5. Profits Tax – Sole Proprietorship

(a) Reporting for Profits Tax - Sole Proprietorship & Partnership

- **Sole Proprietorship**

Where a business is owned 100% by an individual taxpayer, the proprietor should make tax reporting for that business as follows:-

- complete Part 5 of "Tax Return – Individuals" (B.I.R. 60),
- state its business name and Business Registration Number,
- declare its Gross Income,
- compute the Assessable Profits,
- claim expenses (and deductions) , and
- pay Profits Tax at the standard rate on its assessable profits.

If he/she has three sole proprietary businesses, individual tax reporting for each of these businesses will be required.

- **Partnership**

Where a business is not solely owned by the individual for the full year, that individual :-

- should not complete particulars in Part 5 of "Tax Return – Individuals" (B.I.R. 60), and
- should note that the tax reporting for that business should be made on the Profits Tax Return (B.I.R. 52).

(b) Change in Ownership - Sole Proprietorship to Partnership or vice versa

- **Sole Proprietorship changed into Partnership**

Your proprietorship business was changed to a partnership business if you admitted a partner during the year. Please note that for tax purposes,

- the IRD would not regard the proprietorship business as ceased;
- the proprietorship business and the partnership business would be treated as the same business.

- ✧ you should have notified the Business Registration Office of the change in ownership of your business and upon receipt of this information the IRD will issue a Profits Tax return (B.I.R. 52) in the name of the partnership for the year of change;

- ✧ the profits for the year of change (the year of admission of a partner) should not be reported in Part 5 of your B.I.R. 60;

- ✧ *profits for the year of change (whole year) should be reported in the B.I.R. 52* issued in the name of the partnership business;

- ✧ tax returns for subsequent years will be issued in the name of the partnership.

➢ **Partnership changed to Sole Proprietorship**

- ✧ The IRD would not regard the partnership business as ceased.

- ✧ The proprietorship business and the partnership business would be treated as the same business.

- ✧ You should have notified the Business Registration Office of the change in ownership and upon receipt of this information the IRD will stop to issue a Profits Tax return (B.I.R. 52) in the name of the partnership as from the year after the year of change.

- ✧ The profits for the year of change (the year of retirement of a partner) should not be reported in Part 5 of the sole proprietor's B.I.R. 60.

- ✧ ***P**rofits for the year of change (whole year) should continue to be reported in the B.I.R. 52* issued in the name of the partnership business.

(c) Basis Period

➢ You are required to declare the profits/(losses) from the business during the basis period. What does "basis period" mean?

- ✧ The year ended 31 March of the year printed on the return

Example

If the return is for the year of assessment 2004/05,

"basis period" refers to the year ended 31 March 2005.

- ✧ Where the annual accounts are prepared up to any day other than 31 March, the year ended within the year printed on the return.

Example

If the return is for the year of assessment 2004/05,

your annual accounts are prepared up to 31 December,

"basis period" refers to the year ended 31 December 2004.

- ✧ Where you commenced or ceased to carry on a business, please refer to Paragraph (d) below for explanation.

(d) Commencement and Cessation of Business

- ➢ ***Commencement of Business***

If business commenced within the year 2004/05

- ✧ If you closed your first accounts after 31 March 2005, probably there would be no assessable profits for the year 2004/05.

Example

You commenced business on 1 October 2004.

Your first account will be closed on 30 June 2005.

No accounts will be prepared during the year ended 31 March 2005 and there will be no assessable profits for the year of assessment 2004/05.

- ✧ However, if you closed your first accounts on or before 31 March and you have assessable profits, you will have to pay Profits Tax or Provisional Profits Tax on those assessable profits.

And, you have to consider if you need to report for chargeability.

If you closed your first account on 31 March 2005 and do not receive any tax return, say, by the beginning of July 2005, you should not wait for a tax return to be issued to you. You should write to the Commissioner within the time limit as the law requires (i.e., on or before 31 July 2005), tell her that you are chargeable to Profits Tax and ask for a tax return to be issued to you.

- ✧ You should keep business records of all income and expenditure and retain them for at least 7 years. For further information, please read our leaflet ***"Keeping Business Records"***.

- ➢ ***Cessation of Business***

If business ceased within the year 2004/05

- ✧ You should notify the Commissioner in writing of the cessation of your business within 1 month.

Example

If business ceased on 20.4.2005, you should

- inform the Commissioner on or before 19.5.2005, and
- prepare a set of accounts from the last accounting date to the date of cessation

Example

Your last account was prepared up to 31 December 2003, and your business *ceased on 29 February 2005, you should*

- prepare cessation accounts covering the period 1 January 2004 to 29 February 2005,
- declare the assessable profits/(losses) in the tax return for 2004/05, and
- keep business records of all income and expenditure and retain them for at least 7 years.

(e) Deceased Cases

- Peter, the Proprietor has filed tax returns annually for many years. If he died within the year 2004/05, the profits/losses of the sole-proprietorship business up to the date of his death should be reported in his B.I.R. 60 for 2004/05.
  - Peter's business should be regarded as ceased on the date of his death.
  - The executor should prepare accounts from the last accounting date up to the date of death.
  - The executor should declare the assessable profits/(losses) in the tax return for 2004/05.
  - The executor should keep business records of all income and expenditure and retain them for at least 7 years.
  - Where there is a successor to the business, the successor will be treated as a new proprietor operating a new business by the same business name. And, the new proprietor must make a new business registration promptly.

(f) Bankruptcy Cases

- If Mary, the Proprietress went bankrupt during the year 2004/05, she is still required to report the profits/losses of her proprietorship business in her B.I.R. 60 until, if applicable, the business is ceased/sold.

(g) How to Complete the Boxes in Part 5 of B.I.R. 60

- **Put a ✓ in the YES Box in the second line of Part 5 of the "Tax Return – Individuals" (B.I.R. 60) to indicate that you have a sole-proprietorship business, and complete the remaining items in that Part.**

- **If you own more than one sole-proprietorship business**
  - If you have four sole-proprietorship businesses, supply details. The 1st and 2nd businesses in the space provided in the Tax Return – Individuals and those particulars of the 3rd and 4th businesses in the same format on a separate sheet.
  - Separate accounts and computations should be submitted for each business if its gross income exceeded $500,000.

- ***Gross Income***
  - This means ALL TYPES OF INCOME.
  - This should include sale of capital assets and any other non-taxable income, whether or not derived from the principal business activity.

- ***Turnover***
  - This means all income arising from your principal business activities.
  - Items that arise incidentally or are exceptional in nature should be excluded (for example, profits from the sale of capital assets).

- ***Gross profit/(loss)***
  - Generally refers to the difference between turnover and cost of sales.
  - If you are not engaged in the trading of goods and commodities and no such figure exists in the accounts, insert "0" in this box.

➢ *Net profit/(loss) per accounts*

- ✧ Generally refers to the difference between income and expenses/deductions

➢ *Assessable Profits/(Adjusted Losses)*

- ✧ You may click HERE to get the pro forma tax computation to make the necessary adjustment.
- ✧ A separate computation should be prepared for each business.
- ✧ If you have more than one business, make sufficient copies of the pro forma before preparing the computations.

➢ *Approved charitable donations*

- ✧ A list of these charities is available in the IRD website at http://www.ird.gov.hk/eng/pdf/e-s88list-emb.pdf.
- ✧ Enter the total amount of approved charitable donations made during the year.
- ✧ Click HERE to know more about deduction of "approved charitable donations".

➢ *Mandatory contributions to Mandatory Provident Fund Scheme (MPFS)*

- ✧ Enter the amount of mandatory contributions paid by you to a MPFS.
- ✧ The maximum amount deduction allowable to you is $12,000 per year.
- ✧ If you have claimed an amount of deduction under Salaries Tax, that is, under Part 4 of the return, your claim under Part 5 for Profits Tax should be limited to the balance.

  (For example, if you have entered a claim for deduction of mandatory contributions of $8,400 in Box 33 of Part 4, the maximum amount you may insert in Box 42 of Part 5 will be $3,600.)

➢ *Transactions for/with non-resident persons*

- ✧ Put a ✓ in the YES Box in the second line of Part 5 of the "Tax Return – Individuals" (B.I.R. 60) to indicate that during the year you had transactions for/with non-residents.
- ✧ If you have put a ✓ in the YES Box for item (10) in Part 5, you must also complete Section 7 of the Appendix to B.I.R. 60.

(h) Documents to be Submitted

- ***For Small Businesses (i.e., gross income of which do not exceed $500,000)***
  - So long as the gross income of your sole proprietorship business **does not exceed $500,000**, you are not required to attach any financial statements to your tax return. Otherwise, you must submit accounts.
  - Even if you are a Small Business, you must
    - prepare the accounts,
    - complete the return in accordance with the accounts prepared, and
    - retain the accounts and documents as the Assessor may ask you to submit them later for review or other tax purposes.

- ***For businesses other than Small Businesses***
  - You have to submit a set of certified accounts - Balance Sheet and the Trading and Profit & Loss Account.
  - You should also submit a tax computation with supporting schedules, showing how the declared amount of Assessable Profits/(Adjusted Losses) is arrived at.

(i) Dormant Businesses

- Even if your business has been dormant during the year, you are still required to
  - complete items (1) and (2), and
  - enter **'0'** in items (3) to (9).

(j) What if the Taxpayer has a Business to Report but Part 5 was left blank?

- If Part 5 is left blank but the Taxpayer has owned a sole-proprietorship business in the year concerned, the Assessor may estimate the amount of assessable profits, issue a notice of assessment and demand for tax.

- To avoid the issue of an estimated assessment, even if your sole-proprietorship business had ceased, was inactive or operating in losses for the year concerned, you should still complete all the boxes in Part 5. You may complete "0", where applicable. But you should not leave them blank.

- The Commissioner will impose penalty on omission / understatement of profits and on incorrect return. In computing penalties, where Part 5 is left blank (resulting in omissions), the amount of the ultimately assessed profits will be taken to be the amount of profits undercharged.

(k) May an individual business owner reduce his tax liability by electing Personal Assessment?

- The sole-proprietor of a business is assessed to Profits Tax at the standard rate (for Year of Assessment 2004/05, the standard rate is 16%). By electing Personal assessment, his tax demand note will be computed at progressive rates applicable to Salaries Tax on his aggregated income from all sources after deduction of the following :
  - elderly residential care expenses,
  - home loan interest,
  - business losses incurred by his other businesses in the year of assessment,
  - losses brought forward from previous years under Personal Assessment, and
  - personal allowances.

Example

Peter, single, had assessable profits from his sole-proprietorship business amounting to $280,000 for the year of assessment 2004/05. During the year, Peter acquired a property used as his dwelling. Interest paid up to 31.3.2005, on a loan from a bank secured over a mortgage of his dwelling amounted to $60,000.

Personal Assessment not elected

	$
Assessable Profits	280,000
Profits Tax Payable (at standard rate 16%)	44,800

Personal Assessment elected

Assessable Profits		280,000
Less : Home Loan Interest	60,000	
Basic Allowance	100,000	160,000
Net Chargeable Income		120,000

Tax on	first $30,000 @	2%		600
	next $30,000 @	8%		2,400
	next $30,000 @	14%		4,200
	next $30,000 @	20%		6,000
Tax Payable (at progressive rates)				13,200

If Peter elects for Personal Assessment he can claim deductions for home loan interest and personal allowance and get total tax savings of $31,600 (i.e. $44,800 – $13,200).

- The income and deduction position for each individual will differ from year to year. For the same individual, election may be advantageous for one year and disadvantageous in the next. However, taxpayers need not worry about this. If for any year the election that you have made does not result in any tax benefit to you, IRD's computer system can identify your case and automatically tax demand notes will be issued as if you have not made an election for Personal Assessment. Whether for a particular year of assessment a business owner may pay less tax through election for Personal Assessment, it depends on the amounts of his income and deductions for that year. The example below shows that election can be disadvantageous.

Example

Peter, single, had assessable profits from his sole-proprietorship business amounting to $280,000 for the year of assessment 2004/05. For this year he also received salaries income of $360,000 from an employment.

Personal Assessment not elected

					$
Assessable Profits					280,000
Profits Tax Payable (at standard rate 16%)					44,800
Salaries Income					360,000
Less : Basic Allowance					100,000
Net Chargeable Income					260,000
Salaries Tax on					
	first	$30,000	@	2%	600
	next	$30,000	@	8%	2,400
	next	$30,000	@	14%	4,200
	next	$170,000	@	20%	34,000
Salaries Tax payable (at progressive rates)					41,200
Total Tax payable (44,800 + 41,200)					86,000

Personal Assessment elected

Assessable Profits				280,000
Salaries Income				360,000
Total Assessable Income				640,000
Less : Basic Allowance				100,000
Net Chargeable Income				540,000
Tax on				
first	$30,000	@	2%	600
next	$30,000	@	8%	2,400
next	$30,000	@	14%	4,200
next	$450,000	@	20%	90,000
Tax payable (at progressive rates)				97,200

Peter has to pay $11,200 more if he elects Personal Assessment. This is because under Personal Assessment, tax is calculated at progressive tax rates on the aggregated income from all sources. As the marginal scale of the progressive rates is 20%, which is higher than the standard rate of 16%, it may not be advantageous for taxpayers with large amount of income to elect Personal Assessment.

- If you wish to elect Personal Assessment, you should put a ✓ in the YES Box in the second line of Part 6 of your tax return and complete Boxes 51 to 54 . If you are married and your spouse had assessable income for the year of assessment, he/she must also sign at Part 9 of your tax return.