

**HONG KONG TAXATION  
JUNE 2004**

**The examination paper is divided into TWO Sections. Section A is compulsory and carries 40 marks. Candidates should attempt THREE questions from Section B, all of which carry 20 marks each.**

*You should allow yourself approximately 70 minutes in total to answer the questions in Section A, and 35 minutes for each of the questions attempted in Section B.*

*Saturday morning 5<sup>th</sup> June 2004*

*Time allowed: 3 hours*

**SECTION A**

*(Compulsory - answer all parts of this question)*

1. (a) Charles Nip bought a property in January 1999 from the developer for \$4,000,000. The property has been let out since purchase. The latest lease was made on 1 January 2001. The term of the lease is 4 years and the monthly rent is \$15,000. The tenant paid a premium of \$72,000 at the commencement of the lease. The tenant is responsible for the estate management fees while Charles is responsible for the rates. Charles paid rates of \$8,000 in respect of this property during the year ended 31 March 2004.

**REQUIRED:**

Compute the property tax payable for the year of assessment 2003/2004.

*(4 marks)*

- (b) Hable Limited holds all the share capital of Sewil Limited. Sewil Limited wishes to sign a lease agreement renting a flat from Hable Limited to be used as its office. The lease will last for 3 years. The rent is \$90,000 per month in the first year and \$150,000 per month in the second and the third years.

**REQUIRED:**

Explain and calculate the liability, if any, to stamp duty payable on the lease.

*(4 marks)*

- (c) Explain in what circumstances a lump sum received by an employee upon termination of employment is taxable under salaries tax.

*(4 marks)*

- (d) On 31 December 2003 Mr. Kelvin Chan received a lump sum of \$960,000 when he left his employment, after serving his employer for 10 years. Mr. Chan is married with no children. His assessable income for the past years of assessment are as follows:

Year of Assessment	Assessable Income
2000/2001	\$250,000
2001/2002	\$280,000
2002/2003	\$320,000
2003/2004 (excluding the above lump sum)	\$300,000

The tax rates and personal allowances for the years of assessment 2000/2001 to 2002/2003 are as follows:

Married Person Allowance	\$216,000
Salaries Tax Rates	
Progressive Rates:	
First \$35,000	2%
Next \$35,000	7%
Next \$35,000	12%
Remainder	17%
Standard Rate	15%

REQUIRED:

Assuming this lump sum is taxable under Salaries Tax, advise Mr. Chan what he can do to minimize the salaries tax payable. (Computation is not required.)  
(4 marks)

- (e) Ajax Limited, a company which commenced business in 1985, closes its accounts on 31 December each year. The latest financial statements were prepared for the 12 months ended 31 December 2003. The management of the company is planning to change its accounting date to either 30 September or 31 March. According to the plan, financial statements will either be prepared for the 9 months ending 30 September 2004 or the 15 months ending 31 March 2005.

REQUIRED:

Assuming the company has profits subject to profits tax for all the relevant years, determine the basis periods that will be used for the year of assessment 2004/2005 if the company adopts either one of the new accounting dates.

(4 marks)

- (f) On 1 September 2003, Koonchung Limited, a Hong Kong trading company, purchased a new factory unit to store the merchandise that it imports from overseas. The purchase price of the unit was \$3,000,000, half of which was for the land. The company closes its accounts on 31 March each year.

(Continued)

**REQUIRED:**

- (i) Explain whether the company can claim industrial building allowance for the new factory unit. *(2 marks)*
- (ii) Assuming the company cannot claim industrial building allowance, determine the tax relief, if any, in respect of the expenditure on the building in the year of assessment 2003/2004. *(2 marks)*

*(Total: 4 marks)*

- (g) Yang Lung Limited purchased a computer (Annual Allowance 30%) on hire purchase terms in October 2003. The cost of the computer was \$28,000. A down payment of \$4,000 was paid in October 2003, and the balance was to be paid by 12 equal monthly instalments of \$2,000, payable on the first day of each month starting from November 2003. The company closes its accounts on 31 December 2003.

**REQUIRED:**

Determine the deduction that Yang Lung Limited is entitled to make in the profits tax computation for the year of assessment 2003/2004. *(4 marks)*

- (h) Kam Chin Consultancy is a partnership business between Victor Kelly and Golden Coin Limited. The partners share the profits or losses equally after paying salaries of \$10,000 per month to Victor Kelly. Golden Coin Limited is a Hong Kong company and Victor Kelly is an Australian who came to Hong Kong in July 2003. The partnership commenced business in July 2003. For the period ended 31 March 2004, the partnership had a loss of \$120,000 before adjusting for the salaries of \$90,000 paid to Victor Kelly.

**REQUIRED:**

Determine the partnership loss which Golden Coin Limited can use to set off against its own profit, if any. *(4 marks)*

- (i) Jerry Littleton, a Canadian, bought a property for rental in Hong Kong partly financed by a mortgage loan with a Hong Kong bank. He has no other income subject to tax in Hong Kong. He was told that he can reduce the tax to be paid on his rental income by electing personal assessment.

**REQUIRED:**

Advise Jerry Littleton of (i) the conditions for him to be eligible for personal assessment and of (ii) the tax benefits that he can obtain if he is eligible to elect for personal assessment. *(4 marks)*

- (j) In 2001 Hon Yip Limited paid \$2,000,000 for a construction machine which was used for its operations in Hong Kong. The machine was included in the 30% pool for depreciation allowance purposes and was sold to Choy Fat Limited for \$2,200,000 in December 2003. At the same time Choy Fat Limited granted a five years lease to Hon Yip Limited allowing Hon Yip Limited to continue to use the machine in its operations for an annual lease payment of \$500,000.

REQUIRED:

Discuss the profits tax implications of the transactions that took place in December 2003 for both Hon Yip Limited and Choy Fat Limited. *(4 marks)*  
*(Total: 40 marks)*

### SECTION B

*(Answer THREE questions from this Section)*

2. Flickson Limited has been carrying on an import and export business in Hong Kong for many years. The company's profit and loss account for the year ended 31 December 2003 is as follows:

	Notes	\$	\$
Gross profit from sales of goods			6,200,000
Commissions received from consignment sales	1	45,000	
Exchange gain	2	11,000	
Interest income	3	5,000	
Gains on disposal of fixed assets		<u>19,000</u>	<u>80,000</u>
			6,280,000
Less: Audit fee		37,000	
Company secretarial fee		9,000	
Commissions paid	4	141,000	
Compensation and penalty	5	45,000	
Depreciation	13	267,000	
Interest expenses	6	29,000	
Legal fees	7	6,000	
Bad debt expenses	8	32,000	
Rent	9	840,000	
Repairs and maintenance expenses	10	543,000	
Salaries expenses		3,120,000	
Travelling expenses	11	185,000	
Donations	12	400,000	
Sundries (all deductible)		<u>250,000</u>	<u>5,904,000</u>
Net Profit before tax			376,000
Less: Profits Tax			<u>169,000</u>
Net Profit after tax			<u>207,000</u>

Notes:

(1) Commissions were received from Digloy Limited, an Australian company, which has no business in Hong Kong. Flickson Limited signed a contract with Digloy Limited in Sydney to sell the goods of Digloy Limited in Hong Kong on consignment basis.

(2) Exchange gains

Exchange gains on settlement of trade creditors	\$12,000
Exchange gain on repayment of bank loan in foreign currency	8,000
Exchange loss on conversion of bank deposit in foreign currency on balance sheet date	(2,000)
Exchange loss on conversion of debtors on the balance sheet date	<u>(7,000)</u>
	<u>\$11,000</u>

(3) Interest Income

Interest Income received from a deposit with Bank A, a bank in Hong Kong, and the deposit is used to secure the company's bank overdraft.	\$4,000
Interest income charged on overdue accounts of local customers	<u>1,000</u>
	<u>\$5,000</u>

(4) Commissions paid

Commissions paid to Hong Kong agents with their names provided	\$60,000
Commissions paid to Hong Kong agents whose identity was not disclosed	45,000
Commissions paid to overseas agents	<u>36,000</u>
	<u>\$141,000</u>

(5) Compensation and penalty

Compensation to customers due to inability to deliver the goods on time	\$15,000
Penalty imposed by Hong Kong Government due to importation of goods that did not meet the quality standard specified by the Government.	<u>30,000</u>
	<u>\$45,000</u>

(6) Interest expenses

Bank overdraft interest paid to Bank A, and the overdraft facility is secured by the company's own bank fixed deposit placed with the bank	\$18,000
Bank interest paid to Bank B, a bank in Hong Kong, on a loan secured by the company's director who has no other business in Hong Kong	<u>11,000</u>
	<u>\$29,000</u>

(7) Legal fee was incurred for the preparation of initial leasing of the director's quarters

(8) Bad debt expenses	
Specific provision made for the loan to a customer who is in liquidation	\$20,000
Decrease in general provision for trade debtors	(4,000)
Trade debts written off	<u>16,000</u>
	<u>\$32,000</u>
(9) Rent	
Rent for the office and storage facilities	\$600,000
Rent for the director's quarters	<u>240,000</u>
	<u>\$840,000</u>
(10) Repairs and maintenance expenses	
Refurbishment of the office	\$120,000
Replacement of the office carpet	78,000
Refurbishment of the director's quarters leased before the occupancy	330,000
Miscellaneous repairs to office equipment	<u>15,000</u>
	<u>\$543,000</u>
(11) Travelling expenses	
Business trips for the director	\$120,000
Overseas private trips for the director and his family	<u>65,000</u>
	<u>\$185,000</u>
(12) Donations to Hong Kong Community Chest	
(13) It was agreed with the assessor that depreciation allowances for plant and machinery for the year of assessment 2003/2004 were \$112,000.	

**REQUIRED:**

Prepare the profits tax computation for Flickson Limited for the year of assessment 2003/04, and state the reasons for the treatment of items in notes (1) to (12).

*(20 marks)*

3. Michael Boot, a Canadian citizen, was employed by Canlink Limited, a company incorporated in Canada. The company has no office in Hong Kong but Michael served the customers of Canlink Limited in Hong Kong, Taiwan and Japan. He visited Hong Kong for business purposes for 40 days and 90 days during the years of assessment 2001/2002 and 2002/2003 respectively. His employment with Canlink Limited was considered as foreign employment by the Inland Revenue Department.

Michael left Canlink Limited and joined Hinelin Limited, a Hong Kong company, as Chief Finance Officer on 1 September 2003. He is married and his wife stays in Toronto to take care of their 10 year old son and his 65 year old widowed mother.

*(Continued)*

The information about his employment during the year of assessment 2003/2004 is as follows:

- (i) Total salaries of HK\$306,000 from Canlink Limited for the period from 1 April 2003 to 31 August 2003. During this period, he visited Hong Kong for 75 days and lived in a room in a hotel. Canlink Limited paid the costs of the hotel accommodation.
- (ii) In August 2003, he exercised an option that was granted to him by Canlink Limited during his employment with them. The option was granted on 1 April 2001 with the condition that he had to work until 31 March 2003 before he could exercise the option. The option allowed him to purchase 5,000 shares of Canlink (HK) Limited at HK\$20.00 each. When he exercised the option the share price was HK\$34.60 and he subsequently sold all the shares at HK\$36.06.
- (iii) His salary from Hinelin Limited for the period from 1 September 2003 to 31 March 2004 amounted to \$700,000. A furnished apartment was provided by the company free of charge throughout the period. The company owned the apartment and spent \$100,000 to furnish it.
- (iv) Hinelin Limited contracted directly with the utilities companies for the supply of electricity, gas and telephone services. The utilities bills were paid by his employer. The total costs incurred by his employer amounted to \$30,000.
- (v) A sum of \$25,000 was paid by Hinelin Limited to an international carrier for moving his personal belongings from Toronto to Hong Kong.
- (vi) During Christmas 2003, Hinelin Limited paid Michael an allowance of \$20,000 for him to travel to Toronto to visit his family. He spent \$18,000 and kept the balance.
- (vii) In October 2003, he went to Beijing for 7 days for business purposes. He then stayed behind for 2 days for holidays. Hinelin Limited paid \$4,500 for the airfare and \$7,200 for the hotel accommodation in Beijing.
- (viii) Hinelin Limited reimbursed him \$3,000 for his professional membership fee of the Hong Kong Society of Accountants and \$10,000 for his membership fee of the Hong Kong Fitness Club.

**REQUIRED:**

- (a) Compute the Salaries Tax liabilities for Michael Boot for the year of assessment 2003/2004. Provide explanations to your computation. *(17 marks)*
- (b) Explain the factors that the Inland Revenue Department considered in deciding the employment with Canlink Limited was a foreign employment. *(3 marks)*  
*(Total: 20 marks)*

*(Continued)*

4. (a) Patton Limited recently received a notice under s.76(1) from the Inland Revenue Department requesting the company to withhold any sums of money, including salaries, payable to Richard Yeung, a former employee of the company, within a period of 30 days from the date of the notice and to pay such amounts withheld to the Inland Revenue Department. The notice also mentioned that the Salaries Tax for the year of assessment of 2003/2004 owed by Richard was still outstanding.

Richard left the company in December 2003 after working for it for 3 years. In his letter of resignation, which was given to the company in October 2003, he mentioned that he was going to emigrate to Australia. The company did not supply any information to the Inland Revenue Department about Richard's resignation.

**REQUIRED:**

- (i) Discuss the obligations of Patton Limited upon receipt of the notice under s.76(1), and the possible consequences if the company fails to comply with the notice. *(5 marks)*
- (ii) Briefly explain the obligations of Patton Limited under the Inland Revenue Ordinance when the company received the letter of resignation from Richard Yeung, and the legal consequences if the company fails to observe these obligations. *(5 marks)*
- (b) Being the newly appointed Company Secretary of Kai Tak Limited, Cassandra Ho recently reviewed the profits tax assessment of the company for the year of assessment 2002/2003, which was issued in November 2003. She discovered the following points in the assessment.
- (i) The company claimed the gain from the disposal of an investment in shares as a capital gain in the profits tax return, and such gain was included in the profits tax assessment. There was no indication that this matter had been followed up.
- (ii) In the profits tax return, the company computed the commercial building allowance for its office purchased in December 2002 at 2% of its cost, although the rate of allowance should be 4%. The same amount was included in the profits tax assessment.
- (iii) The company purchased a patent in January 2003 and the patent has been used in the company's production in Hong Kong. The company did not claim the deduction of the cost of the patent in the profits tax assessment.

Profits tax for the year of assessment 2002/2003 was paid on the due date.

*(Continued)*

**REQUIRED:**

Advise Cassandra Ho what actions she can take for what she discovered.

*(10 marks)*

*(Total: 20 marks)*

5. Brendan Ho, a widower who passed away on 10 May 2004, owned the following assets on the date of his death:

- (i) A house at a value of \$6,000,000 in Cheung Chau where he lived by himself.
- (ii) A residential flat in Shatin at a value of \$3,700,000. He allowed his son and his daughter-in-law to live there rent-free. He also paid for all the utilities expenditures of the flat. At the time of his death, the outstanding utilities bills amounted to \$3,000.
- (iii) A property in Toronto valued at HK\$2,600,000. The property was let to his friend at a rent of HK\$10,000 monthly payable in advance in Hong Kong. Rent for May 2004 was outstanding.
- (iv) A Canadian dollar bank account with a bank in Hong Kong for an equivalent of HK\$2,400,000.
- (v) A racing horse of a value of \$1,290,000. The horse was in Singapore at the time of his death.

Brendan Ho had the following liabilities on the date of his death:

- (i) A mortgage loan of \$1,100,000 for the purchase of the flat in Shatin.
- (ii) A mortgage loan of \$900,000 for the purchase of the house in Toronto. The loan was contracted with a bank in Hong Kong and secured by the house in Toronto.

In his will, he made a donation of \$1,000,000 from his estate to the Hong Kong Community Chest and left the remainder of the estate to his son.

His executor incurred the following expenditures: his funeral expenses of \$90,000, the cost of the tomb of \$300,000 and legal expenses of \$20,000 in handling his estate.

**REQUIRED:**

- (a) Compute the estate duty payable on the estate of Brendan Ho and provide explanations for your computation. *(12 marks)*
- (b) Assume, for this part of the question only, Brendan Ho transferred properties valued at \$10,000,000 to Jascon Limited, a company registered in Hong Kong, for a consideration of \$1 in 1996, and received \$10,000 per month from the company since 1996 without providing any services. Jascon Limited is a company owned by his son and his daughter-in-law. Explain (i) the implications

of these transactions on the estate of Brendan Ho, and (ii) the possible obligations of the management of Jascon Limited under the Estate Duty Ordinance upon the death of Brendan Ho.

*(8 marks)*

*(Total: 20 marks)*

6. Karneige Corporation is an American company which produces training materials for management courses, and licenses them to be used by other companies in different countries. These training materials were developed in the United States except those mentioned in (iii) below. The company has no office in Hong Kong.

During the year ended 31 March 2004, it had the following transactions:

- (i) It received \$400,000 from Karneige (HK) Consultancy Limited, its wholly owned subsidiary in Hong Kong for the use of the materials in Hong Kong.
- (ii) Through Karneige (HK) Consultancy Limited, it received from Doly Limited, an unrelated Hong Kong company, \$300,000 for the use of its materials in Hong Kong and \$200,000 in the Mainland, respectively.
- (iii) It acquired some other training materials developed by the Management School of the Chinese University of Hong Kong and licensed the use of them to Doly Limited and Karneige (HK) Consultancy Limited in Hong Kong. For the use of these materials in Hong Kong, it received \$20,000 from Doly Limited and \$50,000 from Karneige (HK) Consultancy Limited.
- (iv) In January 2004, Karneige Corporation acquired all the shares of Management Training Limited, a Hong Kong company which operates management training courses in Hong Kong. The original shareholders of Management Training Limited sold the shares of the company because the company suffered huge losses in recent years. Karneige Corporation intends to transfer the profitable operations of Karneige (HK) Consultancy Limited to Management Training Limited.

REQUIRED:

- (a) Discuss the taxability of the royalties received by Karneige Corporation. *(7 marks)*
- (b) With explanations, state the obligations of Karneige (HK) Consultancy Limited, if any, in respect of each of the transactions (i) and (ii). *(6 marks)*
- (c) Discuss the tax implications of the transfer of the operations described in (iv) on Management Training Limited under the Inland Revenue Ordinance *(7 marks)*  
*(Total: 20 marks)*

## Tax Rates and Allowances

### Personal Allowances (2003/2004)

	\$
Basic	104,000
Married Person	208,000
Child – 1 <sup>st</sup> and 2 <sup>nd</sup> (each)	30,000
Child – 3 <sup>rd</sup> to 9 <sup>th</sup> (each)	30,000
Dependent Parent	30,000
Additional Dependent Parent	30,000
Dependent Grandparent	30,000
Additional Dependent Grandparent	30,000
Dependent Brother or Dependent Sister Allowance	30,000
Disabled Dependant Allowance	60,000
Single Parent Allowance	104,000

### Salaries Tax and Personal Assessment Tax Rates (2003/2004)

Progressive Rates:	First \$32,500	2.0%
	Next \$32,500	7.5%
	Next \$32,500	13.0%
	Remainder	18.5%
Standard Rate		15.5%

### Profits Tax Rates (2003/2004)

Corporation	17.5%
Unincorporated Business	15.5%

### Depreciation Allowances (2003/2004)

Plant and Machinery	
Initial Allowance	60%
Annual Allowance	10%, 20% or 30%
	(as specified in question)

### Industrial Building (Building purchased unused)

Initial Allowance	20%
Annual Allowance	4%

### Commercial Building (Building purchased unused)

4%

### Estate Duty Rates (2003/2004)

Principal Value of Estate	Estate Duty Rate
\$7,500,000 and below	Nil
Exceeds \$7,500,000 but does not exceed \$9,000,000	5%
Exceeds \$9,000,000 but does not exceed \$10,500,000	10%
Exceeds \$10,500,000	15%

**Stamp Duty Payable (2003/2004)**

Head 1(1)	\$1 - \$1,000,000		\$100
&	\$1,000,001	-	\$100 + 10% of value above \$1,000,000
	\$1,080,000		
Head 1(1A)	\$1,080,001	-	0.75% of consideration
	\$2,000,000		
	\$2,000,001	-	\$15,000 + 10% of value above \$2,000,000
	\$2,176,470		
	\$2,176,471	-	1.5% of consideration
	\$3,000,000		
	\$3,000,001	-	\$45,000 + 10% of value above \$3,000,000
	\$3,290,320		
	\$3,290,321	-	2.25% of consideration
	\$4,000,000		
	\$4,000,001	-	\$90,000 + 10% of value above \$4,000,000
	\$4,428,570		
	\$4,428,571	-	3% of consideration
	\$6,000,000		
	\$6,000,001	-	\$180,000 + 10% of value above \$6,000,000
	\$6,720,000		
	\$6,720,001 and above		3.75% of consideration
Head 1(2)	Premium		Same as under Head 1(1)
	Rent: Uncertain term		0.25% of annual rent
	Term of less than a year		0.25% of total rent
	Term of 1 year to 3 years		0.5% of annual rent
	Term of more than 3 years		1% of annual rent
Head 2(1)			0.1% of the consideration
Head 2(2)			\$5
Head 2(3)			\$5 + 0.2% of value
Head 2(4)			\$5
Head 3(1)			3% of market value
Head 3(2)			\$5
Head 4			\$5