A guide to Profits Tax for unincorporated businesses (2)

Which receipts are taxable?
Which expenses are deductible?

Foreword

This guide will help answer some of the questions that owners of small unincorporated businesses may have concerning the treatment of business income and expense items under Profits Tax.

To keep it simple and easy to understand, this leaflet does not touch on the question of source of profits.

To know more about the tax rules, you have to refer to the Inland Revenue Ordinance ("IRO") (Cap. 112) and its subsidiary legislations.

Common questions and answers

Q1 If not every receipt from my business is taxable, which is taxable and which is not?

Answer **General Rule**

Receipts arising from day to day operations, e.g. sales of goods and provision of services, are normally your operating income and taxable.

Proceeds from the sales of fixed/capital assets are capital receipts and are usually non-taxable.

Various income closely connected with your business operations are also taxable, including –

- ♦ rental income received from sub-letting part of your business premises;
- ♦ rebates received from trade associates; and
- ♦ the forfeiture of trade deposits or compensation moneys from customers for the cancellation of ordinary business contracts.

Sale proceeds arising from the sale of your business entity as a going concern or of your fixed assets are normally of capital nature and non-taxable. You should however keep in mind the specific provisions in the IRO which relate to the treatment of stock and machinery and plant under such circumstances. (Seek advice from a practising accountant, if required.)

Some examples of taxable receipts -

- trade debts claimed irrecoverable and deducted from previous years' assessable profits recovered from customers;
- grants and subsidies (unrelated to capital expenditures) you received from the Government or other parties;
- rental/charges for the hiring of your computers, equipments and machines;
- sum recovered from an insurance policy for loss of trading stock; and
- sums received for the transfer of a right to receive income.

Some examples of non-taxable receipts -

- proceeds from the sale of fixed assets;
- proceeds from the sale of business interests/goodwill;
- compensation for early termination of business tenancies;
- dividends from corporations; and
- interest income on Tax Reserve Certificates.

Q2 If not every expense/outgoing is deductible from the assessable profits, which is deductible?

Answer **General Rule**

Business expenses related to your day to day operations are normally deductible as your operating expenses, such as –

- rents paid on business premises/quarters for employees;
- light, water and telephone charges for business premises;
- salaries, wages, allowances, bonuses for the hiring of employees;
- employer's mandatory and voluntary contributions to MPF

schemes or MPF-exempted ORSO schemes (but the deduction is limited to 15% of the total emoluments of the employee for the period to which the payments relate);

- MPF mandatory contributions as a self-employed person for the sole proprietor or partner, not exceeding the amount prescribed in the Inland Revenue Ordinance;

- severance or long service payments paid at termination of employments;

- interest and other expenses including legal fees on money borrowed for normal business operations (such as for the purchase of stock) under specified conditions, e.g. the money is borrowed from a financial institution and the borrowing is secured by a mortgage of property, say, property owned by the proprietor and/or the spouse;

- bad or doubtful debts (i.e., sales duly recognized as your turnover but for which you cannot collect payments from customers);

- repairing costs for articles, premises, machinery and plant used in producing profits (other than the cost of improvements);

- the replacement costs of implements and utensils used in producing profits (no depreciation allowance would be allowed in respect of the same items); and

- approved charitable donations of not less than $100, but not exceeding 35% (25% for years of assessment 2006/07 and 2007/08) of the adjusted assessable profits.

Q3 Are there deductions by way of tax incentives?

Answer Yes, some of these deductions are listed below –

- specified expenditures on copyrights, registered designs or registered trade marks;

- capital expenditures on environmental protection facilities;

- ♦ 100% write-off of cost in the year of purchase of a "prescribed fixed asset", which includes
    - machinery or plant used specifically and directly in any manufacturing process,
    - computer hardware (other than that which is an integral part of any machinery or plant), and
    - computer software and computer systems;

  but does not include any leased item or item acquired under hire-purchase terms;

- ♦ capital expenditures incurred on the renovation or refurbishment of buildings (other than domestic buildings) by 5 equal deductions over 5 successive years of assessment;

- ♦ industrial building allowance for industrial buildings and structures; and

- ♦ commercial building allowance for commercial buildings and structures.

Q4 Which expense/outgoing is not deductible from the assessable profits?

Answer Expenses not deductible include *(this is not an exhaustive list)* –

<u>Domestic and private expenses</u>

<u>Examples</u>

- ♦ messing and meals, medical expenses, insurance premiums, birthday celebration expenses for the sole proprietor/partners and/or their family members, etc.;

- ♦ private share of utilities e.g. rates, electricity, water if the premises is used for both business and residential purposes;

- ♦ private share of motor vehicles expenses for vehicles used for both private and business purpose; and

- costs of travelling between residence and place of business and overseas travelling taken not for business purpose.

Payments to sole proprietor/partners and/or the spouse including:

- salaries/remuneration;
- interest on capital/loans;
- rentals for business premises;
- drawings from business; and
- withdrawal of capital.

Capital expenditures or losses

Examples

- the cost of acquiring fixed assets such as plant and machinery, except those prescribed fixed assets as set out in the answer to Question 3;
- the costs of acquiring the business premises including the related stamp duty and legal fees;
- the costs of any improvements to business premises;
- loss of capital; and
- loss on disposal of fixed assets.

Certain contributions to retirement schemes including:

- mandatory MPF contributions for proprietors/partners in excess of the amount prescribed in the Inland Revenue Ordinance;
- voluntary MPF contributions for proprietor/partners; and
- any MPF contributions for proprietor’s/partner’s spouse.

<u>Business losses recoverable under an insurance policy or contract of indemnity</u>

<u>Taxes paid under the IRO, except Salaries Tax paid in respect of employees' remuneration</u>

<u>Sum expended not for producing assessable profits</u>

<u>Examples</u>

- penalties/fines for breaking the laws;
- entertainment expenses not expended for business purpose; and
- rent or expenses relating to premises not occupied for the purpose of producing assessable profits.

Q5 I bought two machines for $200,000 and a second-hand lorry for $50,000. The purchase costs are capital expenditure and cannot be deducted from my assessable profits. Is there any relief that I can claim?

Answer You can claim to deduct depreciation allowances. Please refer to the summary below.

- Initial Allowance (IA) is 60% of the cost of the machinery or plant, to be granted in the year of purchase.
- Annual Allowance (AA) is by nature a "wear and tear" allowance, granted annually on the reducing value of machinery or plant at 10%, 20% or 30% as laid down in the Inland Revenue Rules, a subsidiary legislation under the IRO.
- Some examples of the rates of AA for the more common machinery or plant -

Air-conditioning plant	10%
Room air-conditioners	20%

Electric refrigerators	20%
Washing machines and boilers	20%
Furniture (excluding soft furnishing)	20%
Motor vehicles	30%
Tractors	30%

- A "Pooling System" was introduced in 1980/81. All items of machinery and plant qualifying for AA at the same rate are brought together in one "Pool", with additional items added to and disposal proceeds subtracted from the "Pool".

- A balancing charge arises where the disposal proceeds exceed the reduced value of the "Pool".

- A balancing allowance can only be granted to you on the cessation of the business.

- The allowances that you may claim for your machines and lorry for the year of purchase and the next two years are shown in the table below.

Year 1 (The Year of purchase)	20% Pool $	30% Pool $
Purchase Costs	200,000	50,000
Less: IA (60% of cost)	120,000	30,000
	80,000	20,000
Less: AA	16,000	6,000
Reduced value c/f to Year 2	64,000	14,000
Less: AA	12,800	4,200
Reduced value c/f to Year 3	51,200	9,800
Less: AA	10,240	2,940
Reduced value c/f to Year 4	40,960	6,860

If sold in Year 4 Less: Sale proceeds	23,000	9,900
Balancing charge in Year 4		*3,040
	17,960	
Less: AA for Year 4	3,592	
Reduced value c/f to Year 5	14,368	

Less: AA for Year 5	2,874	
Reduced value c/f to Year 6	11,494	

* Your assessable profits for Year 4 will be increased by the balancing charge of $3,040.

An AA will be given until the balance of the "20% Pool" is reduced to zero. (In practice, this will rarely happen. In normal situation, there would be new assets added to this "20% Pool".)

Q6 In January 2009, I bought a car for $150,000 for private use. As from 1 October 2011, I began to use it partly for delivery of goods to customers. I close accounts on 31 March annually. Is there any relief that I can claim?

Answer Yes, as from 1 October 2011, you may claim part of the car expenses as deductible expenses. If 2/3 of the car is for business use and 1/3 for private use –

Car Running expenses for 6 months (from 1.10.2011 to 31.3.2012)	Amount $
Fuel	12,000
Repairs	15,000
Annual registration fee	9,534
Insurance premium	24,000
Total expenses	60,534

Only $40,356 (2/3 x $60,534) is allowable for deduction.

Furthermore, as you put a used car purchased two years ago to business use, you will not be entitled to IA but you may get deduction for AA. Two years of Notional Allowances (non-business use for two full years) will be written off from the purchase cost. The AA for 2011/12 can be granted as follows –

	Car with private use A.A. at 30% $
Purchase Cost	150,000
Less: 1st Year (2009/10) Notional Allowance	45,000
	105,000

Less: 2nd Year (2010/11) Notional Allowance	31,500
Reduced value	73,500

	Calculation $	**AA to be granted $**
Value introduced in 2011/12	73,500	
Less: AA for 2011/12 (2/3 x $22,050)	22,050	14,700
Reduced value c/f to 2012/13	51,450	
Less: AA for 2012/13 (2/3 x $15,435)	15,435	10,290
Reduced value c/f to 2013/14	36,015	

Further Information and Assistance

You may

(a) visit our web site at www.ird.gov.hk;

(b) telephone 187 8022; or

(c) read related leaflets PAM 56(e) and PAM 58(e) on "A guide to Profits Tax for unincorporated businesses (1) and (3)".

(The contents of this leaflet are for guidance only)

PAM 57(e)
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