

SECTION A – CASE QUESTIONS

Answer 1(a)

Synergy may claim the bank interest income as exempt from profits tax under the Exemption from Profits Tax (Interest Income) Order 1998 (“the Order”) on the basis that the interest income was derived from a local bank, and there was no interest expenses deductible under s.16(1)a, 16(2)(c), (d) or (e) of the IRO. However, under the Order, the exemption shall not apply in the case of any deposit which is used to secure or guarantee money borrowed referred to in s.16(1)(a) of the IRO where the condition for the application of s.16(1)(a) of the IRO is satisfied under s.16(2)(c), (d) or (e) of the IRO and s.16(2A) of the Ordinance does not apply. In this regard, the exemption claim may be challenged on the grounds that the availability of the overdraft facility and the respective bank charge have satisfied the condition for the application of s.16(1)(a), and accordingly the exemption does not apply to Synergy. Whether interest expense deduction has ever been claimed under s.16(2)(c), (d) or (e) of the IRO is irrelevant to the exemption claim.

Answer 1(b)

Synergy could argue that the income derived from the waiver of loan should not be subject to profits tax under s.14(1) of the IRO on the grounds that (i) the amount is capital in nature as it was derived from a waiver of long-term loan advanced from a shareholder, and (ii) the amount is not derived from any of its recurring business or trading activities. However, the IRD may apply s.15(1)(c) of the IRO to deem the amount as a taxable trading receipt. Specifically the amount would be regarded as a grant, subsidiary or financial assistance to Synergy in connection with the carrying on of its business, as the loan was utilised as working capital for its daily business operations.

Answer 2

MPF ordinary annual contribution HK\$630,000

MPF annual contribution incurred in the production of taxable income is deductible under s.16(1) of the IRO, except that the maximum deductible amount is limited to 15% of the total emoluments of the employer under s.17(1)(h) of the IRO. In this regard, the deductible amount of MPF ordinary annual contribution of Synergy should be HK\$525,000 ($\text{HK\$630,000} \div 18\% \times 15\%$).

MPF Special Contribution HK\$390,000

The special contribution to MPF is capital in nature and therefore non-deductible under s.17(1)(c) of the IRO. However, under s.16A of the IRO, the amount is deductible over five years in equal annual installments. In this regard, the deductible amount is HK\$78,000 for the year ($\text{HK\$390,000} \times 1/5$).

Answer 3

Mr. David Fong
Salaries tax computation
Year of assessment 2012/13

	HK\$	HK\$
Annual salaries		1,500,000
Holiday travel warrant		<u>85,000</u>
		1,585,000
Add: Rental value ($\$1,585,000 \times 10\%$)	158,500	
Less: Rent payment to employer ($1,500,000 \times 5\%$)	<u>(75,000)</u>	<u>83,500</u>
		1,668,500
Add: Share option gain ($50,000 \times (\$7-2)$)	250,000	
Bonus	<u>100,000</u>	
		<u>350,000</u>
Net assessable income		2,018,500
Less: Contribution to MPF		<u>(14,500)</u>
		2,004,000
Less: Personal allowance (assuming no other allowances entitled)		<u>(120,000)</u>
Net chargeable income		<u>1,884,000</u>
Salaries tax payable (at progressive rate)		
\$40,000 @ 2%		800
\$40,000 @ 7 %		2,800
\$40,000 @ 12%		4,800
HK\$1,764,000 @ 17%		<u>299,880</u>
		<u>308,280</u>
Salaries tax payable (at standard rate)		
2,004,000 x 15%		<u>300,600</u>
Tax payable, at lower one		<u>300,600</u>

Answer 4

According to the Double Taxation Arrangement (DTA) and the subsequent Protocols entered into between the Mainland of China and Hong Kong SAR, income derived by a resident of one side in respect of employment exercised in the other side will be exempt from tax in the other side if the taxpayer stays in the other side for a period not exceeding the aggregate 183 days in any 12-month period commencing or ending in the taxable period concerned. In order to qualify for the exemption, the respective income must also be paid by an employer of one side and has not been borne by a permanent establishment in the other side.

Mr. Fong stayed in the PRC for 130 days during the 12 months ended December 2012. In this regard, he should not have any PRC Individual Income Tax ("IIT") exposure for the period.

During the 12 months ended March 2013, Mr. Fong stayed in the PRC for 170 days. Accordingly he should not have any PRC IIT exposure for the period.

If Mr. Fong travels to the PRC during the period from April to June 2013 for more than 13 days regardless of the purposes of the travel, his total number of days staying in the PRC for the 12 months ended June 2013 will be more than 183 days. In this circumstance, Mr. Fong will be subject to PRC IIT on employment income derived during his actual working days in the PRC. Actual working days in the case of Mr. Fong include work days in the Mainland and those public holidays in the period he stayed in the PRC.

Answer 5(a)

The upcoming field audit exercise and settlement methodologies applicable to Synergy are as follows:-

Preliminary process

As the tax representatives, Wilson Lee & Co., would assist Synergy to contact the IRD to arrange a mutually convenient time and place for the initial interview. To facilitate a thorough understanding of Synergy's business operations and personal affairs, the initial interview will usually be held in Synergy's office premises and be attended by its management executives together with their tax representative.

In arranging the initial interview, the IRD will request details of the books and records maintained by Synergy for the relevant years to be produced at the initial interview. Prior to the initial interview, Wilson Lee & Co. should have obtained instructions from Synergy to compile relevant comprehensive financial and accounting information from Synergy in order to ascertain its true assessable profits for the respective years.

Initial Interview

The initial interview is a fact finding process. Information about the daily business operations, accounting procedures of Synergy and relevant personal affairs of its directors / shareholders or other relevant persons will be sought during the interview process. Synergy may also be requested to estimate the amount of profit understatement and to place a deposit with the IRD on a voluntary basis to cover the estimated tax liability. After the interview, the IRD will prepare a comprehensive meeting note for Synergy's comment and confirmation.

Book and records examination

After the initial interview, the IRD will carry out basic audit work based on the available information. The IRD may issue notice under s.51(4)(a) of the IRO to Synergy or other third parties for obtaining further information or clarification.

Records and documents will be examined to assess their genuineness and reliability, and if they support the entries in the accounts.

Methodologies for field audit settlement

Where book and records are properly kept and have not been manipulated, transactions not reflected in the financial statements can be identified and reconciled. In this circumstance, Synergy should prepare revised financial statements based on the books and records in order to ascertain its true assessable profits for the IRD's examination.

When books and records have not been kept properly by Synergy, other indirect methodologies may be used for field audit settlement. Indirect methods in this circumstance include the following methodologies:-

- (i) **Assets Better Statement (Net Worth) method:** Adding the directors / shareholders of Synergy and other relevant person's yearly asset increases (i.e. the excess of net assets in any one year over that of the previous year), all expenditure of a non-allowable nature, and deducting receipts which are capital in nature or otherwise not assessable to arrive betterment profits.
- (ii) **Bank deposit method:** Total bank deposits and unbanked deposits with adjustments for the amount of cash receipts directly used for the payment of business / personal expenses held by Synergy or its nominees will be aggregated to represent the total business receipt of Synergy. An "average" or "representative" gross profit ratio is then applied to the total business receipt to quantify the understatement of gross profits.
- (iii) **Business economics (percentage computation) method:** The method involves the application of percentage or ratios (considered typical of business operations similar to those of Synergy) to particular known amounts, for the purpose of computing figures required to determine the sales, cost of sales, gross profits or even net profits of Synergy.

The IRD's Departmental Interpretation and Practice Notes No.11 (Revised October 2007) outlines the details of the field audit process (para.30 to 51) and settlement methods (para. 56 to 80) for comprehensive elaborations.

Answer 5(b)

In Part 14 of the IRO, there are provisions of penalties and offences applicable to both the taxpayer and any other persons assisting the taxpayer to commit an offence and be liable to the same penalty. Specifically under s.80(4) of the IRO, any person who aids, abets or incites another person to commit an offence under s.80 shall be deemed to have committed the same offence and to be liable to the same penalty. In addition, any person who willfully with intent to evade or assist any other person to evade tax shall be guilty of an offence under s.82(1) of the IRO.

In this regard, Wilson Lee & Co. should maintain its professional and ethical standards in advising and assisting Synergy in the process of the field audit exercise in order to avoid the exposure of the penalty or prosecution to itself as the tax representative of Synergy.

* * * END OF SECTION A * * *

SECTION B – ESSAY / SHORT QUESTIONS

Answer 6(a)

A Limited placed deposits with Bank C in Hong Kong so as to secure a loan for its share dealing and investment activities in Hong Kong. Following *CIR v Bartica Investment Limited* 4 HKTC 129, such on-going activities went beyond the mere passive acquiescence and were sufficient to constitute carrying on a business in Hong Kong.

Answer 6(b)

A Limited is a non-PRC tax resident as it was incorporated in Hong Kong with no establishment in the Mainland. Its dividend income from B Limited is subject to Corporate Income Tax on a withholding basis.

As B Limited is the wholly-owned subsidiary of A Limited, pursuant to Article 10 of the Double Taxation Arrangement between the Mainland and Hong Kong, the applicable withholding tax rate is reduced from 10% to 5%. Following the safe-harbour rule promulgated in Public Announcement No. 30, A Limited can be regarded as the beneficial owner of its dividend received from B Limited as A Limited is listed in Hong Kong and the dividend income is derived from its shares in B Limited.

Answer 6(c)

In determining whether the request for information lodged by the Mainland tax authority should be acceded to, the IRD will consider the following factors (see Departmental Interpretation and Practice Notes No. 47):

- (1) Whether the request is specific, bona fide and justifiable for the purpose of investigating the tax affairs of B Limited, or merely a speculative one that has no apparent nexus to the investigation.
- (2) Whether the requested information is “foreseeably relevant” to secure the correct application of the provisions of the Arrangement or the Mainland tax laws.
- (3) Whether the requested information is to be used by the Mainland tax authority for the administration and enforcement of taxes covered by the Arrangement. The information obtained pursuant to the Arrangement cannot be used for non-tax purposes.
- (4) Whether the requested information is such that the Mainland Tax authority would be unable to obtain it in the normal course of its administration.
- (5) Whether the provision of the requested information would be contrary to any public policy.
- (6) Whether the requested information constitutes trade or business secrets of B Limited and/or A Limited.
- (7) Whether the requested information is protected by legal professional privilege.
- (8) Whether the requesting party is the competent authority of a treaty partner.

Answer 7(a)

Year of assessment 2010/11

Basis period: 1 October 2010 to 31 December 2010

Year of assessment 2011/12

Basis period: 1 January 2011 to 31 December 2011

Year of assessment 2012/13

Basis period: 1 January 2012 to 31 December 2012

Explanation

- (1) As the first accounts of D Limited were prepared for a period in excess of 12 months and were closed at 31 December 2011 (i.e. within the second year of assessment), by virtue of s.18C(1)(b) of the Inland Revenue Ordinance ("IRO"), the basis period for the year of commencement will be determined at the Commissioner's discretion. In such circumstances, the Commissioner will usually determine the basis period for the second year of assessment as a period of 12 months counted backwards from the end of the first accounts, whilst the basis period for the first year of assessment will be the remaining period counted from the date of commencement.
- (2) The second accounts were prepared for 12 months up to a day other than 31 March (i.e. 31 December 2012). By virtue of s.18B(2) of the IRO, the Commissioner will adopt the same accounting period as the basis period for the year of assessment in which such period ends (i.e. 2012/13).

Answer 7(b)

<u>Year of assessment 2011/12</u>	<u>Lorry (30%)</u>	<u>Allowance</u>
	HK\$	HK\$
Cash price	520,000	
Less: Initial allowance		
$[(\$40,000 + \$20,000 \times 12) \times 60\%]$	168,000	168,000
	<hr/>	
	352,000	
Less: Annual allowance		
$(\$352,000 \times 30\%)$	105,600	105,600
Written down value c/f	<hr/>	<hr/>
	246,400	273,600
	<hr/> <hr/>	<hr/> <hr/>
 <u>Year of assessment 2012/13</u>		
Written down value b/f	246,400	
Less: Initial allowance		
$(\$20,000 \times 12 \times 60\%)$	144,000	144,000
	<hr/>	
	102,400	
Less: Annual allowance		
$(\$102,400 \times 30\%)$	30,720	30,720
Written down value c/f	<hr/>	<hr/>
	71,680	174,720
	<hr/> <hr/>	<hr/> <hr/>

Answer 8(a)

Stamp duty

The assignment executed on 15 October 2012 is chargeable with stamp duty under head 1(1) in the First Schedule of the SDO.

Although the shop was sold by E Limited within 24 months after the acquisition, no special stamp duty ("SSD") will be charged as SSD is applicable to residential properties only.

Profits tax

It is likely that E Limited will be regarded as having acquired the shop as trading stock and its profits derived from the sale of the shop will be chargeable to profits tax, having regard to the following circumstances:

- (1) E Limited held the shop for a very short period of time. It sold the shop as a confirmor without taking up the assignment.
- (2) E Limited is a newly incorporated company and has become dormant since the sale of the shop. It does not appear that the shop was acquired by E Limited for investment or business purposes.
- (3) The operation of E Limited was wholly financed by shareholders' contributions. There is no evidence that the company is financially capable of holding the shop on a long-term basis.

In ascertaining the amount of assessable profits, the stamp duty for the purchase of the shop is deductible.

Answer 8(b)

Stamp duty

The agreements for sale executed on 1 January 2012 and 1 June 2013 are chargeable with stamp duty under head 1(1A) in the First Schedule of the SDO.

Although the residential flat was sold by Mr. H and Ms. I within 24 months after the acquisition, no SSD will be charged as the agreement for sale dated 1 June 2013 was made pursuant to a court order: s.29CA(11)(a) of the SDO.

Profits tax

In view of the following circumstances, Mr. H and Ms. I may not be regarded as having acquired the flat as trading stock and thus chargeable to profits tax in respect of the profits derived from the sale of the flat:

- (1) Mr. H and Ms. I had used the flat for letting before the sale.
- (2) Mr. H and Ms. I should have been financially capable of holding the flat on a long-term basis. The couple could finance 70% of the consideration by their savings. The rental income from the flat should likely provide sufficient means to the couple to repay the mortgage loan.
- (3) Mr. H and Ms. I did not sell the flat voluntarily. The sale was made pursuant to the compulsory sale order granted by the court.

Property tax

Mr. H and Ms. I are chargeable to property tax in respect of the rental income from the flat.

In ascertaining the net assessable value of the flat, the stamp duty paid for the purchase of the flat is not deductible.

Personal assessment

Mr. H and Ms. I, being retirees, might not have income other than the rental income from the flat. As such, it is likely that the couple can benefit from the election for personal assessment.

By electing for personal assessment, Mr. H and Ms. I are entitled to married person's allowance. They can also be allowed for deduction of the mortgage loan interest incurred in respect of the flat, limited to the net assessable value of the flat.

Answer 8(c)

Stamp duty

The agreement for sale executed on 31 December 2012 is chargeable with stamp duty under head 1(1A) in the First Schedule of the SDO. Although the residential flat was sold by Mr. J within 24 months after the acquisition, no SSD will be charged as the flat was inherited by Mr. J under the will of his deceased's father: s.29CA(11)(b)(iii) of the SDO.

Provided that the above agreement for sale is duly stamped, the assignment executed on 1 April 2013 will be chargeable with stamp duty under head 1(1) in the First Schedule of the SDO by reference to the consideration less a fraction of the stamp duty representing the proportion of the flat that is vested in Mr. K (i.e. 1/2): s.29D(4) of the SDO. Further, Mr. K will be regarded as having acquired the flat on 31 December 2012 and disposed of 1/2 share of it to Mr. L on 1 April 2013: s.29DA(8) of the SDO. SSD will be charged by reference to the relevant share under head 1(1AA) in the First Schedule of the SDO.

Profits tax

It is unlikely that Mr. J will be chargeable to profits tax in respect of his sale of property as the property concerned has inherited from his father's estate.

Salaries tax

As both Mr. K and Mr. L are salary earners, they will be chargeable to salaries tax in respect of their salary income.

In ascertaining their salaries tax liabilities, Mr. K and Mr. L will each be entitled to deduct 1/2 share of the mortgage interest paid in respect of the flat as home loan interest, subject to the maximum limit in s.26E(2)(a)(ii) and (c) of the IRO.

* * * END OF EXAMINATION PAPER * * *