SECTION A – CASE QUESTIONS (Total: 50 marks)

Answer 1(a)

Manchester Knitting Limited
Calculation of Depreciation Allowance 2010/11

		30% HP	Total depreciation allowances
		HK$	HK$
Addition		300,000	
Less: Initial Allowance	(Note)	(109,800)	109,800
		190,200	
Less: Annual Allowance		(57,060)	57,060
Tax written down value carried forward		133,140	166,860

Note: Total principal repayment made for the year
= $120,000 (down payment) + (300,000 – 120,000) ÷ 20 x 7 = $183,000
Initial Allowance : $183,000 x 60% = $109,800

Answer 1(b)

Manchester Knitting Limited
Profits Tax Computation 2010/11

	HK$	HK$
Profit before taxation		3,869,000
Add: Sales proceeds (as balancing charge)	30,000	
Depreciation	84,000	
Interest expenses	15,200	
Exchange loss	10,000	139,200
		4,008,200
Less: Gain on disposal of fixed assets	14,000	
Exempt bank interest income	5,500	
Depreciation allowances	166,860	(186,360)
Assessable profits		3,821,840
Tax thereon @16.5%		630,603

Answer 1(c)(i)

Local bank interest income is exempt from profits tax under the Exemption from Profits Tax (Interest Income) Order 1998 ("1998 Order"). However, the bank interest income of $8,800 derived from the deposit utilised as security pledged to a loan incurring deductible interest expenses (conditions under s.16(2)(d) of the Inland Revenue Ordinance (“IRO”) are satisfied and ss.16(2A) and 16(2B) of the IRO do not apply) would not be eligible for the exemption. Accordingly, the respective interest income is taxable. On the other hand, the bank interest income of $5,500 is exempt from tax under the 1998 Order regardless of the currency denomination.

Interest income from overseas overdue trade debts is taxable as it is derived from the normal course of business and is on-shore in nature.

Answer 1(c)(ii)

The interest expenses of HK$16,800 incurred on bank loan and hire purchase of the motor vehicle with a local bank are deductible under ss.16(1)(a) and 16(2)(d) (and also s.16(2)(e) for hire purchase of the motor vehicle), and subject to the restrictions of ss.16(2A) & 16(2B) of the IRO. Given that the respective bank loan was pledged by a local bank deposit deriving interest income, the 1998 Order would not be applicable and in this connection, these interest expenses would be treated as deductible whilst the interest income is taxable.

Interest to overseas unrelated suppliers on overdue trade debts is deductible under ss.16(1)(a) and 16(2)(e) of the IRO.

As the interest derived by the individual director is not subject to tax under the IRO, the respective interest expenses incurred by MKL are non-deductible as the conditions under s.16(2)(c) or any other provisions of s.16(2) of the IRO are not satisfied.

Answer 2

Under the Provisional Regulations of the People's Republic of China on Business Tax, income derived from (i) prescribed taxable services (e.g. transportation industry, construction industry, etc.), (ii) the transfer of intangible assets or (iii) the sale of immovable properties in mainland China are subject to business tax. The manufacture & sales of garment products are not prescribed taxable services and therefore would not be subject to business tax.

Under the Provisional Regulations of the People's Republic of China on Value Added Tax, the sale of goods, provision of processing, repair and replacement services and the importation of goods in mainland China are subject to Value Added Tax ("VAT"). In this regard, the respective sales income derived by MKL's PRC subsidiary is subject to VAT.

The sale of garment products does not fall into any prescribed category subject to the lower VAT rate of 13% on the sales amount, it is therefore subject to the basic VAT tax rate of 17% on the sales amount.

However, as the garment products manufactured by MKL's PRC subsidiary are sold and exported outside mainland China, the "Exempt, Credit and Refund" method should be adopted to calculate the VAT refund.

If the input VAT paid for the purchase of local raw materials used in the manufacturing of export sales is larger than the output VAT, there may be a VAT refund to MKL's PRC subsidiary provided that it is a general VAT taxpayer and input VAT has been paid relating to the export sales.

Answer 3(a)

In the present situation, the rental allowance received by the director is a cash allowance and would be subject to salaries tax in full under s. 9(1)(a) of the IRO.

Under s.9(1A)(a)(ii) of the IRO, where an employer or an associated corporation refunds all or part of the rent paid by the employee, such a payment or refund is not treated as income. In this regard, MKL can set up a rental refund scheme in order to replace the current cash allowance with full discretion on the usage of the money by the director.

Under the above mentioned rental refund scheme, MKL should have proper controls to ensure that the director has a genuine tenancy arrangement for residential purposes, and that the respective amount paid to the director represents a refund of the rental expenses.

Under s.9(1A)(b) of the IRO, a place of residence for which an employer or associated corporation has refunded all of the rent is regarded as being provided rent free by the employer or associated corporation.

Under s.9(1)(b) of the IRO, if a place of residence is provided rent-free by a taxpayer's employer or an associated corporation, the "rental value" of the residence is regarded as the taxpayer's income which may be chargeable to salaries tax.

Under s.9(2) of the IRO, "rental value" is 10% (for residential flat) of the assessable income as described in s.9(1)(a) of the IRO, after deducting the outgoings, expenses, etc., under s.12(1)(a) and (b), and any lump sum payment or gratuity upon the retirement or termination of the employment of the employee. (Alternatively the rateable value included in the valuation list prepared under s.12 of the Rating Ordinance may be elected as the taxable "rental value" under s.9(2)(b) of the IRO.)

Answer 3(b)

The scheme would be tax efficient for the director from a salaries tax perspective if the amount of tax exempt rental refund under s.9(1A)(a)(ii) is greater than the amount of "rental value" as laid down under s.9(2) of the IRO.

Answer 3(c)

The IRD requires that the employer has to establish clear guidelines to control and exercise proper supervision over the reimbursements of the rent paid by the employee as tenant to the landlord. Only under these circumstances will the rent refund scheme be accepted, so that the "rental value" will be included in the employee's assessable income while the reimbursement of rent will not be treated as assessable income.

Proper control means that

- a clearly defined system is in place, including the ranks of those officers entitled and the limit of the entitlements;

- there is a detailed specification of the rent refund in the contract of employment; and

- the employer examines the tenancy agreement, rental receipts, etc., and retains them for the record.

The IRD also requires that the tenancy agreement should be based on the market rent, and that the normal letting formalities (e.g. duly stamped tenancy agreement and periodic issue of rental receipts) have been executed, and that the rights and obligations between ordinary landlord and tenant have been observed.

Answer 4(a)

For an employment to exist, there must be an employer and employee relationship or a 'contract of service'. Under the principle established in the case of *Fall v Hitchen* (1972) 49 TC 433 (or other relevant case), an employment relationship would not exist if the person who has engaged himself to perform these services performed them as a person in business on his own account, i.e. under a 'contract for service'.

Answer 4(b)

Four kinds of information should be obtained to evaluate whether the consultancy income was derived under a contract of service or a contract for service from a tax perspective (see Appendix B of the Departmental Interpretation and Practice Notes ("DIPN") No.25 (November 2011)).

1. Information regarding the degree of control exercised by MKL. In this regard, the employer in an employment relationship will exercise a higher degree of control over the employee as to how the services are to be performed. Examples of information include: Who decides the work to be done? Who prescribes the work schedule? (or information sought in point 1 of Appendix B of DIPN 25 (November 2011) or other relevant information)

2. Information regarding the capacity of the consultant of MKL to provide the consultancy services i.e., whether the consultant holds a position in MKL. Examples of information include: Does the consultant represent to third parties that he/she is a staff member of MKL? What are the chances of the consultant getting promotion in MKL? (or information sought in point 2 of Appendix B of DIPN 25 (November 2011) or other relevant information)

3. Information to determine whether there is any financial risk undertaken by the consultant in providing the services to MKL. Examples of the information include: Are equipment, capital assets or assistants provided by MKL to the consultant in performing his/her duties? What is the basis of the computation of the consultancy fee received by the consultant from MKL? (or information sought in point 3 of Appendix B of DIPN 25 (November 2011) or other relevant information)

4. Information to determine whether there has been some form of mutual obligation between the consultant and MKL. Examples of the information include: Whether MKL is obliged to pay a wage or remuneration? Whether the consultant is obliged to provide his/her work? (or information sought in point 4 of Appendix B of DIPN 25 (November 2011) or other relevant information)

* * * END OF SECTION A * * *

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

Answer 5(a)

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 5(b)

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.

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 5(c)

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.

In accordance with s.9(4) of the IRO, the tax liability crystallised when Barry exercised the option (i.e. 31 March 2011).

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

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.

Answer 5(d)

(Draft)

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-XXXXXXX-XX-X dated 14 September 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 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

Answer 6(a)

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.

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:

(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.

Answer 6(b)

In accordance with s.19(1)(a) and (d) of the Stamp Duty Ordinance ("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.

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.

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:

Two contract notes: (HK$11 million + HK$2 million) x 0.1% x 2 = $26,000

Instrument of transfer: $5

Answer 7

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.

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.

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.

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.

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:

	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

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%)	(12,800)
Tax written down value carried forward	51,200

Answer 8(a)

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. 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. It was a trading receipt which arose from Herbert's agency business and should be taxable.

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. 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. 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.

Answer 8(b)(i)

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) and recommend him to make full disclosure to the IRD. The firm is, however, not obligated to inform the IRD, nor may it do so without Herbert's consent.

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 8(b)(ii)

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). The firm should also cease to act for Herbert and dissociate itself from the fictitious invoices and receipts provided by Herbert.

* * * END OF EXAMINATION PAPER * * *