Dec 2012 Q7c

1. IRO does not have any provisions on the statutory requirements for offshore fund profits tax exempt application or registration.
2. 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)).

Jun 2012 Q6a

Douglas was the shareholder and managing director of E Ltd., a company incorporated in Hong Kong. Douglas earned a salary of HK\$100,000 per month from E Ltd. and due to the company's good performance in the year ended 31 March 2011, he was also paid a dividend of HK\$2 million. In July 2011, Douglas made use of the dividend as a down payment to purchase his first flat, which cost HK\$4 million, whilst the remainder of the consideration was financed by a mortgage loan.

Due to the default of various European customers, E Ltd. encountered a serious liquidity problem in August 2011. As the banker of E Ltd. declined to increase the latter's credit limit, Douglas sold the new flat for HK\$5 million in September 2011 and advanced part of the net sale proceeds of HK\$2 million to E Ltd. as a shareholder's loan.

Jun 2012 Q6a

As a result of the unsatisfactory business prospects, Douglas sold his shares in E Ltd. to Frank at HK\$11 million, which was equivalent to the net asset value of the relevant shares, in December 2011. As part of an integral transaction of this sale, Frank also undertook to make a loan to E Ltd. to enable it to repay the above shareholder's loan in February 2012.

Required

- (a) Discuss whether the profits derived by Douglas from the sale of his property are chargeable to profits tax.

(5 marks)

Examiner's comment for Jun 2012 Q6a

Performance: Good

Common mistakes:

- failed to identify all the relevant factors such as no trading history and the vendor's financial ability to hold the flat on a long-term basis.
- included in their answers a discussion on the source of profits, which is irrelevant and a complete waste of time.

Answer to Jun 2012 Q6a

1. The chargeability of the profits in question depends on whether the flat is a trading stock or a capital asset. In deciding, it is necessary to ascertain Douglas' intention towards the flat at the time of acquisition. A stated intention is of limited probative value as the intention can only be ascertained by reference to the objective facts and circumstances. Furthermore, the intention must be, on the evidence, genuinely held, realistic and realisable.
2. There is no information given about the stated intention of Douglas at the time of the acquisition. For the reasons given below, however, Douglas will have a reasonable case to argue that the flat was acquired as a capital asset and the profits from its sale should not be chargeable to profits tax:

Answer to Jun 2012 Q6a

- (a) There is no evidence that Douglas frequently engaged in property dealing. As stated in the question, the flat is the first one purchased by him.

- (b) The flat is not luxurious (purchase price of \$4 million). Given his then income level (HK\$100,000 per month) and the significant dividend received (HK\$2 million), Douglas was financially capable of holding the flat on a long-term basis.

- (c) The sale of the flat was triggered by the liquidity problem of E Ltd., and part of the sale proceeds were advanced to the company for operating purposes.

Jun 2012 Q7

Gary is a practising barrister. He is also the proprietor of a high-class French restaurant in Lan Kwai Fong. In 2008, Gary purchased two paintings at HK\$100,000 each from a reputable French artist. The paintings had been kept at Gary's home for collection purposes until January 2010, when Gary decided to place one painting at his chambers and the another one at his restaurant for decoration purposes. He closed the accounts of his chambers and his restaurant on 31 December each year.

Required

Determine whether Gary is entitled to claim depreciation allowance in respect of the two paintings for his legal practice and the French restaurant for the year of assessment 2010/11. Compute the allowance if Gary is so entitled.

(7 marks)

Examiner's comment for Jun 2012 Q7

Common mistakes:

- Not able to grasp the gist of issue (a), however, they could still distinguish the tax treatments between the painting used to decorate the chamber and that for the restaurant.
- Failed to recognize that the paintings had been used by Gary for private purposes and therefore even if they were to be entitled to depreciation allowance, no initial allowance could be granted and notional allowances for the years of private use should be included in the calculation of the 2010/11 annual allowance.

Answer to Jun 2012 Q7

1. Under s.39B of the IRO, Gary, as the proprietor of his legal practice and the French restaurant, can only claim depreciation allowance in respect of the paintings if they were “plant” for the purpose of producing his chargeable profits.
2. One of the paintings was used to decorate Gary’s chambers. Following the Board of Review’s decision in *D52/04*, 19 IRBRD 423, such a painting could not be regarded as “plant” because the creation of atmosphere and ambience is not an important trade function of a barrister so that he or she can solicit more quality clients and generate greater profits.
3. Conversely, the painting which was used to decorate the French restaurant could be argued as “plant” because for a high-class restaurant, ambience and atmosphere are ingredients in the product which it offers to customers: see *CIR v Scottish & Newcastle Breweries Ltd.* [1981] 1 WLR 322.

Answer to Jun 2012 Q7

4. Given that the painting was initially purchased by Gary for his collection and not for business use, Gary would **not be entitled to any initial allowance** by virtue of s.39B(1) of the IRO.
5. Furthermore, as the painting had been used for private purposes before being used by the restaurant, the capital expenditure incurred on the painting has to be computed by **deducting from its actual cost the notional allowances** pursuant to s.39B(6) of the IRO as follows:
6. Computation

	HK\$
Actual cost of the painting	100,000
Less: 2008/09 Notional annual allowance (HK\$100,000 x 20%)	(20,000)
	80,000
Less: 2009/10 Notional annual allowance (HK\$80,000 x 20%)	(16,000)
Notional cost of the painting	64,000

Answer to Jun 2012 Q7

7. Assuming that the restaurant had no asset in the 20% pool other than the painting, the annual allowance in respect of the painting for the year of assessment 2010/11 should be computed as follows:

	HK\$
Notional cost of the painting	64,000
Less: 2010/11 Annual allowance (HK\$64,000 x 20%)	<u>(12,800)</u>
Tax written down value carried forward	<u>51,200</u>

Jun 2012 Q8a

Herbert has carried on an insurance agency business on his own account. Three months ago, the IRD informed Herbert that a tax audit would be conducted in respect of his business accounts for the year ended 31 March 2011. Herbert engaged J & Co. to handle the audit.

After examining the relevant accounts and records, J & Co. found that Herbert had omitted from his accounts an initial signing fee received pursuant to his service contract with the insurance company he joined on 1 July 2010. If he terminates his service contract within five years, he would be required to repay a portion of the initial signing fee. In addition, J & Co. failed to locate certain invoices and receipts in relation to the expenses claimed in the accounts

Required

(a) Discuss whether, and if so, when the initial signing fee should be assessed to profits tax.

(6 marks)

Examiner's comment for Jun 2012 Q8b

Common mistakes:

- Not seem to have any knowledge about *Lo Tim Fat's* case.
- Only mention that the initial signing fee was a trading receipt and should be taxable.
- Wrongly claimed that the fee should be assessed in equal shares over five years, having regard to Herbert's contingent liability for repayment. However, such treatment has been rejected in *Lo Tim Fat's* case.

Answer to Jun 2012 Q8b

1. Herbert entered into a service contract with the insurance company and thus received the initial signing fee in the course of carrying on his insurance agency business.
2. Clearly, the fee was remuneration provided by the insurance company for Herbert's services or in compensation for his loss of earnings from the previous insurance company.
3. It was a trading receipt which arose from Herbert's agency business and should be taxable.
4. Herbert received the initial signing fee on 1 July 2010 (i.e. in the year of assessment 2010/11). On that day, Herbert held the fee beneficially and was entitled to use it for whatever purpose he liked.

Answer to Jun 2012 Q8b

5. Although Herbert had a contingent liability to repay the fee if his service contract was terminated within the next five years, such liability did not crystallise in the year of assessment 2010/11.

6. On the authority of *Lo Tim Fat v CIR 6 HKTC 725*, the initial signing fee accrued to Herbert in the year of assessment 2010/11 and the whole of it should be assessed to profits tax for that year.



➤ **Part C:**
**Salaries tax, Property tax and
Personal assessment**

Dec 2012 Q9

- Mr. and Mrs. Lip married on 1 October 2011. The following information is provided by them for the year ended 31 March 2012.
- A. Mr. Lip was the Finance Director of a company listed on the Hong Kong Stock Exchange. His total remuneration for the year was \$1,350,000. He made a contribution of \$12,000 to his Mandatory Provident Fund Scheme.
 - B. Mr. Lip resided in a residential flat provided rent free by his employer. The flat was leased directly by his employer at a monthly rent of \$45,000.
 - C. Mr. Lip had been granted an option to subscribe for 30,000 shares of his employer's shares on 1 May 2011 at the option cost of \$6,000 payable to his employer. On 1 August 2011 he assigned one third of the shares option to his colleague at the consideration of \$20,000, subsequent to the approval obtained from his employer on the assignment. He exercised another one third of the option on 1 December 2011 at the option exercise price of \$2 per share, whilst on the same day the remaining one third of the share option right

Dec 2012 Q9

was released back to his employer at the consideration of \$100,000. He sold all the shares obtained from exercising the option on 1 March 2012. The market value of the share was \$5 on 1 May 2011, \$6 on 1 August 2011, \$7 on 1 December 2011 and \$8 on 1 March 2012.

- D. Mrs. Lip did not have any full-time or part-time employment during the year. Instead, she carried on a beauty salon business with her sister in the form of a partnership with profit or loss to be shared on an equal basis. The tax loss sustained by the partnership and attributable to Mrs. Lip for the year and agreed by the IRD was \$150,000.
- E. Mrs. Lip has acquired a residential property and has leased it out to generate rental income for a number of years. A new tenancy agreement was entered into and commenced on 1 April 2011 at \$12,000 per month with one month rent free period in April 2011. Rates of \$1,800 per quarter were paid by Mrs. Lip. During the year Mrs. Lip incurred \$165,000 mortgage loan interest for the abovesaid property.

Dec 2012 Q9

F. Mrs. Lip donated \$10,000 to the Community Chest during the year, and enrolled in an MBA course at a local university and paid \$65,000 in school fees for the year. Mr. Lip had been constantly living with his mother for many years. Unfortunately, his mother passed away on 1 February 2012 at the age of 75. Mr. Lip's father was 78 years old and lived in an elderly residential care home. Mr. Lip incurred \$86,000 residential care expenses for the year.

Required:

- (a) Calculate the net assessable income of Mr. Lip for the year of assessment 2011/12. (5 marks)
- (b) Calculate the net assessable value of the property owned by Mrs. Lip for the year of assessment 2011/12. (3 marks)
- (c) Calculate the Hong Kong tax liabilities of Mr. and Mrs. Lip under personal assessment for the year of assessment 2011/12. Ignore the 2011/12 tax reduction and 2012/13 provisional tax in your calculation. (9 marks)

Examiner's comment for Dec 2012 Q9

Performance: Satisfactory

Common mistakes for Q9a:

- made simple arithmetic errors
- wrongly included the share option gain in computing the rental value.

Common mistakes for Q9c:

- wrong deduction of education expenses
- partial deduction of statutory allowances
- omission of the comparison of tax liabilities between progressive rate and standard rate
- failure to apportion tax liabilities between husband and wife.



Answer to Dec 2012 Q9a

Mr. Lip

Net Assessable Income – 2011/12

	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><u>1,649,000</u></u>

Note:

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

Answer to Dec 2012 Q9b

Mrs. Lip

Net Assessable Value – 2011/12

	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><u>99,840</u></u>



Answer to Dec 2012 Q9c

Mr. and Mrs. Lip

Tax liabilities under Personal Assessment

Year of assessment 2011/12

	Mr. Lip	Mrs. Lip	Total
	HK\$	HK\$	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

Answer to Dec 2012 Q9c

Less: Married Person's Allowance	216,000
Dependent Parent Allowance	36,000
Additional Dependent Parent Allowance	<u>36,000</u>
Net chargeable income	<u><u>1,117,000</u></u>
Lower of :-	
- Tax thereon at standard rate (\$1,405,000 x 15%)	<u><u>210,750</u></u>
or	
- Tax thereon @ progressive rate (\$8,400 + ((\$1,117,000 - \$120,000) x 17%)	<u><u>177,890</u></u>
	(applicable)
Total tax payable by Mr. Lip	
\$177,890 x 1,555,000/1,555,000 =	<u><u>\$177,890</u></u>
Total tax payable by Mrs. Lip	
\$177,890 x 0/1,555,000 =	<u><u>\$0</u></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.

Jun 2012 Q5a,b,c

Barry Fisher is a US resident. He graduated as an MBA in 2009. Just before his graduation, Barry was invited by A Inc., a fund house incorporated in the US, to discuss an employment offer in its New York office. The employment was concluded on that occasion with the following terms: (a) Barry's annual salary was US\$100,000 payable into his bank account in the US; (b) he would be granted an option to purchase 100,000 shares in A Inc. at US\$0.10 upon the commencement of his employment, subject to a vesting period of one year; and (c) he would be paid a sum equivalent to his annual salary ("Sum A") if his employment was terminated within two years.

Barry's employment commenced on 1 September 2009. During the first half year, Barry was required to work at the New York office. With effect from 1 April 2010, A Inc. assigned Barry to work for its subsidiary in Hong Kong, A-HK Ltd. His terms of employment with A Inc. remained unchanged during the assignment. Barry came

Jun 2012 Q5a,b,c

to Hong Kong on 1 April 2010, whilst his wife stayed in the US to look after their two-year-old son. During the year of assessment 2010/11, Barry stayed in Hong Kong for 20 days each month.

As a result of group restructuring, A Inc. terminated Barry's employment on 31 March 2011 and paid him Sum A pursuant to his terms of employment. Barry also exercised his share option on that day, when the relevant share closed at US\$0.60.

A-HK Ltd. filed an employer's return reporting the full amount of Barry's remuneration for the year of assessment 2010/11 (comprising salary, Sum A and the share option gain) in May 2011. Failing to receive any tax return from Barry, the Assessor raised an estimated salaries tax assessment on Barry without granting any personal allowances in accordance with the employer's return on 14 September 2011.

Jun 2012 Q5a,b,c

Required

(a) Determine the source of Barry's income from employment for the year of assessment 2010/11.

(3 marks)

(b) Evaluate whether Sum A should be chargeable to salaries tax. Cite the relevant authorities to support your analysis.

(3 marks)

(c) Advise whether and if so, when and how the share option gain realised by Barry should be assessed to salaries tax

(Note: (i) Computation of the share option gain is required; and

(ii) Exchange rate: US\$1 = HK\$7.8).

(8 marks)

Examiner's comment for Jun 2012 Q5a,b,c

Performance: Satisfactory

Common mistakes for Q5b:

- could not quote the *Fuch*'s case to support their explanation.
- misunderstood the question as one on salaries tax exemption for overseas services and therefore failed this question in its entirety.

Common mistakes for Q5c:

- not able to compute the assessable amount by working out the number of days spent in Hong Kong during the vesting period correctly.

Answer to Jun 2012 Q5a

Barry's employment for the year of assessment 2010/11 should have a source outside Hong Kong because:

- (a) Barry was employed by A Inc. which was a company incorporated and operated in the US. Such an employer-employee relationship remained unchanged even after his assignment to Hong Kong from 1 April 2010 onwards.
- (b) Barry negotiated and concluded his terms of employment with A Inc. in the US. As both Barry and A Inc. were residents in the US, it is likely that the terms of employment would be enforceable in the US.
- (c) Barry's salary was payable into his bank account in the US.

Answer to Jun 2012 Q5b

1. In *Fuchs, Walter Alfred Heinz v CIR*, FACV 22/2009, unreported, 1 February 2011, the Court of Final Appeal held that income chargeable to salaries tax under s.8(1) of the IRO is not confined to income earned in the course of employment, but includes, among others, payments as an inducement to enter into employment.
2. Here, Sum A was the substantial compensation which Barry could enforce pursuant to his employment contract if his employment was terminated prematurely. It is clearly an inducement for him to enter into the employment. Thus, it is chargeable to salaries tax.

Answer to Jun 2012 Q5c

1. The gain realised by Barry from exercising his share option is an income chargeable to salaries tax under s.9(1)(d) of the IRO.
2. In accordance with s.9(4) of the IRO, the tax liability crystallised when Barry exercised the option (i.e. 31 March 2011).
3. As Barry's employment with A Inc. was a non-Hong Kong employment and his share option was conditionally granted subject to his services both before and after his assignment to Hong Kong, Barry's share option gain should be assessed to salaries tax on a time apportionment basis as follows:

Notional share option gain

= (US\$0.6 - US\$0.1) x 7.8 x 100,000 shares

= HK\$390,000

Answer to Jun 2012 Q5c

Number of days during the vesting period (i.e. one year from 1 September 2009 to 31 August 2010)

= 365 days

Number of days in Hong Kong during the vesting period (i.e. 1 April 2010 to 31 August 2010)

= 20 days x 5 months

= 100 days

Therefore, the amount of Barry's share option gain that should be assessed to salaries tax should be

HK\$390,000 x 100 days / 365 days

= HK\$106,849.



➤ **Part D:
Stamp Duty**

Jun 2012 Q6b

Douglas was the shareholder and managing director of E Ltd., a company incorporated in Hong Kong. Douglas earned a salary of HK\$100,000 per month from E Ltd. and due to the company's good performance in the year ended 31 March 2011, he was also paid a dividend of HK\$2 million. In July 2011, Douglas made use of the dividend as a down payment to purchase his first flat, which cost HK\$4 million, whilst the remainder of the consideration was financed by a mortgage loan.

Due to the default of various European customers, E Ltd. encountered a serious liquidity problem in August 2011. As the banker of E Ltd. declined to increase the latter's credit limit, Douglas sold the new flat for HK\$5 million in September 2011 and advanced part of the net sale proceeds of HK\$2 million to E Ltd. as a shareholder's loan.

Jun 2012 Q6b

As a result of the unsatisfactory business prospects, Douglas sold his shares in E Ltd. to Frank at HK\$11 million, which was equivalent to the net asset value of the relevant shares, in December 2011. As part of an integral transaction of this sale, Frank also undertook to make a loan to E Ltd. to enable it to repay the above shareholder's loan in February 2012.

Required

- (b) Explain how the purchase and sale of shares in E Ltd. between Douglas and Frank are chargeable to stamp duty
(Note: Computation of stamp duty is required).

(6 marks)

Examiner's comment for Jun 2012 Q6b

Performance: Not satisfactory

Common mistakes:

- failed to invoke section 24(1) and deem the amount of the loan undertaken by Frank as part of the consideration for stamp duty computation.

Answer to Jun 2012 Q6b

1. In accordance with s.19(1)(a) and (d) of the SDO, Douglas and Frank who effected the sale and purchase of the shares in E Ltd. should each make and execute a contract note for stamping under Head 2(1) in the First Schedule of the SDO, and cause an endorsement to be made on the relevant instrument of transfer under Head 2(4) in the First Schedule of the SDO.
2. Except for the agreed consideration of HK\$11 million, Frank also undertook to make a loan to E Ltd. to enable it to repay the shareholder's loan of HK\$2 million to Douglas. In accordance with SOIPN 3, such a **guaranteed injection of funds into E Ltd. is a "payment of money" for the purposes of s.24(1) of the SDO, and s.24(1) applies to deem the amount of the injected funds to be part of the consideration for the transfer.**
3. In light of the foregoing, the stamp duty that Douglas and Frank were liable to pay in respect of the share transaction should be computed as follows:
4. Two contract notes: $(\text{HK\$}11 \text{ million} + \text{HK\$}2 \text{ million}) \times 0.1\% \times 2 = \text{\$}26,000$
5. Instrument of transfer: $\text{\$}5$



➤ Part G: China Tax

Dec 2012 Q8c

Comment on the circumstances below from the Hong Kong tax or PRC turnover tax perspectives and, where appropriate, provide your recommendations. Support your answers with relevant provisions of the IRO or the PRC rules and regulations:

- (c) Prince Limited is a consultancy company incorporated and centrally managed in Hong Kong. Recently, it has been engaged by a PRC client to provide business consultancy services directly in the client's office in Guangzhou, Guangdong Province of the PRC. The services were completed within two weeks, and Prince Limited received RMB100,000 and RMB1,800 as income and travelling expenses reimbursement respectively. The accounting manager of Prince Limited has no idea whether the abovesaid amounts would have any PRC turnover tax exposure in view of the short duration of time providing the services in the PRC, and the relatively small amount of income involved.

(6 marks)

Examiner's comment for Dec 2012 Q8c

Performance: Not satisfactory

Common mistakes:

- wrongly focused on the Double Taxation Arrangement, permanent establishment in Mainland and the 183 days rule.
- underestimated the importance of PRC tax, and did not familiarise themselves with the relevant Business Tax regime in the PRC.

Answer to Dec 2012 Q8c

1. 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).
2. As business consultancy is in the scope of service industry, the applicable rate for business tax is 5%.
3. The business tax liability is therefore $\text{RMB}101,800 \times 5\% = \text{RMB}5,090$, as taxable income includes turnover and expenses reimbursement.
4. 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.



Practice Makes Perfect!

End of Seminar