Hong Kong Tax Tips

Volume 1

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Hong Kong Tax Tips

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From bottom of my heart, my I express the following gratitude:

Gratitude to God

May I express my gratitude to God:
You grant me my life,

For today and its blessings,
I owe You my greatest gratitude.

Gratitude expresses itself
Not for the gifts of this day only,
But for the day itself;
Not for what I believe will be mine in future,
But for the bounty what I've got in the past.

If I can't be content with what I have received,
I am thankful for what I have escaped.

Because so much has been given to me,
I have no time to ponder over what has been denied.

It isn't what I have in my pocket that makes me thankful;
But what I have in my heart.

I believe gratitude will transform my days into satisfaction;
Will turn routine jobs into joy;
And will change ordinary opportunities into Blessings.

Gratitude to my dearest wife

May I also express my gratitude to my wife, Meihua:
Indeed you are so wonderful
that make my business a reality.

If not for your encouragement and forbearance,
I would not have made my dream come true;

A dream that has been on my mind for so many years;
A dream that someday I would be my own master,

Running my own business, doing what I like to do.
Meihua: I love you from the bottom of heart.

Thank you very much.

Preface

How to reduce tax legally? Different tax advisors give different answers. Almost all tax advisors boast their answers to be the most effective and the least costly. Regrettably seldom do they publish their answers in a book. Of course, being a tax advisor, I have my own answers to the question. What's more, I publish them in a book.

I worked at the Inland Revenue Department for 18 years. I handled thousands cases of profits tax, salaries tax, property tax and estate duty. I understand how IRD works and how IRD interprets and practices the tax law. I know their powers as well as their limitations. And above all, I make all my understanding and knowledge the base of my tax tips.

I don't like boasting. I will tell you the truth, the whole truth. I will offer you advice from my knowledge, my work, my experience, my belief and my heart.

I must make it clear that my tax advice cannot make you free of all the tax burden and tax troubles. But you are rest assured that my advice can help you reduce your tax burden and tax troubles legally. Indeed I think it is impossible and unrealistic one can totally remove his tax burden and his tax troubles.

I must emphasize that reduction of tax must be achieved legally. Or else, it will lead to investigation, penalty or even prosecution.

In my experience, there are a lot of simple and easy ways to reduce tax legally. I will tell you about them in this book. So, please take a cup of tea, relax and enjoy reading it. I am sure you will soon discover: Yahoo! Tax reduction is not just a dream!

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Chapter 1 Basic Tax Tips

1.0 Overview of Hong Kong Taxation

The chief income taxes in Hong Kong are under three heads: Salaries Tax, Profits Tax and Property Tax.

For a Hong Kong resident, he may elect for Personal Assessment so that his total income under the three heads are combined and taxed like Salaries Tax. In fact, Personal Assessment is a tax relief, not a charging head. The election is up to the individual taxpayer. Where the taxpayer has salaries income only, such election is obviously pointless. Where the taxpayer has property income, business profit or business loss, then such election may reduce his total tax payable. For more on personal assessment, please read paragraph 1.6 below.

The law governing the aforesaid taxes is stipulated in the Inland Revenue Ordinance (IRO), Chapter 112, and its subsidiary legislations including Inland Revenue Rules and various orders made by Chief Executive under the Ordinance. All the tax law quoted in my book refers to the IRO except otherwise stated.

The Inland Revenue Department is responsible to administer the IRO. In this book, it is sometimes referred to as the IRD or the Revenue.

From time to time, there are many tax cases going to courts and these cases form part of the Hong Kong tax law. As Hong Kong adopts common law as in many English-speaking countries and the IRO originates from the UK, the tax cases of the UK and other common-law countries may be followed when interpreting the Hong Kong tax legislations with similar wordings.

Apart from the income taxes mentioned, there are also a number of government charges, fees, rates, duties ... etc. For simplicity sake, such other topics are not included in this book.

Many people say that Hong Kong's tax system is simple. But do they know how simple? Next time, when you also say that, you can say more by adding the following points. In fact, these points are the salient features of the Hong Kong tax system. Saying them will make people believe you a tax expert.

1. Corporation’s profits tax rate is 16.5%.
2. Individuals’ overall tax rate does not exceed 15%. Low to medium income earners are taxed at lower rates under a progressive-rate system. They will be exempt from tax if their total income is below their total personal allowances.
3. Because of the low tax rates, the Revenue combats tax avoidance vigorously. Indeed, anti-tax avoidance law is difficult and complicated.
4. Only those incomes and profits derived from Hong Kong are taxable.
5. Capital expenditure is not deductible. But generous allowances are granted for expenditure on plant and machinery, acquisition of patents, information technology, scientific research, technical education, construction of industrial building and commercial building, refurbishment of buildings … etc.
6. No tax on capital gains, dividends or interest.

1.1 What to do if you disagree with an assessment

If you disagree with an assessment, the first thing you should do is to write an objection to the Revenue. This is your statutory right. The legal requirements for a valid objection are:

(a) have a written notice of objection signed by you,
(b) send it to the Revenue within one month from the date of assessment,
(c) state your grounds of objection precisely, and
(d) file a tax return if you have not done so.

What if you miss the deadline of objection? Ask the IRD to accept your late objection --- Section 64 states that the Commissioner can accept late objection on the following grounds: (a) absence from Hong Kong (b) sickness, or (c) any other causes that have prevented you from lodging an objection within the time limit. If you have not received the assessment before, ask for a copy of the assessment as well as an acceptance of your late objection. Nowadays, the IRD sends almost all assessments to taxpayers by ordinary post. In fact, some may have been lost during transit of posting. Therefore, to grant the taxpayers benefit of doubt, the IRD accepts by concession almost all late objections in case the taxpayers claim non-receipt of assessments.

Besides, you are entitled to married allowance, child allowance and dependent parent allowance even if you have missed the deadline of the objection. In other words, there is practically no time limit for the statutory allowances --- and you can still get these allowances providing you fulfil the conditions for such allowances. What you should do is to write a letter to the IRD stating your claim for the allowances clearly and file a tax return in support of your claim if you have not done so.

If the assessment was not estimated in the absence of a tax return, then you are entitled to invoke Section 70A to ask for a revised assessment on the grounds that it contains an error or omission. The words “error or omission” are not defined in the IRO. From case law, “error” includes one made by a taxpayer or by the Revenue, whereas “omission” includes an omission of fact and even an omission of claim by the taxpayer. If the Revenue rejects your claim of error or omission, ask for a formal notice of rejection of Section 70A so that you can send a formal objection against their rejection. Then, your objection will be processed as a valid objection under Section 64. In other words, you can still proceed with your claim even if you fail to meet the objection deadline.

The objection and appeal procedures

To put it simply, the conditions of a valid objection under Section 64(1) of the IRO are:-

1. It must be in writing.
2. It must state precisely the grounds of objection.
3. It must be received by the IRD within one month from the date of the assessment.

In law, the one-month objection period can be extended if the taxpayer is prevented from lodging the objection due to absence from Hong Kong, sickness or other reasonable causes. In practice, the objection period can be extended if the taxpayer has reasonable causes for the delay. Virtually the Revenue will accept a late objection if the taxpayer does not receive the assessment. What constitutes "preventing a taxpayer from making the objection" was considered in the case Lam Ying Bor Investment Co. Ltd. v. CIR.

Lam Ying Bor Investment Co. Ltd. v. CIR

This case concerns whether the illness of the sole active director of a company constitute a reasonable cause for late objection. The Company had three directors. It did not object to a profits tax assessment within the objection period. It claimed that the delay had been caused by the illness of the Company's sole active director while the other two directors were either too old or too busy to attend to the Company's affairs. CIR did not accept the late objection. Then, the Company sought a judicial review of the CIR’s decision from the court. The court upheld the CIR's decision. In his judgment, the judge drew a distinction between the circumstances preventing a taxpayer from making an objection within the time limit and the circumstances excusing him from not making an objection within the time limit. It was held that the circumstances had not ‘prevented’ the taxpayer from lodging an objection within the time limit. Rather, the delay was due to the Company's negligence.

An assessment under objection will be subject to revision in all aspects. The revision does not only apply to the grounds of objection, but also cover other aspects. So, as long as an objection is unsettled, a taxpayer can claim for other items which have not been mentioned in his objection letter. But if the assessment is estimated in the absence of a tax return, the taxpayer must file a properly completed tax return in support of his objection. In practice, the Revenue will issue a standard letter to the taxpayer requiring him to submit a tax return to validate the objection within 10 days. If the taxpayer needs more time to complete the tax return, he should first telephone the case officer according to that standard letter and then fax the IRD a written request. Below is a tax case on this topic.

CIR v. Mayland Woven Labels Factory Ltd.

This case concerns what is a properly completed return. The appellant company purported to make a return of profits under section 51(1) of the Inland Revenue Ordinance. It filed a profits tax return but it was not accompanied by the company's balance sheet, profit and loss account and auditor's report, as required in the notice printed in the tax return. The IRD did not accept the tax return as valid and therefore it issued an estimated assessment to the company. Then, the company objected to the assessment. In order to validate the objection, the assessor extended the time limit for the company to submit the required documents. But the company failed to do that. Then, the assessor informed the taxpayer that the objection was invalid. As such, the company lost the right of objection and the assessment had become final and conclusive --- the company must pay all the tax according to the assessment even if the tax estimated exceeded that computed in accordance with the tax return submitted.

If the objection is made against an 'additional' assessment, no revision will be made to the 'original' assessment. Nevertheless, the taxpayer can ask the Commissioner to extend the objection period of the original assessment on the grounds of absence from Hong Kong, sickness or other reasonable causes. In that case, his objection can cover the original assessment as well.

If the objection is made against a Personal Assessment, no revision will be made to its composite assessments. Nevertheless, the taxpayer can ask the Commissioner to extend the objection period of the relevant composite assessments on the grounds of absence from Hong Kong, sickness or other reasonable causes. In that case, his objection can cover all the composite assessments.

To process an objection, the IRD may ask the taxpayer as well as other parties to supply information relevant to the objection. The information required from the taxpayer may include books or documents in his custody. After gathering all the relevant information, the IRD may allow the taxpayer's objection, or propose a revised assessment, or ask for a withdrawal of objection. Should there be no agreement from the taxpayer, the case will be submitted to Commissioner who will determine the objection --- he may confirm, reduce, increase or annul the assessment. If the taxpayer disagrees with the determination, he can appeal to the Board of Review. In that case, the burden of proof that the assessment is excessive will be on the taxpayer. Having heard the evidence and arguments submitted by the taxpayer and the IRD, the Board will decide on the case. If the taxpayer or the Revenue disagrees with the Board's decision, either party can ask the Board to refer the case to the court.

Board of Review's procedures

The following procedures assume that the appellant is represented by a professional (who may be an accountant or a lawyer). The appellant may attend the hearing by himself without a representative.

1. Board chairman and members come in.
2. The chairman checks with the representatives of the appellant and the Revenue about the documents.
3. The appellant's representative gives the opening submission.
4. The chairman asks the appellant's representative if he is

calling any witness.

5. The chairman asks the appellant if he is going to give oral evidence as witness.
6. The witness or the appellant makes an oath or an affirmation.
7. The appellant's representative examines the witness or the appellant.
8. The appellant's representative (or the appellant if unrepresented) gives evidence.
9. The Revenue's representative cross-examines the witness or the appellant.
10. The appellant's representative re-examines the witness or the appellant.
11. After the examinations, the Chairman asks the representatives of the appellant and the Revenue whether a written final submission is prepared.
12. The appellant's representative (or the appellant if unrepresented) presents the final submission.
13. The Revenue's representative presents the final submission.
14. The appellant's representative (or the appellant if unrepresented) gives a reply to the Revenue's submission.
15. The Board delivers an oral decision or reserves to deliver a written decision later.

The role of court in the case stated by Board of Review

On this question, the judge in the case Edwards (Inspector of Taxes) v Bairstow [1956] AC 14 said this: “I think that the true position of the court in all these cases can be shortly stated. If a party to a hearing before commissioners expresses dissatisfaction with their determination as being erroneous in point of law, it is for them to state a case and in the body of it to set out the facts that they have found as well as their determination. I do not think that inferences drawn from other facts are incapable of being themselves findings of fact, although there is value in the distinction between primary facts and inferences drawn from them. When the case comes before the court it is its duty to examine the determination having regard to its knowledge of the relevant law. If the case contains anything ex facie which is bad law and which bears upon the determination, it is, obviously, erroneous in points of law. But, without any such misconception appearing ex facie, it may be that the facts found are such that no person acting judicially and properly instructed as to the relevant law could have come to the determination under appeal. In those circumstances, too, the court must intervene. It has no option but to assume that there has been some misconception of the law and that this has been responsible for the determination. So there, too, there has been error in point of law. I do not think that it much matters whether this state of affairs is described as one in which there is no evidence to support the determination or as one in which the evidence is inconsistent with and contradictory of the determination, or as one in which the true and only reasonable conclusion contradicts the determination. Rightly understood, each phrase propounds the same test. For my part, I prefer the last of the three, since I think that it is rather misleading to speak of there being no evidence to support a conclusion when in cases such as these many of the facts are likely to be neutral in themselves, and only to take their colour from the combination of circumstances in which they are found to occur."

The role of hearing by Commissioners in UK is similar to that of Board of Review in Hong Kong. Below is a tax case concerning grounds of objection.

CIR v. The Hong Kong Bottlers Ltd.

In this case, the company took over the business of another company by acquiring its share capital. The company objected to the profits tax assessment in respect of Industrial Building Allowance. Having gathered facts during handling of the objection, the IRD also disallowed the company's claim for depreciation allowances in respect of plant and machinery. The company appealed to the court.

It was held that when an objection had been made, the Commissioner was entitled to review the whole of the assessment, and increase it if necessary. In other words, the assessment would be subject to revision in all respects and the revision does not only apply to the grounds of objection. In his judgment, the judge said: “It may be that an Assessor, at any time within six years, has power under section 60 to correct a mistake by means of an additional assessment. But that is not what I am asked to decide on this appeal. The question is simply this: Is a taxpayer entitled to limit the jurisdiction of the Commissioner to consider an assessment by the terms of his notice of objection? In my view the answer is ‘no'. Admittedly, the foundation of the Commissioner's jurisdiction under section 64(2) is the receipt by him of a valid notice of objection --- and a notice of objection is not a valid notice unless it states precisely the grounds of objection. But it does not follow that because the grounds of objection must be stated precisely in order to give the Commissioner jurisdiction to consider the assessment, that his jurisdiction is circumscribed by the grounds as framed by the taxpayer. Once the Commissioner is seized of the matter, his first duty is to consider the questions raised by the notice of objection; but it is the assessment he is concerned with. The assessment objected to is the assessment, not part of the assessment or such aspects of the assessment as the taxpayer chooses to have considered. One can readily visualize cases in which it would be utterly impossible for the Commissioner to consider one aspect of an assessment to the exclusion of other aspects. His duty is to consider the assessment made by the Assessor, and to consider it as a whole. Having done so, his powers are not confined to confirming, reducing, or annulling the assessment. The subsection states specifically that he may increase it; and, clearly, the Commissioner's power to increase an assessment is not limited to cases in which the taxpayer, by his notice of objection, may, for any reason, seek to have his assessment increased. If the taxpayer’s submission in this case were well founded, it would mean that in every case in which the Commissioner considered that an assessment should be increased, his duty would be to direct his Assessor to raise an additional assessment under section 60. He would himself, be powerless to increase the assessment, although section 64(2) says that he may do so.”

A diagram to show the objection and appeal procedures

Court of Final Appeal

↑

Court of Appeal

↑

High Court

↑

Board of Review

↑

CIR’s determination

↑

Objection

Author’s advice

The taxpayer should mind the cost of objection and appeal. On receiving a valid objection, the IRD will generally ask the taxpayer to supply information to prove his claim --- that may cause the taxpayer a lot of trouble, time and expenses with a futile end result. So, think twice before you object to the assessment. If the objection cannot be settled at the assessor level, it will be submitted to the Appeals Section; and if there is still no agreement between the IRD and the taxpayer, the appeals officer will prepare a determination for the CIR’s endorsement. If the taxpayer does not accept the determination, then he must lodge an appeal to the Board of Review within the time limit and the format as stipulated in the Inland Revenue Ordinance. Before appealing to the Board, it is advisable for the taxpayer to seek professional advice. Indeed it is quite costly to appeal to the Board in view of the time, effort and professional charge. It should be noted that the Board may impose a charge not exceeding $5,000 on the taxpayer if it thinks his appeal is without merits. In fact, most taxpayers' appeals stop at Board of Review because of the huge cost of a further appeal to the law court.

Hold-over of tax in dispute

If a taxpayer's objection is valid, the Commissioner will inform the taxpayer by way of a standard letter ordering the amount of tax to be held over pending the result of the objection. As stated in all notices of assessment, the IRD requires all taxpayers to pay all the tax, even though part of it is in dispute, on or before the due date unless and until the Commissioner orders otherwise. But if there is undue delay on the part of the Revenue in dealing with the objection, the surcharge as a result of the late payment of the tax will usually be waived. If the taxpayer still receives a notice for payment of surcharge, he should write to the Collector requesting for a waiver.

A taxpayer objecting to an assessment may be required to purchase Tax Reserve Certificates to cover the tax in dispute. The TRC purchased bears interest from the day of issue to the day of determination of the objection at the rate published by IRD on its web site.

If the tax is held over unconditionally and the taxpayer loses the case at last, the taxpayer will be required to pay the tax plus interest on the tax held over. The interest rate is based on the prevailing court-judgment rates. If the Commissioner orders no hold-over of tax in dispute and the taxpayer wins the case at last, then only the tax overpaid will be refunded to the taxpayer ---

there will be no interest on the tax overpaid due to the taxpayer. So, it is preferable for the taxpayer to ask for a conditional hold-over of the tax in dispute: that is to purchase tax reserve certificate for the tax in dispute. In that case, he can earn interest from the tax in dispute if he wins the case at last.

If the Revenue does not deal with your objection or your claim properly, contact the IRD's Complaint Officer by phone via 2594 5000 or by fax via 2802 7625. If you are dissatisfied with the IRD's processing of your complaint, you can complain to the Ombudsman's Office.

1.2 Correction of errors and omissions

Correction of error or omission

According to section 70, an assessment is final and conclusive in the following situations: (a) no valid objection or appeal has been lodged within the time limit; (b) the objection has been withdrawn or dismissed by the Board of Review or a court; (c) where a revised assessment has been agreed under section 64(3); or (d) where an assessment is determined by the Board of Review which refuses to refer the case to court.

Nevertheless, section 60 empowers an assessor to make an additional assessment within 6 years after the end of the year of assessment on matters that have not been determined under the objection. This 6-year time limit is extended to 10 year in case of fraud or wilful evasion.

On the other hand, section 70A allows an assessor to revise an assessment to correct an error or omission within 6 years after the end of the year of assessment.

Section 70 is only applicable to an ‘assessment’. A statement of loss as agreed by the taxpayer with the assessor is not an assessment for the purpose of section 70A, see CIR v Yau Lai Man trading as L. M. Yau & company. In other words, the loss as assessed is not final and conclusive under section 70 and the taxpayer can ask for adjustment of the loss brought forward in the current year of assessment.

The purpose of section 70A is to redress unreasonable hardship, if any, arising from the mistakes made by either the taxpayer or the assessor. This purpose was confirmed in the Board of Review case D6/91.

Board of Review case No. D6/91

In this case the Board rejected the CIR's argument that if a taxpayer took a different view of law on some known facts, section 70A could not be invoked. In its judgment, the Board said: “Clearly there must be finality in taxation matters. That is the clear intention of section 70... Section 70 of the Inland Revenue Ordinance states that assessments are to be final and conclusive for all purposes of the Ordinance. That is a sweeping and draconian section. It is clear that section 70A was introduced to overcome the possible hardship of section 70.”

Hence, based on the aforesaid decision, the first question for reopening of an assessment by section 70A is whether there is any hardship on the part of the taxpayer. If yes, then it is very probable that section 70A can be invoked to redress the hardship.

There is no definition of ‘error or omission' in the Ordinance. So, the Literal Rule may apply (see paragraph 1.7 below) --- that is to look to their ordinary and literal meaning. The meaning of ‘error’ given in the Oxford English Dictionary is ‘something incorrectly done through ignorance or inadvertence; a mistake'. The meaning of ‘omission’ in Webster's New International Dictionary is: an act or instance of omitting, whether by leaving out, or by abstention from inserting, or by neglect or failure to do something. In my work experience, these meanings have all along been adopted by IRD.

Although there are no definition of ‘error or omission’ in the

Ordinance, there are a number of court cases on the issue. Below are two important ones.

Extramoney Ltd v CIR [1997] 2 HKTC 38

In the case, it was held that an error was something that happened inadvertently and it excluded a deliberate act. The facts of the case were complicated. In short, the company deliberately booked certain profits which it did not actually earn. The company's section 70A claim was rejected by the Board of Review on the grounds that the disputed profits were deliberately reported as taxable profits and hence there would be no error on the part of the company. The company appealed to the court and the Board's decision was upheld. On the wordings of "errors or omissions" in section 70A, the judge made the following comments: "In my view, for the purpose of s. 70A, the meaning of "error" given in the Oxford English Dictionary (p. 277) would be appropriate, that is, "something incorrectly done through ignorance or inadvertence; a mistake". I do not think that a deliberate act in the sense of a conscientious choice of one out of two or more courses which subsequently turns out to be less than advantageous or which does not give the desired effect as previously hoped for can be regarded as an error within s. 70A. It is even worse if the deliberate act is motivated by fraud or dishonesty. But the question of fraud or dishonesty need not arise. Hence, in the context of the present case, if there is a change of opinion of the auditors or accountants in respect of the accounts, the first opinion cannot be regarded as an error or omission within the section. Similarly if there is a change of mind of the directors of the company in connection with how any part of the accounts should be made up, the previous decision will not be regarded as an error or omission. Nor is it an error or omission if it is merely a difference in the treatment of certain items in the accounts by those preparing or approving the accounts. If this were permitted, the director or officer of a company will be tempted at a later stage to try and "improve" the company's accounts or change his own decisions if this is to his advantage. This would be contrary to the spirit of the Ordinance that there should be finality in taxation matters. The whole statutory scheme provided in the Ordinance simply cannot work."

The other case on ‘error or omission’ is a Board case. This case is often followed by IRD and is summarized as follows.

Board of Review case D52/99

In this case, the taxpayer bought a property in 1986 as a capital asset. In 1988, the property was divided into 87 individual units. For the years of assessment 1989/90, 1990/91 and 1991/92, 73 units were sold. The IRD was of the opinion that the division of the shop showed the taxpayer’s change of intention from investment to trade. As such, the rebuilding allowance for 1989/90, 1990/91, 1991/92 and 1992/93 were withdrawn, giving rise to additional tax assessments for 1989/90 and 1991/92 and revised loss computation for 1990/91 and an assessment for 1992/93.

The taxpayer objected to the assessments and also the revised loss computations. Furthermore, it invoked section 70A to correct the tax assessments for 1989/90 and 1991/92 on the grounds that the profits derived from the sale of the units were capital gain not chargeable to tax. On the other hand, the IRD raised additional tax assessment for the year of assessment 1990/91 to adopt the IRD’s valuation of Property 1 as at 8 November 1998 (opening stock) when the division took place for computation of the assessable profit. The taxpayer asserted the value of the property to be $30,000,000 which was much higher than the IRD’s valuation of $16,000,000 in order to reduce the assessable profits.

The taxpayer’s appeal was dismissed by the Board who said: “In the tax returns for the years of assessment 1989/90 and 1991/92 submitted by the Taxpayer, the Taxpayer had offered for taxation the profit earned in the sale of the forty-three units of the sub-divided Property 1 in the year of assessment 1989/90 and the seventeen units in the year of assessment 1991/92 booked in the accounts as ‘sale of properties’. The Taxpayer had changed the description of the nature of its business in its tax returns from that of ‘Property holding for rental income’ in the tax return for the year of assessment 1987/88 to ‘Property holding for rental income and property redevelopment for re-sale’ in its tax return for the year of assessment 1989/90 and a similar description in its tax return for the year of assessment 1991/92. The financial statements of these two periods showed clearly that these respective forty-three and seventeen units were treated trading assets. In the 1989/90 balance sheet, Property 1 was re-classified to ‘Property under development’ which was noted as a conversion of Property 1 formerly held for rental income purpose to resale purpose. In the 1991/92 balance sheet, the seventeen units sold (and the profits of which were offered for tax) had been classified as ‘Current assets - property for re-sale/letting’. It is obvious that these forty-three and seventeen units sold were treated in the tax returns and the accounts as current assets or trading stock. There was no error or omission in the two tax returns in question which were clearly prepared on the basis of the two corresponding audited financial statements. Section 70A cannot be used to correct the accounting treatment of the sale of the forty-three and seventeen units in the respective tax returns and audited accounts for the years of assessment 1989/90 and 1991/92. The Taxpayer had made a deliberate choice in the accounting treatment and in submitting the profits made on the sale of the forty-three and seventeen units for taxation. This cannot be regarded as an error or omission under section 70A of the IRO. The Taxpayer’s appeal under section 70A(2) of the IRO is dismissed”.

When does section 70A apply?

Section 70A is applicable when the following conditions are satisfied.

1. The assessment concerned is one made for the last 6 years of assessment; and
2. The tax charged is excessive because of :
   - (i) an error or omission in a tax return or in a statement annexed thereto, or
   - (ii) an arithmetical error or omission in the calculation of the amount of the net assessable value, assessable income or profits assessed or in the amount of the tax charged.

The practical applications of section 70A

In practice, the words "error or omission" include: (a) an arithmetical error, (b) an omission to claim an expense or a deduction or an allowance, (c) an error or omission of fact, or (d) an error of law.

An "error of law" occurs in the following examples:

- Because of ignorance of law, a taxpayer in his tax return reports some non-taxable items. For instance, a taxpayer may invoke Section 70A to claim time-apportionment on the grounds that he omitted to do so in his tax return.
- Because of ignorance of law, a taxpayer reports his business income as employment income in his tax return. For instance, an insurance agent, who has no master and servant relationship with the insurance company, reported his income under Salaries Tax. On the grounds of "error of law", he can invoke Section 70A to have his income re-assessed under Profits Tax so as to get more expenses deduction.

An error or omission can be made by the taxpayer or an IRD officer. In some cases, an error may even be made by a third party, for example: the taxpayer's employer or the bank.

As far as an error or omission made by a taxpayer is concerned, it must be one in a tax return or a related statement. 'Statement' includes the accounts submitted in support of the return as well as any related correspondence made by the taxpayer.

An act deliberately done by an assessor in arriving at the assessment is not an error. For example, the Assessor's disallowance of, say 50%, of entertainment expenses in computing assessable profits is a judgment, not an error. Nevertheless, if the assessor made the judgment based on a wrong fact or has omitted an important fact, then the taxpayer can ask for a revision of the assessment on the grounds of error or omission.

Typical examples of 'error or omission' are:

- A salaried taxpayer reported compensation for loss of an employment as taxable income in his tax return.
- A salaried taxpayer has not claimed married person allowances, child allowances or dependent parent allowance (this claim is still valid even for an estimated assessment in the absence of a tax return).
- A salaried taxpayer has not claimed home loan interest, charitable donation, contribution to recognized retirement scheme, travelling expenses from one workplace to another workplace, self-education expenses... etc. in his tax return.
- A business taxpayer has submitted an incorrect tax computation.
- A business taxpayer reported offshore profit in his tax return.
- A business taxpayer has not claimed depreciation allowances in his tax return.
- A business taxpayer added back an item which should be deductible.
- A business taxpayer made an arithmetical mistake.
- An assessor made a salaries tax assessment based on an incorrect employer return.
- An assessor made an arithmetical mistake in computing the assessable profit.
- An assessor fails to deal with a deduction claimed by a taxpayer.

Below is a court case on ‘error or omission’ frequently adopted by IRD.

Sun Yau Investment Co. Ltd. v. CIR 2 HKTC 17

In this case, it was held that Section 70A did not apply to an estimated assessment in the absence of a tax return. The company failed to make a profits tax return and the assessor estimated its liability for tax at $125,981. The company purported to lodge an objection against the assessment by letter but did not include with it any profits tax return or supporting audited accounts. The letter was not accepted by the Commissioner as a valid notice of objection because it was not made within the one-month period under section 64. Subsequently, the company filed a return for the relevant year together with the audited accounts. It then lodged an application under section 70A of the IRO to re-open the assessment on the grounds that it was excessive as it contained an arithmetical error or omission in the calculation of the amount of the assessable profits. The assessor declined to correct the assessment and his refusal was upheld by the Commissioner. On appeal direct to the court, the judge decided that section 70A had no application because the assessor had not committed any error or arithmetical error simply because his estimated assessment did not coincide with a figure he would have reached had other information been available to him. The judge said: "In my judgment, the wording of 70A is perfectly clear. It covers the case when there has been a miscasting by the Assessor on the material available to him. The Assessor is not in error, let alone arithmetical error, simply because his assessment does not coincide with a figure he would have reached had other information been available to him… The object of the Ordinance is to achieve within the timetable and procedures laid down. Various safeguards and appeal procedures are provided. One of those safeguards is provided by section 70A where in a proper case, the assessor is required to correct his own arithmetical error. That is not this case. I agree not only with the findings of the Commissioner of Inland Revenue but also with his reasons. This appeal is dismissed with costs."

Author's comments: Although the change of judgment by the taxpayer as to the taxability of a gain or the deductibility of an expense will not usually be accepted as an error for the purpose of section 70A, the taxpayer can argue that there is an omission of claim on the grounds on error of law. This argument may stand in some cases.

Prevailing practice

Section 70A is inapplicable where the return or statement was made in accordance with the then prevailing practice. In other words, the claim will not be accepted if there is a change of the

IRD's practice or there is a new court judgment. Whether there was a prevailing practice is largely a question of facts and the taxpayer is entitled to require the IRD to prove it. If the taxpayer does not accept the Revenue’s assertion, he can ask the IRD to issue a formal rejection of his section 70A claim so that he can appeal to the Board of Review.

Formal notice to reject section 70A claim

The IRD should issue a formal notice of rejection if it does not accept the taxpayer's Section 70A claim. When the taxpayer receives the notice, he can lodge a formal objection in accordance with section 64 of Inland Revenue Ordinance against the notice as if it were a notice of assessment.

In practice, where a taxpayer misses the deadline for a formal objection to claim offshore profits, he can also invoke section 70A to make the claim within 6 years after the end of the relevant year of assessment. In that case, the formal procedures of objection will be followed to deal with the claim and if the IRD still rejects the claim, a CIR determination will be issued so that the taxpayer can appeal to the Board of Review to pursue his claim. If the Revenue does not issue a formal notice of rejection of section 70A claim, the taxpayer can pursue his claim by way of a complaint.

1.3 Beware of your legal obligations

If you break the tax law, you have to pay a price. The price may be tax investigation, money fines or even criminal prosecution. So, beware of the requirements of the Inland Revenue Ordinance. Here are some tips for you.

- Never file an incorrect tax return. Make sure every item you put down in the return is correct.
- File the tax return promptly. Ask for an extension of time limit if you cannot make it on time.
- Make sure all the information you supply to the Revenue is

true. If the information required is unavailable, say so.
- If any information supplied to the Revenue turns out to be incorrect, inform them right away.
- Pay tax on time. Jot down the due date in your diary. Beware: the surcharge on unpaid tax is very high, much more than the market interest rates.
- If you are liable to tax and do not receive a tax return within 4 months after the year of assessment, inform the Revenue.
- If you cease to have a source of taxable income, inform the Revenue within one month.
- If you (a salaried taxpayer) are leaving Hong Kong for good, inform the Revenue at least one month before your departure.
- If you change your address, inform the Revenue within one month.
- Keep business records for 7 years.

1.4 Tax penalties

A tax penalty may be imposed on a taxpayer if he fails to comply with the requirements of the Inland Revenue Ordinance. Nevertheless, if the taxpayer has a reasonable excuse for his non-compliance, he will not be penalized. In some cases, even if the "excuse" cannot exempt him totally from penalty, it can still reduce the penalty substantially.

A taxpayer may be liable to penalty in the following situations.
(a) He does not comply with the Revenue's notice of requirement to file a tax return within the specified time limit.
(b) He fails to inform the Revenue of his tax liability within 4 months of the end of year of assessment if he does not receive a tax return.
(c) He makes an incorrect return or statement or supplies incorrect information to the Revenue.
(d) He makes an incorrect return deliberately to evade tax.
(e) He deliberately omits to disclose any particulars in a tax return that are required.

(f) He makes a false statement or entry in a tax return deliberately.
(g) He makes a false statement in connection with a claim for any deduction or allowance deliberately.
(h) He signs an incorrect tax return or statement or account deliberately.
(i) He gives an incorrect answer to a question raised by the Revenue.
(j) He prepares or maintains incorrect books of accounts to evade tax.
(k) He uses a fraudulent act to evade tax.
(l) He does not keep sufficient business record of his income and expenditure.
(m) He does not keep sufficient record of his rental income.
(n) He does not inform the Revenue of his imminent departure from Hong Kong for more than one month.
(o) He does not inform the Revenue of his cessation of business.
(p) He does not inform the Revenue of change of correspondence address.

The court may order the following penalties:

Items	Penalty
(a) to (c)	a maximum fine of $10,000 + treble the tax undercharged
(d) to (k)	a maximum fine of $50,000 + treble the tax undercharged + 3-year imprisonment
(l)	a maximum fine of $100,000 + the court may order the taxpayer to do the act which he has failed to do within a specified time
(m) to (p)	a maximum fine of $10,000 + the court may order the taxpayer to do the act which he has failed to do within a specified time

Where blatant tax evasion is involved, the Revenue may take criminal prosecution against the offender under common law with the offence of cheating the public revenue. If the prosecution is convicted, the sentence will be very severe including imprisonment.

Below are my summary of some important prosecution cases.

Failing to Keep Sufficient Business Records

Mr. Ho is the precedent partner of Sun Cheung Dispensary. He was prosecuted for not keeping sufficient business records in respect of the partnership business. During 1996/1997, the business only kept records of bank statements, cheque stubs, daily income and expenditure sheets, vouchers and the cash register tapes. The records kept were insufficient to ascertain readily the assessable profits for 1996/1997. No proper accounts were maintained for its receipts and payments and for its assets and liabilities. The daily income and expenditure sheets kept were not regarded as sufficient business records for taxation requirements. Mr. Ho pleaded guilty and was fined $80,000.

False claim of staff wages and business expenses

Ms. Pak (白小姐), a famous radio talk-show host, was found guilty of tax evasion. The sentence was a three-month imprisonment and a fine of $200,000. Ms. Pak was prosecuted on four charges on signing fraudulent Profits Tax Returns for 1994/1995 to 1997/1998. The charges concerned the tax returns of a service company beneficially owned by her. The company's major income was derived from her hosting of radio programs from 1994 to early 1997. The IRD's investigation revealed that Ms. Pak had falsely reported an employee having been hired by the company as public relation assistant and had been paid $208,400 for 1995/96 and 1996/97. Besides, the company falsely claimed salaries expenses of $162,950 related to another employee and inflated the entertainment and employee benefits totaled $735,536 and omitted to disclose a contractual bonus of $450,000 in 1994. The inflated entertainment and employee benefits concerned a lot of false and altered restaurant receipts. The profits under-assessed were $1,556,886 and the tax undercharged $210,122.

Two sets of receipts record

The tax evader Mr. K M Chang was prosecuted on a 5 charges concerning wilfully with intent assisting other person to evade tax and omitting sales income from the profits tax returns of a company. He pleaded not guilty to all the charges. Mr. Chang was the director and shareholder of an engineering company that was engaged in the trading of industrial engineering products. The IRD's investigation revealed that the Company issued two types of cash sales invoices, one with serial numbers bearing alphabetic prefix and another with serial numbers bearing no alphabetic prefix. For 1994/95 to 1996/97, the Company omitted from the profits tax returns the sales revenue from all the cash sales invoices with serial numbers bearing no alphabetic prefix. Mr. Chang signed the accounts and the tax returns for 1994/95 and 1995/96. The total tax evaded exceeds $1,000,000. Mr. Chang was convicted on all the 5 charges. He was sentenced to 9-month imprisonment plus a total fine exceeding $2,000,000.

Non-disclosure of profits
The tax evader, Mr. K K Lee, was a director of D F M Ltd. and a beneficial owner of Y F Co. Ltd. and N B Ltd. The three companies made huge profits since their commencement of businesses in 1990, 1991 and 1993 respectively. Mr. Lee did not report profits in the profits tax returns in respect of DFM. He also abeted his mother to file a return for NB with the profits column left blank. The IRD's investigation revealed that: DFM understated profits amounting to $34,413,331 with tax undercharged $5,925,619 for 1990/1991 to l997/1998; YF understated profits amounting to $751,628 with tax undercharged $112,744 for 1992/93; and BN understated profits $12,610,687 with tax undercharged $1,891,602 for 1993/94 to 1995/96. On conviction of the tax evasion charges, Mr. Lee was sentenced to 18 months' imprisonment and a total fine of $11,700,000.

Evasion of Salaries Tax
The tax evader, Mr. Hsueh, was the former Head (Information Technology) of the Hong Kong Monetary Authority and former Chief Information Officer of the Securities and Futures Commission. Mr. Hsueh used false document to deceive Hong Kong Monetary Authority for housing allowances. In the documents submitted, he falsely declared that he rented accommodation so that he could claim housing allowance for more than $1,000,000. As a matter of fact, the alleged rent transaction did not exist and the accommodation was owned by

him through a shelf company. Furthermore, he filed an incorrect tax return to IRD in order to evade tax on the housing allowances. The tax evaded was $22,233. On conviction of the offences, he was sentenced to 4-months imprisonment plus a fine of $75,000. The judge (District Court) said the sentence of imprisonment was because of the offender's serious breach of trust. The imprisonment sentence was suspended for one year by the High Court on the taxpayer’s appeal on the grounds of the taxpayer’s old age and previous clean record.

Section 82A additional tax

Rather than taking prosecution, the Revenue normally issues an assessment of additional tax under Section 82A against the offender. In such case, the maximum penalty will be an additional tax of 3 times the tax undercharged. Such assessment is made where the offence is not so serious to warrant a prosecution or where the evidence is insufficient for the proof required in a criminal prosecution.

This tax is usually called Section 82A penalty. The chief purpose for the penalty is "commercial restitution" --- that is to recover the loss due to the delay in the tax collection. Other purposes include deterring the public from tax offences and educating the offender to comply with the tax law in future.

The penalty is imposed for tax offences without criminal intention of evading tax and for tax offences without sufficient evidence to take criminal prosecution. Because the degree of proof for criminal prosecution, known as “beyond reasonable doubt”, requires a lot of tax investigation work, it is impossible for the Revenue to prosecute every tax offender. So, depending on the evidence adduced and the then manpower constraint, only a few offenders of blatant tax evasion are prosecuted. The remaining tax offenders are penalized by Section 82A additional tax.

Legally speaking, the maximum penalty is three times the tax undercharged and the penalty is imposed by the Commissioner or

Deputy Commissioner of Inland Revenue personally. Of course, in practice, almost all the penalties are exactly the amounts recommended by the assessors, as endorsed by the Commissioner or Deputy Commissioner. This practice is perceivable as there are so many tax cases (including all prosecution, Section 82A, appeal cases) requiring approval, not to mention all such other important duties as policy matters, administrative and public relation work, special tasks… etc. requiring their personal attention.

Before imposing the penalty, the offenders are invited to explain the tax offences. If they have a reasonable excuse, they will not be penalized. What is a reasonable excuse depends on the circumstances of each case.

The assessors' recommendations are generally based on a tax penalty table. As far as investigation and field audit cases are concerned, tax offences are classified into three groups of culpability, namely: (a) intentional disregard, (b) recklessness and (c) no reasonable care. Moreover, each group of offence is further classified into four categories of co-operation, ranging from "voluntary disclosures" to "disclosure denied". The penalty rates on the tax undercharged, before commercial restitution, are as follows.

	Voluntary disclosure	Disclosure on challenge	Belated disclosure	Disclosure Denied
Intentional disregard	15%	75%	140%	210%
Recklessness	10%	50%	110%	150%
No reasonable care	5%	35%	60%	100%

The penalty as determined above is then added to the commercial restitution which is determined by the tax undercharged times the then best lending rates. This computation is usually done by the assessor with a computer program. In any case, the total penalty rate is restricted according to the following table.

	Voluntary disclosure	Disclosed on challenge	Belated disclosure	Disclosure Denied
Intentional disregard	60%	100%	180%	260%
Recklessness	45%	75%	150%	200%
No reasonable care	30%	60%	100%	150%

The Revenue has to advise the offender which group of culpability and which category of cooperation have been adopted. If the offender disagrees with the penalty, he can appeal to the Board of Review. But caution: If the Board opines the taxpayer's appeal frivolous, vexatious, without merit or an abuse of the appeal mechanism, the Board may impose the taxpayer to pay the cost of appeal up to $5,000.

The Revenue states that the penalty to be imposed in a particular case depends not only on the penalty table but also upon the aggravating and mitigating factors in the case. The aggravating factors refer mainly to the un-cooperative attitude of the taxpayer. Although the IRD says the penalty may be adjusted upward by the aggravating factors, this rarely happens in practice because doing so will likely bring the case to Board of Review --- that will add a lot of workload to the investigation officer.

The taxpayer should forward the mitigating factors for a reduction of the tax penalty. The following mitigating factors are published on the IRD’s website.

1. The taxpayer is not well educated.
2. The business is simple and unsophisticated.
3. The taxpayer shows genuine concern, seriousness, responsiveness and co-operation.

4. The taxpayer is sincere.
5. The taxpayer is willing to compromise.
6. The taxpayer accepts a discrepancy when quantified.
7. The understatement is an isolated case.
8. The understatement is relatively small.

Where no field audit or investigation is involved, the section 82A additional tax is as follows.

Profits Tax Cases

(1) Failing to notify the Revenue of tax liability in case of no tax return is received or failing to file tax return within the time limit:
(a) First offence: 10% of the tax undercharged (or 20% of the tax undercharged where two or more assessments involved)
(b) Second offence within 5 years: 20% of the tax undercharged (or 30% of the tax undercharged where two or more assessments involved)
(c) Third or more offences within 5 years: 35% of the tax undercharged (or 50% of the tax undercharged where two or more assessments involved)

(2) For tax offences other than failing to notify chargeability or failing to file return promptly, the penalty table for tax investigation and field audit is normally adopted. Usually the absence of no field audit or investigation is a mitigating factor for a downward adjustment.

Salaries Tax and Property Tax Cases

(1) Failing to notify the Revenue of tax liability in case of no tax return is received or failing to file tax return within the time limit: the Revenue's normal policy is to issue a compound penalty (usually $600) under Section 80(5) of IRO. In general, Section 82A penalty will not be issued in view of the large number of cases and the small tax amounts involved. A taxpayer disagreeing to the compound penalty should not sign to accept the compound offer --- then in the absence of

the taxpayer's acceptance, the Revenue will either take the case to court (in that case the taxpayer can voice his grievance to the judge who will decide the amount of the penalty) or will take no further action in the case.

(2) For simple offences of omission or understatement of incorrect statement, the penalty is as follows:
(a) First offence: 10% of the tax undercharged.
(b) Second offence within 5 years: 20% of the tax undercharged
(c) Third or subsequent offences within 5 years: 35% of the tax undercharged.

(3) For blatant offences such as a false claim for dependent parent allowance, the penalty is100% of the tax undercharged.

Personal Assessment cases

Personal assessment is a kind of tax relief under which the taxpayer claims deductions and allowances. It is up to the taxpayer to elect for Personal Assessment to reduce his total tax payable under schedular taxes (i.e. Profits Tax, Salaries Tax and Property Tax). As almost all relevant incomes should have been already been assessed under the schedular taxes, an omission of income under Personal Assessment giving rise to penalty is rare. In fact, failing to file the Personal Assessment returns promptly will normally lead to disallowance of the claim for the deductions and personal relief, rather than a penalty. As for the false claims of deductions and personal relief, the penalty to be imposed will follow that under Salaries Tax and Property Tax as set out above.

All penalty cases

For the counting of offence, an offence means one for which a warning letter, a compound penalty or a section 82A penalty assessment has been issued. The Revenue points out that the above percentages are for general guidance only. Depending on the circumstances of each case, the penalty may be adjusted upward or downward, although most adjustments are downward.

In my experience, the Revenue, for simplicity sake, generally classifies offences into 5 categories according to their culpability: (1) late submission of tax returns (2) no submission of tax returns (3) failure to notify chargeability (4) omission of taxable income or overstatement of expenses and (5) deliberately submission of incorrect information or an incorrect tax return. The penalty loading rates for the offences are 5%, 10%, 50%, 100% and 150% to 250% respectively subject to downward adjustment for the merits of the case. This serves a rough estimate of the penalty in the norm.

If the tax undercharged is small (say less than $1,000), then the penalty as determined above will usually be less than $300. In such cases, the Revenue will generally think it unworthy imposing a Section 82A penalty. Rather, warning letters will be sent to the offenders to warn them of the legal consequences of future offences.

Where blatant wilful tax evasions are involved, the Revenue may take criminal prosecution against the offenders instead of imposing the Section 82A penalty. A taxpayer having reasonable excuse for the offence should forward detailed written representation to the Revenue to ask for a lenient treatment.

Reasonable excuse

What is a reasonable excuse? It depends on the circumstances of the case. For example, a very small flower shop owner (with a monthly turnover of less than $10,000) fails to keep a complete set of business accounts: His poor education may be accepted by IRD or the Board as a reasonable excuse or a mitigating factor for the offence. In fact, he may be exempt from tax under Personal Assessment (if his taxable profit is less than his personal allowance). On the other hand, if the same offence is committed by a large flower shop, then the shop owner's poor education will not normally be accepted as a reasonable excuse --- this is because he should have hired an accountant to help him do the bookkeeping. From time to time, there are a number of Board of Review cases on what constitutes a reasonable excuse. Below are four cases that were accepted by the Board as having a "reasonable excuse" and so, the penalties imposed by CIR were annulled. But I must point out that these cases are for reference only and similar cases in future may not be ruled as such.

D13/85

A medical practitioner failed to disclose certain employment income in his tax return. He contended that the non-disclosure had been a genuine mistake of oversight as a result of change of employment and it had been just a simple slip of mind. The Board believed that he was an honest man and accepted his explanations as a reasonable excuse and hence discharged the tax penalty. It was held that in deciding whether or not a taxpayer had a "reasonable excuse", the Revenue should consider whether the taxpayer had acted as one would expect a reasonable law abiding citizen to do. A reasonable person is not a perfect person, but an average person using the reasonable skill and care in handling his taxation affairs which one would expect to see from such an average person.

D80/76

A taxpayer failed to disclose the profits derived from sale of land. He was able to convince the Board that he had relied on professional advice and honestly believed that the sales were of a capital nature.

D129/02

A taxpayer was seconded by a UK company to work for its subsidiary in Hong Kong. She did not report her employment income to IRD. She explained that she had believed the employment only liable to UK tax. The Board accepted her explanation as a reasonable excuse.

D14/98

A taxpayer had three sources of taxable income under salaries tax. In her tax return, she disclosed two sources correctly but omitted the one for which she had already resigned. The Board accepted the omission as a genuine oversight. It believed that the taxpayer had mistaken honestly such income as having been reported by the company already. The Board's decision also relied on the taxpayer's submission that she believed the omitted income as having been “assessed” by a provisional assessment upon her application for holding over of the provisional tax. As such, the penalty was discharged.

An important Board case concerning penalty

Below is an important case concerning section 82A penalty. It summarized the law, the history and the matters that should be considered when deciding the penalty.

D118/02

The Board of Review in the case D118/02 commented on the Revenue’s penalty policy. In this case, the taxpayer appealed against a Section 82A penalty concerning failure to comply with Section 51(1) of the IRO that required the taxpayer to file a tax return within the specified time. The penalty was about 50% of the tax undercharged. Having considered the case, the Board reduced the penalty rate to 20%. The appellant’s principal argument for non-submission of the return was his disagreement with the Revenue on the amount of expense reimbursement. The Board opined that this did not constitute a ‘reasonable excuse’. It quoted the following comments in Dunk v Havant General Commissioners [1976] STC 460:

‘What the taxpayer has to declare is “that the return is to the best of his knowledge correct and complete”. If a taxpayer finds circumstances that make the best of his knowledge more than usually unreliable, it is open to him to put against a figure for a particular item of income such words as “Estimated”, “See accompanying memorandum”, or something of that kind, and explain the circumstances. If he has done his best – and, of course, he is under a duty to use all proper sources of knowledge – he will not, in my view, be guilty of making a false statement providing, as I say, he puts in a genuine estimate and, if necessary, explains that it is not very reliable’. The Revenue adopted a 100% starting point in computing the penalty. A brief history and reasoning of Section 82A penalty was given in the judgment as follows:

"The penalty was first introduced by the Inland Revenue (Amendment) Ordinance 1969. When it was first introduced, the offender was ‘liable to be assessed under this section to additional tax of an amount not exceeding the amount of tax which has been undercharged in consequence of the incorrect return ...’ That new section was introduced pursuant to the recommendations in Part I of the Report of the Inland Revenue Ordinance Review Committee (‘the Report’). According to the Report, the new tax was intended to be an ‘administrative penalty’ not applicable to cases involving ‘wilful intent to evade tax’. The Report was of the further view that ‘the administration should not be empowered to impose a heavier monetary penalty for an offence than the maximum penalty which the Court could impose for the same offence’. The then Commissioner of Inland Revenue envisaged that ‘the full penalty equal to 100% of the tax undercharged would only be imposed for aggravated offences such as might be considered as borderline cases for prosecution under Section 82(1)’.

Section 82A was amended by the Inland Revenue (Amendment) (No 2) Bill published in the gazette on 27 March 1975. The amendments empowered the Commissioner to impose additional tax at treble the amount of tax undercharged. The amendments also brought into the net for the first time the cases where the taxpayer fails to comply with the requirements of a notice given to him under section 51(1) or (2A) or fails to comply with section 51(2).

The then Financial Secretary informed the Legislative Council in the course of debates on this Bill that the amendments were introduced because the penalties are not sufficiently high to act as a deterrent to some would-be evaders. Because of high interest rates and inflation, even where the maximum penalty of 100 per cent is imposed as it is in the worst type of case, the taxpayer is often no worse off than if he had paid the tax in due time... With a standard rate of 15 per cent, except for corporations where the rate is ... 16½ per cent, the worst that can happen to an offender if he is caught is to pay tax at 30 or 33 per cent – to put it at its lowest level it is worth taking a sporting chance. The level of penalty was to serve as ... inducement to a taxpayer to make a clean breast of things and submit corrected returns."

Section 82 of the IRO permits penalty to be imposed in relation to seven categories of acts committed by the offender 'wilfully with intent to evade [tax]'. Section 80(2) embodies offences similar to those in section 82A but envisages the same being dealt with by proceedings in Court. On conviction the offender is liable to: (a) a fine at level three (that is, $10,000) and (b) a further fine of treble the amount of tax involved.

For the year of assessment 2000/01, the level of fine under section 80(2) was around $2,500. Of the 33 cases dealt with in Court between 1971 and 2002, the arithmetical mean of further fine imposed for violation of section 80(2) is 97.5% of the tax involved.

According to the penalty loading statement, the Revenue took into account various factors in deciding whether prosecution is to be instituted under section 80(2). Amongst those factors is 'the strength of evidence'. The Board would caution against the use of section 82A as a soft option where there is insufficient evidence to support the violation. The 'administrative penalty' should not be used as an expedient means to shift the evidential burden onto the taxpayer.'

The Revenue says that the actual penalty to be imposed is the amount determined by the penalty table subject to a further adjustment that may be upward or downward according to the merits of each case. In practice, almost all the adjustments are downward. This is because an upward adjustment can easily lead to appeal to the Board of Review --- that will unquestionably increase the workload of the case officers. But a downward adjustment will lower the chance of appeal. So, take my advice: do ask for a downward adjustment, particularly when there are mitigating factors, such as:

1. There is indication of misconception or confusion in completing the tax return.
2. The mistake is due to a slip of the mind.
3. The taxpayer is a lay man without good knowledge of tax

and accounting.
4. The taxpayer has good compliance record before.
5. The taxpayer has taken actions to ensure the omission not to be repeated in future.
6. There are special circumstances warranting a further downward adjustment, e.g. financial difficulty, unemployment, illness... etc.

The above mitigating factors can lead to a further downward adjustment of penalty by up to 25%. So, don't forget to point out such factors in the written representation where applicable.

1.5 Privacy and Access to IRD's record

Privacy

The Revenue must observe privacy with respect to the taxpayers' information. That is to say: Every taxpayer's information must be kept secret and every taxpayer has the right to access to the information kept by IRD to check if it is correct. The authorities governing these two rights are Section 4 of Inland Revenue Ordinance and The Code on Access to information.

Official Secrecy

All IRD's officers have to take a solemn oath of secrecy under the provisions of section 4 of Inland Revenue Ordinance. Breaking the oath is a criminal offence and it may render the offender liable to criminal prosecution and internal disciplinary action. Section 4 is to promote full disclosure of information that is necessary for the Revenue to assess tax correctly.

Code on Access to Information

As a general principle, all information held by the IRD can be accessed by public unless the IRD has valid reasons, whether of public, private or commercial interest, to keep the information secret. However, the IRD cannot disclose any information if the disclosure contravenes a law.

Subject to other legislations, Section 4 of IRO prohibits the IRD from disclosing taxpayer's information to any persons other than the taxpayer or his authorized representative.

The request for information by an enquirer according to The Code on Access to Information must be made in a specified form. On receiving the request, the IRD will examine the claim to decide what information is accessible by the enquirer. Then, it will inform the enquirer of such information and how much is the fee required. The fee is a standard charge of HK$1.50 for every sheet of paper provided (A4 or A3 size). Then, on receiving the IRD’s reply, the enquirer can decide what information he really wants. When he pays the fee, he can get the information.

By exercising the request for information, a taxpayer can know what information is kept by the Revenue and whether such information is correct. Also, by exercising such request, he can ascertain the basis on which the Revenue makes their decision so that he can make better decision of his own as to whether he should pursue his case. Such information may also help the taxpayer to decide a better and wiser strategy against the Revenue's challenges.

1.6 Election for Personal Assessment

Profits Tax and Property Tax are chargeable on a person's income from business and let-out premises respectively and separately. In general, it is advisable for the low-income earners of such incomes to elect for Personal Assessment because they can benefit from the deductions or allowances that are not available under Profits Tax or Property Tax.

Low-income taxpayers of profits tax and property tax may elect for Personal Assessment to reduce their tax payable. In fact, by virtue of the election, they can get the deductions or allowances which are not granted under Profits Tax or Property Tax. What’s more, there is no provisional tax demanded under Personal Assessment and there is only one due date for the tax payable.

But caution: Election for personal assessment is not always advantageous, particularly where high-income taxpayers are concerned because the aggregation of income under personal assessment can push up their marginal tax rates.

In practice, when a taxpayer makes the election, either in a tax return or in a standard application form IR76C, the assessing officer will turn on the election indicator of his case in the computer database and then, the IRD's computer will check with a program to see if such election is to the taxpayer's advantage. If the election cannot reduce the applicant's total tax payable, the IRD will inform the taxpayer accordingly by way of a note in the Profits Tax or Property Tax assessment and the election will not be effected. In that case, the taxpayer's election will not be accepted. Put it simply, the IRD will only accept the taxpayer's election if it can reduce the total tax payable by the taxpayer. Therefore, it is advisable for the taxpayer to make the election if he is not sure whether or not such election is to his advantage.

Who should elect for personal assessment?

In general, a taxpayer should elect for Personal Assessment in the following situations:

1. He has property income only.
2. He has business income only.
3. He pays mortgage interest on let-out property.
4. He has business losses and other incomes such as salaries, property income or business profits.
5. He does not have employment income but business or property income and he made approved charitable donations.
6. He does not have employment income but has business or property income. He wants to claim deduction for self-education expenses, residential care expenses or home loan interest which are not available under profits tax or property tax.

Who should not elect for personal assessment?

In general, the following individuals should not elect for Personal Assessment.

1. He has employment income only.
2. He has employment income and other incomes and his marginal tax rate under Salaries Tax is higher than the standard rate.
3. His business or property income is so big that it will be taxed at standard rate under Personal Assessment and he does not claim self-education expenses, residential care expenses or home loan interest.

Who can make the election?

Only those individuals meeting the following conditions can elect for Personal Assessment:

1. 18 years old or above, or under 18 if both parents have died; and
2. A permanent or temporary resident in Hong Kong. A permanent resident means one ordinarily resides in Hong Kong. A temporary resident means one stays in Hong Kong for more than 180 days in the year of assessment or for more than 300 days in two consecutive years of assessment, one of which is the year of assessment in question.

A married couple may elect if one of them meets the residence condition.

Time limit of election

Election for Personal Assessment must be made within 2 years after the end of the year of assessment or 2 months after issue of any assessment for that year, whichever is the later. Where there is an objection to the assessment, the latter time limit will be extended to 1 month after the assessment becoming final and conclusive.

Late election will be accepted by the IRD if the taxpayer has reasonable excuse for the delay. So, if you are late, do write an explanation for the delay.

Set-off of tax paid

Any tax previously paid under Salaries Tax, Profits Tax and Property Tax can be deducted from the Personal Assessment tax. If the total tax previously paid exceeds the Personal Assessment tax, the excess will be repaid to the taxpayer.

Husband and wife

There is no separate taxation for husband and wife under Personal Assessment. In other words, husband and wife are assessed jointly under Personal Assessment. The tax payable is apportioned between the husband and the wife in the ratio of their respective reduced total incomes and each will get a tax bill.

Under Personal Assessment, income from all employments, businesses or let-out premises are aggregated, and from this total income, the followings are deducted:

- interest on money borrowed for buying the let-out premises,
- approved charitable donations,
- elderly residential care expenses,
- home loan interest,
- mandatory contributions to Mandatory Provident Fund,
- contribution to a recognized retirement scheme,
- business loss,
- loss brought forward from last-year Personal Assessment, and
- personal allowances such as married personal allowances, child allowances… etc.

Then, the tax payable is computed at the progressive rates or the standard rate under Salaries Tax on the reduced total income. In other words, to compute the tax, just substitute the net assessable income under Salaries Tax by the total reduced income (that is before deduction of personal allowances) under Personal Assessment. Thereafter, the tax computation method for Personal Assessment and Salaries Tax are substantially the same. The steps for the tax computation are: (1) Total income minus deductions minus allowances => Net chargeable income (2) Application of the progressive rates to the net chargeable income => Tax payable (3) Check if standard rate applies: standard-rate tax = standard rate * (total income minus deductions): standard-rate tax will apply if it is lower than progressive-rates tax.

An example of personal assessment for 2012/2013

		Husband	Wife
	Net assessable value – Property tax	0	48,000
	Net assessable income before donations – Salaries tax	308,000	0
	Assessable profits after donations – Profits tax	0	142,000
		---------	--------
		308,000	190,000
Less:	Mortgage interest – for purchase of let-out property	0	30,000
		---------	--------
		308,000	160,000
Less:	Concessionary deductions not yet allowed :		
	Approved charitable donations	3,000	0
	Mandatory contributions to MPF	12,000	0
	Elderly residential care expenses	0	40,000
	Home loan interest	50,000	50,000
		--------	--------
		243,000	70,000
Less:	Business losses	8,000	0
		---------	--------
	Total Income	235,000	70,000
		======	=====

	Joint Total Income	305.000
Less:	Married person allowance	240,000

	Net chargeable income	65,000
		======
	Tax thereon	2,550
		=====

Standard-rate tax = $305,000 * 15% = $45,750: It is inapplicable because it is higher than the progressive-rates tax of $2,550.

There is no provisional tax demanded under Personal Assessment and there is only one due date for the tax payable.

The allowances and deductions applicable to Personal Assessment and Salaries Tax for 2012/13 are as follows:

(a) Table of allowances

Basic Allowance	120,000
Married Person's Allowance	240,000
Child Allowance – each (max. 9 children)	63,000
Dependent Brother / Sister Allowance – each	33,000
Dependent Parent Allowance (60+) – each	38,000
Additional D P A (60+) – each	38,000
D P A (55-59) – each	19,000
Additional D P A (55-59) – each	19,000
Single Parent Allowance	120,000
Disabled Dependant Allowance – each	66,000

(b) Table of maximum concessionary deductions

The actual amounts are to be allowed subject to the following limits.

Self-education expenses	60,000
Elderly residential care expenses	76,000
Home loan interest	100,000
Contributions to mandatory provident fund	14,500

(c) Table of tax rates on various bands of net chargeable Income:

Net Chargeable Income = Total Income - Deductions – Allowances

Net Chargeable Income		Rate	Tax
On the 1st band	40,000	2%	800
On the 2nd band	40,000	7%	2,800
On the 3rd band	40,000	12%	4,800
Remainder		17%	

Tax payable is restricted to: (Total income – Deductions) x Standard rate @15%

1.7 The legal aspects of tax administration

Power of assessor to make an assessment

The Inland Revenue Ordinance empowers an assessor to make assessment on any person according to his judgment. But according to case law, the judgment must be made by the assessor <u>honestly</u> and <u>reasonably</u> according to the information available.

Examples of unreasonable judgments

What is an honest and reasonable judgment is of course dependent on the merits of each case. Normally, when an IRD’s assessing officer is making an assessment, he is presumed to be honest unless the contrary is proved. In fact and indeed, to prove to the contrary is very difficult, if not impossible. But even if an assessor’s judgment is honest, it may still be unreasonable. Let’s see the following examples.

Say, a taxpayer's business is very small and located in a remote area and it has been producing steady low profits over the past years. Then, in such case, the assessor should not make an estimated profit of sky-rocket figure, say $10 million. That judgment is apparently unreasonable and unacceptable and therefore, void. Should that really be the case, the taxpayer can lodge a formal objection as well as a complaint against the unreasonable judgment.

Another example of unreasonable judgment is: Say, a taxpayer has ceased his business two years ago but has failed to report that to the IRD or file a tax return. As a result, the assessor issued an estimated assessment to the taxpayer to assess the profits for the years of assessment after the cessation of the business. These estimated assessments are invalid because of no trading in those years. Of course, the taxpayer must, in accordance with the law, inform the Revenue within one month of the business cessation. If he fails to do so, the taxpayer is liable to a penalty. But his failure doesn’t make the assessor’s unreasonable judgment valid.

Power to make estimated assessments

Normally, the assessor's judgment is based on a tax return. But if the taxpayer fails to file a tax return within the time limit, the assessor can make an estimated assessment according to his judgment. Besides, the assessor can also disregard the taxpayer's tax return and make an estimated assessment based on the information available to him. But in any cases, the assessor must make his judgment honestly and reasonably although he is not legally required to disclose the basis of judgment. Nevertheless, the taxpayer can access to the information on which the judgment is made by invoking The Code On Access To Information.

Although the Revenue is not obliged to disclose how the judgment is made, the assessor must exercise his judgment honestly. In the case Mok Tsze Fung versus CIR, HKTC 166, the judge said, “So long as the assessor, or Commissioner, does not act capriciously or dishonestly, his assessment, being made according to his judgment, cannot be disturbed except upon the taxpayer bearing and discharging the onus of proof.”

Validity of assessments

A notice of assessment must state clearly the identity of the taxpayer, the address at which the assessment is to be delivered, the charging head of the taxes, the income assessed, the tax payable and the due date for tax payment. It must also contain the name of the Commissioner and be duly served to the taxpayer either by personal delivery or by post to the taxpayer's last known address. The last known address may be his home address, his workplace, his business premises or the subject property in the case of a property tax assessment. If the assessment is sent by post, it is deemed to be served on the working day following the day of the postal delivery. In the case of Charles C. Y. Cheng versus CIR, HKTC 1087, the delivery of a penalty assessment to the taxpayer’s last known address was held to be invalid because the taxpayer had already informed the Department of his overseas emigration.

Burden of proof

If an assessment is made by an assessor honestly and the taxpayer disagrees with the assessment, the taxpayer will have to lodge an objection in accordance with section 64. To substantiate his objection, the taxpayer must adduce evidence to prove that the assessment is either incorrect or excessive. This burden of proof on the taxpayer is stipulated in Section 68(4) --- Indeed it is heavy.

A tax dispute (other than a prosecution) is a civil proceeding --- and so the degree of proof required is on "a balance of probabilities" under civil law. The criminal degree of proof, namely “beyond reasonable doubt”, has no place in determining tax objections.

On the other hand, a prosecution of tax evasion is a criminal proceeding. In such case, the degree of proof is "beyond reasonable doubt" which is much more stringent than "on a balance of probabilities" as required in an objection case. To put it simply, a crime is an offence against the public at large and the penalty on conviction includes imprisonment. Before taking criminal prosecutions, the Revenue must collect sufficient evidence to prove that the taxpayer had a guilty mind and he deliberately committed an offence (for example cheating the IRD by false information) beyond reasonable doubts. Because of the heavy burden of proof on the Revenue for a criminal prosecution, there are just a few prosecution cases of tax evasion every year. In practice, instead of taking criminal prosecution, the Revenue is inclined to impose a Section 82A penalty on the tax offender. If the taxpayer disagrees to the Section 82A penalty, he can appeal to the Board of Review.

The three basic rules of interpretation

There are three basic rules of interpretation of tax law, namely The Literal Rule, The Golden Rule and The Mischief Rule.

The Literal Rule

Words must be given their literal, grammatical meaning. Words in old statues are given the meaning they had when it was enacted. Words appearing more than once in the same Ordinance must usually be given the same meaning. The duty of court is to interpret the words that the legislature has used. If a statute so interpreted is clear but produces hardship, the remedy is a new statue; it is not the duty of a judge to fill in the gaps.

The Golden Rule

Words should be construed in their grammatical and ordinary sense. In the case Becke versus Smith 1836, the judge said: "It is very useful in the construction of a statute to adhere to the ordinary meaning of the words used, and to the grammatical construction, unless that is at variance with the intention of the legislature to be repugnance, in which case the language may be varied or modified so as to avoid such inconvenience, but no further". In other words, words should not be construed out of its context; nor should their meaning be twisted to fit in a peculiar situation.

The Mischief Rule

The court should look at the mischief for which the Ordinance is to remedy. This rule may be adopted in considering a relief or an exemption: That is to look at the true intent of the legislation: What relief or exemption is to be granted by the legislation? This rule of interpretation was adopted in an Estate Duty case, Foo Ying v Commissioner of Estate Duty 3 HKTC 363, which concerned Quick Succession Relief. This rule only works for a tax relief or an exemption; it does not apply to a legislation imposing a duty or a charge.

No equity in tax law

There is no equity in the interpretation of tax law. In the case Wong Tai Wai David versus CIR (HCIA 2/2003, BOR Vol. 18, page 510) this is said: "Tax is essentially a liability created by statute. By nature, any tax statute is inequitable in the wide sense of the word. It takes away what a person has earned by his sweat and labour and puts it in general revenue for purposes, many of which have no interest or concern to the taxpayer, such as making welfare payments to the unemployed, providing subsidised housing to a section of the general public and funding litigation for those who cannot afford it. There could be an endless list of such purposes which are of no interest to the taxpayer. Yet he has to provide funds for those purposes with the tax he pays. Thus there is no equity about a tax, as by nature it is 'inequitable' in that it takes away what one has earned by his sweat and labour. It is therefore a contradiction in terms to say that a taxing statute should be construed 'equitably'. Since a taxing statute purports to deprive a person of what he has, it should be construed restrictively so that a person would only be taxed if he is caught within the letter of the law. Apart from that, there is no room for giving any taxing statute an 'equitable construction' as suggested by the Appellants. Thus, in interpreting a taxing statute, one just looks at what the statute clearly said. Nothing is to be read in, nothing is to be implied. One just look fairly at the language used. Indeed, Lord Cairns LC had this to say in Partington v A-G (1869) LR 4 HL 100 at 122: 'If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible, in any statute, what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.' "

A summary of interpretation of tax law

A good summary of interpretation of tax law was given in the case Mangin versus IRC [1971] (739): "First, the words are to be given their ordinary meaning. They are not to be given some other meaning simply because their object is to frustrate legitimate tax avoidance devices... Moral precepts are not applicable to the interpretation of Revenue Statues... Secondly, one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to tax. Nothing is to be read in, nothing is to be implied. One can look fairly at the language used ... Thirdly, the object of the construction of a statute being to ascertain the will of the legislature it may be presumed that neither injustice nor absurdity was intended. If therefore a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted."

Rights to objection and appeal

The Assessor has the power to make an honest and reasonable assessment according to his judgment. On the other hand, the taxpayer, if he thinks he is aggrieved by the assessment, has the right to objection and appeal. The conditions for a valid objection are simple: (1) It is in writing (2) It is made within one month of the assessment and (3) It states the grounds of objection.

As for condition (1), the objection notice must be signed by the taxpayer or his representative. As for condition (2), if the delay is due to the taxpayer’s non-receipt of the assessment, the taxpayer's late objection will normally be accepted by the IRD. As for (3), a ground of objection means a reason for the objection: In practice, the taxpayer stating that the assessable income excessive will be a good and sufficient ground of objection.

If the Commissioner of Inland Revenue (CIR) does not allow or cannot settle a taxpayer's objection, he will issue a determination. Then, if the taxpayer disagrees, he can lodge an appeal to the Board of Review. The appeal must be made within one month after the CIR’s determination and set out the grounds of appeal. Besides, the appellant should send a copy of such grounds to the CIR.

The Board of Review is part of the judicial system for hearing tax appeals. It is an independent body comprising legal experts and prominent public figures appointed by the Chief Executive. The Board hearings are informal as compared with court hearings. The taxpayers can appear in person without legal representatives. This makes the appeals affordable to most taxpayers. In fact, because of the low costs involved, many taxpayers disagreeing with the CIR's determinations will appeal to the Board and so there are a lot of cases heard by the Board every year. In order to deter taxpayers from lodging vexatious or trivial appeals, the Board may impose a fee not exceeding HK$5,000 on the appellant taxpayer. The facts found by the Board are final and cannot be appealed to court; but both parties can ask the Board to refer the case to High Court on a point of law. Legally speaking, a point of law includes one involving a mixture of law and facts. Selected Board hearings are published periodically with the identity of the taxpayers concealed. As a common law principle, the judgment of a Board case serves a judicial precedent: It will be followed in subsequent cases on similar issues.

Although a taxpayer disagreeing with the Board's decision can appeal to the court, it is generally not advisable for him to do so in view of the very high legal cost involved unless he is rich and has very good chance to win and the tax in dispute is substantial.

1.8 Advance tax ruling

A person can ask the Revenue to make a tax ruling on a transaction which he is going to do upon payment of a fee. But according to the Revenue’s published practice note, the Revenue will not make a tax ruling on the followings:

- Prosecution
- Tax penalty
- Tax recovery action
- The correctness of a tax return
- To determine or establish a question of facts --- for example to rule on whether a trade is carried on or whether a sale of asset is taxable
- The ruling requires the Revenue to make assumption on a future event
- Any matter being processed under the objection procedures
- Any matter in a tax return which has been already filed with the Revenue
- Any matter concerning the interpretation of a generally accepted accounting principle or a commercial practice
- Any matter involving the interpretation of a foreign law
- The Revenue opines that the matter is not seriously contemplated by the taxpayer
- The Revenue opines that the matter is frivolous or vexatious
- The Revenue opines that the taxpayer has not provided all the relevant information
- The Revenue opines that the matter requires excessive resources
- Any matter being a subject of the Revenue's tax audit or tax investigation

The application must be made in a specified form and supported by the specified information and documents. The initial application fee is $30,000 for a ruling on source of profits under Section 14 and $10,000 for all other cases. The Revenue may ask the applicant to pay more if the case requires more time than a usual case.

The Revenue may withdraw its ruling at any time. Of course, when the ruling is withdrawn, the application fee will be repaid to the applicant. Besides, if there is a new legislation or a new court case on similar matter, the ruling will become obsolete. But in that case, there will be no refund of the application fee.

The Revenue pledges to respond to an application of ruling within 6 weeks. But the response may just be a request for further information or a clarification on certain facts.

1.9 Tax recovery

The Revenue may take legal actions against a tax defaulter (a person who fails to pay tax). In addition to the tax and the surcharge, the defaulter is also liable to pay court fee $630, cost of writ $300 and interest on the judgment sum from commencement of proceedings to full payment. The Revenue may also issue recovery notices to third parties who owe money to the defaulter, requiring them to pay the outstanding tax. Such third parties include the defaulter's employers, banks, or debtors. Besides, the Revenue may also apply to court for a Departure Prevention Direction to stop the defaulter from leaving Hong Kong.

Instalment payments of tax

The Revenue may accept payment of tax by instalments. But beware of the high cost involved: The Revenue will charge you surcharge and interest which may cost more than the prevailing market interest rates.

How to pay tax

Tax can be paid in cash, by cheque at post offices, by mailing of cheques to IRD or by electronic means:

1. By phone: Taxpayers can phone 18011 for registration and then 18031 for payment. The merchant code of the IRD is 10.
2. By ATM: Taxpayers can use Automatic Teller Machines to pay tax.
3. Via internet: Taxpayers can visit IRD’s web site for details.

4. By mailing a cheque to IRD at P.O. Box 28282, Gloucester Road Post Office, Hong Kong.
5. By payment of cash or cheque at post offices.

The taxpayer may also purchase electronic Tax Reserve Certificates to cover his tax liabilities.

IRD's usual tax-recovery procedures

Payment in default is deemed to take place at the close of business on the "due date". Then, several days later, a standard notice of surcharge of 5% on unpaid tax will be issued by the IRD computer to the defaulter, requiring full payment within 10 days of the notice. Then, if tax is still unpaid, the IRD will send recovery notice to a third party including the defaulter's bank, employer or debtor. Then, if tax still cannot be recovered, the Revenue may take legal proceedings against the defaulter to enforce payment.

If tax is unpaid for more than 6 months, a further 10% surcharge will be added to the unpaid amount.

If the outstanding tax is confirmed by the court, it will then become a judgment debt. If it still remains unpaid, execution may be levied on the defaulter's movable property or a charging order be applied against his immovable property. In some cases, bankruptcy proceedings may also be taken against the defaulter.

Where the first instalment of provisional tax is in default, the second instalment tax will become immediately due and recoverable.

1.10 Double taxation relief

Double taxation means the same income is subject to the tax of Hong Kong as well as to the tax of a jurisdiction outside Hong Kong. Double taxation relief (DTR) is a relief granted to certain taxpayers suffering from double taxation. The relief is usually provided by the various Double Taxation Agreements (DTA) signed by the HKSAR Government with other tax jurisdictions. Among them, the most important one concerning taxpayers is the one made between Hong Kong and mainland China.

Indeed, because of the very restrictive conditions of the DTA, most taxpayers suffering from double taxation cannot benefit from the agreements. In fact, the taxpayers getting the tax relief under the DTAs are mostly the big transportation companies, such as airline and shipping corporations which have substantial operations in and out of Hong Kong. Generally speaking, the DTAs are of little practical value to a common taxpayer, even though he has paid overseas tax.

For a salaried taxpayer, if he has paid overseas income tax, he should first seek a total exemption of the relevant income on the grounds of no services in Hong Kong or visiting Hong Kong for not more than 60 days, and if such exemption is inapplicable, then he should apply for the tax exemption under section 8(1A)(c) to exclude the relevant income from the chargeable income.

For a business taxpayer, if he has made profits from overseas activities, he should first seek to exclude such profits from the charge under section 14 under the “operation test”. See Chapter 3, paragraph 3.8.

Tax credit under DTA with mainland China

According to the DTA, tax credit is granted to two kinds of mainland's taxes: (a) Individual Income Tax and (b) Foreign Enterprises Income Tax. In brief, if a taxpayer is a Hong Kong resident and has paid Hong Kong and mainland tax on the same income, he may apply for a tax credit to reduce his Hong Kong tax payable. In the event that the income is not taxable in Hong Kong, no tax credit will be granted.

Since Hong Kong adopts territorial taxation principle, the income derived from mainland is generally not taxable. On the other hand, the Mainland only imposes tax on a person, including an enterprise, if he has a permanent establishment in mainland and derives profits attributable to that permanent establishment. Therefore, generally speaking, double taxation seldom occurs.

Nevertheless, a taxpayer should claim tax-credit under the DTA in the following situations:

1. The taxpayer pays income tax of Hong Kong and mainland on the same income.
2. Where the taxpayer pays Salaries Tax, he is not entitled to Section 8(1A)(c) exemption or the tax reduction under Section 8(1A)(c) is less than that under tax-credit computation. This situation is almost impossible for a salaried employee but it may nevertheless occur for a company director being an office holder.
3. Where the taxpayer pays Profits Tax, the income attributable to mainland's operation is not excluded by the operation test or by the 50:50 apportionment. Since mainland China does not impose tax on a business unless it has a permanent place of business there, this hardly happens.

Where double taxation relief is applicable, the taxpayer should make the claim in his tax return and then the IRD will compute the tax credit with a computer program.

Exemption from China's income tax

Apart from applying for tax credit to reduce his Hong Kong tax, a Hong Kong resident working in mainland China can also enjoy the benefits under the DTA to reduce or exempt his China's income tax. Such benefits include: (a) Only his income attributable to services rendered in the mainland is chargeable to Individual Income Tax and (b) He will be exempt from the Individual Income Tax if all the following conditions are satisfied.

1. The Hong Kong resident stays in China not exceeding 183

days in the calendar year concerned (It should be noted when counting the 183 days, both the days of arrival and departure are taken as one whole day respectively); and

2. The income is paid by, or on behalf of, an employer who is not a resident of China; and
3. The income is not borne by a permanent establishment or a fixed base which the employer has in China.

A Hong Kong resident may be required by the mainland tax authorities to produce a "Certificate of Hong Kong Resident Status" to prove his Hong Kong resident status. The certificate is issued by the IRD free of charge upon application. To apply for the certificate, the person should first obtain a referral letter from the mainland tax authorities stating such requirement and then he should lodge an application with the Double Taxation Section of IRD.

As for the benefit (a), the income for the services rendered in mainland China is usually computed by time apportionment. The time apportionment is usually done by multiplying the relevant income with the number of days in mainland China over 365 days in the relevant calendar year (from 1 Jan to 31 Dec). When counting the number of days of a period in China, the day of entering and leaving China are counted as one whole day. If he is also assessed under Hong Kong salaries tax on time apportionment, his day of arrival in Hong Kong or day of departure from Hong Kong may also be counted as half day each for salaries tax assessment. In case these tax assessments of Hong Kong and China gives double assessment of same income, the taxpayer can ask Hong Kong IRD to raise the issue with the China tax authority. Where he stays in China for less than 183 days, the relevant income for the time apportionment will be his income paid by the China establishment. But where the person stays in China for more than 183 days, the relevant income for the time apportionment will be the total income received by the person from the China establishment plus his income from the associated establishment outside China.

How double taxation relief applies to profits tax

As far as Hong Kong profits tax is concerned, Section 14 of Inland Revenue Ordinance stipulates that only profits arising in or derived from Hong Kong is taxable. Besides, for manufacturers operating across the border, their taxable profits are generally apportioned on 50:50. Besides, Section 16 permits deduction for mainland's / foreign taxes paid in the production of the assessable profits. In fact, all these measures make the double taxation relief practically useless. This is because the tax benefits under these measures generally exceed that available under Double Tax Relief (DTR).

The taxes that may be claimed as tax credit are: Corporate Income Tax and Foreign Enterprises Income Tax (企業 CIT 或外國企業所得稅 FEIT). However, CIT or FEIT paid on sources of income that are not covered by the Arrangement are not creditable --- such non-creditable taxes include the tax on passive income like interest, royalties and dividends. Only tax on profits from a permanent establishment (PE) in mainland is creditable. Where services are rendered in mainland without a PE, the income may still be subject to CIT or FEIT in mainland but the CIT or FEIT will not be creditable in Hong Kong.

To get the tax relief, the taxpayer must prove that an income specified in Article 1, 2 or 3 of the Double Taxation Arrangement has been taxed in mainland and that there is double taxation on the income because Hong Kong also imposes tax on that income.

Where a double taxation relief involves offshore profits claim, the tax set off can only apply to the profits taxed in Hong Kong. For manufacturing businesses taxed on a 50:50 apportionment, paragraph 48 of DIPN 32 says: "However, if income derived by a Hong Kong resident from the Mainland does not arise from Hong Kong it will not be chargeable to tax in Hong Kong. No tax credit will be allowed as the question of double taxation does not arise. In the case of a Hong Kong manufacturer whose profits are apportioned on 50:50 basis, only half of the profits will be taxed in Hong Kong. The other half is regarded as having been derived from the Mainland thus not chargeable to tax in Hong Kong. Under such circumstances, where tax has been paid in the Mainland in respect of half or less than half of the profits, such tax shall not be allowed as a credit against Hong Kong tax payable. If more than one half of the profits are regarded by the Mainland as profits derived therefrom then the tax paid in the Mainland in respect of such profits, in excess of one half of the total profits, will be allowed as a credit against the tax payable in Hong Kong."

In fact, even if DTR is to apply --- in that case the mainland-sourced income must be brought into the Hong Kong tax computation --- the tax credit in respect of the mainland tax is restricted to the hypothetical Hong Kong tax payable in respect of the hypothetical mainland-sourced income, i.e. maximum tax credit = H. K. effective tax rate x Mainland's income after mainland tax / (1 - H. K. effective tax rate). In effect, the restriction of tax credit makes Double Taxation Relief less favourable than the offshore claim for excluding the whole offshore profits from assessable profits. In computing the Hong Kong tax, the mainland tax payment not yet allowed as tax credit is allowable as a deduction from the assessable income.

An example showing how to compute DTR under Profits Tax

Mr. Chan was a sole-proprietor of a Hong Kong business operating between Hong Kong and mainland China. During 2012/13, he stayed in Hong Kong and Mainland for 80 and 285 days respectively. His total profit for 2012/13 was HK$2,600,000. According to the Mainland’s tax bills, he paid CIT at RMB51,000 (equivalent to HK$64,000) on Mainland’s earnings of RMB200,000 (equivalent to HK$250,000).

Year of assessment 2012/13

Computation of Hong Kong effective tax rate:
Profits tax payable on 2,600,000 at 15% is 390,000.
Effective HK tax rate: 0.15

Computation of maximum tax credit:
H. K. effective tax rate * mainland's income after mainland tax / (1 - H. K. effective tax rate) = 0.15 * 186,000 / (1 – 0.15) = 32,823

Mainland's tax not allowed as tax credit
= Mainland tax paid – maximum tax credit
= 64,000 – 32,823 = 31,177

Computation of Profits Tax payable under DTR:
Total profits: 2,600,000
Less: Mainland's tax not allowed as tax credit: 31,177
Adjusted profits: 2,568,823
Profits tax payable on adjusted income: 385,323
Less: tax credit 32,823
Adjusted profits tax payable under DTR: 352,500

As section 14 of Inland Revenue Ordinance assesses profits with a Hong Kong source only, therefore, if Mr. Chan claims offshore exemption successfully, his assessable profits will be reduced to 2,350,000 (i.e. 2,600,000 – 250,000) and his profits tax will also be reduced to 352,500. So, Mr. Chan is advised to examine his case for a total exclusion of the offshore profits under section 14 before he seek relief from double taxation relief under section 50.

How double taxation relief affects Salaries Tax

As far as Hong Kong salaries tax is concerned, a much greater tax relief is already given under Section 8(1A)(c) of Inland Revenue Ordinance which is to exempt the income derived from non-Hong Kong services on which foreign income tax has been paid. Because the tax benefit under double taxation relief is normally less than that under Section 8(1A)(c) exemption, DTR is almost useless.

Even if DTR is to apply -- in such case the mainland-sourced income must be brought into the Hong Kong tax computation -- the tax credit in respect of the mainland tax is restricted to the hypothetical Hong Kong tax payable in respect of the hypothetical mainland-sourced income, i.e. maximum tax credit = H. K. effective tax rate x Mainland's income after mainland tax / (1 - H. K. effective tax rate). In effect, the restriction makes Double Taxation Relief less favourable than Section 8(1A)(c).

In computing the Hong Kong tax, the mainland tax payment not yet allowed as tax credit is allowable as a deduction from the assessable income.

Author’s advice: An employee working both in Hong Kong and mainland China should seek relief under Section 8(1A)(c) exemption. If he works only in mainland China, he should seek full exemption of Salaries Tax.

An example showing how to compute DTR under Salaries Tax

Mr. Heung, a Hong Kong singleton, was employed by a Hong Kong company. His duties include working in Hong Kong and mainland China. During 2012/13, he stayed in Hong Kong and Mainland for 100 and 265 days respectively. His total remuneration for 2012/13 was HK$600,000. According to the Mainland’s tax bills, he paid Individual Income Tax RMB61,000 (equivalent to HK$76,000) on Mainland’s income RMB300,000 (equivalent to HK$375,000).

<u>Year of assessment 2012/13</u>

Computation of Hong Kong effective tax rate:
Salaries tax payable by Mr. Heung on 600,000 is 69,000.
Effective HK tax rate: 69,000 / 600,000 = 0.115 (or 11.5%)

Computation of maximum tax credit:
H. K. effective tax rate x Mainland's income after mainland tax / (1 - H. K. effective tax rate) = 0.115 * 299,000 / (1 – 0.115) = 38,853
Mainland’s tax not allowed as tax credit
= Mainland tax paid – maximum tax credit
= 76,000 – 38,853 = 37,147

Computation of Salaries Tax payable under DTR:
Total employment income: 600,000
Less: Mainland’s tax not allowed as tax credit: 37,147
Adjusted income: 562,853
Salaries tax payable on adjusted income: 63,285
Less: tax credit 38,853
Adjusted salaries tax payable under DTR: 24,432

Computation of Salaries Tax payable under Section 8(1A)(c) relief:
Salaries tax payable by Mr. Heung on 225,000 (i.e. 600,000 – 375,000) is 6,600..

In this case, it is advisable for Mr. Heung to apply for relief under Section 8(1A)(c) because the tax payable is lower.

1.11 Tax avoidance and tax evasion

Tax avoidance is legal but tax evasion is illegal. The distinction between tax avoidance and tax evasion is well established by case law. The leading case is IRC v Duke of Westminister [1936] AC 1 in which the basic principle is spelled out: Every person can arrange his affairs lawfully so as to reduce his tax payable. Some people called this basic principle as "form over substance" --- that means: It is the form of the arrangements done that should be based for determining the tax payable, and not the substance or the intendment of the transactions should be taxed. This basic principle lays the legal foundation for tax planning (sometimes it is called tax mitigation or tax avoidance).

Given the aforesaid principle, if a taxpayer arranges his affairs in such a way that they do not fall within any of the charging provisions of the tax law, he will pay no tax at all. As more and more people are using blatant schemes to avoid tax, the courts have introduced another famous tax principle, namely the fiscal-nullity principle. In this respect, the leading ones are W T Ramsay Ltd. v IRC and Furniss v Dawson. Under this principle, the courts will look to the end result or the substance of the transactions when determining the tax charge.

However, it is widely believed that the fiscal-nullity principle does not apply to the taxes under the Hong Kong IRO. This is because the courts have all along ruling that the fiscal nullity or Ramsay principle only applies where there are no specific anti-avoidance provisions in the relevant tax law. As there are a number of anti-avoidance provisions in the Hong Kong IRO, the fiscal nullity principle is likely regarded as inapplicable. But caution: The principle can still apply to Stamp Duty and Estate Duty as the relevant laws does not contain anti-avoidance provisions.

Although tax avoidance is undesirable to the Revenue or immoral to some people including judges, it does not constitute a criminal offence. But on the other hand, if the taxpayer reduces his tax payable by cheating the Revenue with false information or lies --- for example he claims an expense which does not exist at all or he omits to disclose a taxable income --- he will be guilty of tax evasion. Tax evasion is a crime that can render the taxpayer to very heavy punishment including imprisonment.

At times, the Revenue sees tax avoidance and tax evasion very different from a common taxpayer and his tax advisers. And that's why there are many tax avoidance cases going to the courts. Sometimes, the courts find that the scheme works and let the taxpayer go. But in some other cases, the courts rule in favor of the Revenue, declaring the scheme a sham.

From time to time, the Revenue warns that there is no single hard and fast rule to distinguish tax evasion from tax avoidance. Nevertheless, it points out that in general transactions that are artificial or fictitious likely lead to penal actions. As regards the transactions with a sole or dominant purpose to avoid tax (i.e. the Section 61A cases), the Revenue's published stance is: Those schemes, which are not properly structured, or not adequately supported by evidence or not genuinely effected, constitute a tax evasion. The Revenue also says that a transaction executed as part of an arrangement is real may not necessarily make that the total arrangement real or legal.

In my IRD experience, the distinction between tax avoidance and tax evasion is not clear. In fact, all cases fall somewhere in a continuous spectrum from full honest disclosure to fraudulent concealment. There are a lot of disputes from time to time between the taxpayer and the Revenue as to where the case lies in the spectrum. If the Revenue opines that the case is a fraudulent tax evasion, then criminal prosecution will be taken against the taxpayer, and if the prosecution is convicted, the sentence may be imprisonment plus a heavy monetary fine.

Indeed, from case law, a blatant and ineffective tax avoidance scheme can give rise to a criminal offence: the cheating of public revenue under common law. Cheating the Revenue was defined in a U.K. court case R v Mavji [1986] STC 508: It includes any form of fraudulent conduct which results in diverting money from the Revenue and in depriving the Revenue of money to which it is entitled. Unlike the tax penalties under IRO which are limited, the penalty on conviction of cheating the Revenue under common law is without limit --- it is, of course, at the discretion of the judge.

In law, a fraudulent act requires some element of dishonesty by the accused. In a criminal proceeding, the test for dishonesty, as laid down in the case of R v Ghosh [1982] 1 QB 1053, is defined as: (a) Was the act of the accused dishonest by the standards of reasonable and honest people? and (b) Did the accused realize that his act would be regarded as dishonest by reasonable and honest people?

In many tax cheating cases, dishonesty is the crucial question in the trial. In the absence of a clear distinction between legal tax avoidance and illegal tax evasion, the court may look at the intention of the scheme. Unquestionably a tax avoidance scheme is to reduce tax and so, in some cases, the courts are inclined to regard the tax avoidance as immoral and dishonest and rule against the taxpayers.

A criminal prosecution of tax evasion takes the Revenue a lot of time and effort to gather sufficient evidence to prove the offence and the guilty mind beyond reasonable doubt. So, that is why there are just a few prosecutions every year. Before taking a prosecution, the Revenue will seek advice from the Legal Department. In general, the more concrete evidence collected, the more likely is the prosecution. Because most tax evaders are extremely cunning: They receive their revenue mostly in cash and then spend it without routing through a bank, the Revenue hardly gets the evidence to prove the understated profit, not to say to prove the criminal tax evasion. So, although it is widely believed that there are a lot of wealthy businessmen evading tax in Hong Kong, there are only a few prosecutions against them. In fact, most prosecutions of tax evasion are small and simple cases involving salaried taxpayers for such offence as false claims of dependent parent allowance, elderly residential care expenses, housing benefit… etc.

Ramsay and Furniss principles

The principles are sometimes used by the Revenue to combat tax avoidance. They have been established in a number of cases. A recent one concerning Hong Kong tax is The Collector Of Stamp Revenue v Arrow Town Assets Ltd.

The point at issue in this case is whether or not a memorandum of agreement executed for transferring an immovable property is assessable to Stamp Duty. The Final Court of Appeal unanimously ruled in favour of the Collector by virtue of Ramsay principle.

This case is important because of the judges' analysis of the Ramsay principle. Below is my summary of what the judges said.

Mr Justice Bokhary:

"In this case the Collector of Stamp Revenue advances three discrete grounds in support of his claim to stamp duty... The third ground is the one based on the approach that takes its name from the decision of the House of Lords in WT Ramsay Ltd v. IRC [1982] AC 300... I take the view that the Collector's third ground is well-founded so that his claim to stamp duty succeeds upon a correct application of the Ramsay approach to the circumstances of this case. Accordingly I too would allow the appeal to uphold that claim with costs here and below."

Mr Justice Chan:

"The principle enunciated in Ramsay is 'both a rule of statutory construction applicable to revenue statutes and an approach to the analysis of the facts': Sir Anthony Mason NPJ in Shiu Wing Ltd & others v. Commissioner of Estate Duty (2000) 3 HKCFAR 215 at 239I. What this principle entails, as elaborated and developed in subsequent cases, is this: when faced with a tax avoidance scheme, the court's task is to ascertain the nature of the transaction or composite transactions in question and the true meaning of the relevant statutory provision having regard to the purpose and intention of the legislation and then apply it to the facts of the case, not taking into account any steps in the transactions which have no commercial purpose other than to avoid tax. The court adopts a purposive construction on the tax legislation and applies it to the end result of the transactions."

Mr Justice Ribeiro:

"The Ramsay principle is both a rule of statutory construction and an approach to the analysis of the facts. The aim of the tax-avoidance scheme in Ramsay was to create an allowable loss for the taxpayer as part of a wider plan which involved the cancelling out of that loss by a non-taxable gain. Lord Wilberforce, giving the principal speech, focussed primarily on the proper factual approach to such transactions:

'If it can be seen that a document or transaction was intended to have effect as part of a nexus or series of transactions, or as an ingredient of a wider transaction intended as a whole, there is nothing in the doctrine to prevent it being so regarded: to do so is not to prefer form to substance, or substance to form. It is the task of the court to ascertain the legal nature of any transaction to which it is sought to attach a tax or a tax consequence and if that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.'

As to the particular self-cancelling schemes with which the House of Lords was faced, his Lordship stated: "On these facts it would be quite wrong, and a faulty analysis, to pick out, and stop at, the one step in the combination which produced the loss, that being entirely dependent upon, and merely, a reflection of the gain. The true view, regarding the scheme as a whole, is to find that there was neither gain nor loss, and I so conclude."

Treating such a loss and such a gain as "self-cancelling," necessarily involved an exercise in statutory interpretation, indeed, an exercise of purposive statutory interpretation. If the loss-producing transaction in the scheme were taken alone, it would, falling within the literal words of the statute, attract the tax consequence of being an allowable loss. It would not be "cancelled out" fiscally by the scheme gain since that gain, again if taken alone 0was, on a literal interpretation, non-taxable.

Therefore, when in Ramsay, the House of Lords regarded the loss and gain as "self-cancelling," viewing them as part of a larger, composite transaction, this necessarily implied that as a matter of statutory construction, the provisions which would otherwise confer the desired tax consequences on the individual transactions were not intended to apply to them in the context of the overall scheme.

Lord Wilberforce acknowledged the need for such purposive interpretation, stating :

'A subject is only to be taxed upon clear words, not upon 'intendment' or upon the 'equity' of an Act. Any taxing Act of Parliament is to be construed in accordance with this principle. What are 'clear words' is to be ascertained upon normal principles: these do not confine the courts to literal interpretation. There may, indeed should, be considered the context and scheme of the relevant Act as a whole, and its purpose may, indeed should, be regarded: see Inland Revenue Commissioners v Wesleyan and General Assurance Society (1946) 30 TC11, 16 per Lord Greene MR and Mangin v Inland Revenue Commissioner [1971] AC 739, 746, per Lord Donovan.'

Applying such an interpretation to the facts, his Lordship stated:

"To say that a loss (or gain) which appears to arise at one stage in an indivisible process, and which is intended to be and is cancelled out by a later stage, so that at the end of what was bought as, and planned as, a single continuous operation, there is not such a loss (or gain) as the legislation is dealing with, is in my opinion well and indeed essentially within the judicial function.'

Another way of describing the House of Lords' approach to statutory interpretation in Ramsay is to say that, applying a purposive interpretation, their Lordships disregarded for fiscal purposes the self-cancelling intermediate steps and applied the legislative provisions instead to the scheme viewed as a composite whole.

This was effectively Lord Diplock's approach in IRC v Burmah Oil Co Ltd [1982] STC 30, a case also involving a planned series of self-cancelling transactions, this time aimed at converting a non-allowable loss into a loss that would be deductible for capital gains purposes. Lord Diplock stated : "It would be disingenuous to suggest, and dangerous on the part of those who advise on elaborate tax-avoidance schemes to assume, that Ramsay's case did not mark a significant change in the approach adopted by this House in its judicial role to a pre-ordained series of transaction (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable. .. The approach to tax avoidance schemes of this character sanctioned by Ramsay entitles your Lordships to ignore the intermediate circular book entries and to look at the end result ..."

It may be noted that Lord Diplock, in referring to the circular and self-cancelling book entries, spoke in more general terms of schemes involving the insertion of "steps that have no commercial purpose apart from the avoidance of a liability to tax." While this expression is apt to describe the self-cancelling transactions in question, it is plainly of a wider import. This was seized upon in Furniss v Dawson [1984] AC 474, where the tax-deferment scheme in question did not involve self-cancelling transactions.

In Furniss v Dawson, the Dawson family wished to sell the whole of the issued capital of two operating companies to an outside purchaser called Wood Bastow Holdings Ltd. They embarked upon a scheme which essentially involved incorporating and interposing a Manx company called Greenjacket Investments Ltd between themselves and Wood Bastow, followed by an exchange of their shares in the operating companies for the issue of shares in Greenjacket and the on-sale of those operating company shares by Greenjacket to Wood Bastow for cash. The object of this scheme was to defer liability for capital gains tax which was charged on capital gains accruing on the disposal of assets. It relied on paragraphs 4(2) and 6(1) of Schedule 7 to the Finance Act 1965 which deemed there to be no disposal in cases of company amalgamations, that is, where a company's shares were transferred to another company which thereby acquired control of the first company in exchange for shares in the transferee company. The scheme's contention was accordingly that the share exchange between the Dawsons and Greenjacket led to the latter obtaining control of the former and therefore was deemed by those paragraphs of Schedule 7 not to involve a taxable disposal of the operating company shares. It would follow that any charge to capital gains tax would be deferred until such time as the taxpayers disposed of their shareholdings in Greenjacket realising a chargeable gain.

The House of Lords decided that the Ramsay principle was not confined to self-cancelling transactions and, applying it to the scheme, held: 'The result of correctly applying the Ramsay principle to the facts of this case is that there was a disposal by the Dawsons in favour of Wood Bastow in consideration of a sum of money paid with the concurrence of the Dawsons to Greenjacket. Capital gains tax is payable accordingly.' "

Lord Millett :

"Ramsay was followed and applied by the House of Lords in IRC v. Burmah Oil Co. Ltd [1982] STC 30. This also concerned a circular and self-cancelling transaction which was entered into for the sole purpose of obtaining tax relief. In this case it was designed to convert a bad debt into an allowable loss. At pp.32-33 Lord Diplock described the case before the House as concerning 'a pre-ordained series of transactions (whether or not they include the achievement of a legitimate commercial end) into which there are inserted steps that have no commercial purpose apart from the avoidance of a liability to tax which in the absence of those particular steps would have been payable ... The approach to tax avoidance schemes of this character sanctioned by Ramsay entitles your Lordships to ignore the intermediate circular book entries and to look at the end result ...' "

1.11 Anti-avoidance provisions in the IRO

Since criminal prosecutions are difficult to succeed, the Revenue relies more often on the anti-avoidance provisions in the IRO to counteract the tax benefits of a tax avoidance scheme. The anti-avoidance provisions are as follows.

1. Section 61: The assessor may disregard any transaction that is artificial or fictitious, or any disposition that is not given effect to.
2. Section 61A: It applies to any transaction having the sole or dominant purpose of enabling a person to obtain a tax benefit. This section empowers the Revenue to make an assessment as if the transaction had not been carried out or in such manner as to counteract the tax benefit.
3. Section 61B: It is to restrict the trafficking in loss companies for tax avoidance. To avoid tax, a profitable company buys a company with accumulated tax losses, and then it injects profitable business into the loss company to absorb the losses. This section empowers the Revenue to deny setting off the losses brought forward if it is satisfied that the sole or dominant purpose of the purchase is to obtain a tax benefit.
4. Section 9A: It is to combat tax avoidance scheme in which an employee disguised himself as an independent service provider.
5. DIPN 24 (this is an administrative pronouncement only): It is to restrict deduction for management fee paid to a related company. The legal backing for the pronouncement is Section 16 that grants deduction to an expense only to the extent it is incurred in the production of assessable profits and Section 61 and 61A that concerns tax-avoidance schemes.

6. Section 20: It is to combat tax avoidance scheme involving pricing arrangements with non-residents.
7. Section 16(2): It is to combat tax avoidance involving payment of interest.
8. Section 39E: It is to deny depreciation allowance on plant and machinery under certain lease arrangements including sale and lease back.

Section 61

The Revenue may disregard certain transactions which are artificial or fictitious or not given effect thereto and then, to assess the taxpayer as if there had been no such transactions. Of course, it concerns only those transactions which have reduced tax. There are a number of tax cases on this issue. Below are some important ones.

Rico Internationale Limited v. CIR

In this case, certain payments of commissions were held to be artificial and fictitious. This was because no work had been done for the so-called transactions. In other words, transactions would be a sham and could therefore be disregarded if they were not carried out.

Kum Hing Land Investment Company Limited v. CIR

The company claimed a deduction of commission which was paid to a related company. CIR disallowed the deduction by Section 61. It was held that “transaction” included the whole of any particular transaction, and not merely part of it. CIR, therefore, lost the case. The court said that “transaction” was not just the payment and receipt of the commission but also covered the process from the inception of the idea to pay commission up to the final completion of the service. This implies that for a tax efficient scheme to withstand the challenge of Section 61, all the steps within the scheme must be genuine, of commercial substance and carried out. Otherwise, it is vulnerable to be disregarded by the court upon IRD's challenge.

In that case, the undesirable consequences, such as the legal wrangle and cost, or even penalty, can outweigh the anticipated tax benefit.

Mangin v Inland Revenue Commissioners

In this case, it was held that if there were more than one way to structure his affairs, the taxpayer had the right to choose the more tax efficient way. The court said: "If a bona fide business transaction can be carried through in two ways, one involving less liability to tax than the other, their Lordships do not think that (an anti-avoidance legislation) can properly be invoked to declare the transaction wholly or partly void merely because the way involving less tax is chosen."

Board of Review case D85/02

The taxpayer is a solicitors' firm. It appealed to the Board to pursue its claim for certain management fee paid to its related companies deductible. The Board disallowed the taxpayer's claim and made the following comment: “The deduction of outgoings and expenses is governed by section 16(1) of the IRO: In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period…Where an assessor is of opinion that any transaction which reduces or would reduce the amount of tax payable by any person is artificial or fictitious or that any disposition is not in fact given effect to, he may disregard any such transaction or disposition and the person concerned shall be assessed accordingly.”

CIR v. Douglas Henry Howe

In this case, an author assigned his right to receive royalties worth of $1,200,000 to an overseas company for $1. CIR assessed the taxpayer on the royalties, invoking Section 61 to disregard the transaction. The Board found that the transaction was not commercially unrealistic and so ruled against CIR. CIR appealed to the court. The court dismissed the appeal and said this: “ ‘Artificial’ is an adjective which is in general use in the English language. It is not a term of legal art; it is capable of bearing a variety of meanings according to the context in which it is used. In common with all three members of the Court of Appeal their Lordships reject the trustees' first contention that its use by the draftsman of the subsection is pleonastic, that is, a mere synonym for “fictitious”. A fictitious transaction is one which those who are ostensibly the parties to it never intended should be carried out. Artificial' as descriptive of a transaction is, in their Lordships' view a word of wider import. Where in a provision of a statute an ordinary English word is used, it is neither necessary nor wise for a court of construction to attempt to lay down in substitution for it, some paraphrase which would be of general application to all cases arising under the provision to be construed ... Their Lordships will accordingly limit themselves to an examination of the shares agreement and the circumstances in which it was made and carried out, in order to see whether that particular transaction is properly described as ‘artificial' within the ordinary meaning of that word.”

Author’s comments: In this case, the word ‘artificial' was construed strictly. It was held that the $1 consideration for assignment of copyright was not ‘artificial' within the meaning of section 61. The judge said this in his judgment: “In this situation it does not necessarily follow that the transactions are commercially unrealistic. The overall position remains the same.... Looked at purely from the aspect of gross income the transactions seem unnecessary and unproductive. But the Taxpayer may well have other matters in mind.” Although the judge did not say what “the other matters in mind” were, it made clear that the scope of section 61 was rather limited --- If the tax avoidance transaction could be explained with an ordinary business sense, it should not be disregarded.

Board of Review case D68/90

In the case, the taxpayer claimed a deduction of prepaid interest in respect of a complex series of loan transactions within the group companies. The Board found that there was no serious intention to carry out the terms of agreements “to the full” and that the interest “was a payment made in discharge of a purely artificial liability which was created in order to achieve a tax advantage”. Therefore, the Board ruled that the loan and interest transactions were artificial.

Board of Review case D32/94

In this case, the Board ruled that the arrangement between a medical practitioner and his service company were be largely fictitious --- it was a sham within the scope of Section 61.

It should be noted that Section 61 only empowers the Revenue to delete the tax-avoidance transaction; it does not enable the Revenue to un-do it so as to levy tax on the “original position”. Because of this defect, Section 61A was enacted.

Section 61A

Section 61A has been enacted to plug the loophole of Section 61. It applies to transactions that are done chiefly for tax avoidance. Section 61 only empowers the Revenue to disregard such transactions whereas Section 61A extends the Revenue's power to make an assessment as if the transaction had not been carried out or in such other manner as the Revenue considers necessary to counter the tax benefit concerned. The tax-avoidance transactions are defined as ones with a sole or dominant purpose of enabling a person to obtain a tax benefit.

As established form case law, tax mitigation is acceptable, although from the Revenue's perspective, undesirable. However, tax avoidance is not acceptable by the Revenue because it seriously undermines the principle of fairness and public's confidence in revenue policy.

Section 61A applies when all the following questions give a “yes” answer.
(1) Was there a transaction?

(2) Was it done with a sole or dominant purpose of obtaining a tax benefit?
(3) Was a tax benefit obtained?

Sole or dominant purpose of obtaining a tax benefit

Section 61A(1) says that in deciding the purpose seven matters are to be considered:

1. The manner in which the transaction was entered into or carried out
2. The form and substance of the transaction
3. The result achieved by the transaction
4. Change in the financial position of the subject person
5. Change in the financial position of the other party to the transaction
6. Whether the transaction has created rights and obligations which would not normally be created between persons dealing with each other at arm's length
7. The participation in the transaction of a corporation resident or carrying on business outside Hong Kong

The court's comments on the seven factors

In an Australian tax case Peabody 25 ATR 32, this was said: "In arriving at his conclusion, the Commissioner must have regard to each and every one of the seven matters... This does not mean each of those matters must point to the necessary purpose... Some matters may point in the direction and others may point in another direction. It is the evaluation of these matters, alone or in combination, some for, some against ..."

Author's note: The seven matters of the Hong Kong's section 61A follows the Australian law on the same topic.

Besides, in a Hong Kong tax case re Tai Hing Cotton Mill Development Ltd, it is held that if the effect of a transaction shows "the tax liability to tax is less than it would have been on some other appropriate hypothesis", the taxpayer can be regarded as having obtained a tax benefit. Then, the IRD can adopt the market value to replace the transaction price for profits tax assessment.

Section 61B

Section 61B is to counteract avoidance of tax through purchase and sale of loss companies. See the following example.

A company ABC Ltd. has been making large profits for many years. To avoid profits tax, it paid $10,000 to buy all the shares of a dormant company which had no valuable assets but accumulated tax losses of $5,000,000. Then, it changed the name of this dormant company to, say ABC & Co. Ltd., one like its own name, and then injected its own business into the new company. After setting-off all the losses with its own business profits, it had the dormant company wound-up so that all its assets (bank balances) were distributed to ABC as dividends on liquidation. The dividends on liquidation are not taxable under Section 17. The cost of liquidation was $10,000. By so doing, it avoided to pay tax on $5,000,000 profits ($5,000,000 * 17.5% = $875,000), with a total cost of $20,000, thus giving a net tax saving of $855,000.

To deter taxpayers from avoiding tax, Section 61B empowers the Commissioner of Inland Revenue to deny the loss set-off if he is satisfied that the sole or dominant purpose of the change in shareholding of a company was to avoid tax. In that case, the new company ABC & Co. Ltd. has to pay tax on the business profits injected without the loss set-off.

Section 9A

Section 9A is to combat avoidance arrangements involving the use of service companies to disguise what are in substance master-and-servant employment relationships. For more, please read the topic “Employed versus Self-employed” under Chapter 2.12.

DIPN 24 - Management fee paid to a related company

This is an administrative pronouncement of IRD. It is to restrict deduction for management fee paid to a related company. For details, please read the topic “Management Fee” under Chapter 3.34.

1.12 The IRD's performance pledge

The Revenue's performance pledge sets out the standard processing time of tax cases. If your case falls below the standards, you are entitled to an explanation from the Revenue. If you are dissatisfied with their explanation, you can phone their Complaints Officer at 2594 5000. Below is a summary of performance standards pledged by the Revenue.

	Standard Response Time
Reply to written Enquiries	
• Simple matters	7 working days
• Technical matters	21 working days
Processing of objections or allowances claims	
•Acknowledgement of receipt	18 working days
•Notify taxpayers of the Revenue's decision	4 months
Processing of tax hold-over claim	12 working days
Tax Audit and Investigation	
•Completion of audit / investigation	2 years

1.13 Complaints to IRD

If a taxpayer suffers from delay or is improperly or unfairly treated by an officer of IRD, he can lodge a complaint with the Complaints Section. On receiving the complaint, the case will be reviewed by a senior officer of a rank equal to senior assessor or above. The advantages of complaint are as follows.

1. It will speed up finalization of the case. Indeed the more the time of processing, the longer the trouble and the greater torment the taxpayer will suffer from the tax enquiry.

2. It will remove the unfair and improper treatment by an individual IRD officer. Of course, the well-established official practice will not easily be changed by an unjustified complaint; but indeed the complaint can remove the bias or harsh judgment of a particular IRD officer and so bring the case at least up to the prevailing practice and judgment of the IRD.

3. In my work experience with IRD, the taxpayer will often get the most favourable treatment within the ambit of the law and the prevailing practice. This is evident by a famous idiom: Only the crying babies get the milk! Instinctively, most IRD officers are averse to trouble and they want to settle the case as quick as possible within the limits of their authority.

Chapter 2 Salaries Tax Tips

2.0 Overview of salaries tax

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Chapter 2 Salaries Tax Tips

2.0 Overview of salaries tax

The basic rule is laid down in section 8(1): All income from an employment or an office in Hong Kong is taxable. Such income is stated in the section as "income arising in or derived from Hong Kong".

The general rule for determining "income arising in or derived from Hong Kong" is to determine the location of the employment. After the court case CIR v Geopfert, the Revenue usually looks to three factors: (1) Is the contract of employment executed and enforceable outside Hong Kong? (2) Is the employer a non-resident of Hong Kong? and (c) Is the remuneration paid outside Hong Kong? In general, the factors (1) and (2) are more important than (3) and if the answers are no, the employment will be regarded as "in Hong Kong".

If the employment is in Hong Kong, the whole income from the employment (even part of it is attributable to services outside Hong Kong) is taxable. The only exception is that the employee renders all services outside Hong Kong. In this respect, if the employee visits Hong Kong for not more than 60 days during the year of assessment (from 1 April to 31 March), he will be regarded as rendering all services outside Hong Kong.

If the employment is outside Hong Kong, all income attributable to his services in Hong Kong is still taxable. The income assessable to tax is usually computed on a time basis: assessable income = total employment income x number of days in Hong Kong in the year of assessment / 365. Nevertheless, he can still claim full exemption if he visits Hong Kong for not more than 60 days in the year of assessment.

The above tax charge applies to a common salaries taxpayer. It does not apply to company directors, civil servants, seamen and air-crew to whom special rules are made.

For large-income taxpayers, the tax is computed at 16% (standard rate) on their net assessable income (i.e. assessable income less deductions of expenses and outgoings, home-loan interest and contribution to recognized retirement schemes).

For low-to-medium income taxpayers, the tax is computed by applying the progressive tax-rates to the Net Chargeable Income (i.e. Net assessable income less Personal allowances). The tax computed under progressive tax rates cannot exceed the tax computed at 16% on net assessable income.

A checklist for reduction of salaries tax

1. All your services done outside Hong Kong? If yes, you pay no tax.
2. You visit Hong Kong during the year of assessment for not more than 60 days? If yes, you pay no tax.
3. You are employed by an overseas company and work both within and outside Hong Kong? If yes, your income attributable to services outside Hong Kong is not taxable.
4. You receive from your employer a compensation which is not a reward of services? If yes, such compensation is not taxable.
5. You receive from your employer a gift on your marriage, passing of an examination, during annual dinner... etc.? If yes, such gift is not taxable.
6. Do you receive paid a lump sum on your retirement? If yes, the lump sum is not taxable.
7. You are granted a share option to purchase shares but you have not exercised the share option. In that case, the share option is not taxable.
8. You receive shares from your employer but you cannot sell the shares within a certain period. In that case, the “shares” are taxable but you can claim a very big discount from their valuation because of the restriction on sale. Furthermore, if

they are private shares, you can claim a big discount for the minority shareholding and the unpopular marketability.

9. You terminated your employment and received Long Service Pay or Severance Pay under the Employment Ordinance? If yes, the pay is not taxable.
10. You receive benefit-in-kind (e.g. free medical, free lunch, free transportation, free uniform ... etc.) from your employer and the benefit-in-kind is not convertible into cash? If yes, the benefit is not taxable.
11. You use company car for both business and private purpose and all the motor expenses are borne by your employer? If yes, you pay no tax for the free traveling (the expenses attributable to business are not taxable because they are not your benefit whereas the expenses attributable to private purpose are not taxable because they are benefit inconvertible into cash).
12. You use your own car for both business and private purpose and you receive reimbursement of car expenses from your employer? If yes, the reimbursement of car expenses for business purpose is not taxable because it is not a benefit. The reimbursement of expenses for private use is taxable and is usually computed by an apportionment.
13. You receive free accommodation at a flat from your employer? If yes, the accommodation is taxable at 10% of your relevant income.
14. You receive free accommodation at a hotel room? If yes, the accommodation is taxed at 4% of your relevant income.
15. Your employer has not paid you salaries? If yes, the unpaid salaries are not taxable.
16. You returned part of your salary to your employer because you failed to meet the sales target as stipulated in your employment contract? If yes, the returned salary is not taxable.
17. You wear uniform on duty and you pay laundry expenses? If yes, the laundry expenses are deductible.
18. You pay membership fee to a professional association? If the membership is a prerequisite for your employment, the membership fee is deductible.

19. Do you earn commission based on sales figures? If yes, you can claim expenses deduction.
20. You work partly in Hong Kong and partly in China and you receive hardship allowance for your working in China? If yes, the allowance is not taxable.
21. You work partly in Hong Kong and partly in China and your China income tax is paid by your employer? If yes, the income tax paid by employer is not taxable.
22. You work partly in Hong Kong and partly in China and you pay China income tax? If yes, the income attributable to your services in China is not taxable.
23. You run a small business at your home? If yes, you can claim deduction for part of your household expenses under profits tax. Besides, if you sustain a business loss, you can apply for personal assessment to reduce your tax liability.
24. You omit to claim married person allowance, child allowance, dependent parent allowance or disabled dependant allowance? If yes, you can make the claim even though this is after the one-month objection period.
25. You omit to claim your contributions to elderly residential care expenses? If yes, you can make the claim within 6 years after the year of assessment.
26. You omit to claim your contributions to MPF? If yes, you can make the claim within 6 years after the year of assessment.
27. You omit to claim your home loan interest? If yes, you can make the claim within 6 years after the year of assessment.
28. You omit to claim your self-education expenses? If yes, you can make the claim within 6 years after the year of assessment.
29. You omit to claim your charitable donation? If yes, you can make the claim within 6 years after the year of assessment.
30. Your salary has decreased lately? If yes, you can apply for hold-over of provisional tax.
31. Are you self-employed? If yes, you should be assessed under profits tax instead of salaries tax and then you will be subject to less stringent conditions of expenses deduction.

The checklist is for general guidance only. Indeed the above guidelines are subject to various conditions laid down in the Inland Revenue Ordinance as well as the judgments made in court and Board of Review cases. Besides, there are exceptions to which the above guidelines do not apply. To know more, please read my tax tips below. If you are in doubt, you should consult a tax advisor.

2.1 The basic charge

Section 8(1) of the Inland Revenue Ordinance imposes the basic charge: to tax all the income from employment or pension which are arising in or derived from Hong Kong.

Source of employment

In deciding the charge concerning employment, it is necessary to establish the place where the employment is located. The general rule of how to determine the source is laid down in the court case CIR v. George Andrew Goefert: the chief factors to be considered are: (1) whether the employment contract was made in Hong Kong (2) whether the employer has a residence in Hong Kong, and (3) whether the employee's remuneration was paid in Hong Kong. If the employment is established as a Hong Kong employment, the whole income from the employment, even though part of it is for services outside Hong Kong, is taxable.

CIR v George Andrew Goefert 2 HKTC 210

The taxpayer, a chemical engineer, was an employee of a multinational corporation, Exxon Corporation, with its head office in New York. His employer had a lot of subsidiaries in Asia, including Hong Kong. In 1978, he was transferred to Hong Kong to work for Exxon Chemical Asia Pacific Ltd, a company registered in Hong Kong. Apart from working for the Hong Kong company, he spent a lot of time traveling out of Hong Kong to work for other subsidiaries in Asia. During the year ended 31 March 1982, he spent 41 days outside Hong Kong and claimed time-basis assessment to have the income attributable to the 41 days excluded from salaries tax. CIR disallowed his claim. The taxpayer appealed to the Board of Review successfully. Then CIR appealed to the High Court. But the taxpayer won the case. It was held that the taxpayer had a non-Hong Kong employment and was entitled to get the time-basis assessment.

This case is important because the court laid down the general rules for determining the source of an employment. It should be noted that the judge has made the this reservation: “There can be no doubt therefore that in deciding the crucial issue, the Commissioner may need to look further than the external or superficial features of the employment. Appearances may be deceptive. He may need to examine other factors that point to the real locus of the source of income, the employment.”

Caution: If the Revenue suspects that the three factors of Goefert case are artificial measures to avoid tax, then it will look behind the three factors to find out the true source of employment. An example of a suspicious case is that the overseas employer has a permanent establishment in Hong Kong and the taxpayer has been working with this permanent establishment for several years and the taxpayer still claims the source of employment outside Hong Kong. To find out the true source of employment: whether the taxpayer is employed by the overseas employer or the local establishment, IRD may ask the Immigration Department to supply all the documents (particularly the company's declarations and all employment agreements) in relation to the taxpayer's application for working visa in Hong Kong.

Extension of charge

In addition to the basic charge, an extension of charge is imposed by Section 8(1A) of Inland Revenue Ordinance to assess all the income in respect of the services rendered in Hong Kong. This charge, frequently called "time-apportionment," is used for taxing non-Hong Kong employments.

Time apportionment

Time apportionment is usually done by multiplying the total income from the employment by a fraction: number of days in Hong Kong / number of days of employment period in the year of assessment. The "number of days in Hong Kong" includes "the leave periods outside Hong Kong attributable to Hong Kong services." Normally, all the days in Hong Kong, irrespective of whether they are related to services or not, are counted. But in special cases, for example an employee resides in Hong Kong and he frequently leaves Hong Kong to work at a Shengzhen factory at 9:00 a.m. and then return to Hong Kong on the same day at 7:00 p.m. Then, in such circumstances, his stay in Hong Kong on that day was purely for residential purpose: He can claim to have that day in Hong Kong to be completely excluded from the "number of days in Hong Kong" for the time apportionment. But in general, part of a day in Hong Kong (e.g. the day of arrival in or the day of departure from Hong Kong) is counted as half day (that is 0.5).

An example showing how to do time apportionment

Mr Simons, an American resident, was assigned by his employer, Manhattan Incorporation, to assist his employer’s branch in Hong Kong to set up the information system. During 2005/06, he stayed in Hong Kong for 200 days and in USA for 165. His stay in USA included 30 days annual leave. His total remuneration in the year of assessment was HK$2,000,000.

<u>Year of assessment 2005/06</u>

No. of days in Hong Kong：200
No. of days in USA：165 – 30 = 135
No. of leave days attributable to H K service：30 * 200 / (200 + 135) = 17.9
Adjusted no. of days in Hong Kong：200 + 17.9 = 217.9
No. of days in 2005/06：365

Assessable income：$2,000,000 * 217.9 / 365 = 1,193,973

All work done outside Hong Kong

If an employee (other than a government servant), irrespective of whether he is under a Hong Kong employment or not, performs all his services outside Hong Kong, he will be exempt from Salaries Tax.

What are "services" rendered by an employee?

The Revenue takes the view that services include:

1. supervising junior staff,
2. attending business meetings,
3. reporting duties to supervisors, and
4. taking part in training of staff (whether as a trainer or a trainee).

If the employee undertakes any of the above activities in Hong Kong during the year of assessment, the IRD will generally reject his claim for the exemption.

In practice, to find out whether or not all the services of a claimant are done outside Hong Kong, the IRD will look to the following points:

1. What the duties of the claimant? Say, if he is a production manger responsible for the day-to-day running of a factory in mainland, his claim will be more acceptable. On the other hand, if he is a product designer and travels frequently to and back from mainland during office hours, the IRD will usually challenge the claim. To support the claim, the taxpayer has to supply copy of the employment contract as well as a written confirmation from his employer certifying "no services in Hong Kong" throughout the year of assessment.

2. The number of days the employee stays in Hong Kong during the year of assessment. If he spends less than 60 days, his claim will generally be accepted, even though his claim may fail the 60-day-visit rule because the stay in Hong Kong is not accepted as “visit”. The IRD will usually obtain the facts from the Immigration Department,

3. The timing of his stay in Hong Kong. If he often leaves Hong Kong before 9:00 am and returns after 6:00 pm, he will have a strong case to argue such stay in Hong Kong not involving services in Hong Kong. This information is also ascertainable form Immigration Department.

4. The nature and size of the Hong Kong's and mainland's establishments. If the Hong Kong establishment is very small and its functions are limited as compared to the mainland's establishment, the employee will have a stronger case to argue “no services in Hong Kong'.

From Board of Review cases, a taxpayer bringing work samples from the mainland factory to his Hong Kong employer does not constitute “services in Hong Kong”. Neither was his attending at a training course organized by Productivity Council sponsored by his employer regarded as “services in Hong Kong”.

Board of Review case D15/02

The taxpayer was employed by a Hong Kong company as the supervisor of Dispatch and Production Department in a Shenzhen factory. She was entitled to the Hong Kong statutory holidays subject to the approval of her Shenzhen boss. During the year of assessment, the appellant resided in Hong Kong and she traveled to work in Shenzhen. She was in Hong Kong for a total of 328 days. She attended a computer training course in Hong Kong in order to equip herself for handling Shenzhen department's computers. The appellant could not produce any document indicating payment of tax to the Shenzhen tax authority. It was held that she did not render services in Hong Kong. The board accepted that her attending a computer course in Hong Kong did not constitute "services". As for her stay in Hong Kong for 328 days, the Board accepted the taxpayer's claim it was for family reasons and not related to her work.

The Board's decision was based on the taxpayer's testimony of the following:

1. She worked in Shenzhen during the day but had to return to Hong Kong to look after her children. Her husband and her father-in-law were both residing in Hong Kong.
2. She attended training courses in Hong Kong on her own volition in order to equip herself to handle the anticipated change of Shenzhen's computer system in 2000. She did not attend these courses pursuant to directions of her employer. She had to make use of her own leave entitlements for such attendance.
3. The entire production department was in Shenzhen. She did not render any service in Hong Kong.
4. The Appellant is a sincere and down-to-earth witness.

In general, a taxpayer bringing work samples from the mainland factory to his Hong Kong employer does not constitute "services in Hong Kong". Neither is his attending at a training course, e.g. one organized by Productivity Council sponsored by his employer, regarded as "services in Hong Kong".

Visit Hong Kong not exceeding 60 days

If a person visits Hong Kong for not more than 60 days during the year of assessment, he will be exempt from Salaries Tax. In counting the days of visit, all days in Hong Kong are counted, irrespective of whether they are in relation to services or not and part of a day is counted as one whole day.

The extension of the exemption only applies to a "visit". If an employee's stay in Hong Kong does not constitute a "visit", the exemption will not be granted. Regrettably, the word "visit" is not defined in the IRD. Without the definition, its meaning is determined in accordance with the basic rules of interpretation of tax law, in particular the Literal Rule. In practice, the IRD adopts the definition of the shorter Oxford Dictionary: a visit is a short or temporary stay.

What constitutes a visit?

There is no hard and fast rule for determining whether a period of stay in Hong Kong qualifies a visit. In practice, the IRD adopts a liberal approach if the taxpayer travels frequently in and out of Hong Kong during the year of assessment. Generally speaking, an overseas purchasing clerk coming to Hong Kong to solicit orders for his overseas employer qualifies the exemption. However, a foreign professor employed by a local university under a short-term contract to teach a short course in Hong Kong lasting for less than 60 days is not entitled to the exemption --- this is because the professor performs all relevant services in Hong Kong and he is not required to travel out of Hong Kong during the employment period.

In general, if an employee is assigned to work outside Hong Kong, his casual returns to Hong Kong will be regarded as "visits".

Nowadays, a number of people work in the Mainland and they return to Hong Kong only for family reunion purpose. If they can prove, usually by production of a employer's written confirmation, that they render all the services in the Mainland, then they will be exempt from salaries tax.

The beginning or the ending of an employment in a year of assessment do not usually constitute visit. Therefore, if an employee leaves Hong Kong in the middle of May, his income for 1 April up to his date of departure will be assessable, notwithstanding the total number of stay in Hong Kong in that year of assessment does not exceed 60 days.

In counting the number of days for "visits", part of a day is taken to be one whole day. In other words, the day of arrival and the day of departure are counted as two days. Furthermore, all days in Hong Kong are counted irrespective of whether they are for services or not. This method of counting is established in the court case CIR v. So Chak Kwong, Jack 2 HKTC 174. The court made clear that the words “not exceeding a total of 60 days” in section 8(1B) qualify the word “visits” and not the words “services rendered”.

Since the So Chak Kwong case, there have been a number of Board of Review cases concerning how to count the number of days for the 60-day rule. Among them, the Board case D27/03 summarizes all the previous cases and made the following comments:

" (a) In determining whether a taxpayer has rendered his services outside Hong Kong, no account can be taken of services rendered by him during visits to Hong Kong totaling not more than 60 days under section 8(1B) of the IRO which reads as follows: ‘ In determining whether or not all services are rendered outside Hong Kong for the purposes of subsection (1A) no account shall be taken of services rendered in Hong Kong during visits not exceeding a total of 60 days in the basis period for the year of assessment.’

(b) In section 8(1B), a 1986 High Court decision held that the word ‘days’ qualifies ‘visit’, and not ‘services rendered’. But this was recently queried.

(i) The question is: should the days visiting Hong Kong refer to (a) only visits spent rendering services in Hong Kong; or (b) all the visits to Hong Kong irrespective of whether services were rendered. This question was answered by the High Court in CIR v So Chak Kwong, Jack 2 HKTC 17. It was held that the words ‘not exceeding a total of 60 days’ qualify the word ‘visit’ and not the words ‘services rendered’. Mortimer J at page 188 said: ‘The words “not exceeding a total of 60 days” qualify the word “visits” and not the words “services rendered”. Were it otherwise the Section would be expressed differently. In order to take the benefit of the Section therefore a Taxpayer must not render services during visits which exceed a total of 60 days in the relevant period.’

(ii) This was queried in D37/01, IRBRD, vol 16, 326 where the Board there said at page 329: 'With respect, that will give rise to extraordinary results. For example, someone spending 61 days of holidays or weekends in Hong Kong will not qualify for exemption if he so much as spent half an hour on an ad hoc assignment for his employer in Hong Kong. Such an absurd result could not possibly be the intention of the legislature.' And at page 330: 'It may be that the words "services rendered" should be construed to mean regular work contemplated by the contract of employment and exclude any work done on an ad hoc or an informal basis. Be that as it may, we are bound by the decision in the So Chak Kwong, Jack case. All that we can say is that it is perhaps time for the legislature to review this subsection to clarify precisely what is the true intention of this subsection.'

(iii) We are bound by the So Chak Kwong Jack case. Our interpretation of the current status of the law is that, in counting the 60 days, days visiting Hong Kong include any visits to Hong Kong irrespective of whether services have been rendered in Hong Kong during those visits. By extension of this principle, since 'days' refer to any visit, it cannot be argued that 'days' must be 'work days'. However D37/01 queried whether in the interpretation of 'services rendered', work done on an ad hoc or informal basis should be excluded from 'services rendered'. In a similar way, we have raised this question but in a different context under section 8(1A)(b) in paragraph 9(c).

(c) There is controversy in interpreting the word 'visit'. Can a person with a home in Hong Kong be considered as 'visiting' Hong Kong although he may have been living outside Hong Kong?

(i) The interpretation of the word 'visits' has been taken to mean that residents of Hong Kong who for all intent and purposes are outside Hong Kong for most of a year of assessment can never 'visit' Hong Kong. This was the interpretation adopted in D29/89, IRBRD, vol 4, 340 where the Board in that case decided that section 8(1B) was inapplicable to a Hong Kong resident employed in Hong Kong but whose working place was essentially outside Hong Kong. The reason was that the taxpayer in that

Board decision was normally a Hong Kong resident working in China. This was despite the fact that the taxpayer was in Hong Kong for only 107 days (taking fractions of a day to be one whole day) and according to the taxpayer's calculations he was in Hong Kong for 27 'working' days (viz excluding weekends, public holidays and unpaid leaves). D29/89 decided as he was resident in Hong Kong and not in China, he could not be taken as having 'visited' Hong Kong within the meaning of section 8(1B). As obiter, the Board in D29/89 was of the view that even if the taxpayer could have been considered as 'visiting' Hong Kong, he could not have met the 60 day grace period requirement as the Board had adopted the interpretation of 'day' to include fractions of a day.

(ii) Another Board in D11/97, IRBRD, vol 12, 147 queried this interpretation of 'visits'. The Board stated that: 'The meaning of the word must of course be construed in its context. The context of section 8(1B) is that the person is ex hypothesis outside the jurisdiction for most of the year and the word "visit" may not be inapposite to describe a period of short stay. It seems to us somewhat precarious to hang on that single word an intention, not otherwise expressed, on the part of the legislature to exclude from the beneficial application of section 8(1B) all persons who have their home in Hong Kong.' (iii) We agree with the approach in D11/97. We are not persuaded by the rationale in D29/89 or the arguments put forward by the Revenue in this appeal. We will not deprive a taxpayer of the benefit of section 8(1B) purely on the ground that the taxpayer is a Hong Kong resident or has a home in Hong Kong. First, the Board will have to look at whether a taxpayer was rendering outside Hong Kong all of his services. Then the Board will decide whether the 60 day rule in section 8(1B) applies in favour of the taxpayer so that any services that he did render in Hong Kong for visits totalling less than 60 days will not be used against the taxpayer when determining whether he did render all his services outside Hong Kong.

(d) The word 'day' in section 8(1B) has been the subject of two types of queries: (i) Does 'day' include any day irrespective of whether it is a working day, non-working day, weekend, midweek, public holiday or paid leave or unpaid leave? Or does it include only the 'working' time or day element? (ii) Should fractions of a day be taken to be one whole day so that arrival and departure dates are each included as a day (assuming arrival and departure did not take place within the same day)? Or should they be taken as exactly what they are; fractions only? (i) D37/01 favoured, obiter, the exclusion of non-working hours in the calculation of the 60 days. But given the High Court decision in the So Chak Kwong, Jack case and in the context of circumstances envisioned in section 8(1B), we believe that this is untenable. Services can be rendered irrespective of whether the time in Hong Kong were working days or not. Under the same rationale in the So Chak Kwong, Jack case, ‘days’ include any visit and not only just visits in which services were rendered or visits which were working days or had working hours. (ii) On the question of whether a part day should be considered as a whole day, the legal position is not so clear. From the cases to which we have been referred, this issue was first raised in D29/89 which mentioned as obiter that fractions of a day was to be considered as one day. This principle was applied in D12/94, IRBRD, vol 9, 131, D11/97, D107/99 unpublished and D20/00, IRBRD, vol 15, 297. D20/00 considered this issue with benefit of reasoned and detailed submissions on the law on this issue from the representatives of both the taxpayer and Revenue in that case. It applied the fraction day = whole day approach. But this approach has been queried in other Board cases D54/97, IRBRD, vol 12, 354 and D37/01. The fraction = whole approach contradicts the rule of interpretation of tax law that ambiguities should be resolved in favour of taxpayers. Thus we disagree with the fraction = whole approach. (iii) Should fractions of a day be considered as one whole day when calculating the 60 days? The Revenue answers yes. Taxpayers answer no and point to the inherent unfairness to the Revenue’s approach. A taxpayer entering Hong Kong in the evening of one day and leave Hong Kong the next day within 24 hours of arrival is taken to have visited Hong Kong for two days. In the context of Hong Kong residents working in China returning home for the weekend, this can work especially harshly. A taxpayer returns to Hong Kong in the afternoon or evening of Saturday after his workweek in China and leave Hong Kong on the Sunday evening to be ready for work in China on Monday will have spent 104 days (excluding midweek holidays) in Hong Kong. But we must remember that the 60 day grace period works only if the taxpayer has rendered some services in Hong Kong during his 104 days in Hong Kong. If he had not rendered any services at all in Hong

Kong during those 104 days, his salary is still exempt from tax under section 8(1A)(b). The harshness comes from the fact that he is then effectively deprived of the benefit of the 60 day grace period if he performs any services under his employment contract should he need to perform some services during those weekends in Hong Kong or should he need to return to Hong Kong during mid-weekdays to perform such services. Compare his situation with that of a taxpayer who does not have a home in Hong Kong or does not have to come home to Hong Kong during the weekends. This 'non-Hong Kong' taxpayer can take advantage of the 60 day grace period to allow him to perform some of his services in Hong Kong so long as his visits do not total 60 days. In short, a Hong Kong resident with a family in Hong Kong and who regularly returns to Hong Kong to spend quality time with his family cannot avail himself of the 60 day grace period afforded to a complete non-Hong Kong person. (iv) If the fraction of a day = whole day formula is said to work harshly against taxpayers or against rules of interpretation of tax statutes, what are the alternatives? There are the following:

(1) There is the sum-of-all-parts approach where all the fractions of any part day are simply totaled to give whole days. This approach gives maximum benefit to taxpayers but is unreasonable since stays in Hong Kong of less than 24 hours should as a matter of common sense be considered as at least one day.

(2) Alternatively, a day can be divided into two parts of 12 hours each commencing with twelve o'clock with any hours in Hong Kong less than 12 hours being counted as half a day. By giving half days, the harshness of the whole day approach may be mitigated.

(3) The third approach is more complicated; but it also mitigates the harshness of fraction = whole approach and the other extreme of sum-of-all-parts approach. Each trip to Hong Kong in which the stay in Hong Kong is 24 hours or less is to be counted as one day. For each stay over 24 hours, the total hours in Hong Kong will be divided into 24 hours to count as whole days with the remaining fraction of 24 hours being totaled up using the sum-of-all-parts approach. In essence, this approach treats every

trip to Hong Kong lasting less than 24 hours as one day and every trip more than 24 hours will have any additional hours beyond the initial 24 hours treated as fractions of a day. Of course, if there were two or more trips to Hong Kong within the same day, all the trips added together should be counted as only one day.

(v) None of the suggested alternatives have any legal basis. But then again neither did the fraction = whole approach have any legal basis when it was first considered by the Board in D29/89. We believe that the Revenue and the Board should adopt a flexible approach by looking at the circumstances of each case. Did the taxpayer have a family in Hong Kong? Is he a Hong Kong resident with close connections with Hong Kong? Is he a foreigner with no connections whatsoever? What was the principal reason for the visit to Hong Kong? How long was each visit? How frequent were the visits? Are there any records of entry and departure times and dates? There may be other questions which need to be considered depending on the facts of each case. "

Author's comments: Although the So Chak Kwong Jack case lays down the basic principle on counting the days of visiting Hong Kong, don't forget to put forward the actual circumstances of your case and ask for a flexible approach based on the above Board's ruling.

2.2 Basis period

Salaries Tax is charged on the assessable income earned by an employee or an office holder in a year of assessment that runs from 1 April to 31 March. A final assessment will not normally be made before the end of the year of assessment (save the taxpayer is about to leave Hong Kong). Instead, a provisional assessment is made on the basis of the last final assessment. The tax demanded by the provisional assessment is to be paid by two instalments: 75% in January to March within the year of assessment and 25% in the coming April to June. In other words, tax is payable on the earned "provisional income". If the actual income is 90% of the provisional income or less, the taxpayer can ask for a revised assessment of provisional income. The time limit for such application is 28 days before the due day of the provisional tax (or 14 days after the issue of the demand for provisional tax if this is later).

When the final assessment is raised, the provisional tax charged will be deducted from the tax payable for that year. Normally, in the year of assessment with a commencement of employment, the first tax payable will be a final assessment without a deduction for provisional tax plus a provisional tax for the following year of assessment.

Only the salary received by the employee is taxable. Unpaid salary is not taxable. On the other hand, if salary is returned by the employee to the employer because of failing to meet certain conditions in an employment contract, such salary returned will be accepted as a deduction from the taxable income by way of concession. When accrued salary is received at last, it is taxable in the year of assessment to which it accrues, not in the year of assessment of receipt.

Salary is deemed to be received by an employee if is made available to him or if it has been dealt with by the employer on behalf of the employee or according to his direction. In other words, if the employer pays the employee's salaries tax according to a recovery notice of tax issued by the IRD, the payment of taxes will be treated as taxable income because it is income dealt with on behalf of the employee. Furthermore, income accrued to an employee is defined as when he can claim payment thereof legally.

A taxpayer can apply for relating back a lump sum payment or a gratuity that is paid upon retirement or termination of an office or an employment, or a contract of employment, to enjoy lower tax rates. Besides, he can also apply for relating back of the deferred pay (usually called back pay) of his remuneration to the related period. The effect of the application is that such lump sum, gratuity or deferred pay is treated as income accruing evenly throughout the relevant employment period subject to a maximum of 3 years. The application can be made in the taxpayer's his tax return for the relevant year of assessment. If he fails to do so, he can write to apply within 2 years after the relevant year of assessment.

Hold-over of provisional tax

If the actual income is 90% of the provisional income or less, the taxpayer can ask for a revised assessment of provisional income. The time limit for such application is 28 days before the due date of the provisional tax.

Besides, a taxpayer can ask for hold-over of the provisional tax on the grounds that he is eligible to claim a new allowance, e.g. he married a wife in mainland China, or his employment has ceased or he has objected to an assessment which forms the basis of the provisional tax.

2.3 What are taxable income and benefit?

Section 9 defines taxable income and benefit to include: salary, wages, leave pay, fee, bonus, commission, gratuity, perquisite or allowance whether or not they are derived from employer. Special provisions are laid down in the IRO to tax special perks such as subsidized accommodation, retirement benefits, share options, holiday benefits and children's education subsidies.

The leading Hong Kong court case on taxable emoluments is David Hardy Glynn v The Commissioner of Inland Revenue 3 HKTC 245. In this case, the employee arranged so that his children's expenses were solely borne by his employer. He argued that because such benefit could not be converted into cash and only his employer had the liability to pay, the free education benefit should not be taxable. On appeal, the Court of Appeal ruled that the UK tax cases were irrelevant in taxing of employment benefits for Hong Kong salaries tax and all benefits, whether they were convertible into cash or not, derived from an employment were taxable.

This ruling widened the scope of taxable benefits too much. On further appeal, the Privy Council ruled that the UK tax cases on taxation of perquisite were still applicable to taxing of employment benefits in Hong Kong, thus reversing the decision of Court of Appeal, and that all benefits having cash value are taxable including the provision of free education to an employee's children.

After the Glynn's case, Section 9 was amended so as to restore the old rules for taxing of employment benefits. In short, a benefit is taxable if it is of money's worth. A benefit is regarded as of money worth if it is convertible into money (e.g. by sale) or if it is involved in the discharge of the employee's personal liability (e.g. payment of the employee's credit card liabilities). Furthermore, the provision of free education to an employee's children is taxable in whatever arrangements.

Under Section 9, all kinds of cash allowances arising from an employment are wholly taxable. They include housing allowance, living-cost allowance, transportation allowance, baggage allowances, medical allowance, clothing allowances, tips … etc. So, to make the benefits non-taxable, the employer should be made solely liable to pay the benefits --- In that case, these benefits will be inconvertible into cash or have no cash value. Caution: Such arrangement does not work for subsidized accommodation, retirement benefits, share options, holiday benefits and children's education subsidies because they are subject to special provisions of the IRO.

The allowance paid to an employee to cover the employer's expenses is not taxable because it is not income to the employee. Moreover, the transportation allowance paid to enable the employee to discharge his duties (for example the motor expenses from one work site to another) is not taxable either.

In the case CIR versus Humphrey 1 HKTC 451, a civil servant who worked in Tai Po and lived in Kowloon was given a monthly allowance to cover the traveling expenses from his home to the workplace and vice versa. It was held that the allowance was taxable because the expenses involved were of a private and domestic nature. Author's comment: If the allowance was to cover the expenses between one work place and the other workplace of the employment, such allowance will not be taxable.

Only emoluments for the services rendered by employee are taxable. This principle is laid down in a number of tax cases including Hochstrsser v Mayes (38 TC 673), Reid v Seymour (11 TC 635) and Mairs v Haughey (3 WLR 393). So, if the payment is paid as a gift on a special occasion (e.g. marriage, death, passing an examination… etc.), it is not taxable.

Besides, the following receipts are not taxable:

- compensations for work injuries
- compensation or payment for sickness
- compensation for loss of employment
- compensation for damages in legal disputes
- compensation on redundancy
- compensation for wrongful dismissal of an employee
- legal settlement / compensation for sexual harassment
- legal settlement / compensation for breach of employment contract
- compensation arises from a dispute between an employer and an employee
- payment by a new employer for inducement of an employee to leave his existing employment
- payment for a leaving employee not to compete with his employer within a certain period of time
- payment of employee's relocation expenses from a foreign country to Hong Kong on commencement of employment
- payment of employee's relocation expenses from Hong Kong to a foreign country on cessation of Hong Kong employment
- severance payment
- long-service payments

- certain payments from retirement schemes
- free medical services, free lunch, free training, free transportation, free house-keeping services... etc.
- reimbursement of self-education expenses (not exceeding the statutory limit)
- salary not yet received by the employee
- certain payment made by a new employer to induce an employee to leave his existing employment: vide Pritchard v Arundale (47 TC 680)
- salary received by a consulate employee who is a citizen of and is representing the relevant foreign country. In practice, the exemption will be granted to the employee who holds a consulate passport.
- salary received by the principal staff of certain International Organizations
- certain lump sums withdrawn from an approved retirement scheme (For details, see retirement benefit at Chapter 2.7)
- pensions payable outside Hong Kong
- education grants, subsidies or scholarships
- payments relating to war service
- alimony or maintenance payments to a spouse or an ex-spouse

2.4 Housing benefit

Section 9 states that rental value at 10% of the relevant income is assessed if free accommodation is provided by employer.

Relevant income means the taxable income (excluding rent refund) in respect of the period of free accommodation. Contract gratuity paid on termination of employment is not included in the relevant income for computation of rental value. But if there is no termination of employment, the gratuity will be added to the relevant income and so increase the rental value. If the contract of employment is renewed upon expiry, the Revenue will treat it as no termination of employment. Therefore, in order to avoid the inclusion of the contract gratuity in the relevant income, it is advisable for the taxpayer to have a break, say 2 to 3 weeks, after the expiry of the first employment contract before he signs a new contract of employment with the same employer.

Free accommodation is deemed in case of rent refund by the employer. Based on Board of Review cases, the crucial point in deciding the question of Rent Refund versus Rent Allowance is whether the employer has, from time to time, exercised control over the use of the rent. It should be noted that Rent Allowance is taxable in full without rental-value computation.

The taxpayer may elect to have the rental value be assessed at the rateable value. The taxpayer should make the election if the rental value assessed based on relevant income is greater than that based on rateable value. The rateable value is the estimated annual rent as shown in the rates bill issued by the Commissioner of Rating and Valuation. So, don't forget to check with your rates bill when you are assessed to rental value in your tax bill.

CIR versus Peter Leslie Page

In the court case CIR versus Peter Leslie Page, the judge said: 'The crucial question is what is the nature of the payment … This is a question of fact. The starting point is of course the contract between the taxpayer and the employer… I accept the view that "refund" means "pay back (money or expenses) or reimburse.'

CIR v Chow Hung-kong

The free accommodation occupied by the employee as part of his duties was held to be not taxable.

Board of Review case D46/87

A residence provided to an employee with restrictions on its use was held not a taxable benefit. In other words, a free accommodation is not taxable if there are restrictions on the employee or his family to reside in it.

Housing allowance v rent refund

Housing allowance is taxable in full (the whole amount of the allowance is taken to be the assessable income). But rent refund is taxable at 10% of relevant income. To avoid challenge by Revenue, it is advisable for taxpayers to have the rent refund benefit stipulated in the employment contract and the rent agreement duly stamped.

If it is a rent allowance case, the allowance should be reported by the employer in the Employer's Return of Remuneration and Pensions (IR56B) under item: Any other Rewards, Allowances or Perquisites. If it is a rent refund case, the rental benefit should be reported as free accommodation under item: Particulars of Place of Residence provided.

If the free accommodation is a room at a hotel, a hostel or a boarding house, the rental-value rate will be 4% instead of 10%. If it consists of two rooms, the rate will be 8%. In practice, a room means one unit of residence (that is one room number) although there may be more than one bedroom in that "room".

The meaning of “hotel” is seldom at issue. This is because a hotel is easily identified by its name. In fact, a hotel is managed and well known as such. It has a good management, many serviced rooms and provision of food and a variety of facilities.

What is a hostel? A hostel is a building consisting of many rooms for temporary residents. In the case Re Niyazils Will Trust [1978] WLR 910, it was held that a hostel was a building providing modest and temporary accommodation for workers, travellers and students. The judge commented that provision of food was a usual but not an essential feature of a hostel.

What is a boarding house? This is sometimes at issue. In the case Aberdeen Shopping Plaza Ltd. versus The Incorporated Owners of Aberdeen Ka Ning Mansion HCA 9319/2000, a boarding house was held to be a place where provision of food was essential, apart from the provision of rooms for accommodation.

Board of Review case No. D78/03

This case concerns the distinction between rent allowance (wholly taxable) and rent refund (taxable at 10% of relevant income) and whether the transactions can be disregarded by section 61 of Inland Revenue Ordinance. The taxpayer was a director and a major shareholder of Company A with 51% shareholding. He received money from Company A for the rent he paid to Company B which was owned by the taxpayer and his wife. The dispute is whether there was a genuine landlord and tenant relationship between the taxpayer and Company B and whether the money from Company A was refund of rent.

The Board found that there was no genuine tenancy relationship between the taxpayer and Company B because the tenancy agreement was not stamped under the Stamp Duty Ordinance. The Board concluded that the parties had no genuine intention to carry out the terms of the agreement.

Furthermore, the cheques paid by the taxpayer to Company B matched the company’s monthly repayments to the bank. Although the taxpayer asserted that they had been rent payments, the Board regarded them as loans from the taxpayer to Company B which were recoverable from Company A.

On the fact that rental deposit was not provided under the tenancy, the Board regarded the agreement as an artificial transaction and therefore it could be disregarded by virtue of section 61 of Inland Revenue Ordinance. As a result, the Board concluded that the so-called rent payments were rent allowances wholly taxable under section 9.

Can an employee let his property to employer to obtain tax benefits?

Yes! In law, the owning of a residence by an employee will not deprive him of receiving rent-refund benefit from his employer. In fact, this method is used by a lot of employees to reduce their tax burden.

An employee may pay mortgage interest exceeding the limit of home loan interest: $100,000 in a year of assessment. But any excess of interest payment is not deductible under Salaries Tax. Besides, home loan interest deduction is only available for ten years of assessments. Below is a typical arrangement.

The total remuneration is fixed. To obtain the rent-refund benefit, the employee let his residence to his employer at the market rent. Then, the cash remuneration is reduced by the rent refund. The taxable value of the rent refund is only 10% of the reduced cash remuneration. As a result, the total assessable income under salaries tax decreases.

On the other hand, as the employee receives rental income, he has to pay property tax. But the rates paid by the employee is deductible from the rental income. Furthermore, there is a further deduction of 20% from the rental income. The tax reduction by the free accommodation under salaries tax is generally greater than the property tax.

The tax benefit can be enhanced by election of Personal Assessment under which the employee can claim deduction for all the mortgage interest (there is no such dollar and time limits as home-loan interest under Salaries Tax). The election of

Personal Assessment can generally remove or reduce the property tax.

Caution: The Revenue may challenge the above arrangements by section 61A in the following situation:
1. the employer is controlled by the employee,
2. the tenancy agreement is not stamped,
3. the rent exceeds 50% of the total remuneration, and
4. the rent is excessive when compared to the market rent.

2.5 Holiday benefit

Holiday benefit granted by employer is assessable under section 9(2A)(a). The assessable amount is the actual cost incurred by the employer in providing the benefit to the employee and his family.

The law provides that the charge of tax is irrespective of the following factors: (a) Whether or not the benefit is convertible into cash, (b) Whether or not the employer of the employee has the primary liability to pay the benefit, (c) Whether or not the benefit will add additional cost to the employer, (d) Whether or not the benefit will cause opportunity cost to the employer (for example the lost revenue arising from the sale of discounted-price air tickets by air-liner employer to employee).

In general, the amount taxable is the amount paid by the employer in connection with the benefit. This includes the cost of the air tickets, hotel accommodation, travelling, food, package-tour fee ... etc.

Only “holiday-journey” benefits are taxable. All expenses in connection of business journey are exempt. Business journey means the employee's travelling is required by his employer to perform his duties. If a trip is substantially for business purpose, even though part of the trip is for non-business purpose, the whole journey will be exempt. However, if the non-business portion is significant and can be clearly identified, the expenses attributable to the non-business portion will be ascertained and taxable.

Only the benefit that is provided as a reward for services rendered is taxable. Say, an employee in the lucky draw of the employer's annual dinner gets a round trip air-ticket to USA. That air ticket, although it was bought by the employer, is not taxable because it is a gift made in a social activity and not as a reward for services rendered by the employee.

According to paragraph 19 of DIPN 41, the payment for the relocation of an employee and his family to Hong Kong on commencement of employment or for the relocation of an employee out of Hong Kong is not taxable.

2.6 Granting Share Options to employees

A share option is a right to acquire shares at a prescribed price. The gain realized on exercising or selling the share option granted by the employer is taxable. The taxable gain on exercising the option is the market value as at the date of the exercise less the price paid by the employee. Any gain or loss on sale of the shares after the exercise is ignored. So, if you don't want to take the risk of fall in market value after you get the shares, sell them quickly. The taxable gain on selling the option is the net sales proceeds less the price paid by the employee for the option. So, if you don't sell the option, it won't be taxed.

If the services, for which the share option is granted, are exempt from tax, then the related gain will be exempt too. The exemption is usually computed by a time apportionment.

The taxability of the share options is irrespective of: (a) Who issues the share options, or (b) Where the shares option are issued, or (c) Whether the shares acquired by exercising the options are unsold and held by the employee as capital investment. The crucial question is whether the share options are granted in respect of taxable services in Hong Kong and whether they are exercised or sold.

It should be noted that share options are taxed at the time of receiving the gain, rather than at the time of receiving the share options. Section 11D(b) proviso cannot deem the share options to be assessed on the last day of the employment because section 11D(b) proviso is only applicable to a “payment” and the gain on share options is not a payment. So, terminating an employment will not generally make the share options taxable earlier unless the employee is leaving Hong Kong and he opts to be taxed before his departure.

Employee leaving Hong Kong for good

With a view to finalizing salaries tax before departure, the Revenue may allow, by concession, a taxpayer to elect for a notional exercise of the share option. In that case, the gain is computed as if the option were exercised on any day within 7 days before the filing of his Salaries Tax return for the last year of assessment. This election is made on a mutual understanding that no further tax liability will arise when the option is eventually exercised, assigned or released thereafter. Once the election is made, it will not be withdrawn unless that is made within the objection period --- that is one month after the issue of the relevant assessment. On the other hand, if it transpires that the real gain by the actual exercise, assignment or release of the option is less than the amount assessed under the notional exercise, the taxpayer can ask the Revenue for a revised assessment adopting the real lower gain. So, it is generally advisable for the taxpayer to make the election.

Issue of shares to employees

Shares issued at a discount become taxable at the time of issue. If the shares issued are subject to a restriction, say a holding period of 2 years, then the taxpayer can ask for a discount when computing the taxable value. In fact, the discount rate can be more than 50% off the market value. So, don't forget to fight for a high discount rate if the shares offered are subject to restrictions for resale. Where the shares offered are the ones listed in a stock market, there are seldom disputes as to their valuation. Where the shares belong to a private company, the IRD will usually adopt the dividend-yield method: that is usually done by a capitalization of the average last 3-year dividend per share at a discount rate. In theory, the discount rate is the expected rate of return from the shares by a reasonable buyer. This may be the then market interest rate as adjusted upward to account for the risk associated with the shares in question. In fact, the discount rate is often disputed by the taxpayer with the IRD and it is often resolved by compromise in accordance with the objection or appeal procedures.

2.7 Payments at the end of an employment

A compensation for loss of employment is not taxable. But what is a compensation for loss of employment? Let's see what the Board of Review said:

D43/93

An employer terminated an employee's employment without serving the notice as required in the employment contract. By negotiation and agreement, a lump sum was paid to the employee. The Board ruled that the sum was compensation for loss of employment and therefore not taxable.

D13/94

An employee's employment was terminated due to business restructuring. A lump sum was paid to the employee to discharge the employer's obligations for long service payment or severance payment under the Employment Ordinance. The employee was subsequently employed by another company related to the employer. The Board ruled that the sum was a compensation and not taxable.

D16/95

An employee terminated his employment at the request of his employer. He was paid certain benefits on the termination of employment. The taxpayer submitted that the payment had been made by his employer in consideration of the resignation. The Board ruled that the payment for the lay-off was not taxable.

D3/97

An employee received a lump sum on termination of service in the form of early retirement. The Board held that 75% of the sum was paid as “gratuity” for past services rendered and 25% for compensation of loss of employment. The Board said: “It was not the label, but the real nature of the payment, that is important. Where a payment is made partly for a taxable purpose, for example, as a gratuity in consideration of past services and partly for a non-taxable purpose, for example, to compensate the employee for loss of employment, the payment should be apportioned, and salaries tax can only be levied on the former.”

D70/01

An employee resigned voluntarily. He reached a written agreement with his employer under which he would receive a sum of $2,310,00 as “full and final settlement of all claims (present or future) for all remuneration (accrued or unaccrued, statutory or otherwise) in relation to the service agreement”. The sum was not made in accordance with the provisions of the Employment Ordinance. Instead, it was a negotiated amount of compensation. The Board found that $627,000 out of the sum was taxable housing allowance and the balance $1,683,000 being non-taxable compensation.

Author's advice

1. Where a lot of employees are made redundant due to downsizing or closure of certain business activities of the employer, the Revenue will generally allow the lump sum paid on termination of employments as compensation for loss of office (not taxable).

2. If the lump sum is already provided in the employment contract to be paid on termination of employment, the Revenue will assess the lump sum as “remuneration paid in arrear for the employee’s past service”.
3. If the lump sum is paid to induce the employee to start a new employment, say with an associated company of the employer, the Revenue will assess the sum as “remuneration paid for future service of the employee”.
4. The long service payment and severance payment paid in accordance with Employment Ordinance upon termination of an employment are exempt from Salaries Tax. Where there is no termination of employment, the above payments can still be exempt from tax under the Revenue’s extra-statutory concession. This concession applies where the employee’s salary is adjusted downward by way of a dismissal followed by a fresh immediate re-employment. In such case, if the employer pays the employee a sum representing the Long Service Payment or Severance Payment, the sum will be exempt from tax.
5. Contract gratuity paid on termination of employment is not included in the relevant income for computation of rental value. But if there is no termination of employment, the gratuity will be added to the relevant income and so increase the rental value. If the contract of employment is renewed upon expiry, there will be no termination of employment. Therefore, in order to avoid the inclusion of the contract gratuity in the relevant income, it is advisable for the taxpayer to have a break, say 2 to 3 weeks, after the expiry of the first employment contract before he signs a new contract of employment with the same employer.
6. In your tax return you can state the cessation of employment and ask for no charge or reduced charge of provisional tax for the following year of assessment.
7. If your actual income is 90% or less than the provisional income assessed, you can ask for a reduced charge of the provisional tax. The time limit for such application is 28 days before the due day of the tax payment.

2.8 Retirement benefit

As far as salaries tax is concerned, retirement benefit may be classified into two types: a lump sum payment on retirement and a regular monthly payment after retirement. In general, a lump sum payment on retirement from a recognized retirement scheme is exempt and a regular monthly payment (i.e. pension) is taxable.

What is retirement?

Retirement is defined in section 8(3) of IRO as: (a) a retirement from the service of the employer at a specified age not less than 45 years; or (b) a retirement after a period of service of not less than 10 years; or (c) an attainment of a specified age of retirement or the age of 60, whichever is the later.

Termination of employment by death or by incapacity to work

For tax purpose, the termination accords the same treatment as a retirement.

Retirement schemes

With the enactment of Mandatory Provident Fund Schemes Ordinance in December 2000, almost all retirement schemes in Hong Kong are subject to regulation by Mandatory Provident Fund Schemes Authority. As such, almost all retirement schemes operating in Hong Kong are recognized for tax purpose. There are two categories of recognized retirement schemes: (a) ORSO Scheme and (b) MPF Scheme.

What is an ORSO scheme?

It is a scheme defined in the Occupational Retirement Schemes Ordinance (ORSO). In fact, most ORSO schemes operated before MPFSO.

What is a MPF scheme?

A MPF scheme is a defined contribution retirement scheme managed by an approved trustee as defined in the Mandatory Provident Fund Schemes Ordinance "MPFSO". MPF schemes are applicable to employees aged 18 to 65 whether they work full-time or part-time for 60 days or more. It also covers casual construction workers and self-employed persons below the age of 65. Nevertheless, the following persons are not covered by MPF schemes: (a) persons who have been employed for less than 60 days, (b) domestic helpers, (c) self-employed hawkers, (d) persons covered by pension (e.g. government employees), (e) persons covered by statutory provident fund schemes (e.g. teachers of subsidized schools), (f) persons to work in Hong Kong for not more than 12 months or covered by overseas retirement schemes, and (g) persons covered by recognized ORSO schemes.

There are three types of MPF schemes: (1) Master Trust Schemes: suitable for employees of more than one employer, self-employed persons with accrued benefits transferred from another scheme, (2) Employer Sponsored Schemes: suitable for large employers, and (3) Industry Schemes: suitable for employees of industries with high labour mobility.

Employer and employee are separately required to contribute 5% of the employee's income (total 10%). If the employee's monthly income is greater than $20,000, their contribution is restricted to: 5% of $20,000, i.e. $1,000 each. If the monthly income is less than $5,000, the employee is not required to make contribution but the employer still has to make the 5% contribution.

A self-employed person can make contribution on a monthly or a yearly basis. He must join a registered scheme within 60 days of the commencement of self-employment.

Termination of employment with service of 10 years or more

The lump sum payment is not taxable. This applies to both ORSO and MPF schemes.

Termination of employment with service of less than 10 years

The lump sum payment attributable to employee's contribution is not taxable.

Tax relief and exemption

In case of an MPF scheme, the lump sum payment attributable to the employer's mandatory contribution is also exempt. The lump sum payment attributable to the employer’s voluntary contribution (the accrued benefit) is exempt up to a limit called the "proportionate benefit" which is defined as: Accrued benefit x No. of completed month of service / 120. The excess of the lump sum payment attributable to the employer’s voluntary contribution over the limit is taxable.

In case of an ORSO scheme, the lump sum payment attributable to the employer’s voluntary contribution (the accrued benefit) is exempt up to a limit called the "proportionate benefit" which is defined as: Accrued benefit x No. of completed month of service / 120. The excess of the lump sum payment attributable to the employer’s voluntary contribution over the limit is taxable.

Leaving Hong Kong for good

If an employee leaves Hong Kong permanently and his employment ceases on his departure from Hong Kong, the exemption of proportionate benefit for termination of employment will apply. However, if there is no termination of service (for example he is seconded to an overseas associated company), the portion attributable to the employer's voluntary contribution is taxable in full. In other words, the exemption of "proportionate benefit" will not apply.

Set-off of retirement benefit

If part of the retirement benefit is used to set off the Long Service Payment or Severance Payment under the Employment Ordinance, the amount of set-off is deductible from the taxable amount.

Contribution to a retirement scheme

An employee can claim deduction for his mandatory contribution to a recognized retirement scheme. The maximum deduction is $12,000 per year.

2.9 Pension benefit

Under section 8(1), pension arising in Hong Kong is chargeable to salaries tax. No definition of “pension” is made in IRO. So, the Literal Rule applies so that its ordinary meaning will be adopted. In short, pension is a periodical payment to a person in consideration of his past services.

Section 9(3) extends the charge to cover a pension which is voluntary or is capable of being discontinued. This provision was to overcome the decision in Stedeford v. Beloe 16 TC 505 in which pension was held to be excluding voluntary payments.

Like employment income, only the pension arising in or derived from Hong Kong is assessable. This necessitates the determination of the location of the source of the pension. From case law, the location of the fund from which the pension is paid is the decisive factor in determining whether the pension is arising in Hong Kong or not. But this does not mean that the place where the assets making up the fund determines the location of the pension. In fact, regard should be made to the place where the fund is managed and controlled. Normally, this is situated at the place of the business that employed the pensioner. But in some special cases, it can be located at the place where the trustee has power to control the fund.

As far as Hong Kong government pensioners are concerned, all the pension based on total length of service is chargeable to salaries tax, even though part of which is attributable to services done outside Hong Kong. In all other cases, the pension attributable to services outside Hong Kong is exempt.

2.10 Children's education benefit

This benefit is held to be taxable in the case CIR v David Hardy Glynn even though the obligation for the payment was put on the employer solely. In fact, since the case, section 9(2A)(b) has been introduced to reaffirm its taxability. The taxable amount is the amount paid by the employer.

2.11 Non taxable incomes

Payment not for services rendered is not taxable. Only emoluments for the services rendered by employee are taxable. If the payment is paid as a gift on a special occasion (e.g. marriage, death, passing an examination … etc.), it is not taxable.

Reimbursement of employee's education expenses

If the amount reimbursed does not exceed the statutory limit, it is not taxable. Or else, the excess is taxable.

Expenses allowance is not taxable

If the employer pays an employee to cover the company's expenses (for example the traveling expenses for carrying out duties), the payment is not taxable.

Remember the general rule: Benefits inconvertible into

cash are non-taxable

Except those specifically provided in the law (such as housing benefit, children's education benefit, holiday benefit … etc.), the benefits which cannot be converted into cash are not taxable. What is meant by "benefits inconvertible into cash"? In short, it means the benefits cannot be sold in the open market or they do not have an open market value. Such non-taxable benefits include: free medical services, free lunch, free training, free transportation, free house-keeping services... etc.

2.12 Deduction of expenses

Section 12 says all outgoings and expenses, other than that of a domestic, private or capital nature, which are wholly, exclusively and necessarily incurred in the production of assessable income, are deductible.

The tests of "wholly" and "exclusively" should not be construed narrowly. In my experience, the Revenue accepts reasonable apportionment of expenses for deduction even if the expenses are not "wholly" and "exclusively" incurred in the production of assessable income.

Where the employer reimburses the expenses incurred by the employee, the Revenue may accept such reimbursement as non-taxable income. Or else, the employee can claim a deduction for the expenses allowance.

Where the employee is required to wear uniform on duty, the Revenue may grant a flat rate deduction (about $2,880 per year) for the laundry expenses incurred by the employee. This flat rate deduction is usually proposed by the Revenue when the employee claims the deduction in a tax return or a formal objection to the assessment. The employee can get a greater deduction if he can substantiate his claim by documentary proof.

Where the employee has part-time jobs, the Revenue may grant a flat rate deduction (about 10% of the part-time income) for the travelling expenses between the workplaces. This flat rate deduction is usually proposed by the Revenue if the employee claims the deduction in a tax return or in a formal objection to the assessment. The employee can get a greater deduction if he can substantiate his claim by documentary proof.

Where the employee is a member of a professional body (e.g. law society) and the membership is relevant to his job, the Revenue may allow a deduction for the annual membership fee. In practice, the fee paid by a solicitor or assistant solicitor for obtaining and renewing practicing certificate is deductible. The registration application fee and annual renewal fee paid by doctors, engineers, social workers… etc. are also deductible. But the annual insurance premium to cover the liability in case of professional negligence is not deductible.

Where the employee is a sales-person, the Revenue may grant a flat-rate deduction (about 10% on the commission income) for the commissions, entertainment and travelling expenses incurred by the employee. The flat rate deduction is usually proposed by the Revenue if the employee claims the deduction in a tax return or in a formal objection to the assessment. The employee can get a greater deduction if he can substantiate his claim by documentary proof. If the employee is an insurance agent, the flat-rate deduction will normally be in the region of 1/3.

Where the taxpayer is a construction subcontractor, the Revenue may grant a flat-rate deduction of 80% for his expenses including workers' wages. In other words, about 20% of the gross receipts is taxed as net assessable income. If the employee claims more deduction, he must substantiate his claim by documentary proof.

Where the taxpayer is a councilor of District Council, Legislative Council or Executive Council, he can claim deduction for the expenses in running his office. Where no breakdown of expenses is submitted, the Revenue will usually take 50% of his official income as the deduction.

Where the chairman(主席), treasury(財政) or secretary(秘書) of an Owners Incorporation (業主立案法團) receives salaries from the incorporation, such salaries are taxable. But these taxpayers can claim deduction for the expenses in running their offices. Where no breakdown of expenses is submitted, the Revenue will usually take 50% of the official income as the deduction.

Where the employee is an estate agent, the annual licence fee paid to Estate Agents Authority is deductible.

Where the employee is an employee of a university, the cost recovery charge paid to the university for doing outside work is deductible.

Where the employee is disabled, he can claim depreciation allowances in respect of the expenditure on computer, wheelchairs, artificial arms and legs.

Case law on expenses deduction

The following two cases illustrate the basic principle of expenses deduction.

CIR v Robert P Burns 1 HKTC 1181

The taxpayer was a racehorse trainer. Because he broke the Rules of Racing, he was disqualified by the Royal Hong Kong Jockey Club for six months. He appealed successfully against the disqualification. He claimed a deduction under salaries tax for the expenditure of the appeal. It was held that the claim for deduction failed because the expenditure was not incurred in the production of the income although it aimed to place the taxpayer back in the position to earn assessable income.

CIR v Sin Chun Wah 2 HKTC 364

The taxpayer had been employed by Water Supplies Department (WSD). He was offered a new job at the MTRC. To get the new job, he terminated his employment with WSD without giving the required 3-month notice and so he lost his last month salary. He claimed for a deduction of the lost salary from his assessable income. It was held that the deduction was not incurred in the production of his assessable income.

2.13 Home Loan Interest

Section 26E of Inland Revenue Ordinance states that the interest paid on loan for purchase of residence is tax deductible. In brief, the qualifying conditions are:-

1. the person is the property owner; and
2. the property is a rateable unit in Hong Kong; and
3. the property is used as the person's residence; and
4. the loan is subject to mortgage from a recognized lender such as a bank.

A car park in the same property development of the residence is accepted as part of the residence.

There is a limit on the interest deduction. The current limit is $100,000 since 2005/06. If the deduction is below the limit, the unused part cannot be carried forward. A person can only get the deduction for a total of 10 years of assessments. It is up to him to apply for the deduction for any year of assessment throughout his working life.

Where the property is partly owned by the person, the interest deductible is restricted to his share of ownership.

Where the property is jointly owned by the person and his spouse, the deduction ratio of interest is 50%. But if the spouse has no income chargeable to tax, he can get the remaining 50% deduction by spouse's nomination. If the spouse has income chargeable to tax, nomination is disallowed but that spouse can still get her share of the deduction in her own assessment. If the couple elects for joint assessment, then the total interest will be allowed in their joint assessment.

Where a re-mortgage loan is borrowed to repay the first loan, the interest on the re-mortgage loan attributable to the repayment of the first loan is deductible.

Where an additional loan is borrowed after the purchase of the property, the interest on the additional loan is not deductible.

2.14 Self Education Expenses

Section 12(1)(e) states that a person can get a deduction for Self-Education Expenses. In brief, the qualifying conditions are:-

1. the expenses are paid to a recognized educational institute such as university, college, school, technical institute; and
2. the expenses include tuition and examination fees for a course of education, and the course of education is related to employment, whether present employment or future employment; and
3. the expenses are not reimbursed or are not to be reimbursed by employer or any other person.

Only the actual amount paid in the year of assessment should be claimed. No spreading of the expenses throughout the period of the course is allowed. The maximum deduction is $40,000.

Deduction for examination fee of a professional examination relevant to your employment is allowable. Besides, courses of language proficiency or for higher level of education are also acceptable.

2.15 Donations to Charity

A taxpayer making a donation to charity can claim tax deduction if:

1. it is a donation of money; and
2. it is for charitable purpose; and
3. it is paid to a charitable institution or a trust of a public character that is exempt from tax under Section 88 or to the Hong Kong SAR government; and
4. the total donations in the year of assessment is not less than $100.

A taxpayer can also claim deduction for his spouse's donations.

The maximum deduction is 25% of his net income (assessable income less deductions).

2.16 Elderly Residential Care Expenses

A taxpayer may claim the elderly home expenses he pays for his or his spouse's parent or grandparent subject to the following conditions:

1. The parent or grandparent is at least 60; or if under 60, he is eligible to claim disabled allowance.
2. The expenses actually paid by the taxpayer or by his spouse in the year of assessment.
3. The expenses are paid to a recognized elderly home in Hong Kong.
4. The expenses cover accommodation, food, nursing care and sundry expenses but exclude those of private medical care or those of a personal nature not in the nature of residential care.
5. The expenses reimbursed by Social Welfare Department cannot be claimed.

Even taxpayers paying tax at standard rate can get the deduction.

Full-year expenses are allowed when the parent reaches 60 in the year of assessment. In other words, no time apportionment of the expenses is necessary.

The maximum deduction is $60,000 for each parent.

A taxpayer should not claim Dependent Parent Allowance and Elderly Residential Care Expenses for the same parent for the same year of assessment. If that is the case, his claim for Dependent Parent Allowance will be void and only his claim for Elderly Residential Care Expenses will take effect. So, if the conditions of both claims are satisfied, the taxpayer should decide which claim to make. Normally, if the elderly home expenses are more than $30,000, it is advisable for him to claim Elderly Residential Care Expense. Otherwise, he should claim Dependent Parent Allowance.

2.17 Husband and wife

In so far as taxation is concerned, a husband and his wife refers to a couple of a lawful marriage. According to section 2, "marriage" means (a) any marriage recognized by the law of Hong Kong; or (b) any marriage, whether or not so recognized, entered into outside Hong Kong according to the law of the place where it was entered into and between persons having the capacity to do so, but shall not, in the case of a marriage which is both potentially and actually polygamous, include marriage between a man and any wife other than the principal wife, and "married" shall be construed accordingly. A wife is defined as a married woman of a marriage within the meaning of the IRO.

In short, the marriage must be a lawful marriage between a man and a woman. A marriage of the same sex (同性戀婚姻) is not acceptable for tax purpose.

Separate assessment

As far as tax is concerned, husband and wife are treated as separate individuals. Each party is required to complete his / her tax return, to notify the IRD of his / her chargeability to tax and to pay his / her own tax.

For 2005/06 onward, the basic allowance for an individual (whether a singleton or a married person) is $100,000.

Joint assessment

Under salaries tax, if the total net income of one spouse is less than his / her total allowances, there will be unused personal allowances under his / her own assessment. In that case, the couple can elect for joint assessment to have their incomes and personal allowances combined in one single assessment so as to reduce their overall tax liabilities.

Should the election not reduce their total tax, the IRD will inform the taxpayers so and the election will not be effected. So, it is advisable for the couple to elect for joint assessment if either spouse has low taxable income.

The election must be signed by both spouses in a tax return or in a form specified by Board of Inland Revenue. The time limit for the election adopts the time limit of the relevant tax return or within one month after a relevant salaries tax assessment becoming final and conclusive.

The joint election can be withdrawn within one month of the issue of the joint assessment. But once withdrawn, no re-election will be accepted. However, if there are adjustments to either spouse's original assessment rendering the tax reduction of joint assessment no longer applicable, the election will be deemed invalid and revised assessments will be issued under separation taxation basis.

Normally, only one joint-assessment will be issued to the spouse liable to tax. This is unlike Personal Assessment where the total tax will be apportioned between the spouses so that each spouse will get an assessment. If both spouses are required to pay tax before the joint assessment, they will have to nominate one to get the joint-assessment.

For joint assessment in case of a newly-wed couple, the marriage will be deemed to start from the beginning of the year of assessment; that is 1 April. In other words, there will be no apportionment of a spouse’s income between before and after the marriage.

For 2005/06, the married person allowance is $200,000.

2.18 Married Person's Allowance

If a taxpayer’s spouse does not have any taxable income, the taxpayer need only claim Married Personal Allowance in his own tax return. In other words, no election for joint assessment is necessary.

Full allowance ($200,000 for 2005/06 onward) is granted in the year of marriage, separation, divorce or death. No apportionment of the allowance is required.

Whether or not the spouse is a Hong Kong resident does not affect the eligibility of the allowance.

Where a person is living apart from his spouse, he is not entitled to the allowance unless he maintains his ex-spouse. But if his ex-spouse has assessable income, the allowance will not be granted unless they both elect for joint assessment.

A married person may also claim Disabled Dependant Allowance in respect of his disabled spouse. The condition for the claim is that the spouse must be eligible to claim Disability Allowance from the Social Welfare Department. For 2005/06 onward, the disable allowance is $60,000.

2.19 Child Allowance

A taxpayer may claim child allowance if he maintains an unmarried child who is below 18, and if 18 to 25: a full time student, or if over 25: disabled for work.

For 2005/06 onward, the allowance is $100,000 per child, with the maximum of 9 children.

Whether or not the child is a Hong Kong resident does not affect the eligibility of the allowance. According to section 27, the word "child" is defined as any child of a person chargeable to tax or of his or her spouse or former spouse whether or not born in wedlock and includes the adopted or step child of either or both of them. "Adopted" is defined as: adopted in any manner recognized by the laws of Hong Kong.

Full allowance is granted in the year of assessment in which the child is born.

No double claim of child allowance is accpted for a child. No sharing or splitting of child allowance among a couple is allowaed unless the couple is living apart or divorced. If the couple has more than one eligible child, either spouse can make the claim for all the children and then the other spouse gets no child allowance at all. In general, it is advisable for the spouse with higher income to make the claim.

A claim for living-apart has to be proved by production of court order or separation deed. A married person living apart from his spouse temporarily is not accepted as living-apart for tax purpose.

The sharing of the child allowance between a living-apart or divorced couple is based on their contribution to the maintenance and education of the child. In practice, equal sharing is assumed unless the claimant can provide proof that he makes a greater contribution.

A divorced or living-apart person may also claim Single Parent Allowance if he provides sole or predominant care to the child in the years of assessment after year of the divorce or separation. Whether such care exists is mainly a question of facts. In general, the Revenue looks to whether the claimant is responsible for the provision of the daily care and supervision of the child. The proof may include production of the child's student handbooks, medical record, resident card… etc. Apportionment of the allowance between the parents on time basis may be accepted if either parent provides sole or predominant care for the child during different periods during the year of assessment. For 2005/06 onward, the basic allowance is $100,000.

A taxpayer may claim Disabled Dependant Allowance in respect of his disabled child. The condition for the claim is that the child must be eligible to claim Disability Allowance from the Social Welfare Department. Full allowance is granted for the whole year of assessment in which the disability is certified. For 2005/06 onward, the disable allowance is $60,000.

2.20 Dependent Parent Allowance

If a taxpayer maintains his parent, he can claim the allowance. To qualify the allowance, the parent must ordinarily reside in Hong Kong and be 55 or above; or if under 55, he is disabled.

According to section 2, “parent” means: a parent of whose marriage the taxpayer or his spouse is the child; the natural father or mother of the taxpayer or his spouse; a parent by whom the taxpayer or his spouse was adopted; a step parent of the taxpayer or his spouse; or a parent of his deceased spouse.

Maintaining the parent means paying the parent at least $12,000 during the year of assessment or living with the parent "not for full consideration" for at least 6 months. The phrase "not for full consideration" means the taxpayer subsidizing the living costs of the parent; the allowance can still be granted even if the parent contributes to pay his own living expenses or some of the household expenditure.

A taxpayer may also claim Additional Dependent Parent Allowance if he lives with his parent "not for full consideration" throughout the whole year of assessment.

Full allowance is granted for the whole year of assessment in which the parent reaches 55. Also full allowance is granted for the year of death. No time apportionment of the allowance is required.

No double dependent parent allowance for the same parent is allowed. If two or more persons claiming the allowance, they should reach an agreement as to who can get the allowance. If no such agreement is made, no one can get the allowance.

For 2005/06 onward, the allowance for each parent (aged 60 and above) is $30,000 with an additional allowance of $30,000 for continuous living together throughout the year of assessment. If the parent is aged 55-59, the respective allowances are half: $15,000 for non-continuous living together and additional $15,000 for continuous living together.

In addition, a person may also claim Disabled Dependant Allowance in respect of his disabled parent. The condition for the claim is that the parent must be eligible to claim Disability Allowance from the Social Welfare Department. For 2005/06 onward, the disable allowance is $60,000.

Dependent parent allowance and additional dependent parent allowance may also be claimed for grandparents on same conditions as for parents.

2.21 Dependent Brother or Sister Allowance

A person can get the allowance if he maintains his brother or sister who is single and under 18; or if over 18 and under 25: who is on full time study; or if at any age: who is disabled for work.

For 2005/06 onward, the allowance for each brother /sister is $30,000.

Whether or not the brother or sister is a Hong Kong resident does not affect the eligibility of the allowance.

No double allowance for maintaining the same child is allowed. In other words, if child allowance is granted to the child's parent, no Dependent Brother or Sister Allowance will be granted.

A taxpayer may also claim Disabled Dependant Allowance in respect of his disabled brother or sister. The condition for the claim is that the brother or sister must be eligible to claim Disability Allowance from the Social Welfare Department. For 2005/06 onward, the disable allowance is $60,000.

2.22 Computation of salaries tax

An example of salaries tax computation

Throughout the year ended 31 March 2006, Mr. Wong, a singleton, was employed as an accountant with a monthly salary of $50,000. In his tax return, he claimed deduction for membership fee to Hong Kong Society of Accountants $2,000, contribution to Mandatory Provident Fund $12,000 and expenses of self-education $15,500. According to his last-year tax bill, he had paid $80,000 for Provisional Tax for 2005/2006.

In October 2006, Mr. Wong received a tax bill. Assuming the tax return was totally accepted by the Revenue, his assessment and tax payable shown in the tax bill would be as follows:

<u>Final tax payable for 2005/2006</u>

Net assessable income: $50,000 * 12 = $600,000 less membership fee $2,000 less MPF contribution $12,000 less self-education expenses $15,500 equal to $570,500.
Net chargeable income: $570,500 minus basic allowance $100,000 equal to $470,500.

Tax payable at progressive rates (please see Chapter 1 paragraph 1.6): $83,300
(Standard rate restriction: $570,500 * 16% = $91,280 --- not applicable)
Less: Provisional tax paid per last-year tax bill $80,000.
Balance tax payable: $83,300 minus $80,000 equal to $3,300.
Add: Provisional tax payable for 2006/2007, as computed according to the financial budget, that is $78,895.
Total tax payable: $3,300 + $78,895 = $82,195.

<u>Two installments of payments</u>

The first installment is made up of (a) balance of tax payable for 2005/2006: $3,300 and (b) 75% of the provisional tax payable for 2006/2007, i.e. $78,895 * 75% = $59,171. Total payable for first installment: $62,471. The due date is usually in January to March 2007.
The second installment of tax is 25% of provisional tax payable for 2006/2007, i.e. $78,895 * 25% = $19,724. The due date is usually in April to June 2007.

2.23 Hold-over of provisional tax

In the aforesaid example, Mr. Wong can apply for hold-over of provisional tax for 2006/2007 on the following grounds:-

1. The provisional income was likely to be less than 90% of the amount assessed.
2. He was eligible to claim a new allowance, e.g. he married a wife in mainland China in the year 2006/2007.
3. His employment has ceased in 2006/2007.
4. He has objected to the prior-year assessment for 2005/2006.

Application for hold-over of provisional tax must be lodged 28 days before due date or 14 days after the issue of the demand for provisional tax. It must be made in writing and lodged with this Department within the prescribed time limit.

If the application is lodged on the grounds of fallen income for 2006/07, Mr. Wong should furnish a computation to demonstrate a drop of the net chargeable income by more than 10%, when compared with that for 2005/06.

As most taxpayers would have their 1st installment of tax due in January 2007, the most appropriate time to lodge holdovers will be in November and December 2006. By that time, you should know the actual income figures for the 7 months to 31 October 2006, and you should be in a better position to estimate your income for the remaining 5 months to 31 March 2007.

2.24 Working in mainland China

If all your work is done in mainland, you are entitled to full exemption. If you occasionally come back to the Hong Kong office to attend meetings or report duties, the exemption will fall through. So, you had better report duties to your Hong Kong boss through telephone, fax or e-mail. It is also advisable for your employment contract to stipulate your duties in mainland only.

In general, the relief under Section 8(1A)(c) of Inland Revenue Ordinance (IRO) is greater than the double taxation relief under Section 49. In brief, the Section 8(1A)(c) relief is to exempt the income attributable to services in mainland if mainland's Individual Income Tax is paid on such income. So, you had better keep all your mainland tax bills for your claim.

Hardship allowance for working in mainland China has been held by Board of Review as not taxable.

Hardship allowance is not taxable - vide Board of Review case No. D56/91

An employee was employed by a Hong Kong company to work in mainland China in addition to his work in Hong Kong. He received a hardship allowance while he worked in mainland. He paid mainland's income tax on part of the allowance. He claimed full exemption on the whole of the allowance. The Revenue only allowed partial exemption for the allowance on the grounds that only part of the allowance was taxed in mainland. The employee appealed to the Board of Review to claim whole exemption of the allowance.

The Board allowed the appeal and said: “It was clear as a matter of fact that the entirety of the hardship allowance was paid to the taxpayer in respect of the services which he rendered in the Peoples' Republic of China. The fact that under the procedures adopted in the Peoples' Republic of China when calculating the tax to be assessed, a percentage or fraction was applied to the taxpayer's emoluments with the effect that a reduced rate of tax applied to the hardship allowance did not mean that the same had not been assessed to tax in the Peoples' Republic of China.”

Individual Income Tax paid by the employer should be wholly excluded under Section 8(1A)(c). As the whole of the IIT paid by the ER is wholly attributable to the services rendered outside Hong Kong, it should be wholly excluded under Section 8(1A)(c). According to Article 3(2) of the Arrangement with the Mainland for the Avoidance of Double Taxation of Income, a resident of one side working in the other side should be taxed by the other side in respect of the remuneration of that other side. So, if a Hong Kong resident working in the mainland China and Hong Kong, the China side should only tax the part of the income attributable to the services China. In general, this is achieved by time apportionment of his total income during the year. Since the mainland’s tax refers only to the services rendered in the Mainland, it should be excluded under the section 8(1A)(c) exemption.

If you only work in Hong Kong during visits not exceeding 60 days during the year of assessment, you are entitled to full exemption. But this exemption will not apply if your main base of work is in Hong Kong. In counting the days for this exemption, the Revenue takes the departure day and the arrival day as two whole days in Hong Kong. You'd better keep record of all your stay in Hong Kong.

If your employment is of a non-Hong Kong source, you are entitled to claim relief under Section 8(1A)(a): that is to exempt the income attributable to your services in mainland. In practice, the exemption is computed on time basis: that is by reference to the number of days in mainland over the number of total days in Hong Kong and in mainland. From case law, whether your employment is of a non-Hong source depends on three factors: location of employment contract, location of employer's residence and place of payment of remuneration. So, you should keep record of your stay in mainland as well as the documents concerning the source of your employment.

2.25 Separate employment contracts

Section 8(1) of Inland Revenue Ordinance levies tax on income from an employment in Hong Kong. From case law, an employment exists where there is a master and servant relationship in doing work. If the employment is in Hong Kong, all the income from the employment is taxable even though part of it is attributable to services outside Hong Kong.

It is very difficult for a person to convince the Revenue that he has separate employments with the same employer on the grounds that he has separate employment contracts: one for his work in Hong Kong and another for his work outside Hong Kong. This is because such artificial division of employment contracts will usually be regarded by the Revenue as a tax avoidance measure. In other words, the Revenue will strive to impose tax on all the income from the same employer, whether or not part of such is from an employment contract with services outside Hong Kong.

If the taxpayer's employer is not a resident in Hong Kong, it is advisable for the taxpayer to arrange for his employer contract to be negotiated, signed and enforceable outside Hong Kong. It is also advisable to have the remuneration paid into a bank account outside Hong Kong. With all these arrangements, the taxpayer can argue that his employment is not in Hong Kong and so only the income attributable to his Hong Kong services taxable.

If the taxpayer is employed by a foreign company and he is required to work outside Hong Kong as well as work for an associated company in Hong Kong, then it is advisable for him to enter into two separate contracts of employment: one with his foreign employer for his work outside Hong Kong and one with the associated company in Hong Kong for his work in Hong Kong. As such, he can argue that they are indeed separate employments (two different employers) and so only the income under the Hong Kong employment will be taxable.

2.26 Employed versus Self-employed

A self-employed person is subject to profits tax with expense deductions more favourable than those under salaries tax.

If a taxpayer claims to be assessed under profits tax, he has to discharge the burden of proof. A business registration is just one of the many factors for the proof.

An employment exists where there is a legal relationship of master and servant. An employee is under a "contract of service" whereas a self-employed person is under a "contract for services".

In Market Investigations v. Minister of Social Security [1969] 2 QB 173 the judge said: "The fundamental test is whether the person engaged himself to perform these services performing them as a person in business on his own account? If the answer to that question is ‘Yes’, then the contract is a contract for services. If the answer is ‘No’, then the contract is a contract of service. No exhaustive list has been compiled and perhaps no exhaustive list can be compiled of the considerations which are relevant in determining that question, nor can strict rules be laid down as to the relative weight which the various considerations should carry in particular cases. The most that can be said is that control will no doubt always have to be considered, although it can no longer be regarded as the sole determining factor; and that factors which may be of importance are such matters as whether the man performing the services provides his own equipment, whether he hires his own helpers, what degree of financial risk he takes, what degree of responsibility for investment and management he has, and whether and how far he has an opportunity of profiting from sound management in the performance of his task... In order to decide whether a person carries on a business on his own account it is necessary to consider many different aspects of that person's work activity. This is not a mechanical exercise of running through items on a check list to see whether they are present in or absent from a given situation. The object of the exercise is to paint a picture from the accumulation of detail. The overall effect can only be appreciated by standing back from the detailed picture which has been painted, by viewing it from a distance and by making an informed, considered, qualitative, appreciation of the whole. It is a matter of evaluation of the overall effect of the detail, which is not necessarily the same as the sum total of the individual details. Not all details are of equal weight or importance in any given situation. The details may also vary in importance from one situation to another. The process involves painting a picture in each individual case."

Whether or not a person running a business on his own is largely a largely question of facts. From time to time, the courts and tribunals suggest a number of tests --- yet no one is conclusive. The choice of tests depends on the nature of that particular trade, profession or industry as well as on the facts of that particular case. In general there are three common tests: control test, integration test and economic reality test.

Economic reality test

The test looks at the financial aspects to see if a person is running his business on his own account. This test was laid down in the case Fall v. Hitchen, in which the judge said: "Is the person who has engaged himself to perform these services performing them as a person in business on his own account?' If the answer to that question is 'yes', then the contract is a contract for services. If the answer is 'no', then the contract is a contract of service. No exhaustive list has been compiled and perhaps no exhaustive list can be compiled of the considerations which are relevant in determining that question, nor can strict rules be laid down as to the relative weight which the various considerations should carry in particular cases. The most that can be said is that control will no doubt always have to be considered, although it can no longer be regarded as the sole determining factor; and that factors which may be of importance are such matters as whether the man performing the services provides his own equipment, whether he hires his own helpers, what degree of responsibility for investment and management he has, and whether and how far he has an opportunity of profiting from sound management in the performance of his task."
The test was then applied in the UK case of Market Investigations Ltd. v. Minister of Social Security. In that case a woman was engaged to do market surveys at fixed rates. She arranged her working hours, selected her interviewees. She was free to work for other organizations, without any supervision albeit subject to rigid rules, It was held that she was employed. The court ruled that a person might carry out more than one employment at the same time --- the control exercised was enough to be compatible with a contract of service --- the payment of a fixed fee could not be considered in isolation from the general test of whether she was carrying on business on her own account. Thus, she did not run her business on her own account.

The economic reality test may not be used in "professional people" cases. In the case of Hall v. Lorimer [1994] 1 WLR 209

--- the taxpayer was a vision mixer working for 20 or more production companies on single day assignments, in which the judge said: "In cases of this sort there is no single path to a correct decision. An approach which suits the facts and arguments of one case may be unhelpful in another. I agree with the views expressed by Mummery J. in the present case [1992] 1 W.L.R. 939, 944: ‘In order to decide whether a person carries on business on his own account it is necessary to consider many different aspects of that person’s work activity. This is not a mechanical exercise of running through items on a check list to see whether they are present in, or absent from, a given situation. The object of the exercise is to paint a picture from the accumulation of detail. The overall effect can only be appreciated by standing back from the detailed picture which has been painted, by viewing it from a distance and by making an informed, considered, qualitative appreciation of the whole. It is a matter of evaluation of the overall effect of the detail, which is not necessarily the same as the sum total of the individual details. Not all details are of equal weight or importance in any given situation. The detail may also vary in importance from one situation to another. The process involves painting a picture in each individual case. As Vinelott J. said in Walls v. Sinnett (1986) 60 T.C. 150, 164: ‘It is, in my judgment, quite impossible in a field where a very large number of factors have to be weighed to gain any real assistance by looking at the facts of another case and comparing them one by one to see what facts are common, what are different and what particular weight is given by another tribunal to the common facts. The facts as a whole must be looked at, and what may be compelling in one case in the light of all the facts may not be compelling in context of another case... Again the question whether the individual is in business on his own account, though often helpful, may be of little assistance in the case of one carrying on a profession or vocation. A self-employed author working from home or an actor or a singer may earn his living without any of the normal trappings of a business. For my part I would suggest there is much to be said in these cases for bearing in mind the traditional contrast between a servant and an independent contractor. The extent to which the individual is dependent on or independent of a particular pay master for the financial exploitation of his talents may well be significant."

Control test

It is the traditional common-law test for an employment relationship. And it is still the most important test.

This test was first laid down by the judge in the court case R v. Walker who said: "It seems to me that the difference between the relations of master and servant and of principal and agent is this: A principal has the right to direct what the agent has to do; but a master has not only that right, but also the right to say how it is to be done."

Subsequently, in the case of Yewens v. Noakes, the judge said: "A servant is a person subject to the command of his master as to the manner in which he shall do his work". The control test is to consider whether the "servant" is answerable to a "master" for "what he does, how he does and when he does".

Control by the employer may include:

- working hours,
- approval for leave,
- training,
- how to report duty,
- duties or responsibilities, or
- where, when and how the work is to be done.

Some judges commented that the test might be too simple in the context of modern world. Now, it is no longer a conclusive test for all cases. For example, in the case of Morren v. Swinton and Pendlebury Borough Council (1965) 2 All ER 349 at 351, the judge pointed out that when dealing with a man of some special skill and experience, the employer might not be necessary to tell the employee how to do the work; therefore the absence of control and direction in such cases might be of little use as a test.

There may be situations where one is hired to do work which is under the strict control of the client but, nevertheless, the contract is not a contract of service. An example is Queensland Stations Pty. Ltd. v. Federal Commissioner of Taxation, the "drover" case, where the judge said: "In considering the facts it is a mistake to treat as decisive a reservation of control over the manner in which the droving is performed and the cattle are handled. For instance, in the present case the circumstance that the drover agrees to obey and carry out all lawful instructions cannot outweigh the countervailing considerations which are found in the employment by him of servants of his own, the provision of horses, equipment, plant, rations, and a remuneration at a rate per head delivered."

Integration test

The "organization" or "integration" test was introduced by the judge in the case Bank voor Handel en Scheepvaart NV v. Administrator of Hungarian Property (1954) who said: "the test of being a servant does not nowadays rest on submission to orders. It depends on whether the person is part and parcel of the organization ..."

This test looks at whether the individual can be regarded as part of the "employer's" organization. That is whether he is an integral part of the organization or is just casually or temporarily engaged for doing a task ancillary to the employer's main activities. For example, a car repairer rendering services to a garage is more likely to be an employee more than a businessman rendering car repairing service.

2.27 Disguised employments

Nowadays, some professional employees use service companies to take advantage of the less stringent expenses deduction under Profits Tax vis-à-vis that under Salaries Tax. With the service-company arrangement, the "employment" is changed into, or in some cases disguised as, a "contract for services". As such, the head of charge changes from salaries tax to profits tax: Under profits tax, expenses are deductible to the extent they are incurred in the production of profits; but under salaries tax, expenses are generally not deductible unless they satisfy the stringent conditions of Section 12(1)(a): that is to say they are not of a domestic, private or capital nature, and they are wholly, exclusively and necessarily incurred in the production of assessable income. It follows that a lot of expenses that are not deductible under salaries can become deductible under profits tax. In order to deter taxpayers from avoiding tax with service companies, the Revenue has introduced Section 9A.

The Revenue says Section 9A will be invoked if tax avoidance is suspected. In other words, where there is no tax avoidance, the IRD should not use Section 9A, but should look to such factors established in case law as master and servant relationship, control, organization, economic risk... etc. to determine the question of "contract of service" versus "contract for service".

Under Section 9A, if a "relevant person" pays remuneration for services rendered by a "relevant individual" to a company controlled by that individual, the remuneration is deemed to be employment income and assessed as such on that individual. In other words, the relationship between them is taken to be an employee relationship between the "relevant person" and the "relevant individual", disregarding what agreements or arrangements have been made between them. As it is an employee relationship, the "relevant person" must discharge all the legal obligations of an employer under the tax law, or else he is liable to penalties.

Section 9A applies if the following conditions exist:
(a) The relevant person carries on a trade, a profession or a business, or a prescribed activity;

(b) The relevant person enters into an agreement with the relevant individual for the services carried out by the relevant individual. The agreement may be in writing or implied; and
(c) Under the agreement, remuneration for such services is paid to a “service company”.

A prescribed activity under (a) is one prescribed in the Gazette by the Revenue under Section 9A(6). So far, there has been no such prescribed activity.

It is anticipated that Section 9A can affect many business arrangements that are done without a tax-avoidance purpose. To restrict its effect, the law provides that a business arrangement satisfying all the following conditions falls outside its scope:

(a) the agreement does not provides for remuneration to include annual leave, passage allowance, sick leave, pension entitlements, medical payments or accommodation, etc;
(b) in the case of the agreement requiring any services to be carried out personally by the relevant individual, that individual also carries out similar services for other persons;
(c) the performance of the relevant individual is not subject to “employer-type” control or supervision by the relevant person;
(d) the remuneration is not paid on a basis commonly used under a contract of employment;
(e) the relevant person does not have the right to terminate the services in a manner commonly provided for under a contract of employment; and
(f) the relevant individual is not held out to the public to be an officer or employee of the relevant person.

Besides, the Commissioner of Inland Revenue may in his discretion exclude a business arrangement from Section 9A if he is satisfied that at all relevant times the carrying out of the services under the agreement is not substantially in the nature of an office or employment. This provides an escape route for those arrangements that fail to meet all the above conditions.

2.28 Employee versus Office holder

An employee has a master and servant relationship with his employer. The work of an employee is within the control of his employer as to what to do, how to do and when to do.

An office holder holds an office created by law or covenants. The office holder's duties are statutory and irrespective of whoever holding the office. A common example is the director office of a company.

Not all so-called "directors" are office holders in law. If a "director" is employed by a company through an employment contract, he is an employee only, not a "director" for tax purpose.

The income from a Hong Kong employment is taxable in full. The remuneration from a Hong Kong office is taxable in full too. So, in general, whether the income is from a Hong Kong employment or from a Hong Kong office is unimportant.

From case law, the location of a director office depends on the management and control of the company. In practice, the director office of a company incorporated in Hong Kong is treated as locating in Hong Kong unless the contrary is proved.

Board of Review Case D123/02

The taxpayer was a director of a company incorporated in Hong Kong. He received directors' fees. He argued that such fees were of a source outside Hong Kong because all the directors' meetings were held outside Hong Kong.

The Board dismissed the taxpayer's appeal and held that:-

1. The source of income is a question of fact and is not determined solely by where directors' meetings were held. (CIR v Geopfert 2 HKTC 210).
2. The location of the appellant's office as director of the

company was determined by where the company was resident (McMillian v Guest (1942) 24 TC 190).

The Board found that part of the superior and directing authority of the company was present in Hong Kong. Besides, it kept house and had substantial business operations in Hong Kong. The Board concluded that the company was resident in Hong Kong (Swedish Central Railway Company, Ltd v Thompson (1925) 9 TC 342).

For a non-Hong Kong employment, the income attributable to services outside Hong Kong is exempt. Furthermore, for an employee performing services in Hong Kong during visits not exceeding 60 days, he is exempt from tax too. But these exemptions do not apply to a Hong Kong office holder. Therefore, for a non-resident working partly in Hong Kong and partly overseas, the distinction of his income between employment and office can affect his tax liability significantly.

In practice, a person may hold the capacity of an employee and an office holder at the same time. If the employment contract does not clearly make a distinction of the remuneration for the two capacities separately, the Revenue may take all the remuneration as taxable income. So, to avoid tax dispute, it is advisable to have the remunerations for these two different capacities clearly defined.

The IRD's line of arguments in the case is noteworthy. It argues that even the company's central management and control is <u>made</u> outside Hong Kong, the company is still resident in Hong Kong on the following factors:

1. It is incorporated in Hong Kong.
2. Its registered office is in Hong Kong.
3. It carries on business of air cargo agency in Hong Kong or its customers are all local cargo forwarders carrying on their businesses in Hong Kong.
4. It carries on business at a fixed place of business in Hong

Kong.
5. It recruits staff in Hong Kong.
6. It maintains a bank account in Hong Kong to pay the director's emoluments.
7. It is required by law to keep its registers of members, directors and secretary at its registered office in Hong Kong.
8. Its accounts are audited in Hong Kong.
9. Its directors have to comply with the Company Ordinance of Hong Kong.

Author's comments

The place of residence of a company does not merely hinge on the place of the directors' meetings although in general the place of directors is a very important factor. In fact, with advanced information technology, some business meetings are conducted via internet and the physical place of the meeting is unimportant. In practice, if the company is incorporated in Hong Kong and its business is mainly done in Hong Kong, then the directors' office will be regarded as in Hong Kong even though the directors' mainly stay outside Hong Kong.

2.29 Tax clearance on leaving Hong Kong

Under section 51(7), a person chargeable to tax must notify the Revenue of his imminent departure from Hon Kong if the departure period is more than one month. Such notice must be given at least one month before the expected date of departure although the Revenue can accept shorter notice. Notification is not required if the person has to frequently travel in and out of Hong Kong in the course of his employment or business.

Besides, under section 52 of IRO, an employer must notify the Revenue of his employee's imminent departure from Hong Kong. Notification should be made in the form IR56G reporting the date of departure as well as the employee's income up to the date of departure. Such notice must be given at least one month before the date of departure. After the notification, the employer should immediately withhold payment of any sum due to the employee until he receives a “letter of release” from the Revenue.

As soon as the Revenue receives a notification that a taxpayer is about to leave Hong Kong permanently, a tax return for that year of assessment will be issued to the employee. The employee should call at the Revenue to file the tax return and get the tax assessment for tax payment as early as possible.

If the person has outstanding share options as part of his taxable income, he can elect for a notional exercise for computing the gain on the share options. It is assumed that the share options are exercised on a day as chosen by the person within 7 days before the filing of the related tax return. Given this assumption, the taxable gain is computed for the year of departure, and there will be no further tax liability when the share options are actually exercised or sold afterwards. It is advisable for the taxpayer to make the election if the taxable gain so computed is zero or quite small.

If the person withdraws accrued benefits from a recognized retirement scheme, he can get exemption under the Proportionate Benefit rule.

If the person does not clear his tax liabilities before he leaves Hong Kong, the Revenue will issue a “recovery letter” to the employer requiring payment of tax from the sum withheld.

A tax officer may apply to court to stop a tax defaulter from leaving Hong Kong.

2.30 Employer's obligations

An employer is required to notify the Revenue of a new employee who is likely to be chargeable to Salaries Tax: when his annual income is apparently larger than the basic allowance. The notification should be made in the form IR56E. The time limit for the notification is three months after the appointment date.

An employer is required to deliver a form IR56B to the Revenue in respect of every employee who is likely to be chargeable to Salaries Tax every tax year. The time limit is stated in the Revenue's letter annexed with the forms, usually within one month of the letter.

An employer must notify the Revenue of the termination of employment of an employee who is chargeable to Salaries Tax. The time limit for the notification is at least one month before the termination. The notification should be made in the form IR56F.

An employer must notify the Revenue of an employee who is about to leave Hong Kong for more than a month. The notification should be made in the form IR56G. The time limit for the notification is at least one month before the date of departure. This notification is not required if the employee frequently travels in and out Hong Kong during his course of employment. After the notification, the employer cannot pay the employee without the permission of the Revenue.

The above provisions also apply to a person who is deemed to be employed under Section 9A of IRO or an office holder liable to Salaries Tax under Section 8.

Employers are required to report the employee's income even if it consists of a variable commission.

Free lance broker, writer, artiste, artist or sportsman... etc. who does not have a fixed office and does not have a master-servant relationship with the company is treated as carrying on a business chargeable to Profits Tax. Nevertheless, the Revenue still requires the company to file quasi Employer's Return IR56M where the total payment to such person exceeds $25,000.

An IR56M should also be filed where total payment to a site subcontractor in a year of assessment exceeds $200,000.

The Revenue may impose penalty or take legal action against those employers who do not comply with the legal requirements.

Chapter 3 Profits Tax Tips

3.0 Overview of profits tax

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Chapter 3 Profits Tax Tips

3.0 Overview of profits tax

Hong Kong's profits tax is low and simple. A person is liable to pay it if he carries on a business in Hong Kong. Only the profits sourced in Hong Kong are taxable. Profits earned outside Hong Kong are not taxable. Capital gains, bank interest or dividend receipts are not taxable either.

The profits tax rate is 17.5% for corporations and 16% for unincorporated businesses (year of assessment 2005/06 onward).

All expenses incurred in the production of assessable profits are deductible from the taxable incomes. The deductible expenses include employees' remuneration, manufacturing costs of production, sales expenses, financial expenses, administrative expenses… etc.

Capital expenditures are not deductible. Nevertheless, generous allowances are granted for the following capital expenditures: purchase of plant and machinery, construction of industrial building and commercial building, acquisition of information technology and patents, refurbishment of business premises, establishment of retirement scheme, scientific research, technical education… etc.

Rate of allowances (until the cost is exhausted)

- Allowance for plant and machinery: an initial allowance of 60% on cost and an annual allowance ranging from 10% to 30% on the written down value.
- Industrial Building Allowance: an initial allowance of 20% on cost and an annual allowance of 4% on cost.
- Commercial Building Allowance: an annual allowance of 4% on cost.
- Expenditure on information technology (i.e. computer hardware and software): 100% initial allowance on cost.
- Expenditure on acquisition of patent: 100% initial allowance on cost.
- Establishment cost of employees' retirement schemes: an

annual allowance of 20% on cost for 5 years of assessment.

- Refurbishment of business premises or hotel: an annual allowance of 20% on cost for 5 years of assessment.
- Scientific research: 100% initial allowance on cost.
- Technical education: 100% initial allowance on cost.

Tax computation

Profits Tax is levied on the actual assessable profits in the basis period for the year of assessment concerned.

- Tax payable = Assessable profits * Tax rate
- Tax rate: 17.5% for a corporation; 16% for a person other than a corporation (for year of assessment 2005/06)

Assessable profits are the accounting profits as determined in accordance with generally accepted accounting principles and then adjusted in accordance with the provisions of Inland Revenue Ordinance.

A checklist for reduction of profits tax

1. Did you carry on a business or a trade? If no, you pay no tax.
2. Was your business or trade carried on in Hong Kong? If no, you pay no tax.
3. Did you earn profits from activities outside Hong Kong? If yes, such profits are not taxable.
4. Did you include capital receipts in your accounting profits? If yes, you should exclude them from assessable profits.
5. Did you purchase computer hardware or software? If yes, their cost is wholly deductible.
6. Did you purchase machinery or plant for manufacturing purpose? If yes, their cost is wholly deductible.
7. Did you incur expenditure on patent, trademark, design… etc.? If yes, the expenditure is wholly deductible.
8. Did you incur expenditure on research and development? If yes, the expenditure is wholly deductible.
9. Did you incur expenditure on technical education? If yes, the expenditure is wholly deductible.

10. Did you treat repairs expenditure as cost of improvement in the accounts? If yes, you should claim full deduction of the expenditure in the tax computation.
11. Did you incur expenditure on refurbishment? If yes, such expenditure is fully deductible over 5 years of assessment.
12. Have you claimed depreciation allowances for plant and machinery?
13. Have you claimed industrial building allowances?
14. Have you claimed commercial building allowances?
15. Have you excluded all non-taxable receipts from the assessable profits?
16. Suppose you are an individual taxpayer. Can personal assessment reduce your total tax liability?
17. Suppose your trading receipts have dropped recently. Have you applied for hold-over of provisional tax?
18. Suppose you run a factory in China. Have you excluded the profits of China factory from assessable profits?
19. Suppose you have paid China's FEIT. Have you claimed double taxation relief?
20. Suppose you have incurred losses previously or from other trades. Have the losses been fully set off the assessable profits?

3.1 Basic charge

Every person (including an individual, a partnership, a body of persons, a corporation) carrying on a trade, a business or a profession in Hong Kong is chargeable to Profits Tax. But caution: Not all his profits are taxable: For example, the profits earned from activities outside Hong Kong are not taxable. This exemption is known as "territorial taxation principle". Besides, profits of a capital nature are not taxable. These are the two major kinds of non-taxable profits. In fact, there are more kinds of non-taxable profits which are to be discussed later.

Let me first talk about the first kind of exempt profits --- profits not derived from or not arising in Hong Kong --- these profits are sometimes called profits without a Hong Kong source.

Under this exemption, if a chargeable person has only profits derived from activities outside Hong Kong, no profits tax liability will arise. If a person has profits derived from Hong Kong as well as profits derived from outside Hong Kong, then only the profits derived from Hong Kong will be assessable.

This exemption is irrespective of whether the person is a resident or non-resident of Hong Kong. But there are special rules applicable to non-residents. The special rules are discussed in paragraph 3.59.

Whether a trade, a business or a profession is carried on in Hong Kong is chiefly a question of facts --- there are a few court cases on this question.

Whether assessable profits are derived from Hong Kong is also largely a question of facts. There are a lot of court cases and indeed, from time to time, new cases are emerging on this issue. Before going into source of profits in details, let me first discuss who are charegable persons under profits tax.

3.2 Chargeable person

For profits tax, a chargeable person includes an individual, a partnership, a body of person, and a corporation.

In a few cases, a person carrying on a trade, an adventure of trade or a business claims that he should not be chargeable because he runs the business for someone else. To put such claims in legal terms, we say the person is claiming he is a trustee only and the chargeable person should be the “someone else” who is, in law, called the beneficial owner.

A beneficial owner of a trade or a business is undoubtedly chargeable to tax. But is a trustee chargeable to tax? There are two Board of Review cases on the question.

In D37/93, a nominee held certain assets which the beneficial owner used for trading. It was held that the trustee was not chargeable with respect to the trading profits and the chargeable person should be the beneficial owner.

In D98/99, the trustee was actively engaged in such trading activities as purchase, financing and sale of property. It was held that the trustee's activities constituted trading and so the profits derived by the trustee were taxable in his name. The Board rejected the taxpayer's argument that he was a trustee only and ruled that even if the taxpayer had been a “trustee”, he would have been a “trustee” carrying on an adventure of trade. The profits made out of the business adventure were in fact profits derived by him as trustee. So, the profits were assessable.

From these two cases, it seems that a trustee is not liable to Profits Tax in respect of the profits made by the beneficial owner. But the trustee is liable to pay tax on the profits made by him from carrying on the trade.

Special types of taxpayers

There are special provisions in the Inland Revenue Ordinance to tax the following types of businesses.

- Section 23: Life insurance companies
- Section 23A: Insurance companies other than life insurance companies
- Section 23AA: Mutual insurance corporations
- Section 23B: Ship-owners
- Section 23C: Resident aircraft-owners
- Section 23D: Non-resident aircraft-owners
- Section 24: Clubs and trade associations
- Section 15(1)(i): Financial institutions

3.3 What is a trade?

Section 2 of Inland Revenue Ordinance defines that "trade" <u>includes</u> every trade and manufacture, and every adventure and concern in the nature of trade. Because this definition uses the word “include”, it is obviously not a conclusive and exhaustive definition of “trade”. In fact, it does not give a test of what is a trade. Legally speaking, it expands the ordinary meaning of the word "trade" by inclusion of “every adventure in the nature of a trade” --- that means even one single transaction can constitute a trade if it falls within the meaning of “an adventure in the nature of a trade”. Perhaps, in commercial reality, a trade takes such a wide and open-ended variety of forms that it is virtually impossible to give a full definition for it.

Although there is no full definition of “trade” in statute law, it is widely and generally accepted in practice that trading consists of purchase and sale of goods, manufacturing, or provision of services. So, if you are engaged in any of these activities, you are certainly regarded as carrying on a trade and there will be no points to argue for the otherwise.

Gaming or gambling profits are generally not taxable because the game-players or the gamblers are not carrying on a trade. In the Board of Review case D55/87, an ex-amateur jockey who made substantial winnings from betting on horses was held that he had not carried on a business and therefore the profits were not assessable. In the Hong Kong tax case CIR versus Dr. Chang Liang Jen 1 HKTC 975, an economist speculator buying and selling shares in the stock market was also held as not carrying on a trade.

Simmons and Simmons v. IRC

In the UK court case Simmons and Simmons v. IRC, the judges’ comments on the word “trade” are noteworthy. They are quoted as follows:

"Trading requires an intention to trade; normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment?

Often, it is necessary to look at further questions such as: Whether a permanent investment may be sold in order to acquire another investment thought to be more satisfactory and whether that does not involve an operation of trade? Whether the first investment is sold at a profit or at a loss?

Intentions may be changed. What was first an investment may be put into the trading stock, and, I suppose, vice versa. If findings of this kind are to be made precision is required, since a shift of an asset from one category to another will involve changes in the company's accounts, and possibly, a liability to tax: see Sharkey v. Wernher [1956] AC 58."

The UK case Fry versus Burma Corporation Ltd. 15 TC 144 also made useful comments on "trading" which are quoted as follows: "Trade refers to the various activities of commerce – the winning and using the products of the earth, or multiplying the products on earth and selling them or manufacturing them and selling them, the purchase and sale of commodities, or the offering of services for a reward, such as conveyance and the like..."

Besides, in the UK case Griffiths versus J. P. Harrison (Watford) Ltd. 40 TC, this was said: "The word 'trade' is one of those common English words which do not lend themselves readily to definition, but which all of us think we understand well enough. We can recognize a trade when we see it, and also an adventure in the nature of trade. But we are hard pressed to define it."

Furthermore, the judge in the UK case Ransom versus Higgs 50 TC 1 said: "Trade is infinitely varied; so we often find applied to it the cliché that its categories are not closed. Of course they are not: but this does not mean that the concept of trade is without limits, so that any activity which yields an advantage, however indirect, can be brought within the net of tax … Trade cannot be precisely defined, but certain characteristics can be identified which trade normally has …"

Badges of trade

Badges of trade were first summarized by the Royal Commission on Taxation of Profits and Income in United Kingdom. In their report published in 1955 they identified six badges of trade: (1) the subject matter of the realization (2) the length of the period of ownership (3) the frequency or number of similar transactions (4) supplementary work in connection with the subject matter (5) the circumstances leading to the realization and (6) the motive.

Afterwards, the leading case on the issue was Marson v. Morton which concerned a one-off purchase and sale of land. The Revenue treated the gain as taxable trading profits. The judges ruled that based on the evidence there had been no trade and the land had been acquired for long term investment. The judgment was important because it summarized what were badges of trade as follows:

"The following list of "badges" was not comprehensive and no one pointer was decisive:

1. Was the transaction a one-off transaction? Lack of repetition indicated that it might not be trade.
2. Was the transaction related to the trade that the taxpayer ordinarily carried on?
3. The nature of the subject matter of the transaction might be a valuable pointer: was it matter of a kind generally traded with and could it readily be turned to account?
4. It might be helpful to look at the way in which the transaction was carried through.
5. What was the source of finance? If finance was borrowed that might be an indication to short-term resale and trading.
6. Was the item sold as it stood or was work done on it? If work was done, that again was a pointer to a transaction being a trading one.
7. Was the item purchased and resold in one lot or broken down into saleable parcels: if broken down that was a pointer to a trading transaction.

8. What was the purchaser's intention as to resale at the time of purchase? If he intended to hold an item indefinitely, albeit to make a profit at the end of the day, that pointed to investment and not to trade. If before the purchase a resale contract already existed that would be a strong pointer to the transaction being trade.
9. Did the purchase of the item provide the purchaser with any enjoyment or pride of possession or produce an income for him pending resale. If so that might show an intention to buy for personal satisfaction or investment rather than an intention to trade.

To reach a factual assessment of a case it was necessary to stand back and look at it as a whole and to ask ‘was this an adventure in the nature of trade? Put in more homely language ‘was the taxpayer investing his money or was he doing a deal?’ ”

Can "disposal of a property" constitute a trade?

In deciding whether the profit from disposal of a property is taxable, we have to ascertain what the vendor's intention towards the property at the time of acquisition was --- Was it acquired with an intention of resale? or was it acquired for use as a residence? or used as a long term investment? In deciding whether a trade existed or not, it is the intention of the vendor that matters. The intention of the buyer is irrelevant. Below are my quotations from some important cases.

Cunliffe v. Goodman

In this case, the judges said: "It is clear that the intention which must prove against the landlord is a definite intention. This intention may be revocable, but it must not be provisional. A purpose so qualified and suspended does not in my view amount to an 'intention' or 'decision' within the principle. It is mere contemplation until the materials necessary to a decision on the commercial merits are available and have resulted in such a decision. In the present case it seems to me that she never reached, in respect of the first scheme, a stage at which she could decide on its commercial merits; nor, in respect of the second scheme, the stage of actually deciding that scheme was commercially eligible unless indeed she must be taken not merely to have repudiated her architect's authority but to have decided that it was commercially ineligible. In the case of neither scheme did she form a settled intention to proceed. Neither project moved out of the zone of contemplation out of the sphere of the tentative, the provisional and the exploratory into the valley of decision."

All Best Wishes Limited v CIR

In this case, the judge said a mere declaration of intention was of limited value. A declaration made in the absence of supporting evidence is called “a bare assertion without proof”. The judge commented that subjective intention has to be tested against objective facts and circumstances. The intention must be genuinely held, realistic and realizable. It should be noted that this case is frequently quoted in a number of Board of Review cases concerning whether purchase and sale of a property are made with an intention to profit and hence they constitute a trade or an adventure in the nature of a trade.

The facts of this case are summarized as follows. The taxpayer participated in a joint venture with three other companies in a property development in Shatin. The construction cost was financed by a mortgage loan. Before the issue of occupation permit, two blocks of residential units were put to sale. One month after the issue of occupation permit, one block was specifically allocated to the taxpayer and then it was put to sale.

The other three companies accepted the sale of the two blocks was in the course of trading. However, the taxpayer argued that the block allocated was originally intended for capital investment and the sale was only triggered by its directors' emigration. The Board upheld the CIR's determination assessing the profit on the sale. The taxpayer appealed to the High Court and the appeal was dismissed.

In his judgment, the High Court judge said: “The intention of the taxpayer, at the time of acquisition, and at the time when he is holding the asset is undoubtedly of very great weight. And if the intention is on the evidence, genuinely held, realistic and realizable, and if all the circumstances show that at the time of the acquisition of the asset, the taxpayer was investing in it, then I agree. But as it is a question of fact, no single test can produce the answer. In particular, the stated intention of the taxpayer cannot be decisive and the actual intention can only be determined upon the whole of the evidence. Indeed, decisions upon a person's intention are commonplace in the law. It is probably the most litigated issue of all. It is trite to say that intention can only be judged by considering the whole of the surrounding circumstances, including things said and things done. Things said at the time, before and after, and things done at the time, before and after. Often it is rightly said that actions speak louder than words."

Stanwell Investments Ltd. versus CIR

This case concerns profits on sale of whether profits from sale of properties within a group of companies are assessable to Profits Tax. In late 1988, Lucky-Goldstar International (HK) Limited bought the 15th and 16th floors of a commercial building for about 143 million dollars. Then, the company used the 15th floor as its office and let out a substantial part of part of the 16th floor to Goldstar Electron (HK) Limited. In late 1990, Lucky-Goldstar sold the two floors to its ultimate holding company Stanwell Investments Limited for about 148 million dollars. The sale was not completed until November 1994. In March 1995, Stanwell sold the 16th floor to Goldstar for 212 million dollars. Profits Tax assessment was made on Standwell to assess the profit from the sale.

The Board upheld the Commissioner's determination of the assessment. The taxpayer appealed to the High Court. The taxpayer contended that the acquisition of the properties by Standwell was not for seeking profit, but as a result of re-shuffling of assets within the group and the properties were originally acquired by Lucky-Goldstar for own use and also for long term investment (that is for rental income). The court accepted the taxpayer's proposition and allowed the appeal.

Board of Review case D142/00

Two groups of companies (Group B and Group D) formed a joint venture to purchase and redevelop certain pieces of land. Company G was nominated by both groups as the joint-venture vehicle to purchase the land. Each group owned 50% of Company G. The taxpayer was a subsidiary of Group B. It held 50% of Company G through a company called Company H. After the property redevelopment, Group B sold all his beneficial interest in Company G to Group D through a series of transactions as follows.

The taxpayer bought a foreign empty-shell company (Company J) for US$1. Group B transferred its 50% interest in Company G into Company J.The taxpayer then sold Company J to Group D for $141,352,73.

The taxpayer was assessed to profits tax in respect of its sale of Company J. The case went to the Board. The taxpayer's arguments are two pronged and reproduced as follows:

(1) The taxpayer did not, in law, trade in the J Share. Nor was the purchase and sale of the J Share an adventure and concern in the nature of trade.
(2) Even if there was trading, no profit was earned because the increase in the value of Company J (through the allotment of new Company G shares and transfer of one subscriber share of Company G to Company J) should be deducted in computing the taxable profit. The second part of Taxpayer's submission relied on Sharkey v Wernher (1956) AC 58. The Taxpayer argued that this case established the principle that the existing value of an investment has to be deducted in computing any taxable trading profit. This part of the argument was presented in two alternative forms: (a) There should be deducted from the assessable profit (earned in the disposal of Company J) the value of the 'gift' (of the 50% shareholding in Company G) given to Company J which substantially increased Company J's value. The value of this gift was exactly the consideration paid for the transfer of the J Share. Hence there was no profit. (b) The J Share was incapable of being traded or sold until it was made valuable by, essentially, the injection of the new Company G share allotments. The 'trade'

could not have commenced until Company J held the 50% in Company G and, at this point, the market value of Company J should be increased (reflecting the addition of the Company G shares to Company J's asset). Therefore at the time Company J became tradable, its increased value (the consideration paid for the transfer of the J Share) must be the starting point in the calculation of assessable profits. When the J Share was sold at that consideration, there was no profit.

The Board held that the profit was taxable on the following rulings:

Company J was acquired and used by Group B with the intention, at the time of acquisition, to dispose of it to Company C.

The acquisition and sale of Company J was trade under section 14 of the IRO, after considering the various badges of trade/indicia and all the facts of the case. Any surplus realized was subject to profits tax.

As to whether there was any taxable profit from the trade, the Sharkey v Wernher principle had only been applied by the Revenue in the past in 'change of intention' situations, but none existed in this case.

If the taxpayer's appeal were to succeed, Sharkey v Wernher would have to be applied in the reverse, but there was no legal basis to apply it in this way. Sharkey v Wernher did not apply in the present case or generally: CIR v Quitsubdue (1999) 3 HKC 233 applied.

The intention to trade must be carried out by actions

Intention must be able to be carried out. In the Board of Review case D11/80, this was said: "Intention' connotes an ability to carry it into effect. It is idle to speak of 'intention' if the person so intending did not have the means to bring it about or had made no arrangements or taken any steps to enable such intention to be implemented." Therefore, if the taxpayer does not have the ability financially to hold the property on a long term basis, the asset was probably not acquired as an investment.

A property originally purchased by a person as an investment could be changed into a trading stock as a result of a change in that person's intention or actions made to the property. Likewise, a trading stock can be changed into an investment with the same theory. But, most important of all, there must be clear and concrete evidence to prove that there is a change of intention.

The intention to make profit is only one of the Badges of Trade, although that is a very important badge in case there is only one single disposal of property. Indeed, the absence of a profit-seeking motive does not necessarily make the profit not taxable, especially where there are a lot of similar activities. If a non-profit-making institution wishes to seek exemption from tax, it should apply for a broad-brush exemption from the Charitable Donations Section of the Inland Revenue Department.

In my IRD experience, the question of whether the profit from the sale of a property is taxable depends very much on the taxpayer's ability to adduce sufficient evidence or to call witness to prove that the acquisition of the property is not for resale, but for self-use or capital investment. In fact, the Board's decisions on this issue are not always consistent even on similar facts. In some cases, the Board believes the taxpayer's submissions while in other cases, it believes not. For your reference, I append below a list of cases in which the Board accepted the taxpayer's claim that the property had not been acquired for sale for profit.

Self-residence: D64/87, D49/89, D23/92, D17/95, D18/95, D77/96, D100/96, D102/96, D16/97, D61/97, D63/98, D65/98, D108/98, D119/98, D96/99, D106/99, D119/99, D124/99, D15/00, D60/00, D111/00, D76/01, D8/90, D3/92, D8/95, D6/97, D8/98, D12/98, D97/02

Rental income: D24/95, D59/97

Long term investment: D26/02

You see: The purpose most acceptable by the Board is for "self-residence" use. So, take this advice: Don't hurry for a quick sale if you want the gain to be non-taxable. And do live in the property for some time before you sell it. That may save you from a tax dispute.

Can the loss on sale of property be tax deductible?

As a taxpayer can be taxed on profit on disposal of property because he carried on a trade of property dealing, he can, on the grounds of trading, claim loss on sale of property.

A taxpayer suffering from loss on sale (or diminution in market value) of property can argue that the loss (or diminution in market value) is a trading loss so that it can be tax deductible. Besides, an individual taxpayer can claim his trading loss to set off his total income under Personal Assessment. In my IRD experience, the question of whether or not the loss (or diminution in market value) is deductible depends on the taxpayer's ability to adduce sufficient evidence or to call witness to prove that the acquisition of the property is for resale, rather than for self-use or capital investment. In some cases, the IRD or the Board accepts the taxpayer's claim. To support your argument, you may refer IRD to the judgments in Board of Review cases D63/01, D117/01 and D70/02. Below are the factors usually considered by IRD when dealing with loss claimed on property dealing.

The basic principle
Whether a person is carrying on a trade of property dealing is a question of fact. The claimed intention of property trading is test checked with the facts, the reasons and the circumstances in that case.

The intention to trade
The IRD usually takes the view that if a taxpayer intends to commence a trade, the first thing he will do is to take out a business registration certificate. Without the registration, the IRD

may challenge that the taxpayer's claimed intention is just saying and not substantiated by actions. But take this advice: From case law, the absence of a business registration does not by itself fail the taxpayer's claim --- in fact, having a business registration or not is never a conclusive or decisive factor in deciding the question. So, don't give up your claim too early just on this point when you still have a strong case on other points.

Number of similar transactions
The IRD usually checks with its computer database and the Land Registry to see if any property sales took place in the past. If profits of previous sales have been assessed, then the claimed loss will likely to be accepted. But heed my advice: Don't give up your claim too early just on this point when you still have a strong case on other points.

The length of ownership
The shorter the period, the stronger the case you can argue for property trading

Whether borrowing is used for purchase of the property?
The use of borrowing, especially short-term loans, to finance the purchase of the property is a very strong point to argue for trading. In general, the shorter the borrowing period, the more forcible to argue for intention to hold the property on short-term as well as for sale and to rebut the IRD’s claim that it is a long term investment.

The use of the property
If the property is vacant from purchase to sale, then the taxpayer will have a strong point to argue for trading.

Whether the property is used as taxpayer's correspondence address?
If the property has been used as a correspondence address, the IRD will argue that it is kept for long-term investment purpose,

and not for trading. So, beware when you complete the tax return.

Whether home loan interest has been claimed on the property?

If the taxpayer claims home loan interest for the property, the IRD will argue that the property was not purchased for trading, but for residential purpose.

How the property is put to sale?

If actions have been made to sell the property, for example putting up newspaper advertisements, appointment of estate agents… etc, you will have a good point to argue for trading. So, don't forget to put forward this point.

Author's comments

Maybe, you ask: "I have only salaries income and so I can only get salaries tax assessments. During the year of assessment, I bought a flat with a view to selling it shortly at a profit. I borrowed short-term loans to pay the down-payment. I did not reside in the flat. I put up advertisements in newspapers for the sale shortly after I signed the Sale and Purchase Agreement. Because of the sudden change in market conditions and the lack of fund to repay the short-term loans, I sold the flat within 3 months of the purchase at a loss. Can I claim the loss to set-off my salaries income and if yes, how?"

My answer: "You have a strong case to claim for the loss set-off. To make the claim, you should, in your tax return, elect for Personal Assessment and ask for the loss set-off. If the IRD does not accept your claim, then you should insist for a compulsory Personal Assessment (even it is without the loss set-off) so that you can raise an objection to it under Section 64 of IRO to pursue your claim."

Can "sale of inherited property" constitute a trade?

As a matter of law principle, sale of inherited property by the owner will not normally be regarded as trading. Instead, it is a realization of the assets devolved on the owner from his ancestors. In other words, the profit derived should not be assessable.

Hudson's Bay Co. versus Stevens

In the case Hudson's Bay Co. versus Stevens 5 TC 424, a company set up by royal charter was engaged in fur trading. It acquired a lot of lands in Canada through its charter, and as a result of later negotiations, the company developed and sold the lands over a number of years. The court held that the sale had not amounted to trading in property --- the company had been doing no more than an ordinary land owner who had sold portions of an estate devolved from his ancestors.

However, if substantial development has been made to the inherited property, the property can be changed to a trading stock. In the case Pilkington versus Randall 42 TC 622, the appellant (who was also a trustee) and his sister were beneficial owners of a land held by a trust devised by their deceased father. The trustees obtained planning permission, built roads and sold the land in plots in the early years. Then, his sister wanted to sell the land faster so that she could get her proceeds from the estate early. Then, the appellant bought his sister's beneficial interest. He continued to build roads and install drains with a view to selling the land at higher prices. Furthermore, he put advertisements in the press. The judges rejected the appellant's contention the appellant was merely realizing an estate of his deceased father --- and he ruled that when the appellant purchased his sister's beneficial interest, he commenced a trade as a property developer.

Change of capital asset into trading stock

What constitutes a change of intention depends on the merits of each case. If a capital asset is redeveloped for sale, the value of the asset as at the change of intention will be the cost of the developed property.

Board of Review cases No. D41/91 and D47/91

In the case D41/91, a flat was sold by a company to its director. In another case D47/91, a property was sold by a company to its associated company. In these two cases, the Commissioner sought to tax a notional gain arising from the estimated market value of the property at the sale, based on the famous law principles established in the cases Sharkey v. Wernher 36 TC 275 and Petrotim Securities Ltd v. Ayres 41 TC 389. The IRD attempted to use estimated market values to substitute the actual considerations of the relevant transactions --- on the grounds that the parties were closely connected so that the actual considerations do not reflect the true market selling prices. The CIR's determinations were rejected by the Board of Review. It was held that there had been no room for the application of the Sharkey-Petrotim principle to Hong Kong tax law because the Inland Revenue Ordinance had already contained anti-avoidance provisions, such as Section 61A.

To sum up, when deciding whether the profit from disposal of a property is a taxable trading profit or a non-taxable capital gain, we have to ascertain what the vendor's intention towards the property at the time of acquisition was --- that is to say, whether the property acquired with an intention of resale? or was it acquired as a long term investment? Where the property is inherited, the question to ask is whether the inherited property has been changed into a trading commodity by the vendor's activities leading to the sale of the property.

Change of intention to trade

As said before, the "intention" of the vendor at the purchase is the most important factor in property dealing cases. However, in reality, people's minds change from time to time and so does the intention of holding a property. As said above, a capital asset can be changed into a trading commodity --- and in such case, the change is the result of a change in vendor's intention from holding the property to proactively selling the property which is evidenced by the vendor's activities leading to the sale of the property. Below is a Hong Kong tax case on change of intention to trade.

Hong Kong Oxygen & Acetylene Company Limited v CIR
HCIA2/2000

The taxpayer received two sums of $90,000,000 each in 1993/94 and 1994/95 respectively. It argued that they were capital receipts and therefore not taxable. The Board of Review found that the sums were paid by a property developer under an agreement to redevelop certain land owned by the taxpayer for sale as residential units. The land had been held by the taxpayer as a fixed asset. CIR contended that at the time when the taxpayer decided to redevelop the land, the land was changed into a trading stock; therefore, the two sums were received in respect of trading stock and as such, they were revenue receipts and taxable. The Board confirmed the CIR's determination. The taxpayer appealed to the court and the appeal was dismissed. The court said the question of law formulated in the case would not permit the taxpayer to challenge the Board's findings of facts and the question as to whether a receipt is of revenue or capital nature depends on the facts of each case. Author's comment: The court seemed to say that because there was no question of law in this case, the Board's finding of facts was final and so, the case should not be referred to the court for judgment.

Let us read the following U.K. tax case on change of intention.

Lionel Simmons Properties Ltd v CIR

In this case, the judge said: "Trading requires an intention to trade: normally the question to be asked is whether this intention existed at the time of the acquisition of the asset. Was it acquired with the intention of disposing of it at a profit, or was it acquired as a permanent investment? Often it is necessary to ask further questions: a permanent investment may be sold in order to acquire another investment thought to be more satisfactory; that does not involve an operation of trade, whether the first investment is sold at a profit or at a loss. Intentions may be changed. What was first an investment may be put into the trading stock – and, I suppose, vice versa. If findings of this kind are to be made precision is required, since a shift of an asset from one category to another will involve changes in the company's accounts, and possibly, a liability of tax (cf Sharkey v Wernher [1956] AC 58). What I think is not possible is for an asset to be both trading stock and permanent investment at the same time, nor to possess an indeterminate status – neither trading stock nor permanent asset. It must be one or other, even though, and this seems to me legitimate and intelligible, the company, in whatever character it acquires the asset, may reserve an intention to change its character. To do so would, in fact, amount to little more than making explicit what is necessarily implicit in all commercial operations, namely that situations are open to review."

The Sharkey and Petrotim principle

The principle is sometimes used by IRD to combat tax avoidance schemes involving the transactions of the same parties (where Sharkey principle applies) or the transactions between related parties (where Petrotim principle applies). Such transactions are called non-arm-length transactions. The following is my précis of the two cases.

Sharkey v. Wernher

The taxpayer carried on both the running of a stud farm and that of racing stables. The profits of the stud farm were taxable, whereas those from the racing stables were not. She transferred some horses from her stud farm to her racing stables. It is important to note that the taxpayer accepted that some amount must be credited in the accounts of the stud farm in respect of the transfer, and the only question before the House of Lords was whether that amount should be the cost of rearing the horses or their market value. It was decided that the person who disposes of part of his stock-in-trade not by way of sale in the course of trade, but for his own use, enjoyment, or recreation, must bring into his trading account for income tax purposes the market value of that stock-in-trade at the time of such disposition. It was also held that the decision could be applied vice versa. In other words, if capital assets are converted into trading stock, the market value of the assets at the time of conversion should be used as the price for determining the taxable profit on the sale.

Petrotim Securities Ltd v. Ayres

The taxpayer sold certain securities to an associated company for less than the market value. It was held that the sale was not bona fide sale and hence, the estimated market value must be taken for tax purpose.

Can Sharkey-Petrotim principle apply in Hong Kong?

There is a court case on this question:

CIR v. Quitsubdue Limited (1999) 5 HKTC 13.

In this case, the company bought all units in two buildings and then redeveloped them into a new commercial building. The company's shares changed hands twice in 1987. The Revenue assessed the company with respect to the surplus of then market value over the cost of the properties based on legal principle of Sharkey v Wernher.

The taxpayer appealed to the Board. It was held that the taxpayer had acquired the properties as trading stock and that there was change of intention in 1987. But the Board ruled that the Sharkey principle was inapplicable in the circumstances of the case. CIR appealed to the Court of First Instance. The court dismissed the Revenue's appeal. It was held that based on the evidence of that case the intention of the taxpayer had always been to hold the properties as a capital investment.

The judge said: "(a) the principle in Sharkey v. Wernher did not apply whether generally or in the circumstances of the case; (b) the indisputable principle is that a person cannot trade with himself. If he cannot trade with himself, it must follow that he cannot make a profit out of trading with himself. The charge under section 14 of the Inland Revenue Ordinance is a charge on real profit. So, it follows that a person cannot be charged with profits on 'self-trade' as it does not exist; (c) when a self-supplier supplies himself with a commodity, he is not trading with himself - he is withdrawing that commodity from his stock-in-trade. If he chooses to do that, he should correspondingly pay back whatever he deducted from his trading account as the expenses for that commodity."

The judge in the obiter commented on the question of whether the principle of Sharkey v Wernher was applicable to Hong Kong tax. He said because section 14 of our IRO was a charge only on real profit, a person could not be charged with profits tax on 'self-trade' as no profit actually existed. He went on to say that the situation in Sharkey v Wernher was that a person appropriated her own trading stock; but under Hong Kong tax law, a trader could not be taxed on a notional profit when he only appropriated his stock.

Author's comments

The above judgment has cast serious doubts on application of the so-called Sharkey - Petrotim principle to Hong Kong tax. Maybe, the Revenue will put forward this principle in another case when the tax involved is huge. In most cases, the Revenue is inclined to invoke section 61A, instead of the Sharkey principle, to make an assessment on the profits concerned when tax avoidance is apparent.

3.4 What is a business?

Business is defined in Section 2 of Inland Revenue Ordinance as including farming, poultry and pig rearing, letting of any premises by a corporation, and sub-letting by any other person. Of course, Section 2 is only an "inclusive" definition: It does not define exactly "what is business" for tax purpose.

Apart from above, there are no more definitions on "business" in the Ordinance. So, in that case, we have to look to the Literal Rule of interpretation under common law as well as to court cases to find out more about the meaning of business. The following is my summary of some relevant cases.

Lam Woo Shang versus CIR

In this case, the letting of a number of furnished properties by an individual was held to be running of a business. After the court decision, the relevant laws were amended so that a person, other than a corporation, received rental income from the property owned by him shall be liable to Property Tax, even though the profits can also be liable to Profits Tax.

Although the court's decision on letting income from furnished properties to be chargeable under Profits Tax has become stale after the law amendment, this case is still important because its comments on the meaning of "business" --- which was said to be “anything which occupies time, attention and labor of men”. Furthermore, in the judgment, the judges quoted from a UK tax case Smith versus Anderson this: “Business itself is a word of large and indefinite import. It is a word of extensive use and indefinite signification.”

The IRD’s perspective

In the IRD's perspective, a business is usually also a trade or an adventure in the nature of trade. In fact a business or a trade is taxed on same basis. Therefore, as far as taxation is concerned, if we can establish there is a trade or an adventure in the nature of trade, there will be no practical importance to consider whether it is also a business.

Author’s comments

The rental income received by a corporation is normally subject to Profits Tax. If a corporation has paid Property Tax, he can apply for setting off the Property Tax paid against its own Profits Tax liability. If a person receives letting income from a property not owned by him (for example he let out a property which he rents from a landlord), the rental income will be chargeable under

Profits Tax.

3.5 What is a profession?

This question seldom gives rise to dispute because most professionals are keen to be recognized as such. Generally speaking, professionals are members of a professional society such as accountants, doctors and lawyers.

I.R.C. versus Maxse

The question of profession was expounded in the U.K. case I.R.C. versus Maxse 12 TC 4 as follows: “What is a profession? I am reluctantly finally to propound a comprehensive definition. A set of facts not present to the mind of the judicial propounder, and not raised on the case before him, may immediately arise to confound his proposition. But it seems to me as at present advised that a profession in the present use of language involves the idea of an occupation requiring either purely intellectual skill, or of manual skill controlled, as in painting and sculpture, or surgery, by the intellectual skill of the operation, as distinguished from an occupation which is substantially the production or sale or arrangements for the production or sale of commodities. The line of demarcation may vary from time to time. The word “profession” used to be confined to the three learned professions, the Church, Medicine and Law. It has now, I think, a wider meaning. It appears to me clear that a journalist whose contributions have any literary form, as distinguished from a reporter, exercises a profession; and that the editor of a periodical comes in the same category. It seems to me equally clear that the proprietor of a newspaper or periodical, controlling the printing, publishing and advertising, but not responsible for the selection of the literary or artistic contents, does not exercise a “profession” but a trade or business other than a profession.”

Author’s comments
As far as profits tax is concerned, the distinction between a profession and a trade or a business is unimportant. This is because they all are liable to tax on like basis.

3.6 Whether a business is carried on in Hong Kong?

This question applies also to a trade or a profession. Although the discussion below refers to a business explicitly, it also applies to a trade or a profession.

Once we have established that there is a business, the next question is: Is it carried on in Hong Kong? If no, then no profits tax is payable.

Trading with Hong Kong should be distinguished from trading in Hong Kong --- see UK court case Grainger & Son versus Gough 3 T.C. 467. The former (trading with Hong Kong) does not give rise to any profits tax liability; but the latter (trading in Hong Kong) does.

Setting up a buying office in Hong Kong does not by itself make it chargeable to profits tax. For example, some foreign supermarkets may send purchasing officers to Hong Kong to buy goods --- Generally speaking, this is no trading in Hong Kong. But if a permanent establishment is set up in Hong Kong to buy and sell goods, the permanent establishment will make the foreign company liable to pay profits tax.

What is a permanent establishment?

Permanent establishment is defined in Inland Revenue Rule 5 as: "a branch, management or other place of business, but does not include an agency unless the agent has, and habitually exercises a general authority to negotiate and conclude contracts on behalf of his principal or has a stock of merchandise from which he regularly fills orders on his behalf." In short, a permanent establishment is a fixed place of business of a permanent nature.

Whether a business is carried on in Hong Kong is largely a question of facts. In general, we look to the identifiable business operations carried on in Hong Kong, for example manufacturing, property development, provision of services… etc. However, if there are only minimal activities or the operations are carried out in different places including Hong Kong, we should look to location of the effective control of the business --- that is: Where is the brain?

In the case San Paulo Brazilian Railway Co. Ltd. versus Carter 3 T.C. 407, the court decided that the business was carried on in UK because UK was the place where the directors exercised their control and direction, even though the railway was located in Brazil.

In the case Malayan Shipping Co. Ltd. versus FCT 34 ALTR, this was said: "Where the brain which controls the operations from which the profits arise is in Australia the business is, at any rate partly, carried on in Australia."

Again, the question is largely a totality of facts, taking into account such factors as location of capital, employment of staff, location of activities... etc. --- see the case The Egytian Hotels Ltd. versus Mitchell 6 T.C. 542.

An agent may be regarded as trading in Hong Kong if he accepts orders and binds his principal generally. But if he only solicits orders which are passed to the oversea principal for acceptance, he will not be regarded as trading in Hong Kong.

When a person is carrying on a trade or business in Hong Kong, only his profits arising in or derived from Hong Kong is chargeable to profits tax. Those profits not arising in or derived from Hong Kong are not taxable.

According to IRD's booklet on "The Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation", the following activities will not be regarded as a permanent establishment:

1. A place for storage, display or delivery of goods only;
2. A place for maintenance of goods only;

3. A place for maintenance of goods to be processed by another enterprise;
4. A place for purchasing or advertising goods or for collecting information for the enterprise;
5. A place for carrying on an activity of a preparatory or auxiliary character for the enterprise;
6. A place for any combination of the above activities which is of a preparatory or auxiliary character for the enterprise.

A "representative office" in Hong Kong is not regarded as a permanent establishment on the following conditions:
1. the activities are for the enterprise itself;
2. the activities do not directly generate profits; and
3. the functions of the representative office are only of a supportive nature.

The assessable profits of a non-resident carrying on a business with a permanent establishment in Hong Kong, if the Hong Kong accounts cannot reflect the true profits derived from Hong Kong, are determined in accordance with Inland Revenue Rule 5. For details, see paragraph 3.59 below.

3.7 Assessable profit

What is assessable profit? This question hinges on two points: first, there is a profit, and second, the profit is assessable.

The Inland Revenue Ordinance does not define “profit”. In fact, there are a number tax cases, particularly in the U.K., on this question. In business practice, profit means the net accounting profit, or the net gain, or the surplus of incomes over expenses. It follows that profit concerns determining incomes and expenses.

The second point is: What profits are assessable? As established from tax cases, assessable profits are the accounting profits determined in accordance with generally accepted accounting principles (GAAP) as adjusted to conform with the provisions of Inland Revenue Ordinance. See CIR v Secan Limited & Ranon

Limited.

Then, what are accounting profits? Or put it more precisely: What are accounting profits in accordance with GAAPs? That is, indeed, a huge topic and there are a lot of accounting textbooks on the question. Besides, the Hong Kong Institute of Certified Public Accountants has from time to time issued Hong Kong Accounting Standards to standardize the accounting treatments of various topics of importance. Among these principles and practices, the following principles are of fundamental importance and have all along been adopted for tax purpose.

Going concern principle
When preparing the business accounts, we assume that the business will go on in the foreseeable future.

Accrual or matching principle
Expenses incurred but not yet paid for should be taken into account when computing profits. Likewise, the expenses paid for future accounting periods should be carried forward to match the related future revenue and hence they are not deductible when computing the current-year profits.

The basic principle
Incomes or gains of a revenue nature are included in the Profit and Loss Account and hence taxable.

Accounting Standards

All published accounts of listed companies follow the Hong Kong Accounting Standards (HKAS). In fact, the HKAS follows substantially the International Accounting Standards (IAS). These accounting standards are the base of the generally accepted accounting principles in Hong Kong.

Since the judges of the Final Court of Appeal in the Secan case ruled that the accounting profits in the Profit and Loss Account as determined in generally accepted accounting principles must be adopted for tax purpose (unless there are specific provisions laid down in the Inland Revenue Ordinance), the computation of Hong Kong taxable profits is generally in line with the international accounting practice. This is of course good news to most foreign investors coming to do business in Hong Kong because they now find our tax system predictable and comprehensible. But this court ruling may not always be welcome by businessmen, particularly who previously made use of the difference between the various accounting practices or tax treatments to reduce tax.

In practice, to most lay business people on the streets, the Hong Kong Accounting Standards and the International Accounting Standards are too difficult to fully understand. Fortunately, these accounting standards concern mainly the very large limited companies which are rich enough to hire professional tax advisors. For the lay businessmen (i.e. the small-to-medium sized enterprises), in view of their relatively simple nature and small size of business, they need not bother these accounting standards much. Anyway, if you have questions about accounting standards, I suggest you consult a professional accountant.

General accounting practices

The following practices are well known to accountants. They are also applicable to tax computation unless there are specific treatments made under the IRO or tax cases.

- Incomes or gains of a capital nature are credited to capital reserves and hence not taxable.
- Expenses or losses of a revenue nature are recognized in the Profit and Loss Account and hence deductible.
- Expenses or losses of a capital nature, even though they may in some cases be deductible in computing accounting profits, are not tax deductible --- and if they have been charged to Profit and Loss Account, they will be added back in computing the assessable profits.

Naturally, taxpayers are inclined to claim more incomes to be capital in nature (non-taxable); and the Revenue will treat more losses of a capital nature (non-deductible).

3.8 Only profits with a Hong Kong source taxable

Section 14 of IRO lays down the basic charge of profits tax: All profits having a Hong Kong source generated from a trade, profession or business in Hong Kong are taxable. In law, a profit having a Hong Kong source means it is arising in or derived from Hong Kong. Furthermore, Section 2(1) adds to say this: All profits from business transacted in Hong Kong, whether directly or through an agent, are deemed to be profits arising in or derived from Hong Kong.

Indeed, source of profit is a frequent issue in profits tax. In fact, this is chiefly a question of facts although the question must be decided in accordance with the principles laid down in tax cases. To put it in another way, it is also a question of how to draw conclusion from the facts of the case in question based on the principles, reasoning and propositions as developed by the judges in the tax cases from time to time.

The question concerning source of profit is a big topic of taxation for big companies which are engaged in activities across the border of Hong Kong. But for those companies operating in Hong Kong only, the source question is not a popular issue as the Revenue is inclined to assess the whole profits and will not allow offshore claim except in rare cases.

There are many tax cases on the issue of source of profits. The first case I want to say is CIR versus Euro Tech (Far East) Ltd. In this case, it was held that the crucial point in determining source of profit was: What and where the taxpayer did to earn the profit? It was said that profit could arise in Hong Kong even though the activities in Hong Kong were minimal or they just comprised administrative work. So, beware, when there is a permanent place of business in Hong Kong, the IRD will attempt to assess the whole profits and if the taxpayer wants to claim certain profits are offshore, he has to supply evidence to prove his claim.

Before dwelling on the law and practice in detail, I would like you to understand that this topic is sometimes quite controversial and there is no one single hard and fast rule applicable to every case. Different professionals, including judges, lawyers, tax practitioners and even IRD officers may draw different conclusions from facts of the same case. There are of course a number of general rules developed from case law. My general advice for a common taxpayer, in this respect, is: Do follow as far as possible the general rules. This is because any disputes going beyond these general rules may not be accepted by the Revenue and if the case goes to the court, it can be very costly, troublesome and time-consuming. Below is a summary of the general rules.

(1) "Arising in" and "derived from" have the same meaning - see CIR v. Hong Kong & Whampoa Dock Co. Ltd and CIR v. International Wood Products Ltd.
(2) Source of profit is a practical, hard matter of fact - see CIR v. Hong Kong & Whampoa Dock Co. Ltd and CIR v. International Wood Products Ltd.
(3) The fundamental principle is to look to what the taxpayer has done to earn the profit in question and where he has done it - see CIR v. Hang Seng Bank Ltd.
(4) The basic approach is to ascertain what are the operations that gave rise to the profit and where are they - see CIR v. HK-TVB International Ltd.
(5) The crucial concern is the gross profits derived from the relevant transactions - see CIR v. Hang Seng Bank Ltd.
(6) Where gross profit from a transaction takes place in various locations, it may be apportioned between inside Hong Kong and outside Hong Kong - see CIR v Emerson Radio Corporation.
(7) Where the profit is inseparable, the locality should be determined by the acts that are more immediately

responsible for it - see Bank of India v. CIR.

(8) The absence of an overseas permanent establishment does not always make all the profits of a Hong Kong business arising in or derived from Hong Kong - see CIR v. HK-TVB International Ltd (My comment: The Revenue only accept this as a rare case)

(9) The location of the day-to-day decisions does not by itself determine the locality of profit - see CIT v. Chunilal B. Mehta of Bombay [1938].

Below are some important tax cases:

CIR v The Hong Kong Whampoa Dock Co. Ltd.

This case concerns the profit derived by a Hong Kong ship-building company from a ship-salvage operation performed in waters outside Hong Kong's boundary. The company argued that because the operation was done outside Hong Kong, the profit was not taxable. The Board allowed the company's appeal. CIR appealed to the court. The court upheld the Board's decision and held that the payment of services is of no importance in deciding the issue and because almost the entire services performed, which gave rise to the profits, were performed outside Hong Kong, the profit did not arise in or derive from Hong Kong.

CIR v Euro Tech (Far East) Ltd.

The taxpayer was incorporated in Hong Kong. It was a subsidiary of a UK public company. Its business comprised of marketing and trading of electronic equipments. The equipments were bought from the UK parent company as well as from within the group companies. It entered into a distributorship agreement with a Korean company and a Singaporean company. Having received orders from these two companies, the taxpayer sent orders to its UK parent or group companies. Then, the equipments were shipped directly from UK to the two companies. The profit earned by the taxpayer was assessed to Profits Tax. The taxpayer appealed to the Board who allowed the appeal. Then, CIR appealed to the High Court and got the Board's decision reversed. The court ruled that it was the bridging operations done by the taxpayer between the UK companies and the two overseas buyer companies in Hong Kong that gave rise to the profit. The court said: "If a taxpayer has a principal place of business in Hong Kong, it is likely that it is in Hong Kong that he earns his profits. It will be difficult for such taxpayer to demonstrate that the profits were earned outside Hong Kong and therefore not chargeable to tax."

CIR v International Wood Products Ltd.

The company acted as agent for two overseas principals for sale of logs. It appointed sub-agents outside Hong Kong for the sale. Orders and payments were sent directly to its principals. The company received commission and passed on sub-commission to the sub-agents. Profits Tax assessments were raised to assess the amount retained by the company. The Board annulled the assessments because the work giving rise to the commission was found outside Hong Kong. This decision was upheld by the court saying that the source of the commission income was the place where the services were rendered to earn the income and the source in the case was outside Hong Kong --- the services done by the sub-agents outside Hong Kong --- even though the company did some ancillary services in Hong Kong.

CIR v Karsten Larssen & Co. (H. K.) Ltd.

The case also concerned commission involving overseas services but the commission was held to be taxable. In the case, the commission was earned by a ship broker for seeking charterers and concluding charter agreements. Although some services were carried out overseas by an agent appointed by the taxpayer, the profit retained by the Hong Kong company was held to be derived from Hong Kong --- based on the fact that there was an agreement identifying the taxpayer and the overseas agent and their share of the commission.

Sinolink Overseas Ltd. v CIR

The company bought plywood for sale in Hong Kong and mainland China. The company did not have an office in China but had one in Wanchai. Its sales to China were concluded in China by a director who had full power to sign contract on behalf of the company. After conclusion of the sales, the company sent purchase orders to overseas manufacturers. The company argued that it had carried on two businesses: one in Hong Kong and the other in China. Both arguments were rejected by the court. Applying the operations test, the judge Hunter J ruled that it was the activities of the Hong Kong office that produced the profits. The reasoning is as follows: (1)The setting for business and the logistics for the purchase and sale were all done in Hong Kong. (2)The purchases were managed and arranged in Hong Kong. (3)The China sales were concluded in China. But the company's profits should be regarded as from both the purchase and sale. This factor could not alone make the profit from China sales non-taxable. (4) The post-contract activities and management work were done in Hong Kong. On a totality of the above factors, the judge concluded that all the profits --- whether from Hong Kong sales or China sales --- were taxable. The decision in Sinolink case is controversial. Its importance has been falling, especially after the recent case CIR v. Magna Industrial Company Ltd.

CIR v. HK-TVB International Ltd.

The taxpayer (hereinafter called TVBI) carried on the business of licensing films that had been produced by its parent company HK-TVB Ltd (hereinafter called TVB). Pursuant to agreements between the taxpayer and TVB, the taxpayer was granted the exclusive right to broadcast and export TVB's television films and programs outside Hong Kong and to grant sub-licenses to others. The negotiations between the taxpayer and its customers usually took place outside Hong Kong. The business contracts signed by the overseas customers were sent to the taxpayer in Hong Kong for conclusion. The taxpayer objected to the profits tax assessment on the grounds that the profits were outside Hong Kong. The Board agreed to the taxpayer's arguments. The case finally went to Privy Council. It was held that the profits were assessable because the operations producing the profits --- the acquisition of the exclusive rights of granting sub-licenses together with the relevant films and the grant of those sub-licenses together with the provision of the film by contracts with individual customers --- were carried out in Hong Kong.

CIR v Emerson Radio Corporation

The taxpayer is an American corporation manufacturing and selling electronic equipments. It was the registered owner of a trade mark “E”. It had a wholly owned subsidiary in Hong Kong. The Hong Kong subsidiary contracted with manufacturers in various Asian countries, including Hong Kong, for the manufacture of electronic equipment to be sold mainly in US. No goods were sold in Hong Kong. Profits tax was paid by the Hong Kong subsidiary in respect of its trading profits arising from its course of business in Hong Kong. The Hong Kong subsidiary had entered into a royalty agreement with the taxpayer under which the Hong Kong subsidiary was allowed to use the trade mark on goods sold by the Hong Kong subsidiary to the US. CIR assessed the taxpayer to profits tax on its royalty income under Section 15(1)(b). The taxpayer appealed to the Board on the grounds that the trade mark was not used in Hong Kong. The Board dismissed the taxpayer's appeal and ruled that the royalty income was indivisible sum --- it could not be apportioned between goods manufactured in Hong Kong and goods manufactured outside Hong Kong. The taxpayer appealed to Court of First Instance. It was held that only the royalty income attributable to the goods manufactured in Hong Kong is taxable and the income attributable to the goods manufactured outside Hong Kong is not taxable. Therefore, apportionment of income could be made. The ruling of the Court of First Instance was upheld by the Court of Final Appeal.

Bank of India v CIR

The Bank was carrying on business in Hong Kong and was active in trade financing through discounting of foreign bills. The bills originated from international trade. The drawers of the bills, companies of Hong Kong, were suppliers of goods. The drawees were importers of goods residing outside Hong Kong. The Bank was the payee. On application of the customers, the Bank discounted the bills and paid the proceeds to the customers in Hong Kong while the collection of the value of the bills on maturity was performed overseas by the Bank's agent. The Bank made profits from the difference between the costs of the bills and proceeds on the maturity of the bills. The profits were assessed to Profits Tax. The Bank appealed to the Board who decided in favor of CIR. The Bank appealed to the High Court. CIR won. It was held that the operations from which the profits arose took place in Hong Kong.

Board of Review case D14/96

The company was a travel agent selling outbound tours through its retail outlets in Hong Kong. It claimed that the outbound tour income should not be assessable because such income arose mainly from activities outside Hong Kong. The Revenue disallowed the claim and the company appealed to the Board of Review. The Revenue contended that the income was derived from the buying and selling of tour packages and all such activities were done in Hong Kong. In fact, the company had a number of retail outlets in Hong Kong. It also purchased all airline tickets for its tours in Hong Kong. The Board’s approach was to analyze the case by identifying the company’s activities concerning the issue. It found that the company’s relevant activities consisted of:

1. the marketing and sale of the tours through its retail outlets
2. the purchase and sale of airline tickets
3. the discharging of the obligations of the company and its agents for the tour services

No doubt, the first and second type of activities were done in Hong Kong. As for the third activity, the Board found that it took place mainly outside Hong Kong. In this activity, although no formal agency agreement was entered into by the company with its land operators in each tour destination, the land operators acted on behalf of the company to perform the various activities which the company had contracted to provide for the tour. The relationship between the company and the land operators was based on trust and the land operators should be regarded as agents of the company and their activities were also relevant to the earning of the profits. The Board considered whether the profits should be apportioned between the three activities. However, the Board found this question problematic because neither the company nor the CIR admitted the possibility of apportionment. The Board said: “Presumably this was on the basis that the profit was on inseparable whole obtained as the indiscriminate result of the entirety of operations.” So, the Board adopted the principle of the Whampoa Dock case: where apportionment was not possible, the locality where the profits arise must be determined by considerations which fasten upon the acts more immediately responsible for the receipt of the profit. Having considered all the relevant facts, the Board took the view that the first and second activities namely marketing and sale of the outbound tour in Hong Kong was more immediately responsible for the receipt of the profit. The Board therefore held that the profit arose in Hong Kong and was taxable.

Exxon Chemical International Supply SA v CIR

The taxpayer was the wholly-owned subsidiary of a multi-national corporation in the USA. It carried on business in Hong Kong and the Bahamas. In the course of business in Hong Kong, it purchased goods from one affiliate within the group and sold them to another at a profit. The taxpayer invoked Section 70 A to correct a profits tax assessment on the argument that all services (for example shipping of goods) were performed outside Hong Kong. After his claim rejected by CIR, the taxpayer appealed to the Board which upheld the CIR's determination. The taxpayer then appealed to High Court and his appeal was dismissed.

In the Exxon case, the court said: "ECIS submits that before deciding where a profit is derived (or, I suppose, where it arises) it is necessary first to determine how the profit is derived and then (and then only) secondly to determine where it is derived. I am content for the purposes of the present case to accept this; having already demonstrated how the profit on the transaction in question was derived I can satisfy myself that it was derived from a “mark-up” on sales (as ECIS itself submitted) and I can go on to consider where it was derived. I ask myself: Where did ECIS obtain the buyer's order for the goods? The answer is that it obtained that order in Hong Kong. I ask myself: Where did ECIS place its order with the seller for the goods to meet the buyer's requirement? The answer is that it placed that order from Hong Kong. These acts, the obtaining of the buyer's order in Hong Kong and the placing of the order with the seller from Hong Kong, are the foundations of the transaction; for it is the differential between the selling price and the buying price (“the mark-up”) which generates, indeed represents, the profit... In my judgment (and on this I agree with the Board), on the facts ECIS derived its profit from what it did in Hong Kong. The income which arose from the “mark-up” taken by ECIS arose where the mark-up was taken; that is to say, in Hong Kong. No doubt, income arose on the delivery of the goods to the buyer, but that was the income of those responsible for getting the goods from Houston to Singapore. The only income of ECIS was its “turn” between the selling and buying prices. ECIS does not operate, outside Hong Kong, any activity with a view to profit. It is in my view immaterial that the subject of the transaction, effected in this case by the acceptance of ECIS of the order from the buyer and matched (at a profit) by its own order placed with the seller, was a load of lube oil additive destined for transhipment from the USA to Singapore. The business was transacted in Hong Kong."

CIR v. Magna Industrial Company Ltd.

The taxpayer was a limited company carrying on business in Hong Kong. It acquired industrial products from its wholly-owned subsidiary and sold them to overseas customers. The subsidiary acquired the products from overseas suppliers and warehoused them in its name in Hong Kong. The taxpayer set up a sales network comprised of independent contractors in their own countries. The independent contractors were to find suitable distributors, to train and supervise them and to promote the sale of the taxpayer's products. The independent contractors were authorized to enter into sales orders. The independent contractors sent the sales orders to taxpayer in Hong Kong for processing. Then, the taxpayer bought the goods from its subsidiary and shipped the goods to the customers and collected the sales money. The profit made by the taxpayer on the sale of the goods was assessed to Profits Tax. The taxpayer appealed to the Board successfully. It was held that the activities in the purchase of products were those of the wholly-owned subsidiary, and not the taxpayer, and the sales of products were effected by a network of overseas independent contractors who had the authority to bind the taxpayer to specific orders. Therefore, the profits were derived outside Hong Kong. CIR appealed to the High Court. The High Court allowed CIR's appeal based on the findings that the subsidiary was the taxpayer's agent in its purchase activities in Hong Kong. The taxpayer appealed to Court of Appeal. This time, the taxpayer won and the Board's findings and decision were restored.

Note the following court comment: "More often than not, it would not be the quantity of activities but the nature and quality of them that matters more. The cause and effect of such activities on the profits is the determining factor. It is what role such activities played and the relative importance of them in the making of profits that would usually tilt the scale and not the number of activities carried out at a particular place… This is a case of trading profit and the purchase and the sale are the important factors. We place on record that we have included in our deliberations all of the relevant facts and not just the purchase and sale of the products. Clearly everything must be weighed by a Board when reaching its factual decision as to the true source of the profit. We must look at the totality of the facts and find out what the Taxpayer did to earn the profit... Obviously the question where the goods were bought and sold is important. But there are other questions: For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was payment effected?"

Author’s comment: It is noteworthy that different judges have different decisions on the same issue in the same case. This reflects the practical difficulty in identifying what is the immediate operation to earn the profit in question. The reality is: If the IRD disallows an off-shore claim, the taxpayer has to appeal to the Board or even the court and then to bear all the costs involved and the uncertainty of the judgment. Therefore, a prudent taxpayer must endeavor to put forward all the relevant facts as early as possible to convince the IRD to accept his claim.

Wardley Investment Services (Hong Kong Limited) v CIR

Taxpayer was a company incorporated in Hong Kong and carried on business as investment adviser. In the course of business, it arranged for sale and purchase of overseas securities on behalf of its clients; and from such activities it earned rebate from overseas stock-brokers. The rebate was assessed but the taxpayer appealed to the Board against such assessment. In its decision, the Board of Review ruled that the rebate was not assessable. The ruling was based on the 'operation test' and its findings that the 'operations' giving rise to the profits were done outside Hong Kong. The Board's findings and decision were overturned by the High Court. The taxpayer appealed to Court of Appeal. It was held by majority that the profits were taxable because the taxpayer did nothing outside Hong Kong to earn the profits. Author's comment: In my experience, it is hard to convince the Revenue to accept the offshore claim where the taxpayer's activities outside Hong Kong were minimal. It should be noted in this case that the overseas operations giving rise to the profits were not done by the taxpayer but by the overseas stock-brokers.

Commissioner of Inland Revenue v. Hang Seng Bank Ltd.

This case concerned the investment activities of a Hong Kong bank in the purchase and sale of certificates of deposit, bonds and gilt edged securities. Both the purchase and sale of these financial instruments (that gave the profits) took place outside Hong Kong (in London and Singapore). It was held that the relevant profits were made as a result of activities that took place outside Hong Kong even though the decision to buy or sell the instruments in question was made in Hong Kong. Accordingly, the profit was not taxable.

It was held that there are three conditions for a charge to arise:
(1) the taxpayer must carry on a trade, profession or business in Hong Kong;
(2) the profits to be charged must be "from such trade, profession or business" carried on in Hong Kong;
(3) the profits must be "profits arising in or derived from" Hong Kong."

The principle derived from this case is: "one looks to see what the taxpayer has done to earn the profit in question."

To summarize, Lord Bridge of Harwich made the following comments: “It is not enough for the purposes of section 14(1) merely to find the existence of profits which have been made by a business carried on in Hong Kong. It does not follow that such profits arose in or were derived from Hong Kong. Thus, for example, the fact that a company carries on business in Hong Kong (as many Hong Kong companies do) does not mean automatically that all its profits become liable to profits tax. One must go further to inquire whether the relevant profits actually arose in or were derived from Hong Kong. These are the very words found in section 14(1) as well as other related parts of the Ordinance such as section15 and also rule 2A of the Inland Revenue Rules… The three conditions must be satisfied before a charge to tax can arise under section 14: (1) the taxpayer must carry on a trade, profession or business in Hong Kong; (2) the profits to be charged must be 'from such trade, profession or business,' which their Lordships construe to mean from the trade, profession or business carried on by the taxpayer in Hong Kong; (3) the profits must be 'profits arising in or derived from' Hong Kong. Thus the structure of the section presupposes that the profits of a business carried on in Hong Kong may accrue from different sources, some located within Hong Kong, others overseas. The former are taxable, the latter are not. The determination of whether or not profits arise in or are derived from Hong Kong is ultimately a question of fact depending on the nature of the relevant transactions:-see 322H(4). However, the "broad guiding principle" is that one must look to see what the taxpayer has done to earn the relevant profits. Section 14(1) also requires that the relevant profits must have arisen from activities or operations carried on by the taxpayer in Hong Kong. This last requirement follows from the words in section 14(1), "assessable profits arising in or deriving from Hong Kong".

Kwong Mile Services Limited v CIR

The taxpayer carried on business in Hong Kong. It got profit from a property development in mainland China. Such profit was assessed to Profits Tax. In fact, the profit was from its underwriting of the sale of the property in Hong Kong. The underwriting contract was a two-page document and contained six short clauses. The taxpayer agreed to underwrite the sale of the units in the building in the sum of $84,314,015. The underwriting period was up to 30 June 1992. If on or before that day, the total price the developer received from the sale of the building exceeded $84,314,015, then the developer would pay the difference to the taxpayer. If the amount was less than the underwritten amount, the taxpayer would have to pay the difference to the developer and take up the unsold units. To implement the underwriting, the taxpayer advertised the property development in Hong Kong and secured contracts of sale for the units with purchasers in Hong Kong. The purchasers had to sign in Hong Kong a "pre-contract provisional agreement" with the developer. The taxpayer arranged for these purchasers to go to Mainland to sign a pre-contract formal agreement" with the developer. The taxpayer was not a party to these agreements. The sale was a big success. The amount from the sale exceeded the underwritten sum of $84,314.015. The taxpayer received the agreed difference from the developer. The taxpayer appealed to the Board against the Profits Tax assessment. The Board allowed the taxpayer's appeal. Then, CIR appealed to High Court and CIR won. Then, the taxpayer appealed to Court of Appeal and again, CIR won. The courts ruled that it was the underwriting of the sale that gave rise to the profit and because the underwriting was substantially carried out in Hong Kong, the profit derived from Hong Kong and therefore taxable.

CIR v Orion Caribbean Ltd

This case concerns source of interest income. In this case, the company received deposits from its holding company outside Hong Kong. Then, it lend the money to a person outside Hong Kong. The CIR argued that by accepting the deposits the company was a financial institution under section 15(1)(i) and therefore the interest income is taxable. This argument was rejected by the court. The following court's comments are noteworthy.

"There are three difficulties inherent in this proposition. The first is that it attributes to Lord Bridge's words, even if they are taken in isolation, a rather broader meaning than that which they naturally bear. Lord Bridge speaks of profit earned 'by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities'. The reference to 'property assets' in relation to the letting of property or the lending of money may have been intended to refer simply to the exploitation of property or money owned by the taxpayer. If ORPL lent its own money to a borrower in, say, New York, then other things being equal there might be little difficulty in saying that the location of the source of the interest on the loan was New York. If on the other hand, Lord Bridge was intending to cover, by his examples, a case such as that of OCL where they money has to be borrowed before it can be lent – like the commodities which have to be bought before they can be resold – it would be surprising if he were suggesting that regard should be had solely to the place of lending, to the exclusion of the place of borrowing. Secondly, and more generally, the proposition that Lord Bridge was laying down a rule of law to the effect that, in the case of a loan of money, the source of income was always located in the place where the money was lent, is one that cannot stand with the opening words of Lord Bridge quoted above, nor with the explanation of his remarks by Lord Jauncey in the HK-TVB case, nor with the whole range of authority starting from the judgment of Atkin LJ in F.L. Smidth & Co v Greenwood onwards, to the effect that the ascertaining of the actual source of income is a 'practical hard matter of fact', to use words employed, again by Lord Atkin, in Liquidator, Rhodesia Metals Ltd v Commissioner of Taxes [1940] AC 774 at page 789. No simple, single, legal test can be employed..."

Author's comments: In general, the IRD will adopt the "provision of credit" test to decide the source of interest income. However, because of the above court comment, other tests may be used if the "provision of credit" has apparently been used as a trick to avoid tax.

Source of trading profits

First, I would like to quote what is said in the IRD's DIPN 21 below.

“6. The question of the locality of profits derived from trading in commodities or goods has produced the most controversy... Generally the determining factor, as indicated in the Privy Council decisions, is the place where the contracts for purchase and sale are effected. However, as the Court of Appeal noted in Magna, the totality of facts must be looked at in determining what the taxpayer did to earn the profit: “... the question where the goods were bought and sold is important. But there are other questions: For example: How were the goods procured and stored? How were the sales solicited? How were the orders processed? How were the goods shipped? How was the financing arranged? How was payment effected?”. This reflected the statement by the High Court that “More often than not, it would not be the quantity of activities but the nature and quality of them that matters more. The cause and effect of such activities on the profits are the determining factors. It is what role such activities played and the relative importance of them in the making of profits that would usually tilt the scale and not the number of activities carried out at a particular place.” The headnote to Case No. D9/89, quoted by the Court of Appeal in Magna, is also worthy of note: “Generally, the employment of staff and the maintenance of an office in Hong Kong, with all necessary services and facilities including telephone and telex, are the essence of a trading company’s activities. Where these are all in Hong Kong, it could be concluded resultant profits have a Hong Kong source. The fact that goods are and delivered outside Hong Kong is not material for this purpose.”

7. The Department considers that because the locality of profits is a hard, practical matter of fact, “effected” cannot merely mean legally executed (as this would depend on formal legal rules of offer and acceptance) and thus must contemplate the actual steps leading to the existence of the contracts including the negotiation and, in substance, conclusion and execution of the contracts.

8. …the Department's views … can be summarized as follows:

- *(a) Where both the contract of purchase and contract of sale are effected in Hong Kong, the profits are fully taxable.*
- *(b) Where both the contract of purchase and contract of sale are effected outside Hong Kong, no part of the profits are taxable.*
- *(c) Where either the contract of purchase or contract of sale is effected in Hong Kong, the initial presumption will be that the profits are fully taxable. Matters, such as those mentioned in paragraph 6 above, will be examined to determine the issue.*
- *(d) Where the sale is made to a Hong Kong customer, the sale contract will usually be taken as having been effected in Hong Kong.*
- *(e) Where the commodities or goods are purchased from either a Hong Kong supplier or manufacturer, the purchase contract will usually be taken as having been effected in Hong Kong.*
- *(f) Where the effecting of the purchase and sale contracts does not require travel outside Hong Kong but is carried out in Hong Kong by telephone, fax etc., the contracts will be considered as having been effected in Hong Kong.*
- *(g) The purchase and sale contracts are important factors but the totality of facts must be looked at to determine the locality of the profits.*

9. There may be cases where the activities of a Hong Kong trading business are limited to the following:

- *(a) issuing or accepting an invoice (not order) to or from an ex-Hong Kong customer or supplier (whether related or not) on the basis of contracts of sale or purchase already effected by an ex-Hong Kong associate;*
- *(b) arranging letters of credit;*
- *(c) operating a bank account, making and receiving payments; and*
- *(d) maintaining accounting records.*

This situation commonly arises when a Hong Kong business, as a member of group and pursuant to group directives, carries out the above activities and "books" the profits in Hong Kong. Provided the activities of the Hong Kong business do not include the acceptance or issue of sale or purchase orders in or from Hong Kong, the profits would not be taxable...

10. A trading company, carrying on business outside Hong Kong, may set up a branch in Hong Kong to act as a buying office. The activities of the branch are confined to the purchase of goods in Hong Kong and it is not involved in their sale, either in Hong Kong or elsewhere. In such a situation, a liability to Hong Kong profits tax would not arise. The function of a buying office may also be carried out by a subsidiary company or by an accredited agent (either related or unrelated). However, as for a branch, the subsidiary company or accredited agent must not be involved in the sale of the goods. On the other hand, any commission or other remuneration earned by the subsidiary company or accredited agent for performing its services in Hong Kong will be fully taxable.

11. …in the Department's view, the question of apportionment does not arise in relation to trading profits. Trading profits will be either wholly taxable or wholly non-taxable.

12. Cases may arise where it is claimed that contracts of purchase and of sale have been effected outside Hong Kong by employees of the Hong Kong business traveling abroad or by fully accredited overseas agents. In this context, an agent is regarded as fully accredited if it has, and habitually exercises, a general authority to negotiate and conclude contracts on behalf of his principal. Normally the activities of a fully accredited agent and an employee are accorded the same weight if it can be shown that the employee has full authority to conclude contracts without reference to the business in Hong Kong. In considering claims that contracts have been effected outside Hong Kong by employees, Assessors will require details of traveling, hotel and subsistence expenses in respect of each individual transaction.

Where it is claimed that contracts are effected by overseas agents it will be necessary to provide agency agreements or other documentary evidence to support the claim. "

Author's comments on IRD's practice

The DIPN states the published official view of IRD. In my IRD experience, assessors may sometimes depart from the published practices in the circumstances of each particular case. So, if a taxpayer thinks he has merits to get the offshore exemption, he should pursue his claim with the relevant facts.

You may notice that the IRD's published official view is quite conservative and stubborn on assessing trading profits to tax. In my experience, if a taxpayer has a permanent place of business in Hong Kong, the IRD officers will be inclined to assess the whole profits to tax. This is evidenced by point (c) under paragraph 8 of the DIPN that trading profits will be assessed in full if either the purchase or the sale is in Hong Kong. From the view point of IRD, this assessing practice is logical and reasonable because the basic role of IRD is to collect and protect revenue from profit-making people, rather than to let them get out of the tax net.

The IRD's published practices are quite lengthy. To summarize, the IRD's lines of assessing practices are as follows:

(1) The important factors are purchase and sale --- the actual steps leading to the contract of sale including negotiation, conclusion and execution of the contracts. But other factors may also be considered.

(2) The totality of facts is to ascertain what acts make the profit. The nature of acts is more important than the quantities of the facts.

(3) If the contracts of purchase and sale are effected in Hong Kong, the profits are taxable.

(4) If goods are sold to a Hong Kong customer, the sale will generally be treated as "effected in Hong Kong".

(5) If goods are purchased by a Hong Kong business from a

Hong Kong supplier, the purchase contract will generally be treated as "effected in Hong Kong".

(6) If sale is concluded overseas with the terms of contracts such as price, discount and credit terms, are finalized in Hong Kong, the sale will not be regarded as effected outside Hong Kong.

(7) In general, the Revenue does not accept apportionment of trading profits --- the profit is either wholly taxable or wholly non-taxable.

Source of manufacturing profits

First, let us look at what is said in the IRD's DIPN 21 which is quoted follows:

"The Department considers that, where goods are manufactured in Hong Kong, the profits arising from the sale of such goods will be fully taxable because the profit making activity is considered to be the manufacturing operation carried out in Hong Kong.

In the situation where a Hong Kong company manufactures goods partly in Hong Kong and partly outside Hong Kong, say in the Mainland, then that part of the profits which relates to the manufacture of the goods in the Mainland will not be regarded as arising in Hong Kong.

A Hong Kong manufacturing business, which does not have a licence to carry on a business in the Mainland, may enter into a processing or assembly arrangement with a Mainland entity. Under these arrangements, the Mainland entity is responsible for processing, manufacturing or assembling the goods that are required to be exported to places outside the Mainland. The Mainland entity provides the factory premises, the land and labour. For this, it charges a processing fee and exports the completed goods to the Hong Kong manufacturing business. The Hong Kong manufacturing business normally provides the raw materials. It may also provide technical know-how, management, production skills, design, skilled labour, training *and supervision for the locally recruited labour and the manufacturing plant and machinery.*

The design and technical know-how development are usually carried out in Hong Kong.

In law, the Mainland processing unit is a sub-contractor separate and distinct from the Hong Kong manufacturing business and the question of apportionment strictly does not arise. However, recognizing that the Hong Kong manufacturing business is involved in the manufacturing activities in the Mainland (in particular in the supply of raw materials, training and supervision of the local labour) the Department is prepared to concede, in cases of this nature, that the profits on the sale of the goods in question can be apportioned… This apportionment will generally be on a 50:50 basis.

If, however, the manufacturing in the Mainland has been contracted to a sub-contractor (whether a related party or not) and paid for on an arm's length basis, with minimal involvement of the Hong Kong business, the question of apportionment will not arise. For the Hong Kong business, this will not be a case of manufacturing profits but rather a case of trading profits.

Profits of the Hong Kong business will be calculated by deducting from its sales the cost of goods sold, including any sub-contracting charges paid to the sub-contractor in the Mainland. The taxation of such trading profits will be determined on the same basis as for a commodities or goods trading business.

Example 1

A Hong Kong company manufactures goods in Hong Kong and sells them to overseas customers. The fact that the company has sales staff based overseas does not give a part of the profits an overseas source. This is not a case for apportionment. The whole *of the profits are liable to profits tax.*

Example 2

A Hong Kong garment manufacturer has a factory in the Mainland where sweater panels are knitted. These panels are then transported to the manufacturer's factory in Hong Kong where they are sewn together into finished garments for sale. This would be a case where the manufacturing profit could be apportioned.

As a corollary to example 1, where a company manufactures goods outside Hong Kong and sells them to Hong Kong customers, the manufacturing profits are not liable to profits tax. However, in the exceptional case where the sale activities in Hong Kong are so substantial as to constitute a retailing business, the profits attributable to the retailing activities are fully taxable."

Author's comments on IRD's practice

In my work experience with IRD, the Revenue's line of practice is as follows:

The source of profits of a manufacturing concern is the location of the factory. In other words, if goods re manufactured in Hong Kong, the profits from the sale will be fully taxable. This is because the profits are derived from the manufacturing operation done in Hong Kong.

If goods are manufactured partly in Hong Kong and partly outside, that part of the profits attributable to the manufacturing outside Hong Kong is not taxable. The place of sale is unimportant.

Nowadays, many Hong Kong manufacturers set up factories in other places which have abundant supply of cheap land and labour. Usually, the Hong Kong manufacturer brings into such other places capital, materials, technical knowledge, management, training, supervision... etc. On the other hand, they pay rent of the land and hire workers for their factories. In general, with a view to avoiding tax disputes, the Revenue allows apportionment of profits derived from the sale and manufacturing of the goods concerned on a 50:50 basis: that means only 50% of the profits are assessable.

If the manufacturing is contracted out by the Hong Kong manufacturer to an independent sub-contractor in other places and the Hong Kong manufacturer plays little part in the manufacturing, the Revenue will accept the profits from the manufacturing as not assessable. Nevertheless, the profits made by the Hong Kong manufacturer from the sale of the goods (derived from the selling price less the subcontractor cost and other expenditures) are fully taxable.

Many Hong Kong manufacturers set up factories in mainland to reduce cost and improve competitiveness. In general, there are two kinds of processing arrangements, namely contract processing and import processing.

Contract processing

In Chinese, contract processing is called “來料加工” or “三來一補”. This kind of processing agreement was popular when mainland China first opened its door to Hong Kong manufacturers in 1970s. At that time, most places in Guandong were poor and the municipal governments wanted Hong Kong manufacturers to set up factories there. These factories were owned by the Hong Kong manufacturers who provided machineries, skills and raw materials “三來” and money to subsidize the municipal governments for running the factories “金錢補助: 即是一補”. Under the agreement, the Hong Kong manufacturers send the raw materials to mainland factories for processing and then bring back the finished goods. The Hong Kong manufacturers pay rent to the mainland municipal administration and wages to the workers. What the Hong Kong manufacturers do in Hong Kong is soliciting of sales orders, design and development of products, packaging, quality control, transportation of goods, storage, financing, insurance … etc. In the light of the substantial activities done in mainland, the IRD allows a 50:50 apportionment of the profits earned in respect of the sale and manufacturing of the goods. The Hong Kong manufactures were, of course, happy with the tax practices because 50% of their profits was tax free (they were not subject to the mainland tax under the processing agreements).

Import processing

Under the contract processing agreements, the mainland municipal administration can only get rent for the land in addition to the agreed money subsidies. They do not have a share in the profits arising from the manufacturing. At the time when they did not have the skill to do the manufacturing, they might be satisfied with such arrangements. However, after several years, when they acquired the skill and the capital to run the factories, they wanted a share of profits. So, to enable both Hong Kong enterprises and the mainland parties to have a share in the profits, an import processing agreement "進料加工" is executed. Under the agreement, a separate entity for the manufacturing is set up which will buy raw materials from the Hong Kong enterprise and then sell the goods to Hong Kong enterprise as well as overseas customers. For such cases, the IRD treats the sales of raw materials and purchases of finished goods of the Hong Kong company as normal trading transactions and assess the whole profit accordingly. In other words, no 50:50 apportionment is allowed. Nevertheless, if the IRD suspects the sales or purchases do not reflect the real market prices on arm-length basis, it may invoke Section 61A to tax the profit removed.

Field audit and investigation cases

In practice, the IRD may accept apportionment of profits in tax audit and investigation cases in which the taxpayers have substantial activities in mainland China.

Source of interest income

The basic test for determining the source of interest is the so-called "provision of credit" --- See the Revenue's published practice note DIPN 13. In brief, the test of "provision of credit" looks at the place where the fund is made available to the borrower. If it is made available outside Hong Kong, for example in an offshore bank account, then the interest will have a non-Hong Kong source.

However, for those businesses consist of borrowing and lending money, the place of lending is not always decisive --- vide the case Orion Caribbean Ltd. 4 HKTC 432. In such cases, regard should also be made to the chief place of business.

Normally interest will have a Hong Kong source if it forms part of a transaction done in Hong Kong --- for example a Hong Kong manufacturer sells his goods to an overseas buyer on extended credit terms --- See Board of Review case BR 20/75.

Form case law in Australia, South Africa and New Zealand, the following factors are to be considered when determining the source of interest income.

1. The place where the credit is provided
2. The place where the loan agreement is concluded
3. The country in which agreement is enforceable
4. The place where the interest is paid
5. The currency of the transaction
6. The place where the borrower is resident
7. The place where the loan money is used

Miscellaneous incomes

Know-how fees are assessable if the Hong Kong company is essentially the source of the know-how.

The profit from the sale of packaged tours to people in Hong Kong is with a Hong Kong source and taxable --- See Board of Review case D14/96.

If a person or company earns commission by luring buyers or seeking suppliers for its customers, the activities making the commission will be the arrangements between the related parties. If the arrangements are performed in Hong Kong, the commission is taxable. Otherwise, it is not taxable. Normally, the location or residence of the buyers or suppliers, how they are sought by the concern, and the incidental activities prior to or subsequent to transactions are unimportant in determining the source of the commission. Read the case CIR v. International Wood Products Ltd 1 HKTC 551.

In general, the Revenue adopts the following practices:

Nature of profits	Assessing practices
✧ Rental income from realty	➢ Physical location
✧ Sale of realty	➢ Physical location
✧ Purchase and sale of listed shares	➢ Location of stock market
✧ Purchase and sale of private shares	➢ Locations of the relevant contracts
✧ Service fees	➢ Where the services are performed
✧ Royalties	➢ Location of the usage
✧ Interest (not received by a financial institution)	➢ Location of the provision of capital

3.9 Deemed assessable profits

Section 14 of Inland Revenue Ordinance lays down the basic charge to profits tax. In addition, Section 15 deems the following to be taxable trading receipts.

- Money received or receivable from the exhibition or use in Hong Kong of cinematography or television film or tape, any sound recording or any advertising materials connected with such film, tape, or recording [Section 15(1)(a)].

- Money received or receivable for the use or right to use in Hong Kong a patent, design, trademark, copyright material or secret process or formula or other of a similar nature [Section 15(1)(b)].

- Money received or receivable for the use or right to use outside Hong Kong a patent, design, trademark, copyright material or secret process or formula or other of a similar nature if the payment for such are deductible under profits tax. [Section 15(1)(ba)]. This provision is to counteract the tax avoidance schemes following the decision of Emerson case.

- Money received or receivable by or accrued to a person carrying on business in Hong Kong by way of grant, subsidy or similar financial assistance other than sums in connection with capital expenditure [Section 15(1)(c)].

- Money received or receivable by way of hire, rental or similar charges for the use of movable property or the right to use movable property in Hong Kong [Section 15(1)(d)].

The deeming provisions of Section 15(1)(a) and Section 15(1)(b) apply where the transactions cannot be caught by the basic charge. In other words, they will not apply to those transactions that have already been assessable under Section 14. In general, they apply to non-residents who do not carry on a trade or a business in Hong Kong. Money received includes lump sum payments or periodical payments. The assessable profits under these two provisions are further deemed to be 30% of the money received.

The deeming provisions of Section 15(1)(c), Section 15(1)(d) and Section 15(1)(b)(a) do not stipulate an assessable-profits rate. In other words, the actual net amounts received or receivable will be taken into the assessable profits. The deeming provision of Section 15(1)(c) concerns only those persons carrying on a trade or business in Hong Kong. However, the deeming provision of Section 15(1)(d) targets those persons who do not carry on a trade or business in Hong Kong whereas Section 15(1)(b)(a) is an anti-avoidance provision.

3.10 Capital gains are not taxable

Section 14 of Inland Revenue Ordinance exempts profits arising from the sale of capital assets. Even without this exemption, it is a generally accepted accounting practice that capital gain should not be included in trading profits. There are a number of court cases on the captioned question: drawing distinction between income from “fixed capital” and income from “circulating capital” --- referring the former to “capital receipts” and the latter to “revenue receipts”.

It has been established from case law that “fixed capital” is what the owner turns to profit by keeping it in his own possession; whereas “circulating capital” is what he makes a profit of by parting with it and letting it change masters. It follows that land and buildings, plant and machinery, long-term leases and goodwill are fixed capital retained and used in the business --- they form part of the permanent structure of the business --- any receipts from their sale, or compensation for their loss or damage, are capital receipts and thus, non-taxable.

On the other hand, an asset forms part of the circulating capital if its is acquired in the ordinary course of business --- It is to be sold, or to be manufactured for goods to be sold --- for example: trading stock and raw materials --- Any receipts related to such items are revenue receipts and taxable.

Compensation receipts from tangible assets

Compensation receipts from sale or loss of tangible assets often give rise to tax disputes --- Whether it is of a capital nature (not taxable) or a revenue nature (taxable)? Let us look at the following cases.

Glenboig Union Fireclay Co. Ltd. versus CIR

In this case, a railway company took legal action to prevent the extraction of fireclay from beds under its track. The action was unsuccessful and the railway company paid the fireclay company a sum of money to refrain from working under the track, in order to sterilize that particular asset. The amounts paid for refraining from carrying on trade operations depended on the circumstances of the payment, the nature of the asset and of the trade. If the compensation derived from a capital asset then it would be capital; and if from a revenue matter, then the compensation would be on revenue account. In fact, the amounts were calculated according to the profit that might have been earned if Glenboig had worked the bed. It was held that the payment was a capital receipt, being compensation for the permanent loss of a fixed capital asset --- the right to work the beds. The fact that loss of profits was taken into account in arriving at the amount of compensation did not alter the nature of the payment, which was capital. In his judgment, the Lord Wrenbury said: "Was that compensation profit? The answer may be supplied, I think, by the answer to the following question: Is a sum profit which is paid to an owner of property on the terms that he shall not use his property so as to make a profit? The answer must be in the negative. The whole point is that he is not to make a profit and is paid for abstaining from seeking to make a profit. It was the price paid for sterilizing the asset from which otherwise profit might have been obtained."

Burmah Steam Ship Co. Ltd. versus CIR

In this case, the court commented on the Glenboig case that had the compensation to Glenboig been paid for temporary interference with its workings, it would have been assessable. In the Burmah's case, the company contracted for repairs to a second-hand vessel. The ship repairer exceeded the agreed time for the overhaul and damages were paid to cover the consequential loss of expected profits had the vessel been available for trade. It was held that the payment was for loss of profits and hence taxable. It should be noted that the asset, the ship, was not lost or damaged, and the compensation was to fill the hole in the company's profits which was created by the temporary loss of the use of the ship. In his judgment, the Lord President (Lord Clyde) drew a distinction between filling a hole in the trader's profits and filling a hole in the trader's assets: "A sum received to compensate for loss of profits would be income chargeable. A sum received to compensate for loss of a capital asset would be a capital receipt outside the charge. Suppose some one who chartered one of the Appellant's vessels breached the charter and exposed himself to a claim of damages at the Appellant's instance, there could, I imagine, be no doubt that the damages recovered would properly enter the appellant's profit and loss account for the year. The reason would be that breach of the charter was an injury inflicted on the Appellant's trading, making (so to speak) a hole in the Appellant's profits, and the damages recovered could not therefore be reasonably or appropriately put by the Appellant - in accordance with the principles of sound commercial accounting - to any other purpose than to fill that hole. Suppose, on the other hand, that one of the Appellant's vessels was negligently run down and sunk by a vessel belonging to some other ship owner, and the Appellant recovered as damages the value of the sunken vessel, I imagine that there could be no doubt that the damages so recovered could not enter the Appellant's profit and loss account because the destruction of the vessel would be an injury inflicted, not on the Appellant's trading, but on the capital assets of the Appellant's trade, making (so to speak) a hole in them, and the damages could therefore - on the same principles as before - only be used to fill that hole."

The different tax treatment between the Glenboig case and the Burma case was discussed in the case London & Thames Haven

Oil Wharves Ltd. versus Attwooll 43 TC 491.

London & Thames Haven Oil Wharves Ltd. versus Attwooll

The company owned and operated an oil storage installation. One of its jetties was damaged through negligent handling of a tanker and put out of use for more than one year. The tanker owners admitted liability but the amount they paid over was less than the cost of repairs to the jetty. The company was insured against physical damage to its property but not against consequential damage to its business. The company and the insurers agreed to apportion the sum received from the tanker owners between the cost of repairs and damages for loss of use of the jetty. The insurers then paid over the excess of the full cost of repairs over the compensation apportioned to repairs. The compensation apportioned to loss of use of the jetty from the tanker owners was assessed because it was payment for loss of profits and thus a revenue receipt. The company did not agree and appeal to the court.

The court upheld the Revenue's decision and differentiated the total loss of a fixed asset from its partial injury as follows: “In the case of a total loss what can be recovered from the assumed wrongdoer is the value of that which has been lost. If the thing lost is a ship or a jetty which is ordinarily used for the purpose of earning profits, the fact of its profitability is an element to be considered in assessing its capital value. In such a case the owner's right is a right to recover the value of the thing which has been lost… in such circumstances what is recovered is properly treated as a capital receipt. But where there is only partial injury, as there was in the present case, there are necessarily two elements to be considered if the owner is to be put back, so far as money can do it, in the same position in which he would have been but for the tortfeasor's wrongdoing. First, he can recover the whole cost of repair, which is without doubt a capital receipt. Secondly, he can also recover something in respect of the loss of use during the period of repair… why should not damages recovered under this head be regarded as a trading receipt, in that they represent the trading profit which the owner would have earned if he had the use of his ship or jetty?”

Now, let us read the following Hong Kong tax case.

Board of Review case D 12/90

This case concerned an insurance agent who was the leader of seven work teams. By an agreement with her employer, the number of work teams under her control was reduced to five and she received compensation for commission from the two teams that she lost. The compensation was assessed to profits tax on the grounds that it filled the holes of her incomes created by the arrangement. The taxpayer appealed to the Board and this was held: "At first sight, it would appear that a substantial lump sum payment made in exchange for the surrender of contractual rights would constitute a capital payment. However, on the strength of the authorities cited before us, this initial assumption is erroneous. It is clear from the decided cases that where a person is carrying on a trading or agency type business, sums of money which the person receives for changing or giving up agencies or agency rights are to be construed as being payments received in the course of carrying on the business unless it is clear from the facts that the payment is of a capital nature. In the Allied Mills case, the taxpayer received a lump sum payment for compensation for termination of an agency agreement.

Though the sum paid was significant and the agency was a significant part of the taxpayer's business, the Australian Court held that the money had the character of an income receipt. What was given up was the right to exploit the distributorship and thus to pursue profits. The compensation was not to be classified as consideration for the taxpayer going out of business and did not involve a parting by the taxpayer of a substantial part of its business undertaking. It was held that the termination was entered into in the course of the taxpayer's business. We will not set out in detail what was stated in the Allied Mills case, but it is a useful summary of the many decided cases and we think that the Allied Mills case sets out the right approach to take in cases of this nature. The question to be answered is whether or not the rights or benefits which the Taxpayer was entitled to under her agreement with the insurance company comprised a capital asset of her business. It is necessary to look at all of the facts of each case and care must be taken when drawing analogies from the facts of one case to another. It is also interesting to note the clear statement in the Allied Mills case that because a transaction is unusual or extraordinary, it does not change the nature of the payment provided it is entered into in the course of carrying on of the business. The learned Judge in the Allied Mills case cites with approval the words of Lord Evershed MR in Anglo-French Exploration Co. Ltd. v. Clayson [1956] 36 TC 545 at 557 as follows: 'They seem to me to emphasize that sums received for the cancellation of an agency or of other similar agreements which have been entered into by the recipient in the ordinary course of its trade will themselves, prima facie, be regarded as received in the ordinary course of trade unless the transaction involve a parting by the recipient with a substantial part of its business undertaking.' In our opinion, that statement is a useful and correct summary of the law… In the present case, if one carefully looks at the facts before us, it is clear that the business of the Taxpayer continued after the receipt of this lump sum payment much as it had done before. We cannot see any justification for finding on the facts that the rights given up by the Taxpayer were capital assets of her business. She was doing no more than accepting a lump sum payment in exchange for giving up the right to receive override commissions in respect of two out of seven 'units'. The Taxpayer had not invested any capital in acquiring these 'units' and indeed so far as we are aware, she had no formal contractual relationships with the 'units'. Her contractual relationship was with the insurance company. In all of the circumstances, we find on the facts that the payment received was a trading receipt received in the course of the business of the Taxpayer and accordingly is subject to profits tax. For these reasons we dismiss this appeal."

Compensation receipts from intangible assets.

Sometimes, it is quite difficult to distinguish whether compensation is of a capital nature or a revenue nature when it involves intangible assets, such as cancellation of an agreement.

Let us see the following case.

Short Brothers Ltd. versus CIR 12 TC 955

In the case, shipbuilder received compensation for the cancellation of a contract to build two ships. It was held that it was received in the ordinary course of trading in connection with a trading contract and it was not compensation for the termination of any part of their business nor for the loss of any capital asset as in the Glenboig case. This was because the company was free to make other contracts and to use their yard to build other ships. The judge Rowlatt J distinguished the case from the Glenboig case, saying: "The sum of £100,000 which they received was not in any material sense received as compensation for not being allowed to make their profits; that is to say, it was not received in respect of the termination of any part of their business; nor was it received in respect of any capital asset, as was the sum in the Glenboig case that was received in respect of the obligation not to work the seam of fireclay; it was the same thing really, to all intents and purposes, as selling the seam of fireclay."

Author's comments

Where agency contracts are concerned, the first question to consider is whether or not the contract concerned forms part of the capital structure of the business --- If it is, it is likely of a capital nature. Let's see some more tax cases below.

Kelsall Parsons & Co. versus CIR

In this case, a firm acted as agents on a commission basis under a number of agency agreements. The business began in 1914 with two agencies, one of which was for George Ellison Ltd. Over the years, the Ellison's agreement was renewed from time to time and on occasion the terms and conditions were modified and the firm also hired other agencies. Between 1930 and 1934 the firm had about nine to eleven agencies. The Ellison's agency was the most profitable and at times gave as much as half the company's gross commission. The company received £1,500 compensation for the termination of the Ellison's agreement. The firm claimed that the whole structure of their business was affected, and that the sum received was capital. But the compensation was held as a trading receipt. The reasoning for the judgment was “The compensation was a trading receipt. The firm's business was to obtain as may contracts of this kind as possible; it was a normal incident that contracts might be modified, altered or discharged from time to time. In that case, the fixed framework of the business was not affected; they were not parting with an enduring asset of the business.”

Barr Crombie & Co. Ltd. versus CIR

The Barr Shipping Co Ltd was formed in 1924 and owned a fleet of ships. Barr Crombie had an agreement with Barr Shipping to manage the latter’s ships. In 1942 and when the agreement still had some eight years to run, Barr Shipping cancelled it and went into liquidation. It was held that the compensation was of a capital nature because the agreement was virtually the whole assets of the company. When it was terminated, practically nothing remained in the company's business. The judge, Lord Normand, said: “That is not an agreement that a certain sum shall be payable as remuneration, but that a sum which would have been payable as remuneration, if the contract had taken its expected course, should become payable at the date of liquidation, although no services could thereafter be rendered… In short the remuneration contemplated by the agreement is used as a measure of the sum which would be payable as compensation if the carrying out of the agreement… became impossible by reason of liquidation … annual payments in the nature of profits may be used as a measure by which to calculate the sum to be paid, the resultant sum is not thereby made itself an annual payment or a profit…The parties here were far-sighted and they foresaw the possibility of liquidation and made just such arrangements as might have been made later by other parties less far-sighted but willing to deal on a reasonable basis when liquidation became inevitable…It is, therefore, an entirely different case from Kelsall Parsons & Co…I regard the payment here as a payment made, in the sense of Lord Cave’s observations, 'once and for all', and received by the Appellant Company as the price of surrender of its only important capital asset. In Kelsall Parsons & Co, on the other hand, the payment was in return for the loss of a single agency out of about a dozen agencies carried on by the company, and the fact that the payment in that case did not represent the whole capital assets of the company is easily shown by the fact that in the year after the surrender of the single agency profits were no less than they had been the year before the surrender…Where you have a payment for the loss of the contract upon which the whole trade of the Company has been built, where the expected profits of the contract are used to measure the loss of them for a period of future years, and where in consequence of the loss the Company’s structure and character are greatly affected, the payment seems to me to be beyond doubt a capital payment.”

3.11 Voluntary receipts

Whether a payment is voluntary or not --- that is whether it is made with or without legal obligations --- does not affect its taxability. The following cases are usually adopted by IRD.

CIR versus Falkirk Ice Rink Ltd.

In this case, a members club used the facilities of the taxpayer in the course of its business. The club gave the taxpayer a sum to cover the additional cost of the facilities. It was held that the receipt was made to supplement the revenue of a trading company, and although voluntary, was chargeable to tax.

Simpson versus John Reynolds & Co. (Insurances) Ltd.

If a voluntary payment is made after the cessation of a trading activity, it may be non-taxable. In this case, a company of insurance brokers lost an important client on a change of control of the client company which undertook to pay 5,000 pounds by annual instalments of 1,000 pounds in recognition of the long period during which the taxpayer acted for the client. It was held that the payments were gifts and not an additional reward for services rendered and therefore not taxable.

IRC v John Lewis Properties PLC

This is a UK court of appeal case. It gives guidance on how to turn a series of recurring income (taxable) into capital receipt (non-taxable). The taxpayer owned five properties and let them out to its holding company. By an assignment, the taxpayer assigned to a bank the right to receive rents over the 5-year lease term for a lump sum determined by capitalizing the rents at 7.6%. The taxpayer claimed that the lump sum a capital receipt. The Revenue contended that the sum being the discounted value of future rents must be revenue and assessable. The courts decided in favour of the taxpayer. In making their decisions, the courts took into accounts the following factors: duration of the assignment, the value of the asset assigned, the diminution in the value of the assignor's interest after the assignment, the payment as one lump sum and the transfer of the legal rights to receive rents to the bank.

3.12 Exempted receipts

The following are exempt from the assessable profits:

1. Dividends received from a corporation
2. Profits already assessed to Profits Tax in name of other persons such as partnership
3. Interest on: tax reserve certificates, bonds issued under the Loans Ordinance, the Loans (Government Bonds) Ordinance, Exchange Fund debt instruments, or Hong Kong dollar-denominated multilateral agency debt instruments
4. Sums accrued to an authorized mutual fund corporation or an authorized unit trust by way of interest gains or profits arising from the sale or other disposal or on the redemption on maturity or presentment of securities gains or profits under foreign exchange contracts or futures contracts.
5. Interest on deposits with a bank or a financial institution (but this exemption does not apply to bank or a financial institution who is a taxpayer).

Where a taxpayer makes profits on qualifying debt instruments, such instruments are only taxed at half the relevant profits tax rate. To find out what are “qualifying debt instruments” and their tax treatments, please visit the IRD's website at http://www.ird.gov.hk.

Section 26(b) states that there should not be any double taxation of profits: Any profits chargeable under Part IV of the Inland Revenue Ordinance (Profits Tax) of a person shall not be included in the assessable profits of any other persons under the same part. This provision is to ensure that any part of profit of a partnership will not be taxed again when it is received by a partner (whether he is a corporate or individual partner) as such profit has already been taxed under the name of the partnership.

3.13 When are profits assessable?

This question seldom gives rise to tax disputes. As there are no specific provisions in the Ordinance on this question, the generally accepted accounting practices should apply. Among these practices, the most relevant ones are “accrual” and “prudence” concepts.

As established from case law, a profit (or an income) “accrued” to a person when he is entitled to claim it in law. On the other hand, by the “prudence” concept, profits should not be taken into profit and loss account until they are earned. In other words, neither future profits nor anticipated profits are assessable.

Generally speaking, when goods are delivered or when services are provided, the customers are legally bound to pay --- The sales revenue should then be recognized as “receivables” in the ledger even though their payments are received later.

As regards the interest on a fixed deposit, the day of accrual is the maturity date of the deposit because the depositor cannot claim it before that day. However, for interest on a savings account, the interest accrues to the depositor on a day-to-day basis and so it should be spread evenly throughout the period concerned.

As regards the sale of property by instalments, if the profit on sale is taken in the profit and loss accounts on a pro-rata basis, such basis should be adopted for tax purpose --- see CIR versus Montana Lands Ltd. HKTC 334.

Basis period of assessment

Normally, for a business that has been running on for years, the basis period is either:

1. the period of the year of assessment if the annual accounts ends on 31 March;
2. the accounting year that ends in the year of assessment if the accounts ends on a day other than 31 March ; or
3. the lunar year that falls in the year of assessment if lunar year is adopted for accounting.

Commencement of business

In practice, the day of business commencement declared by the business owner upon registration of business is usually adopted without queries. But in case of dispute, it can be quite difficult to determine the exact day of business commencement. Indeed, which day of business commencement is chiefly a question of facts. Generally speaking, a retailer starts to trade when goods are first offered for sale. A manufacturer starts trading when the manufacturing process begins. A property developer starts trading when he first enters into a project of property development by taking such steps as appointment of an architect to draw up the development plan.

In fact, the day of business commencement affects the deductibility of certain expenditures. Although by accounting principle all expenditures in setting up a business is of a capital nature and therefore should be capitalized, the Revenue does, by concession, allow deduction for those pre-commencement expenditures which are of a revenue expenditure such as rent, electricity, employee salaries and wages… etc. before the business commences.

Section 18C of Inland Revenue Ordinance lays down the rules for determining the basis period of business commencement. The basic principle of such rules is: The basis periods throughout the business life should start from the date of commencement to the date of cessation. Of course, this is to tax all the profits of the business throughout its life. Normally, if the business accounts are made on a 12-month basis, the first basis period will be exactly the first accounting year. Otherwise, there are special provisions. See examples below.

Example A

First business accounts cover 12-months.
Business started on 1 July 2005.
Annual accounts made up to 30 June every year.

Basis periods and assessments:
Year of assessment 2005/2006: No assessment.
Year of assessment 2006/2207: Accounts covering 1 July 2005 to 30 June 2006.
Year of assessment 2007/2008: Accounts covering 1 July 2006 to 30 June 2007.

Example B

First business accounts cover 6 months.
Business started on 1July 2005. First accounts made up to 31 December 2005. Subsequent accounts all made up to 31 December.

Basis periods and assessments:
Year of assessment 2005/2006: From 1 July 2005 to 31 December 2005 --- 6 months.
Year of assessment 2006/2007: From 1 January 2006 to 31 December 2006 --- 12 months.
Year of assessment 2007/2008: From 1 January 2007 to 31 December 2007 --- 12 months.

Example C

First business accounts cover 18 months.
If the first accounting period covers more than 12 months, the Revenue will decide the basis period for the business commencement as it thinks fit. In practice, the profits are apportioned by reference to the normal accounting date.

Business started on 1 July 2005. First account covers 1 July 2005 to 31 December 2006 showing assessable profits of $180,000. Subsequent accounts are made up to 31 December.

Basis periods and assessments:
Year of assessment 2005/2006: Basis period 1 July 2005 to 31 December 2005: $180,000 * 6 / 18 = $60,000.
Year of assessment 2006/2007: Basis period 1 January 2006 to 31 December 2006: $180,000 8 12/18= $120,000.

Cessation of business

Like business commencement, business cessation is largely a question of facts. Usually, the Revenue adopts the day declared as such in the taxpayer's notification to Business Registration Office.

Sometimes, disputes arise on this question. Again, the question of whether a business ceases, or when it ceases, depend on the circumstances of each case. As a general rule, we should look to whether actions are done to close down the business --- Such actions include disposal of stock without replenishment, sale of capital assets, death of a sole-proprietor… etc. Let us see some tax cases on this question.

J. & R. O'Kane & Co. versus CIR 12 TC 303

In this case, a firm of wine merchants decided to close down the business. So, they did not replenish the trading stock. They gradually sold out the remaining stock for two years. It was held that they carried on their business over the last two years.

This was said in the judgment: “A trader who wishes to retire from business may wind up his business in several ways; he may sell his concern as a going concern, or he may auction off his stock. But there is another way quite as effectual, and that is by continuing to carry on his business in the ordinary way, but not replenishing his stock which he has accumulated as it is sold. Then he will leave himself with no stock, and therefore he can retire from business. But the fact that he realizes stock in the process of carrying on the trade as he has hitherto done will effectuate both purposes.”

Cohan's Executors versus CIR 12 TC 602

In this case, a person trading in ships died soon after placing an order for a ship to be built. His executors continued the contract, having refused the shipbuilder's offer to terminate the contract. Then, the ship was finished and sold for a profit. The court held that the executors were not carrying on a trade but were merely realizing the deceased's estate to the best advantage. This was said in the judgment: “It is clear that in many cases a proper administration and realization of a testator's business may involve a continuation of the business for a time so as to dispose of the business as a going concern. … The executors had the benefit of a contract for the building of a ship for them at a price which would be considerably below the market value of the ship when built. It seems to me that was an asset, an a very valuable asset, of the estate of the testator. …. Undoubtedly the executors were realizing an asset, and the only question is whether they were doing something more, whether in the course of realizing it they were carrying on the business”

In the Hong Kong tax case Tai Shun Investment Co. Ltd. versus CIR HKTC 370, the taxpayer, a property developer company, went into liquidation. It was held that there had been no evidence suggesting the liquidator carried on a trade even he did the following things: collection of rent in arrear; collection of instalment payments of purchase; conveyance of title to property to the buyers. The judge ruled that the liquidator's actions were just to tidy up the affairs of the company.

Basis periods involving cessation of business

For a business started after 1 April 1974

The basis period for the year of cessation is from the day following the end of the previous basis period to the date of cessation --- This is to ensure that all the profits throughout the business life are fully assessed. It follows that the assessment may cover a period of more or less than 12 months. The question of whether there is a succession or not has no relevance here. See the following example.

A business started on 1 July 2004. Profits per accounts: year ended 30 June 2005 $200,000; year ended 30 June 2006 $120,000; 6 months to 31 December 2006 $50,000.

<u>Basis periods and assessments</u>
2005/2006: basis period 1 July 2005 to 30 June 2006 $200,000
2006/2007: basis period 1 July 2006 to 31 December 2007 (18 months): $170,000.

For a business started before 1 April 1974

The determination of basis period and profits for the businesses started before 1 April 1974 is different from those started after. This is because there was a change of “preceding year basis” to “actual year basis” in 1974/1975. Moreover, the basis period and profit determination depend on whether the business is succeeded or not. To provide tax relief for certain businesses, a “transitional amount” for the profits commencing on the day following the normal accounting date in 1974/75 to 31 March 1975 may be deducted from the assessable profits for the period from the day following the end of the previous basis period to the date of cessation. Let us see the following example.

A business started on 1 May 1972. Profits per accounts: year ended 31 December 2006 $120,000; 8 months to 31 August 2007 $160,000. Profits for 1 January 1975 to 31 March 1975: 21,000.

<u>Basis periods and assessments</u>
2006/2007: basis period 1 January 2006 to 31 December 2006: $120,000.
2007/2008: basis period 1 January 2007 to 31 August 2007: $160,000 less transitional amount $21,000 equal to $139,000.

Author's comments: The provisions applicable to a business started before 1 April 1974 are becoming stale now. In fact, nowadays in Hong Kong, most businesses are not older than 30 years. And if such an old business exists now, it should have been running well and hence it should go on and on. As such, the provisions for cessations of such old businesses are of little practical importance.

Change of accounting date

Where there is a change of accounting date, at least one of the following must occur in a year of assessment:

1. there are two sets of accounts ending within one year of assessment; or
2. accounts are not made up to the old accounting date.

That year of assessment is called the year of change.

In these situations, Section 18E of Inland Revenue Ordinance empowers the IRD to assess the profits for the year of change as well as the year preceding the change on such basis as it thinks fits. In practice, the IRD is to assess, on one hand, as far as possible all the profits throughout the business life and, on the other, to get the assessments on to the new accounting date as soon as possible.

Example A

Two sets of accounts end within one year of assessment. So, Section 18E(1)(b) of Inland Revenue Ordinance applies here. Business started on 1 May 1998.

Assessable profits are as follows:-

- 12 months to 30 April 1999: $270,000
- 12 months to 30 April 2000: $280,000
- 8 months to 31 December 2000: $220,000
- 12 months to 31 December 2001: $300,000

Year of change is 2000/2001 (because two set of accounts end in that year of assessment). The Revenue's discretion applies to 2000/2001 and 1999/2000.

Basis periods and assessable profits

- 1998/1999: Nil
- 1999/2000: 12 months to 30 April 1999: $270,000.
- 2000/2001: 12 months to 30 April 2000: $220,000 plus 8 months to 31 December 2000: $280,000 equal to $500,000. (The inclusion of the extra 8 months profits is to ensure that all profits throughout the business life are fully assessed.)
- 2001/2002: 12 months to 31 December 2001: $300,000.

Example B

Accounts are not made up to the old accounting date.
So, Section 18E(1)(a) of Inland Revenue Ordinance applies.
Business started on 1 October 1999.

Assessable profits are as follows:-

- 12 months to 30 September 2000: $200,000
- 12 months to 30 September 2001: $240,000
- 9 months to 30 June 2002: $200,000
- 12 months to 30 June 2003: $290,000

Year of change is 2002/2003 (because accounts are not made up to the old accounting date). The Revenue's discretion applies to 2002/2003 and 2001/2002.

Basis periods and assessable profits

- 1999/2000: Nil
- 2000/2001: 12 months to 30 September 2000: $200,000.
- 2001/2002: 12 months to 30 September 2001: $240,000
- 2002/2003: 9 months to 30 June 2002 $200,000 plus 3 months to 30 September 2001 $240,000 * 3/12 = $60,000; total profits assessed = $200,000 + $60,000 = $260,000. (There is a double assessment of the profits for the 3 months to 30 September 2001 --- this double assessment is made by the Revenue's discretion to bring up the assessable profits to cover 12 months)
- 2003/2004: 12 months to 30 June 2003: $290,000.

3.14 Deductibility of expenses

Like assessing profits, the basic principle of "following the generally accepted commercial principles subject to provisions made in the Ordinance" applies to allowing deductions.

Generally speaking, the basic questions to ask are:

(a) Is it a capital or revenue expenditure?
(b) Does it meet the Section 16(1) conditions?
(c) Is it disallowed by Section 17?
(d) Was it incurred in the basis period?

3.15 Capital expenditure or revenue expenditure?

What is capital expenditure? How to distinguish it from revenue expenditure? Regrettably, the Inland Revenue Ordinance does not give a clear answer to these questions. So, in that case, we have to look to the generally accepted accounting principles. Also regrettably, the accounting principles in this area are not authoritatively and clearly set out. Nevertheless, based on general accounting practices, there are three factors to be considered: (1) the nature of the expenditure, (2) the period of use and (3) the materiality of the expenditure.

Nature of expenditure

If the expenditure is for purchase of a fixed asset such as a land property, a plant, a machine, a computer, a motor vehicle… etc., then it will normally be regarded as a capital expenditure. If an expenditure is for purchase of trading stock or for the day-to-day running of the business (such as rent, salaries, wages, electricity, water, management fee… etc.), it will be of a revenue nature.

Period of use

A capital expenditure normally has a useful life for a number of years. A revenue expenditure usually has a short useful life of less than one year.

Materiality of expenditure

A capital expenditure usually costs a lot of money, for example, the purchase of an office or a motor car. On the other hand, a revenue expenditure is usually an immaterial item, for example, the purchase of some ball pens. It should be noted that an immaterial item, such as a stapler, can have a useful life for many years --- but as it does not worth keeping record for such immaterial thing as a capital asset --- it is still treated as a revenue expenditure under the name of stationery or office supplies.

Case law on capital and revenue expenditure

Because the accounting practices on distinguishing capital from revenue expenditure are not totally clear and authoritative, there are a number of court cases on the question. From case law, a capital expenditure is an expenditure on fixed capital; whereas a revenue expenditure is an expenditure on circulating capital. Indeed, there have been a lot of court cases on the issue. In fact, at the beginning of court judgments, many judges like to quote the economist Adam Smith's definition on fixed and circulating capital, which is stated in his famous book [*The Wealth of Nations* 國富論], which is quoted for you as follows:

"Fixed capital is what the owner turns to profit by keeping it in his own possession whereas circulating capital as what he makes a profit of by parting with it and letting it change masters. The latter capital circulates in this sense. Thus premises, plant, leases and goodwill are fixed capital retained and used in the business. They form part of the permanent structure of the business and receipts for their sale, or compensating any physical loss or damages will be capital receipts and not taxable. On the other hand, an asset will be a part of the circulating capital of the business if it is acquired in the ordinary course of trade, and is sold, or is used in manufacturing what is sold e.g. trading stock, raw materials. Receipts related to these items are revenue receipts and taxable."

In fact, an asset can, on one hand, be a fixed capital to a trader; but on the other, a circulating capital to another trader. Indeed, the distinction between them depends very much on the nature of the trade of the trader concerned and how the asset is used by that trader. Take a motor vehicle as an example: It is a fixed capital to most traders; but it is a circulating capital to a trader or a manufacturer of motor vehicles.

Whether an expense is capital or revenue is a question of facts as well as a question of law --- and indeed, it is to be determined on the merits of each particular case. It is trite to say that there are no hard and fast rules for this question. It is usually, and regrettably, not a question with a clear answer of yes or no. As a matter of reality, it is hard to distinguish capital nature from revenue nature in practical circumstances. So, there are many tax cases on the question. Below are some important ones.

British Insulated and Helsby Cables v Atherton

In this case, the company paid a lump sum to make the nuclear fund of a retirement scheme for its staff. It was held that the lump sum was of a capital nature because it was a "once and for all" expenditure. Author's note: The test of "once and for all" was commented by many judges afterwards and now it should not be used as the only and conclusive test for the issue.

Vallambrosa Rubber Co. Ltd. v. Farmer

This case concerned the deductibility of expenditure incurred in planting rubber trees which had not produced rubber yet during the basis period. In his judgment, the judge said: “Capital expenditure was spent once and for all; whereas income expenditure was expected to be recurrent.” Author’s comments: This test is not final or conclusive either. Indeed, there are many cases where payments made once and for all were held to be revenue in nature and deductible, for example, in the case Smith v. Incorporated Council of Law Reporting for England and Wales [1914] 6 TC 477: a lump sum paid to a law reporter on his retirement was held to be of a revenue expenditure.

National Australia Bank Ltd. v. FCT

In this case, a substantial one-off sum was paid to enable the taxpayer to acquire a right to be the exclusive lender under a home loan scheme --- the payment was held to be of a revenue expenditure. Author’s comments: There are, however, tax cases in which certain recurrent payments were held to be capital in nature, for example, in the case IRC v. Land Securities Investment Trust Ltd. [1969] 45 TC 495, certain “rent payables” covering a period of ten years which was in consideration of the purchases of some properties were held to be of a capital expenditure and in the Hong Kong case, Wharf Properties Ltd. v. CIR [1997] 4 HKTC 310, interest paid on loans which were used to acquire certain land for redevelopment was also held to be of capital nature.

IRC v. Carron Co. [1968] 45 TC 65

A payment having a long-term advantage can still be of a revenue expenditure. In this case, the company, which was incorporated by royal charter, incurred certain expenditure on obtaining a new charter in order to remove certain restrictions on its business operations imposed under the old charter. It was held that the expenditure was of a revenue nature because the expenditure was to facilitate better administration and management of the company.

Wharf Properties Limited v CIR 4 HKTC 310

This case concerns whether certain interest payments are of a capital nature or revenue nature. The company was a wholly-owned subsidiary of Wharf (Holdings) Limited. It entered into an arrangement to purchase a tram depot at Causeway Bay. The purchase was stated to be for the redevelopment of the depot into a commercial complex subject to a condition for the provision of tram depot after the redevelopment. The commercial complex was now known as Times Square. The purchase money was financed by short-term loans from banks and financial institutions. The company paid millions of interest before the completion of the project. Before its completion, it sold the redevelopment to another wholly-owned subsidiary company of the Wharf group. The Revenue argued that the interests paid should be disallowed because it was of a capital nature. The Revenue’s argument was upheld by the High Court, Court of Appeal and also the Privy Council.

Author’s comments: Interest incurred for the acquisition of a fixed asset is of a capital nature. But once after the fixed asset was put to use for earning assessable profits, the interest will have a revenue nature and thus it may be tax deductible subject to other conditions of the Inland Revenue Ordinance. For more about interest deduction, please see my tax tip on interest deduction below. Indeed, the Wharf Properties case is important because of the judge Chan J comments on the term 'capital expenditure': capital expenditure includes that is incurred as a capital and also expenditure which, although not a capital in itself, is payment of a capital nature. In his judgment, he said that if the expenditure was a capital payment, it was of course caught by section 17(1). But even if it was not a capital payment, the court had to consider whether it was of a capital nature or revenue nature. According to the judge, in order to decide the question of whether an expenditure was of a capital or revenue nature, one had to examine not only the status or nature of the expenditure but also the reason or purpose for which and the circumstances under which it was incurred. None of the tests was decisive. The answer to the question depended very much on the facts of each case and ultimately it was common sense appreciation of all the guiding features which would provide the answers. In his judgment, the judge laid down some tests on the question of ‘whether a particular payment or item of expenditure can be regarded as capital in nature’ namely: (a) fixed or circulating capital test, (b) once and for all or securing expenditure test, (c) enduring benefit test, (d) profit yielding structure test (e) the three matters considered by Dixon J in Sun Newspapers Limited & Associated Newspaper Limited v Federal Commissioner of Tax [1938] 5 ATD 87.

Author’s summary

First, I would like to quote what was what Dixon J said in the case of Sun Newspapers Ltd.: "There are three matters to be considered: (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment."

Second, I would refer to the Board of Review case D95/89: A taxpayer paid a deposit on application for a government tenancy and subsequently he forfeited it upon withdrawal of the application. That payment was held to be capital in nature and therefore it was not deductible. Besides, in the Board of Review case D5/91, a lump sum payment to acquire a permanent membership in a trade association was held to be of a capital nature.

Third, I would quote the following Hong Kong tax case.

CIR v. Tai On Machinery Works Ltd. [1969] 1 HKTC 411

In this case, the company erected a building for its own use and that building was of course a fixed capital. The company borrowed money to finance the erection of the building and so paid interest on the loan. It was held that before the building was ready for use by the taxpayer, the interest on the loan for such periods was of a capital expenditure and so, it was not deductible; whereas for the interest payable after the building was available for use, it was revenue expenditure and therefore deductible.

Regrettably, although there are so many tax cases, there is no one single simple and fast rule evolved to decide whether a payment is capital or revenue. To sum up the case study, I would like to quote the following judges' comments.

- In the case Atherton v British Insulated and Helsby Cables Ltd 10 TC 155, the judge said: "It is easy to imagine many cases in which a payment, though made 'once and for all' would be properly chargeable against the receipts for the year…" (Author's interpretation of the judgment: A 'once and for all' payment is probably of a capital nature but it is not always a capital expenditure; it can be a revenue expenditure in a particular case.)
- In the case BD Australia Limited v Federal Commissioner of Tax [1965] 112 CLR 386, the judge said: "Fixed capital is prima facie that on which you look to get a return by your trading operations. Circulating capital is that which comes back in your trading operations."
- In the case Sun Newspapers Ltd. v. F. C. of T [1938] 61 CLR 337, the judge said: "Expenditure is of a capital nature if its purpose is to establish, replace, or enlarge the capital structure of the business... Recurrence is not a test; it is no more than a consideration the weight of which depends upon the nature of the expenditure."

Anyway, having read the judges' above wise comments, if you are still unsure as to whether your lump-sum expenditure is of a revenue or capital nature, I suggest you claim full deduction first. Then, if your claim is questioned or disallowed by IRD, you should seek professional advice on whether you should fight or give up.

Special provisions in the IRO

The following expenditures, although they are of a capital nature, are still tax deductible because of the specific provisions in the Inland Revenue Ordinance.

(a) Section 16(1)(g) allowing deduction for registration of trade mark, design, or patent – see paragraph 3.34 below ;
(b) Sections 16A and Section 16AA allowing deduction for approved retirement schemes – see paragraph 3.30 below;
(c) Section 16B allowing deduction for scientific research – see paragraph 3.36 below;
(d) Section 16E allowing deduction for purchase of patent rights – see paragraph 3.34 below;
(e) Section 16F allowing deduction for building refurbishment over 5 years of assessment – see paragraph 3.27 below;
(f) Section 16G allowing deduction for purchase of computer hardware or software – see paragraph 3.29 below and for purchase of machinery for manufacturing – see paragraph 3.46 below.

3.16 Section 16(1) deductions

Section 16 of Inland Revenue Ordinance states that in ascertaining the assessable profits there shall be deducted outgoings and expenses to the extent to which they are <u>incurred in the production of the profits</u> chargeable to tax for <u>any</u> year of assessment.

Because Section 16(1) allows deduction of expenses to the extent that they are incurred in the production of assessable profits, expenses charged in the accounts are to be apportioned between "deductible" and "non-deductible" wherever applicable. The

Revenue's practice for the apportionment is based on Rules 2A, 2B and 2C of the Inland Revenue Rules which are quoted as follows:

(a) where profits are derived partly within Hong Kong and partly outside:
Expenses directly attributable to the profits derived outside Hong Kong are to be disallowed --- Apportionment is based on turnover or sales.

(b) where profits are derived from trading (taxable) and also from dividends (non-taxable):
   (i) interest incurred for financing the investments producing dividends --- not allowable.
   (ii) management cost of the investment --- no apportionment needed in general.

In the production of assessable profits

The UK income tax law allows expenditure incurred "for the purpose of the trade" – see Section 130 of ICTA 1970. Australia and South Africa tax law adopts "in the production of (or producing) the income", similar to Hong Kong. From the Hong Kong court cases, it appears that there are no clear distinctions between the UK's "for the purpose of the trade" and the Hong Kong's "in the production of profits". This is evidenced in the Hong Kong tax case CIR versus Swire Pacific Ltd. HKTC 1145 in which similar criteria to those of UK have been adopted. Below is my summary of the case.

CIR versus Swire Pacific Ltd.

Swire Pacific carried on a shipyard business. In early seventies, its workers went on strike when the company decided to merge with another company. In order to end the strike, the company paid to the workers "retirement grants" of $22,000,000. The

Revenue disallowed $18,000,000 as deduction on the grounds that such payment had not made in the production of profits of the business that had just three more months to last; but rather, it was to preserve of the company's assets and to safeguard the merger. The court rejected the Revenue's contention and ruled that there was ample evidence to support that the payment was to get the workers back to work, so that the company could continue to earn profits for the remaining months and to avoid damages had the strike continued; and hence, it was for the production of profits. It follows from this case that if a payment is made with “a purpose of earning profits”, it is deductible even though the payment turns out to be unprofitable.

Below is a Board of Review case on section 16(1).

Board of Review Case No. D46/02

In this case, 80% of the sauna, gymnasium and physical- fitness expenses incurred by a jockey was held to be deductible. The issue was whether a jockey was entitled to deduct expenses for sauna, gymnasium and physical training from his assessable profits? The taxpayer was a professional jockey. In his tax return he sought to deduct an apportionment of 80% of $87,490 which was the sum total of various expenses including sauna, gymnasium and physical training. The CIR in his determination rejected the claim on the grounds that the expenses were of a private nature and therefore not deductible by virtue of section 17(1) of Inland Revenue Ordinance. The case went to the Board. During the hearing the taxpayer called three jockey trainers to be his witness to give evidence as to why the jockey’s weight was so important. The taxpayer submitted that his normal weight was 118 pounds but he had to keep within 113 pounds in order that he could ride a horse that was to carry 116 pounds. He stressed that that was not easy. To achieve that, he had to go regularly to the gymnasium to do very strenuous exercises.

Author’s comments

The taxpayer’s claim was not fully substantiated by receipts. Although the Revenue was challenging the amount spent and querying whether they were actually spent, the appellant did not provide further evidence in support of his claim. It was held that:

1. The onus was on the appellant to satisfy the Board that the expenses were incurred.
2. For the purpose of this appeal, the Board was only prepared to accept the eight invoices totalled $5,600. The appellant might well have incurred other similar expenses during the material period. However it was not for the Board to speculate as to how much more he might have incurred.

The Revenue did not challenge the appellant's evidence that his normal weight was 118 pounds and he had to deduct five pounds in order to make the necessary weight to ride some of the horses that were required to carry a weight of no more than 116 pounds. The Board found that the expenses were indeed for business purpose and allowed 80% of the $5,600 proved by the appellant.

The conditions for a deduction under profits tax does not require the whole of the expenses was incurred in the production of assessable profits. Part of the expenses with a private nature does not disqualify the deduction. Rather, the deduction can be granted to the extent of the expenses, in the above case: 80%, that was incurred for business purpose. How much is the extent deductible depends on the merits of each case. But it is advisable for the taxpayer to keep full record, including the date, amount, nature of the expenses and the bills, receipts, vouchers to prove his claim in case of IRD's challenge.

For any year of assessment

To qualify for the deduction, the expenditure needs not only to be for the production of chargeable profits for the year of assessment in which the expenditure incurs, but also for any year of assessment. In practice, the IRD takes "any year of assessment" to mean any following year of assessment. For example, if a taxpayer pays insurance premium for production of profits in future years, it can still be deductible.

3.17 Section 17 of Inland Revenue Ordinance

Subject to other provisions in Inland Revenue Ordinance, the followings are not deductible under section 17:

- domestic or private expenses --- subsection (a)
- expenses not for production of assessable profits --- subsection (b)
- capital expenditure --- subsection (c)
- cost of improvements --- subsection (d)
- any sum recoverable under insurance or contract of indemnity --- subsection (e)
- rent for premises not used for production of assessable profits --- subsection (f)
- taxes paid under the Ordinance other than salaries tax of employees --- subsection (g)
- excessive annual ordinary contributions to approved retired schemes ("excessive" means the contribution for a particular employee is more than 15% of his total emoluments) --- subsections (h). (i), (j), (k) and (l)
- any remuneration, interest on capital, voluntary contribution to mandatory provident fund in respect of the proprietor, or his spouse, a partner or his spouse --- subsection (2).

3.18 When an expenditure is incurred?

Section 16(1) says expenses "incurred" during the basis period are deductible. Regrettably, the word "incurred" is not defined in the Inland Revenue Ordinance.

From case law, "incurred" does not completely mean "paid". Generally speaking, an expenditure is incurred when the claimant has committed a definite or absolute or committed liability and that the amount has been ascertained on an accurate basis, even though the amount of liability may not yet be determined – See CIR v Lo & Lo 2 HKTC 34.

Accrual for rent, interest, insurance, lighting and heating… etc.

in respect of the accounting period are acceptable for tax purpose. In other words, no adjustments are necessary.

Provisions for contingent liabilities are generally not allowable. Transfer to a general reserve against possible future expenditure or loss is not allowable either.

3.19 Prepaid expenditure

In short, prepaid expenditure is payment in advance for purchase of goods or services or for use of a property. Letting alone the nature of expenditure, the timing of expenditure can sometimes give rise to disputes as to which basis period they belong.

It is well established that generally accepted accounting principles apply unless there are specific provisions in the Inland Revenue Ordinance. In fact and indeed, the “accrual” accounting practice as regards payments in arrear has all long been accepted by IRD. As for payments in advance, before the "Secan" case (see below), the IRD accepted full deduction in the basis period of payment even though the expenditures should be carried forward to match future related income / period under the "accrual" practice. Now, from the Secan case onwards, the IRD has revised its practice so that full deduction will not be granted if the taxpayer’s accounts have adopted "accrual concept" in respect of the prepaid expenditure. Below is my summary of the Secan case

The Secan case

Precisely, the name of the case is Commissioner of Inland Revenue v Secan Limited & Ranon Limited 5 HKTC 266. In this case, the taxpayers were engaged in the development of property for sale. The financed the developments by borrowings. The development took years to complete. Rather than expensing the interest on the loans in the year in which it was incurred, the taxpayers capitalized the interest as part of the cost of developments. When the property was sold four years later, the taxpayers claimed deduction for the total interest expenses although a major portion of the interest expenses were capitalized to stock or work-in-progress at the year end. CIR disallowed the claim on the grounds that upon capitalization the interest charges had been deducted in calculating profits and therefore could not be deductible again. The taxpayer contended that by failing to deduct interest charges for the earlier years, its tax computations understated the loss in these years. In other words, the taxpayer claimed back deductions for all the prior-years interest expenditure. The CIR's contention was that the taxpayer's computations and financial statements for the first three years, which were agreed to show a true and fair view of the taxpayer's affairs, were correct; the Ordinance did not prohibit the capitalization of interest; and furthermore, because of the capitalization, the interest could not give rise to any losses brought forward. The Board upheld CIR's determination and ruled that the expenses had been deducted in the “value of trading stock”. The Court agreed with the CIR's contention.

3.20 Cost of goods sold

As you know, profit equals sales minus cost. The question of what "sales" or what "income" are assessable are discussed in paragraph 3.7 above. Now, let me talk about what is "cost" or precisely, what is "cost of goods sold".

A trader selling goods must first get it, buy it or make it. Therefore, the cost of acquisition or cost of purchase or cost of production --- including all the related costs such as delivery, commission, breakage... etc as well as the cost of manufacturing --- must form part of the cost of goods sold. For an on-going business, not all the goods purchased or not all the goods manufactured during the accounting year are sold out at the end of the year --- as such, the cost of the remaining goods or the closing stock or the work-in-progress at accounting year end must be excluded from the total cost of goods sold for the year --- and such cost of unsold goods should be carried forward to the following year to match the related sales of that following year. Then, in the following year, there will be cost of goods brought forward (called opening stock) at the start of accounting year and such opening stock must form part of the cost of goods sold for that following year.

If we put the aforesaid into a mathematical formula, that is to say:

Profits = Sales - Cost of goods sold; whereas:
Cost of goods sold = Opening stock + Cost of purchases - Closing stock.

Indeed, this accounting equation is well known to every accounting and tax professional.

In practice, the computation of cost of purchases seldom gives rise to tax disputes. But the valuation of stock can sometimes lead to tax disputes because there are a number of valuation methods of stock valuation under the so-called generally accepted accounting practices and in fact, different methods of stock valuation can give rise to different amounts of assessable profits.

3.21 Valuation of stock

In the context of this topic, stock refers to the goods for sale in the course of trading. As there is no specific provision in Inland Revenue Ordinance on the topic, we have to follow the generally accepted accounting practices and the relevant case law. Indeed, it is a well known accounting practice that trading stock is valued at the lower of cost and net realizable value.

What is Cost?

The IRD adopts the definition of “cost” in the Statements of Standard of Accounting Practice (SSAP) issued by Hong Kong Institute of Certified Public Accountants from time to time. In brief, “cost” means the actual or historical cost. This includes all costs incurred directly on the purchase, conversion and bringing the stock to its existing location and condition. Also included is the overhead expenditure which can appropriately be allocated to the cost of stock --- and as such, the overhead expenditure is carried forward as part of the closing stock, instead of being recognized as a revenue expense in the period in which it was incurred.

In the case of property development, borrowing costs (such as interest on loans to finance the development) may be included in the cost of work-in-progress or stock of property units. As for manufactured goods, cost includes raw materials, direct labour, other direct charges and allocated indirect manufacturing overhead expenditure.

To what extent indirect expenses or overheads should be included in the stock valuation? This question can sometimes lead to tax disputes. Normally, the generally accepted practice of that particular industry should be adopted; but it is not uncommon to find different practices adopted by different accountants in the same industry. In that case, the emphasis is on "consistency" --- providing the method is one of those commonly used in that industry and it is consistently adopted by the taxpayer from year to year, the IRD will accept it for tax purpose.

Apart from the absorption of overhead into cost of stock, there are indeed a number of stock valuation methods as suggested by different accounting textbooks. As this is a big accounting topic, I do not want to go into details of how these methods work. If you want to know more about these methods, I suggest you read an accounting textbook. Anyway, I would like to tell you that not all the valuation methods found in accounting textbooks are acceptable for tax purpose. So, you may ask the following question.

Which method of stock valuation is acceptable for tax purpose?

Below is a summary of the views as announced by the IRD in its Departmental Interpretation and Practice Notes No. 1.

- First-in-first-out (stock is valued on the assumption that the one purchased first will be sold first): This method is generally acceptable for tax purpose.
- Standard cost (stock is valued at a standard price according to the judgment of the valuer): This method is acceptable if the standards are frequently revised to reflect the actual or historic cost,
- Adjusted selling price (stock is valued at selling price less the normal profit margin): This method is frequently used by retailing industry, for example supermarkets. It is acceptable if it gives a reasonable approximation of the historical cost.
- Last-in-first-out (stock is valued on the assumption that the one sold will be the one bought latest): This method is not acceptable for tax purpose because it does not reflect the historical cost of closing stock.
- Base stock (stock is valued on the assumption that certain amount of goods are maintained as a buffer): This method is not acceptable for tax purpose, also for the reason similar to LIFO.

As said earlier, stock is valued at the lower of cost and net realizable value. Having discussed about "cost", I would like to explain the meaning of "net realizable value".

What is Net Realizable Value?

Net realizable value means the anticipated selling price less the selling expenses. This value should be determined under normal market conditions and not under forced sale in bulk. As you now can see, net realizable value is, put it simply, the estimated current market price.

Fair value

The concept of “fair value” is introduced in the latest accounting standards on valuation of stock. This concept follows the well-known “true and fair view” principle for preparation and auditing of financial statements of limited companies. The question of whether a valuation is fair or not is often a professional judgment in the light of a number of factors including the condition and location of the stock and the prevailing market situation. For special kinds of stocks with significant value (for example: a building under development), the valuation (fair value) should be certified by an independent professional (for example: a property surveyor).

Summary of court cases

As said before, there are a number of court cases on stock valuation. The following is my summary of some important ones.

- Ahmedabad New Cotton Mills Ltd. v. Bombay Commissioners of Income Tax: If opening and closing stocks were undervalued, the true profits could be established by raising both valuations.
- CIR v. Cock Russell & Co. Ltd: It is right to use the lower of cost or market value (i.e. net realizable value) to individual items of stock.
- Minister of National Revenue v. Anaconda American Brass Ltd: The L.I.F.O. method of determining cost was rejected by the Privy Council.
- Patrick v. Broadstone: The base stock method was rejected.
- Duple Motor Bodies Ltd. v. Ostime: The valuation method should be consistent from year to year.
- Freeman, Hardy & Willis v. Ridgeway: The replacement value method was rejected.
- CIR v. Quitsubdue Ltd: A trader takes goods out of trading stock for own use was not trading. The cost should be deducted from the purchase cost of the stock. No profit computed on the market value of the stock taken should be assessed.
- CIR v. Secan Limited: Interest expense was absorbed into

the valuation of work-in-progress of a property developer. The property developer's claim for full deduction of the interest expense on the grounds that it has already been incurred during the basis period was rejected. This was because by capitalization of the interest, the interest would be deductible when the trading stock was sold. Moreover, where a generally accepted accounting practice has been adopted by the taxpayer for preparation of accounts, it should be followed for determination of assessable profits unless there are specific provisions in the law.

Special kinds of stocks

In practice, there are three special kinds of stock, namely (a) shares and securities, (b) building and engineering contracts and (c) investment properties, requiring special accounting and taxation treatments.

In fact, item (c) investment property is not a kind of trading stock; it is, strictly speaking, a kind of capital expenditure and so, it should be read in conjunction with paragraph 3.10. Its discussion here is because it is a kind of stock mentioned in the IRD's Departmental Interpretation Notes No. 1 under the topics of "Valuation of Stock".

The reason for special accounting treatments of the three kinds of stock is chiefly due to the special nature of such stocks. For a comprehensive understanding of the relevant accounting treatments, I suggest you study the Accounting Standards as published by the Hong Kong Institute of Certified Public Accountants from time to time . As a law principle, standard accounting practices are to be followed for tax computation in so far as they are not in conflict with the tax law. Regrettably, accounting standards are not easy for a layman to understand. Fortunately, most small-to-medium enterprises do not have these three kinds of stocks. So, in general, they need not bother the accounting standards much. Anyway, for your reference, the accounting and taxation practices for the special stocks are summarized as follows.

Shares and securities held as trading stock

Obviously, the taxpayers concerned are those engaged in share dealings. Such taxpayers include stockbrokers, share dealers, investment consultants and securities traders. The value of the stocks and securities does not depend on their cost of acquisition but hinges on their market price that fluctuates from time to time. Their valuation in the balance sheet is, as a usual accounting practice, shown at their market value as at the balance sheet date instead of "at the lower of cost or net realizable value". So, in line with the usual commercial practice, the IRD in its Departmental Interpretation Practice Note No. 1 says: "The Department does not regard as obligatory the valuation of shares and securities held as trading stock to be at the lower of cost or market value. Either a valuation on a consistent basis of cost or a consistent basis of the lower of cost or market value would be regarded as a valid basis acceptable to the Department." It also says: "In the banking and securities industries, securities held for dealing purposes are usually carried at market value held for dealing purposes are usually carried at market value, with fluctuations in values of such securities taken to the profit and loss accounts, irrespective of whether they are realized profits or losses. This basis, if consistently applied, is acceptable for taxation purposes."

Building and engineering contracts held by property developer

This topic concerns property developer only. As you know, most property developers are very big corporations and they employ a variety of professionals including engineers, accountants and tax consultants. Property development frequently involves building and construction work covering several years of assessment. Indeed, valuation of building and construction work (i.e. contract work) is a big and controversial topic. It concerns how and when to take profits throughout the construction (or the contract) period. In this regard, the DIPN says: “The Department generally accepts the principles promulgated in SSAP that when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date... Profits recognized in the financial statements of an accounting year under the percentage of completion method should be adopted for tax purpose.”

Investment property

“Investment property”, or sometimes called as “property investment”, refers to the property held for rental income. Investment property is not a trading stock; it is a long-term investment. Any profits (or losses) from the sale of long-term investments are of a capital nature. As a general taxation principle, capital profits are not taxable and capital losses not deductible. On the other hand, any income derived from the holding of the investment is of a revenue nature and taxable.

As far as taxation is concerned, valuation of investment property means capitalization of all expenditures in connection with the acquisition of the property. That is to prohibit the tax deduction of all expenditures of acquisition before the property is put to use (in this connection “put to use” means the letting out of the property). After acquiring the property, the property can be let out for production of assessable profits. Therefore, the expenditures incurred after the date of acquisition (or for the period after the acquisition) are of a revenue nature and tax deductible.

In its DIPN No. 1, the Revenue says: “Where a person incurs expenditure on the acquisition… of a property… for the production of income by way of letting, it is of primary importance that all capital expenditure is correctly treated for taxation purposes; it is always necessary that there be a strict application of proper principles in distinguishing between revenue and capital expenditure… All overhead expenditure, including administration expenses, correctly attributable to the acquisition of the site and the construction of the property, are properly capitalized. These will include finance expenses up to the date when the property is capable of being used for the production of profits... This will usually be the date of the Occupation Permit or the date from which rent is first receivable. After that date interest is correctly a revenue charge. The remuneration of employees and staff directly engaged on the planning, construction and fitting up of the property should also be included in the expenses charged to the cost of the property."

3.22 Sales expenditure

Section 16(1) of Inland Revenue Ordinance lays down the basic test: An expense is allowable if it is incurred in the basis period for the production of assessable profits. Based on this principle, expenditure for sales promotion, marketing and delivery of goods or services are generally deductible.

Nevertheless, the following topics sometimes give rise to tax disputes:

- business entertainment
- commissions, rebates and discounts
- bad debts
- entertainment expenditure

Business entertainment expenditure is generally tax deductible. This is because the expenditure should, by its very nature, be incurred in the course of the business and therefore it satisfies the Section 16(1) condition, namely: "incurred in the production of assessable profits".

In the case Bentleys, Stokes and Lowless versus Beeson 33 TC 491, a firm of solicitors claimed the cost of entertaining clients. It was held that the expenditure was deductible because it had been made for promotion of business. The judge ruled that the fact that the firm partner received some benefit from the expenditure could not change its purpose that qualified the deduction.

Since most business entertainment is deductible, the IRD will not query it unless the amount is very big or unreasonable. In that case, the IRD may challenge: To what extent the expenditure is incurred in the production of profits? Depending on the amount claimed and the information available, the IRD will disallow the portion that is, in its opinion, not attributable to production of profits. In that case, if the taxpayer does not agree to the disallowance, he will have to lodge a formal objection. As stipulated in Section 68(4) of IRO, the burden of proof that the assessment is excessive is on the taxpayer. Therefore, it is always advisable for the claimant to keep detailed record of business entertainment expenditure including date, purpose of entertainment, name of client, vouchers and bills.

3.23 Commissions, rebates and discounts expenditure

According to Departmental Interpretation and Practice Note No. 12, the Revenue requires separate disclosure of the above items when the taxpayer submit his tax return. The separate disclosure should be made in a schedule annexed to the tax computation. Small businesses are however exempt from such disclosure although they are still required to keep such information as the Revenue may require the information within seven years of such payments.

The IRD's requirements stated in the practice note are : “Instead of showing the income net of commissions, rebates and discounts, taxpayers should return the gross income and clearly distinguish the payment of commissions, rebates and discounts in the accounts and tax computations submitted in support of profits tax returns. Besides, the following information should be disclosed upon enquiry:

(i). full name, address and identity card number or business

registration number of the recipient;
(ii). whether the recipient has any relationship with the taxpayer;
(iii). amount of the payment;
(iv). details of services rendered; and preferably
(v). evidence of payment."

Failure to meet the requirements may give rise to disallowance of the expenditure or penalty for not keeping sufficient business record. Besides, the Revenue may seek to assess the taxpayer on the payments as if he were the "agent" of recipient.

Furthermore, the Revenue issues the following warning: "Where taxpayers have made commission, rebate and discount payments without proper disclosure and caused loss to the revenue, they are advised to take advantage of the statement of practice relating to voluntary disclosure contained in Departmental Interpretation & Practice Notes No. 11 (Elements of Tax Investigation).

Taxpayers who do not comply would run a grave risk of prosecution under the Inland Revenue Ordinance when, as a result of Departmental enquiries, evidence of concealed commissions is obtained. In addition, the auditor responsible may also be liable to prosecution under sections 80 and 82 of the Ordinance."

3.24 Bad debts

Bad debts are debts that have become irrecoverable. Not all bad debts are tax deductible. Generally speaking, a deductible bad debt must fulfill two conditions:

(a) Had the debt been good, the revenue from the debt would have formed part of the assessable profits.
(b) The debt is proved to have become irrecoverable during the basis period --- See Section 16(1)(d) of IRO.

All trading debts giving rise to Hong Kong profits meet the first condition. No deduction will be allowed for those debts in relation to operations or activities outside Hong Kong if their receipts are not assessable.

The taxpayer is required to supply documentary evidence of the recovery action to prove the debt having become irrecoverable. Just identifying a debt appearing to be irrecoverable is not sufficient. The taxpayer should have taken actions to recover the debt. Recovery actions include writing to the debtor to ask for payment. If the debtor does not pay within a time limit, the debt will generally be accepted as bad and qualify a deduction.

Doubtful debts are deductible if they are estimated to be bad as at the Balance Sheet date. But the taxpayer may be required to supply the name and address of the debtor, the nature of the debt and details of the recovery action to prove the claim for the deduction. Generally speaking, all specific provision for bad debts is deductible. But general provision for bad debts is not deductible because the composite debtor and the related recovery action cannot be substantiated.

The question of whether the debt is bad should be decided honestly in the circumstances as at the Balance Sheet date. Matters occurred after this day should be ignored.

The receipts recovered from the bad debts that have been allowed bad are assessable.

3.25 Protecting or defending an asset

In principle, the expenditure incurred for protecting or defending an asset which is used for production of assessable profits is deductible.

In the case Morgan versus Tate & Lyle Ltd. 35 TC 367, the company waged an extensive propaganda campaign that was intended to prevent nationalization of the whole of the company's trade. The court ruled that the expenditure was for the purpose of the trade. The judge commented that defending a profit earning asset, or all the company's assets, came within the definition of for the purpose of the trade.

3.26 Repair and replacement expenditure

Section 16(1)(e) allows cost of repairs to premises, plant, machinery, implements, utensils or articles used in earning assessable profits.

Inland Revenue Rule No. 2 defines “implements, utensils or articles” to include the following: belting, crockery and cutlery, kitchen utensils, linen, loose tools, soft furnishings, surgical and dental instruments, tubes for x-ray and infra-red machines.

Repairs expenditure should be distinguished from improvement expenditure because the former is allowable while the latter is non-allowable deduction under Section 17(1)(d).

Generally speaking, “repair” means reverting the asset to its original capability or function, whereas “improvement” means a new function or a significant enhancement made to the original asset. In practice, most repairs may involve some elements of improvement --- If the elements of improvement are minor or only incidental to the repair, the whole amount is still deductible without separating the cost of improvement from the cost of repair.

If improvement expenditure satisfies other provisions in the Inland Revenue Ordinance, such as scientific research, computer stuff, machinery for manufacturing ... etc., it is still deductible. Furthermore, it can qualify depreciation allowances if such expenditure is related to "plant and machinery".

Replacement or repairs expenditure for “implements, utensils or articles” is an allowable deduction.

3.27 Refurbishment expenditure

Section 16F allows deduction for expenditure on renovation or refurbishment of a non-domestic building or structure over 5 years of assessment (20% each). Any person who incurs the expenditure in the production of taxable profits can claim the deduction.

A domestic building or structure is defined as any building or structure used for habitation. It does not include any building or structure used as a hotel or guesthouse, or any part of a hotel or guesthouse, according to section 16F(5). It follows that the expenditure on a hotel or a guesthouse qualifies the deduction. However, the expenditure on residential buildings used for letting or on directors' or staff's quarters does not qualify the deduction.

No definition of “renovation” or “refurbishment” is laid down in the Ordinance. In practice, the IRD adopts the ordinary dictionary meanings. According to the Shorter Oxford English Dictionary, “renovation” means renewal or restoration whereas “refurbishment” means renovation.

It should be noted that repair expenditure, providing it is incurred in the production of assessable profits, is 100% deductible under Section 16(1)(e). But the deduction for renovation or refurbishment expenditure spreads over 5 years of assessment. So, it is preferable to distinguish repairs expenditure from renovation or refurbishment expenditure in order to get greater tax savings. As said before, “repair” means bringing the asset back to its original conditions without substantial improvement, whereas “renovation” or “refurbishment” implies a substantial improvement to the asset. Below is a court case on the issue of “repair” versus “improvement”.

Conn v. Robins Brothers Ltd

In this case, the business premises was over 400 years old and in a state of substantial disrepair. The repair work was very substantial including: (a) constructing a new roof; (b) inserting steel joists to support the new first floor walls; (c) replacing oak flooring with concrete; (d) building a new shop front and (e) replacing timbers with oak-encased steel beams. The overall expenditure was held as revenue expenditure on the grounds that the fundamental structure of the premises did not change.

Where the building renovated or refurbished is no longer used for the production of profits, for example, when the building or structure is disposed of or returned to the landlord upon termination of lease, the taxpayer can still claim the 20% deduction in the remaining years of assessment until the expenditure is exhausted. See section 16F(2).

Where a taxpayer ceases to carry on his business before the refurbishment expenditure is exhausted, the deduction for the year of cessation is still 20% of the expenditure. No more deduction will be granted after the business cessation even though the balance of expenditure has not been fully written off.

The deduction under section 16F does not apply to the capital expenditure which is incurred:

1. for a building which is used or intended to be used as a domestic building;
2. to enable the building to be first used substantially by the person for the production of chargeable profits; or
3. to enable the building to be used for a purpose different from that for which it was used immediately before the capital expenditure was incurred.

Capital expenditure incurred on the initial construction, decoration or fitting out of a commercial building or structure, and expenditure on alteration of a building to enable a different usage do not qualify for the deduction under section 16F but they may qualify for commercial building allowance under section 33A.

3.28 Removal expenditure

Whether or not removal expenditure is allowable depends on the circumstances leading to the removal as wells as what assets are removed.

If the removal is voluntary for improvement or expansion or in the interest of the business, the removal expenditure will generally be regarded as of a capital nature and as such, not allowable. Nevertheless, in such circumstances, the part of the expenditure in relation to dismantling, transport and re-erection of plant and machinery, etc. can still be treated as qualifying expenditure for depreciation allowance. Besides, the part of expenditure in relation to removal of trading stock is, in any case, still of a revenue nature and therefore allowable.

If the removal is forced by circumstances beyond the control of the taxpayer, for example termination of a lease by the landlord, the whole cost of the removal is allowable. In that case, not only the transportation cost, but also the dismantling and erecting cost of plant and machinery, are deductible.

3.29 Purchase of computer hardware and software

Under Section 16G, the purchase cost of computer hardware and software for producing assessable profits is wholly deductible.

Computer hardware includes mainframe computer system as well as standalone personal computers. A computer system forming an integral part of a plant or machinery does not qualify the Section 16G deduction as a prescribed computer stuff --- Instead, it should be treated as part of the relevant plant or machinery; it may qualify a deduction as a prescribed asset for manufacturing under Section 16G, or in any other cases, it may attract depreciation allowances as a usual plant or machinery.

The meaning of computer software is well understood and does not usually give rise to disputes. So, there is no elaboration on this term whether in the Inland Revenue Ordinance or in the IRD's published practice notes.

It should be noted that only the hardware and software used for the production of assessable profits qualify the Section 16G deduction. Where they are only partly used for the profits-earning purpose and partly not, the expenditure will be apportioned between the purposes.

Computer hardware and software purchased on hire purchase or held on lease do not qualify a Section 16G deduction. Nevertheless, the hire-purchase asset may attract depreciation allowances as a usual plant or machinery, whereas the monthly rent payments of the leased asset may qualify a full deduction, providing the assets are used in the production of assessable profits.

Where the computer stuff for which the deduction has been allowed is sold, the sales proceeds is deemed to be taxable receipts.

3.30 Employees' expenditure

Generally speaking, almost all kinds of expenditure for the benefit of employees are deductible. This includes the reward for staff's work and cost for promotion of good relationship with staff. To say it clearly, the deductible payments include:

1. salaries, wages, commissions… etc
2. year-end bonus
3. various kinds of leave pay
4. cost of various kinds of staff benefits
5. severance payment or long service payment under labor law
6. funeral expenses or funeral allowance to the relatives of a deceased employee
7. grants or subsidies to the relatives of a deceased employee
8. payments involving sickness or injury of employee

If excessive severance payment or long service payment are paid on cessation of business, the IRD may challenge the payments to be non-deductible. The IRD's argument is that they are not incurred in the production of profits. But the IRD's argument may not always be upheld by the court: In the case CIR v Cosmotron Manufacturing Co. Ltd. 4 HKTC 562, the Privy Council held that the severance paid in accordance with employment law, even on cessation of business, was still wholly deductible.

Small gifts to employees on their marriages are deductible because they are to promote good staff relationship. But large gifts may not be deductible because they are likely to be made out of personal reasons, rather than in the production of assessable profits.

Some overseas companies having permanent establishments in Hong Kong make use of substantive salary payments to senior expatriate employees to reduce tax. To do that, the expatriate employees are arranged to render services both within and outside Hong Kong. In that case, if they stay in Hong Kong for not more than 60 days during a year of assessment, they will be exempt from Salaries Tax. On the other hand, their employer can claim full deduction for the salaries payment if their services are incurred in the production of assessable profits.

Losses made by embezzlement or misappropriation by an employee (other than a director) are deductible because they are arising out of and incidental to the carrying of the trade --- See Curtis versus J. G. Oldfield 9 TC 319.

Contributions to approved retirement schemes

Special contributions, including initial contribution to set up the fund, are allowed by spreading equally over 5 years of assessment – Section 16A(2) of Inland Revenue Ordinance. Regular contributions made by employer are deductible up to a "15% limit": The deduction for each employee is restricted to 15% of his total income. No deduction is allowed for the excessive contribution. Regular contribution consists of the employer's mandatory and voluntary contribution under Mandatory Provident Fund Scheme.

Excessive remuneration

In the case Copeman versus V, William Flood & Sons Ltd. 24 TC 53, large remunerations were paid to the relatives of the directors who worked for the company. The Revenue challenged that the payments were excessive and therefore should be disallowed. It was ruled that the court could not interfere with the company's right to pay whatever remuneration they liked; the court said this was not the point and the point was: Whether such payments were incurred for the purpose of the trade?

Author’s comments

The crucial question is not whether the remuneration is excessive or value for money. The question is: To what extent the remuneration is incurred for the production of assessable profits? As the Revenue cannot set a reasonable market price for the remuneration, it will be inclined to take a liberal view in this respect unless the remuneration is paid to a closely-connected person and is unreasonably high, incommensurate with his age, experience, qualifications and work duties. If the remuneration is very unreasonable, the Revenue may invoke anti-avoidance legislations to deny deduction.

3.31 Excessive remuneration to a director

The Revenue cannot make rules on how much remuneration should be paid to a director. As a matter of fact, and as a matter of course, the payment of remuneration must be at the taxpayer's full discretion. Given this discretion, many large companies make use of payment of director fee to achieve tax savings. The tax savings is due to the different tax rates between salaries tax and profits tax as well as the favourable tax treatment of perks under salaries tax --- As a result, the tax payable on director fee (and perks) under Salaries Tax will be lower than the tax reduction under Profits tax.

Say, in the year of assessment 2004/05, a company with $30,000,0000 profits pays its director a cash remuneration of $2,000,000 plus free accommodation (by way of a total rent refund $2,000,000) plus non-taxable benefits (say free transportation, free meals, entertainment… etc. with a total cost of $1,000,000), then the tax reduction by this simple arrangement will be quite substantial: This is because the company can seek a deduction of the total cost $5,000,000 from its assessable profits, giving a tax reduction of $5,000,000*17.5% = $875,000 ; whereas on the other hand the salaries tax payable on this total cost will be $352,000 (assuming the director is single), thus giving to net tax saving of $523,000. In fact, if greater non-cash benefits are given to the director, the tax savings will even be greater.

Of course, the Revenue can challenge that the director's remuneration is unreasonable and excessive. However, as the company has the full power and discretion to pay its staff at whatever remuneration, there will be little room for Revenue to succeed unless the remuneration far exceeds the highest market rates. Then, in such case, it is up to the Revenue to justify its challenge that the expenditure is not incurred for the production of assessable profits; instead, it is just made for tax avoidance. To strengthen its challenge, the Revenue may also invoke anti-avoidance law to counteract the tax benefits.

Below are some cases often followed by the IRD.

L. G. Berry Investments Ltd v Attwooll

In this case, the company arranged to set the amount of directors' fees to absorb its profits every year. For the year under dispute, the Revenue found that only one-third of the directors' fees were a legitimate management expense. It was held that not every dollar spent by an investment company is an expense incurred in the production of profits. In upholding the Revenue's assessment, the court said: “In any particular case the whole of the directors' remuneration is expenses of management is a question of fact and challenged whether directors' remuneration equivalent to the net surplus would still be claimed as an expense of management if the surplus had been ten times greater or even one hundred times greater. The Inland Revenue may investigate the true nature of expenses claimed by a company as expenses of management. As a general rule, it is normally possible to justify larger fees for property investment companies than for other types of investment companies. Properties, by their very nature, usually require a greater degree of physical care, attention and management than that for a portfolio of securities. If the directors are actively engaged in managing their properties, rather than having an agent do it for them, then, as a general yardstick, a director's fee of between 15 and 25 per cent of the company's total income will be allowed.”

In conclusion, there is no hard and fast rule on how much the legitimate amount of director fee should be paid by a company. The question hinges on the amount of time and effort done by the directors. It is a question of facts as well as a judgment by a reasonable man. In practice, the Revenue usually looks to what the directors did by referring to the minutes of the director meetings.

The Revenue does not normally challenge the deduction of director fee under Profits Tax. This is because the fee is still taxable under Salaries Tax in the hands of the director. However, it is noteworthy that the tax payable on the director fee under Salaries Tax will generally be less than the tax reduced by the deduction under Profits Tax. In my IRD experience, only in rare cases where the tax savings is very large (say, more than $1 million) will the Revenue invoke anti-avoidance to counteract the tax savings from schemes involving excessive remuneration to directors.

3.32 Interest expenditure

In general, interest is deductible if the money was borrowed for the purpose of producing assessable profits. The question of deductibility hinges on the use of the money borrowed. If it is used as circulating capital, the related interest is generally allowable. If the money is used for private investment or personal use, the interest is not deductible.

If the money is to purchase fixed assets, it is allowable providing the asset is being used for producing the assessable profits. If the fixed asset is not completed (that is not being used for producing profits yet), the related interest will be capitalized and therefore not deductible.

In determining the purpose of the money borrowed, the IRD looks to the direct and immediate purpose or the direct use of the money. This practice was upheld in the tax case 9 C.T.B.R. (N.S.) Case 106 in which the taxpayer divided her property into two parts: One was let out and the other was occupied as her residence. With a mortgage secured on the property, she borrowed money to buy another new property. Then she moved out from the old property to the new property. Then, she also let out her former residence. She claimed that the borrowed money for the new property was to enable her to let out her former residence: because without the new property she could not have moved out from her former residence. Her claim was rejected by the court and it was held that only the direct use of the money should be considered and in that case, the direct use of the money was for the purchase of the new property and not the old property.

The practice of looking at the direct and immediate purpose of the loan was also upheld in a Hong Kong tax case called Zeta Estates Ltd. v CIR, HCIA 2/2005. In this case, the Board of Review found that the direct and immediate purpose of obtaining the loan was for distribution of dividends to the shareholders. The taxpayer, however, claimed that the loan was to replenish the company's working capital after the distribution of dividend. The Board did not accept the claim as fulfilling the section 16(1) requirement of “in the production of assessable profits”. As section 16(1) fails, there is no need to consider the conditions under section 16(2). The taxpayer appealed to the court against the Board’s decision. The court upheld the Board’s decision.

In the case I.T. Case 572 (1944) 13 S.A.T.C. 461, it was held that if the money borrowed was to acquire a profit-producing asset, the fact that the taxpayer later made interest free loans before having repaid the loan would not affect the deductibility of the interest.

In the Hong Kong Board of Review case D22/88, it was held that where the loan was mixed with the shareholder’s fund to produce both assessable and non-assessable profits, the entire loan could be accepted as used to produce the assessable profits.

Where the money borrowed is used for a combination of purposes, the current practice is to make apportionment between the purposes. In this connection, the loan amounts attributable to the different purposes are to be ascertained with reference to the respective amounts and the interest is then apportioned accordingly.

Section 16(1)(a) of Inland Revenue Ordinance states the basic test of deductibility for interest expenditure. In short, the interest will be deductible if it satisfies Section 16(1) and at least one of the conditions laid down in Section 16(2). Now, let us see what are section 16(2) conditions.

Section 16(2)

The conditions stated in Section 16(2) are as follows:

- Section 16(2)(a) allows interest paid on money borrowed by financial institutions.
- Section 16(2)(b) allows interest paid by a utility company.
- Section 16(2)(c), (d) and (e) refers to common businesses:
- Under subsection (c), if money is borrowed from a person other than a financial institution, interest paid can only be

allowed if such interest is chargeable to tax on the part of the recipient. Therefore, interest paid to foreign lender is generally disallowed.

- Under subsection (d), interest on money borrowed from a financial institution (including a foreign one) is allowable if the loan obtained is not secured against a deposit from the borrower or a connected person producing interest not chargeable to tax. This is an anti-avoidance measure tackling those businesses who received non-assessable interest and paid deductible interest on the same fund. [In 1998, an exemption order was made by Chief Executive under Section 87 to abolish the payment of profits tax on bank interest. But in law the bank interest is still "chargeable" to profits tax although no tax is payable. As an anti-tax avoidance measure as before, the exemption order contains a clause to deny exemption to the bank interest on deposits that are pledged against a loan making the interest.]
- Subsection (e) looks at the purpose of the loan. If the money is used to wholly and exclusively finance the acquisition of plant and machinery or trading stock in the production of assessable profits and the lender is not connected with the borrower, the interest is allowable.
- Section 16(2)(f) allows interest paid by a corporation on listed debentures or marketable instruments.

The term "connected person" under subsection (d) and (e) includes a partner, shareholder, member, director, and their close relatives, and associated corporation in case the person is a corporation.

The introduction of section 16(2) condition is because after the abolition of interest tax a lot of taxpayers avoided tax through payment of interest. To deter the tax avoidance, the Revenue imposed restrictions for deduction of interest under section 16(2). Since then, interest expenditure is deductible only when it satisfies both section 16(1) and section 16(2). In brief, the section 16(1) condition is that the interest is paid for loans borrowed for the production of assessable profits and section 16(2) requires fulfilment of at least one of the six prescribed conditions.

The conditions (a) and (b) refer to taxpayers who are financial institutions or public utilities. All borrowings by a financial institution satisfy condition (a) while any borrowings by public utilities at a rate of interest not exceeding a specified rate will satisfy condition (b).

The condition (c) refers to borrowings from persons other than financial institutions. The chief requirement is that the interest payable on the loan is assessable in the hands of the recipient. If the money borrowed is made available in Hong Kong, the condition is prima facie fulfilled.

The condition (d) refers to the borrowings from financial institutions. A loan from a financial institution will satisfy condition (d) if: (i) the loan is not secured or guaranteed by any deposit with the financial institution; or (ii) the loan is secured or guaranteed by a deposit with the financial institution provided by the borrower or his “associate 相聯者” under section 16(3) and the interest received on the deposit is subject to profits tax.

The condition (e) will be fulfilled if the money is borrowed wholly and exclusively to finance capital expenditure on machinery and plant or for the purchase of trading stock and the lender is not a connected person under 16(3).

The condition (f) refers to corporate borrowings through issue of debentures or other “marketable instruments”.

In general, the section 16(2)(c), (d), (e) and (f) conditions concern mainly very big companies within a group of multi-national holding and subsidiary companies. They do not generally affect local enterprises of small to medium size. Indeed they are too complicated for an ordinary small taxpayer to fully comprehend. Anyway, if you want to carry out tax reduction arrangements with payment of interest, you are suggested to seek advice from a professional accountant or tax consultant.

The following examples illustrate how conditions (a), (b), (c) and (d) operate in practice.

Example 1

Mr. A carried on business as a toy manufacturer. To obtain additional working capital, he borrowed money from Hang Seng Bank. In this case, the bank loan fulfilled condition (d).

Example 2

Mr. B was the sole-proprietor of an import and export firm. To increase his working capital, he borrowed money from Hang Seng Bank. The loan is secured by a fixed deposit held in name of Mr B's wife who did not run a business. Since the interest received by the wife (an associate) was not chargeable to tax in Hong Kong, the borrowing did not fulfil condition (d).

Example 3

C Limited carried on a secretarial business in Hong Kong. Mr D was the major shareholder and managing director of the company and he received dividends and salaries from the company. To expand its business, C Limited borrowed a loan from Wing Lung Bank. The borrowing was secured by a deposit that was held by Mr D with a foreign financial institution. Being a shareholder and a director of C Limited, Mr D is an associate of C Limited. As the interest income of the foreign deposit is not taxable, the borrowing by C Limited did not fulfil condition (d).

Example 4

E Limited operated a garment factory in Hong Kong. To expand its factory premises, E Limited borrowed a loan from Bank of East Asia. The borrowing was partly secured by a fixed deposit with the same bank held by F Limited, a wholly owned subsidiary of E Limited. F Limited also carried on business in Hong Kong. Although the borrowing was secured by a deposit that was owned by an associate, the loan still fulfilled condition (d) because the interest on the deposit is taxable in the hands of F Limited.

Additional conditions since 25 June 2004

With effect from 25 June 2004, two additional conditions must be fulfilled for deduction of interest on loans borrowed from non-financial institutions under section 16(2)(c), borrowed from financial institutions under section 16(2)(d) and borrowed for specific purposes under section 16(2)(e) loans. The additional conditions are:

1. The loan is not secured by a deposit held by or a loan advanced by the borrower or an associate of the borrower with or to the lender, a financial institution, an overseas financial institution or an associate of any of these parties, where the interest generated by such deposit or loan is not taxable.

2. There is no arrangement in place such that the interest payment will be ultimately paid back to the borrower or to a person connected with the borrower.

The purpose of the additional conditions is to counteract the tax avoidance schemes involving multi-level borrowings through trust arrangements, loan and interest assignments, or loan sub-participation. These schemes created deductible interest expenses in respect of internally funded loans so that the interest received by a party related to the borrower was not taxable (for example by making the money available offshore).

3.33 Management fee

Management fee paid to a building management company for managing the premises used by the taxpayer for production of assessable profits is deductible. This is seldom a tax issue.

What is at issue on this topic is the management fee paid to a closely-connected “service company” for managing an unincorporated business. This is because such payments are often used to avoid tax. See the following example.

An unincorporated business ABC & Co. made a $2,000,000 profits. To reduce the assessable profits, the business owners set up another unincorporated business XYZ & Co. to manage its business. Then, ABC paid $1,500,000 management fee to XYZ, thus reducing ABC's assessable profits to $500,000. Then, XYZ paid the business owners and their relatives remuneration and provided them free accommodation and a lot of non-cash benefits. With the personal allowances, graduated tax rates, non-taxable benefits... etc. under Salaries Tax, their total tax liabilities were dramatically reduced.

If the tax benefit is considerable, the Revenue will argue that the management fee is too excessive to justify a deduction because it is not incurred for the production of assessable profits, but for the avoidance of tax. In such case, the Revenue may invoke anti-avoidance law to counteract the tax benefits.

DIPN 24 - Management fee paid to a related company

This is an administrative anti-avoidance pronouncement of IRD. It is to restrict deduction for management fee paid to a related company. The legal backing for the pronouncement is Section 16 that grants deduction to an expense only to the extent it is incurred in the production of assessable profits and Section 61 and 61A that concerns tax-avoidance schemes.

DIPN 24 sets out a formula to determine maximum amount of deduction for payment to “service company”. It limits the deduction to 112.5% of the costs to the service company of providing “qualifying services”. Qualifying services are the non-professional services that provide the infrastructure in which the business operates. Examples of such services are the provision of premises, administrative staff, plant and equipment and office supplies. Excluded from the "qualifying services" are the services provided by the business owners or any fee-earning professional staff. Therefore, the salary or benefits paid to the business owners or the professional running costs such as audit fee of the service company cannot form part of the deductible management fee.

If the management fee is paid to unrelated persons (i.e. it is an arm-length payment), the Revenue will generally allow the payment without challenging the amount. Nevertheless, the DIPN (paragraph 15) requires the taxpayer to keep the following documents:

1. the agreement under which the services are provided (it should specify the relevant services, the basis on which fees are to be paid, the period covered by the agreement, etc);
2. minutes of meetings recording approval of the terms of the service company agreement and any subsequent amendment;
3. invoices and receipts in respect of transactions between the parties;
4. working papers in respect of the calculation of the fees charged by the service company;
5. bank record in respect of each party; and
6. employment contract in respect of persons employed by each party.

3.34 Patent rights, etc.

Section 16E of Inland Revenue Ordinance allows deduction for expenditure that is incurred for acquiring patent rights, or rights to any know-how, for use in Hong Kong.

“Patent rights” is defined to mean the rights to do or authorize the doing of anything which would, but for that right, be an infringement of a patent. In practice, it includes copyrights, design, trademarks ... etc.

“Know-how” is defined to mean any industrial information or techniques likely to assist in the manufacture or processing of goods or materials.

To qualify the deduction, the patent etc. must be:

- for use in Hong Kong,
- for production of assessable profits, and
- not one purchased from an “associate”.

“Associate” is widely defined to cover many closely-connected persons. This condition is obviously an anti-avoidance measure.

There is no requirement that the patent etc. acquired must be used in the basis period. If the claimant can prove that it will be used in Hong Kong, it can be deductible.

According to section 16E(3), if the patent having attracted the deduction is sold, the sales proceeds will be deemed to be a taxable receipt.

Apart from section 16E, section 16(1)(g) allows deduction for the cost of registration of patent rights, trademark, or design which is used for earning assessable profits.

3.35 Technical education

Section 16C of Inland Revenue Ordinance allows deduction for “any payment to be used for the purpose of technical education related to that trade or business at any university, college, technical college or other similar institutions" which are approved by Commissioner of Inland Revenue.

A list of "approved institutes" is published on the IRD's homepage (http://www.ird.gov.hk).

It should be noted that section 16C is to broaden the scope of deduction under section 16(1). In other words, the expenditure not meeting the Section 16C conditions may still be deductible if it satisfies Section 16(1).

Technical education is deemed to be related to a trade or business if it is a kind of requisite for persons engaged in that trade or business.

All payments for technical education concerning an approved institute qualify the deduction. There is no such requirement that the taxpayer's employee must study in the institute. It does not matter whether the payment is paid to the institute or its students.

3.36 Scientific Research

Section 16B of Inland Revenue Ordinance allows deduction for expenditure incurred on scientific research by a person carrying on a trade or business. The deduction is applicable to all payments made or all expenditure incurred during the basis period.

Scientific research is defined to mean any activities in natural or applied science for the extension of knowledge. Qualifying activities include the application of new scientific principles in an existing area of research and the application of existing principles in a new area of research.

Quality control is not accepted as "scientific research" because it is not an extension of knowledge. According to the IRD's Departmental Interpretation and Practice Note No. 5, "research" requires more than "quality control". The IRD says that "research" connotes "working for tomorrow or trying to develop new products or improve the present products; whereas quality control is only for working for today or for ensuring the present product up to a required standard".

From 1998/99 onwards, the definition of scientific research is expanded to cover any systematic, investigative or experimental activities carried on for the purposes of any feasibility study or in relation to any market, business or management research. This extended category includes expenditure incurred in relation to a new product even before the commencement of production.

3.37 Donations

Approved charitable donations are allowable deduction under Section 16D of Inland Revenue Ordinance. "Approved charitable donation" means a donation of money to Hong Kong SAR Government or an approved charitable organization which is exempt from tax under Section 88 of Inland Revenue Ordinance. A list of such organizations is published on the IRD's homepage (http://www.ird.gov.hk).

No deduction is granted for donations totalled less than HK$100. The maximum deduction is 25% of the assessable profits before deducting loss brought forward.

No double allowance will be given to those donations which have been already allowed under Salaries Tax or Personal Assessment or which have been allowed as qualifying expenditure for Scientific Research or Technical Education.

A donation means a donation of money. If a "donation" is to buy something at lower than its market price, then it will not attract any tax relief. See the Hong Kong tax case Re Standford Yung Tao Yung.

It should be noted that a donation not meeting the above conditions for charitable donation or a donation exceeding the

25% limit can still qualify a deduction if it can satisfy section 16(1) --- that means the taxpayer has to prove that it is incurred in the production of assessable profits. If tax relief is sought under section 16D, the section 16(1) test can be ignored.

3.38 Deduction of overseas taxes

Section 16(1)(c) of Inland Revenue Ordinance allows deduction for mainland's / foreign taxes, which are of substantially the same nature as those under the Inland Revenue Ordinance, paid on interest or gains under Section 15(1) (f), (g), (i), (j), (k) or (l).

Indeed, section 16(1) stipulates the general test of deductibility of an expenditure before section 16(1)(c). The general test is extended by “including” inter alia section 16(1)(c) that concerns mainland's / foreign taxes. As such, the general test must first be satisfied (that is whether the expenditure is incurred in the production of assessable profits) before we can consider the conditions of section 16(1)(c). If the “overseas tax” expenditure is not incurred in the production of assessable profits, then it should be disallowed and there will be no need to consider section 16(1)(c). Only if the “overseas tax” expenditure is incurred in the production of assessable profits will it be necessary to consider whether it also meets the section 16(1)(c) conditions: If it still passes, it will be allowable deduction; and if no, no dedicton.

When considering the section 16(1)(c) conditions, it is necessary to determine whether the foreign tax is: (1) a charge on profits or (2) an expense that must be borne regardless of whether or not there is a profit. A tax on profits under (1) is not deductible because it is part of the profits and it is not “incurred … in the production of profits” in accordance with section 16(1). This is because the foreign tax is a disbursement of profits and it is not “money expended for the purpose of producing such profits”. In other words, only the foreign tax paid under (2) meets the section 16(1)(c) conditions.

Although a charge on the profits (e.g. FEIT paid in mainland China) under (1) as aforesaid cannot qualify a deduction from assessable profits, the taxpayer can claim tax credit for it under Double Taxation Relief. For details, please see Chapter 1 Basic tax tips, paragraph 1.10.

As regards the foreign tax paid under (2), since the mainland's / foreign tax is payable irrespective of whether a profit is made, the foreign tax should not be regarded as an appropriation of the profits; but instead, it should be regarded as a tax of substantially the same nature as those under the Inland Revenue Ordinance. If it is paid in respect of any interest or gains which have been assessable under Section 15(1) (f), (g), (i), (j), (k) or (l) of the Inland Revenue Ordinance, then it will be an allowable deduction. Usually, the foreign tax takes the form of a withholding tax on the interest or royalties gained. According to its Departmental Interpretation and Practice Note No. 28, the IRD requires the gross amount of the interest or royalties (that is before deduction of the related foreign taxes) to be included in the reported assessable profits before the IRD may consider the taxpayer’s claim for the deduction of the foreign taxes paid.

3.39 Expenditure for ceasing the business

In the case Basssett Enterprise versus Petty 21 TC 730, the company made certain payments to employees to release the company from its contractual obligations under certain service agreements signed with the employees. It was held that such payments were not made “for the purpose of the trade” and hence they were not deductible. The court ruled that these arrangements were part of an agreement for selling the majority of the company shares to a prospective purchaser and as such, the expenditure was not made for the purpose of the trade; but rather, they were incurred in the interest of the purchaser. It follows that payment that is solely for ceasing a business is not deductible.

However, in a Hong Kong tax case, CIR versus Swire Pacific Ltd. HKTC 1145, the wages paid to workers who went on strike to protest a merger was held to be deductible. The rationale between the different tax treatments is that in the Swire case the payment was to enable the company to go on for some time before the cessation of business.

Besides, in another Hong Kong tax, CIR v Cosmotron Manufacturing Co. Ltd. 4 HKTC 562, the Privy Council also ruled that the severance paid in accordance with employment law on cessation of business is deductible. This was because the severance was the employer's <u>legal obligations</u> under the employment law <u>in the course of normal business operations</u> and such payment is not solely for ceasing a business.

Judging form the above case law, I opine that the deductibility of cessation expenses hinges very much on whether the taxpayer can adduce evidence to prove that the payment is incurred in the course of business and is not solely for ceasing the business. If the amount disallowed by IRD is substantial, the taxpayer should seek professional advice and then, if appropriate, pursue the case vigorously with documentary evidence and case law.

3.40 Exchange losses and gains

Of course, the question is: Whether the exchange losses are deductible and whether the gains assessable? The answer is: The losses are deductible and gains assessable if they are: (a) incurred in the production of assessable profits, and (b) of a revenue nature.

In principle, exchange differences that arise from an investment or from an appreciation or a devaluation of currency outside the scope of trading should not be taken included in the assessable profits. To put it in another way, only those exchange differences in connection with the profit earning activities should be brought into the calculation of assessable profits or tax losses.

Normally, exchange differences arising from the settlement of trade debts due to trade creditors or due from trade debtors are of a revenue nature. Likewise, exchange differences arising from receipts of revenue and payments of expenses are of a revenue nature too. In other words, all these exchange differences should be included in the assessable profits.

On the other hand, the exchange losses or gains on acquisition of fixed assets or long-term loans should be excluded from the computation of assessable profits. This is because they are of a capital nature.

Now, let us see the following cases.

Beauchamp v. Woolworth 61 TC 542

It was held that a loan was a revenue transaction if it was temporary, fluctuating and incurred in defraying the running costs of the business. In the case, the loan did not form part of the daily operating activities in earning profits. It was a fixed amount for 5 years. It was used as an additional capital. In the circumstances, the loan was a capital transaction.

Author's comments: When dealing with incomes received in foreign currency, the gains or losses resulting from currency fluctuations between the transactions generating the income and the settlement of the amounts due from the debtor are revenue in nature.

Davis v. Shell Co. of China Ltd.

In this case, exchange gains from bank deposits were held as having a capital nature. That was because the deposits were not arising from the trading activities --- which consisted of sale of goods and services.

IRD's practice

The IRD accepts those foreign currency funds placed on <u>current accounts</u> with banks as having a trading purpose if the funds are mainly for purchase of trading stock or payment of operating expenses. Hence, any losses are deductible or any gains assessable. As regards fixed deposits held with banks, the IRD usually regards them as having a capital nature.

Let's see the following tax cases.

CIR v. Li & Fung Ltd.

The case concerned exchange gains from bank deposits --- some 7 days call deposits in US banks. In fact, the fund was generated from sales proceeds of exported goods. Unquestionably, it was originated from trading activities. But it was held that its nature had been changed to capital investment when the fund was placed on the bank deposits. The exchange difference after the change was of a capital nature.

CIR v. Chinachem Finance Co. Ltd.

It was held that when deciding whether a loss arising from borrowing was capital or not, regard should be made to the length and the terms of borrowing, as well as to the nature of the trade. In the case, because of the short-term nature of the loan, the exchange losses were held as having a revenue nature.

For 2005/06 onward, the IRD has published a Departmental Interpretation Practice Note No. 42 regarding financial exchange difference arising from financial instruments. The definition of "financial instruments" follows the definition of the same term in the Hong Kong Accounting Standard No. 32, namely "any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity". In brief, financial instruments include debts such as debtors' and creditors' balances. In the DIPN, the IRD says: "On the whole, the Department will follow the accounting treatment stipulated in HKAS 39 in the recognition of profits or losses in respect of financial assets of revenue nature. Accordingly, for financial assets or financial liabilities at fair value through profit or loss, the change in fair value is assessed or allowed when the change is taken to the profit and loss account... For loans and receivables.., the gain or loss is taxable or deductible when the financial asset is derecognized or impaired and through the amortization process. Valuation methods previously permitted for financial instruments, such as the lower of cost or net realizable value basis, will not be accepted... Besides, the IRD does not accept the argument that when the financial instruments are marked to market, the profits recognized in the profit and loss account are unrealized profits and therefore not taxable until realized in later periods. Such argument is essentially based on the decision in Willingale v. International Commercial Bank Ltd, [1978] STC 75... A financial asset or financial liability at fair value through profit or loss includes a financial asset or financial liability that is held for trading. It is classified as trading if it is acquired or incurred principally for the purpose of selling or repurchasing; or there is a pattern of short-term profit-taking. Therefore, the change in fair value and the gain (or loss) on disposal, recognized in the profit and loss account, are taxable (or deductible)."

Author's comments

Gains or losses from speculations in foreign currencies are generally excluded from computation of assessable profits unless such activities have constituted a trade.

When preparing final accounts, some overseas trade debtors accounts or trade creditors accounts denominated in foreign currency are translated into Hong Kong dollars. The generally accepted accounting practice is that the exchange gains or losses from such conversions are to be recognized in the Profit and Loss Account. This accounting practice is acceptable to IRD, although strictly speaking, such gains or losses are unrealized as at the balance sheet date.

If a taxpayer keeps his books and accounts in a foreign currency, his accounting profit will be, of course, computed in that foreign currency. In that case, the taxpayer has to convert the accounting profit into Hong Kong dollars when computing the assessable profit. In practice, the IRD adopts the "average rate of exchange during the year" for the conversion. The average rates of various currencies are published on the IRD’s website from time to time.

3.41 Post cessation expenditures and receipts

The date of business cessation is, of course, a question of facts. In practice, the IRD adopts the day reported by the taxpayer to the Business Registration Office.

According to section 15D(2) of IRO, all business expenditures incurred after the business cessation are deductible providing they would have been deductible had they incurred before the cessation. If a profits tax assessment has been final and conclusive under section 70, the taxpayer can claim the deduction by virtue of section 70A.

According to Section 15D(1), all business receipts after the cessation are taxable on such basis as if they were received before the cessation. In fact, this rarely happens in practice because there should be no trading after the cessation. Anyway, the IRD has the power to raise an additional assessment under Section 60 to assess such business receipts in case they have not been assessed in the original assessment. The time limit for making an additional assessment is 6 years after the end of the relevant year of assessment. However, if the cessation is due to the death of a sole trader before 11 February 2006, the time limit is 1 year after the death or 1 year after the filing of affidavit for the deceased's estate, whichever is the later. If the death occurs on 11 February 2006 or later, the time limit is 3 years after the end of the year of assessment in which the death occurs.

There are special provisions with regard to valuation of trading stock on business cessation. Where the stock is sold to a person who will use the stock in a business carried on in Hong Kong and will be claiming the purchase cost as a deductible expense, the actual sales proceeds will be adopted for the valuation. In any other cases the valuation will be the estimated open market value as at the cessation day.

A balancing allowance (which is a deduction from assessable profit) may arise on business cessation if the reducing value of machinery or plant exceeds their disposal proceeds. If the reducing value is less than the disposal proceeds, the difference will be a balancing charge which is a taxable receipt. Where the assets are transferred to another person succeeding the business, there will be no balancing adjustments and the successor will inherit the reducing value and get an annual allowance. Where there is no sale and no successor, the IRD will estimate their open market value as at the business cessation --- in practice the IRD will take the reducing value as their open market values so that no balancing adjustment is necessary. If an asset is sold at a price less than the estimated open market value within one year after the cessation, the taxpayer can claim balance allowance based on the actual sales proceeds instead of the estimated value.

3.42 Notional expenditure

A notional expenditure means such “expenditure” only exists imaginarily and no money has been paid for such expenditure. It is usually the loss anticipated or the profit forfeited if an act or transaction is done. In economics, it is called “opportunity cost”.

By the “prudence concept” or “historical cost concept” of the generally accepted accounting principles, such expenditure is not an expense in the accounts. Because generally accepted accounting principles are generally followed for tax purpose (save specific provisions in the tax law), notional expenditure is not deductible.

In the case Lowry versus Consolidated African Selection Trust Ltd. 23 TC 259, the company claimed a deduction that involved no expenditure --- the company issued shares to its employees at par value which was considerably below the then open market value --- the taxpayer claimed the difference as an expenditure. The court rejected the claim.

3.43 Fines and penalties

It is a well-known law principle that a fine or a penalty due to the wrongdoing of a taxpayer is not tax deductible.

In the case CIR v Alexander von Glehn & Co. Ltd. 12 TC 232, the company paid certain fines because they sold certain goods that are prohibited by law. It was held that although the fines were incurred in the course of the trade, they were not made for earning profits. As such, they were not deductible. On the other hand, the profits from the illegal trading were taxable.

3.44 Industrial building allowance

In general, all expenditures of a capital nature are not deductible. Depreciation provided under generally acceptable accounting practices is of a capital expenditure. So, by the general principle, it is not deductible. Nevertheless, it is a long-standing government policy to encourage people to invest in capital expenditures and hence, a depreciation allowance is to be granted to taxpayers who incur certain capital expenditures and such depreciation allowance is to replace the accounting depreciation.

Indeed, the taxation depreciation allowance is generally greater than the accounting depreciation during the early life of the asset concerned. Of course, the total taxation depreciation allowance should equal the total accounting depreciation throughout the whole life of the asset --- because both refer to the “net expenditure” from purchasing the asset during the whole life of the asset. The net expenditure, if expressed by a mathematical formula, is: Cost of purchase minus Disposal proceeds.

According to the Inland Revenue Ordinance, there are three types of depreciation allowances: Industrial Building Allowance, Commercial Building Allowance and Plant and Machinery allowance. Let me talk about Industrial Building Allowance first.

Section 18(F) of Inland Revenue Ordinance grants depreciation allowances for any expenditure incurred on industrial building used for a qualifying trade. There are two kinds of allowances: (a) initial allowance for the initial expenditure and (b) annual allowance for the residue of expenditure.

Before dealing with these two allowances, we should ascertain what expenditures can attract the allowance. An analysis of the law shows that this question hinges on three factors: (1) there must be a qualifying trade, and (2) the expenditure must be a qualifying expenditure and (3) the claimant must be a qualifying person.

Qualifying trade

Not every building having “industrial building” in its name is an industrial building for tax purpose. Even a building without “industrial building” in its name may qualify. The point is, of course, whether the building is within the meaning of an “industrial building” under the Inland Revenue Ordinance.

Section 40 defines an industrial building by reference to the trade, undertaking or business for which it is used. A number of trades are specified under various headings. Of these heading, the most frequently encountered ones are under subsection (a): the buildings are for a trade carried on a mill, factory or other similar premises; and subsection (c): the buildings for a trade which consists of the manufacture of goods or materials, or the subjection of goods or materials to any process. In practice, these two categories give the most industrial buildings.

Besides, a building falling within subsection (d) can also be an industrial building. This subsection concerns a trade of storage --- That means a warehouse owned by a warehouse company can qualify. However, it should be noted that a warehouse used by a retailer for storage of his goods before sale does not qualify under this subsection. This is because the storing of goods are only part of a non-qualifying trade, and the storing of goods does not by itself form a trade. In the case CIR versus Tai On Machinery Works Ltd., HKTC volume 1 page 411, a retail distributor of goods claimed to have subjected goods to a process. Because the storing of goods for subjection to a process was only a small part of the taxpayer's trade (which was a non-qualifying trade), its claim for industrial building allowance was rejected by court. It should be noted that although the storage that forms part of a non-qualifying trade cannot attract the allowance, a trade of storage can.

Subsection (a) refers to the buildings used for a trade that was carried on a mill, factory or other similar premises. As the meaning of a "mill" or a "factory" is quite clear, this subsection is rarely subject to disputes.

Subsection (b) refers to the buildings used for a trade that consists of the manufacture of goods or materials, or the subjection of goods or materials to any process. The word "manufacture" is clear and therefore does not usually lead to disputes. But what is "subjection of goods or materials to a process"? This is sometimes arguable. Please read the following analysis.

Subjection of goods or materials to a process

In the case Kilmarnock Equitable Co-operative Society Ltd. versus CIR 42 TC 675, the taxpayer was a company engaging in the sale of coal in bulk as well as in small paper packets. Because of an increase in the sale of small packets, it incurred capital expenditure on the erection of a building for the packaging. The coal was conveyed by a conveyor belt from wagons in the yard to a hopper. Then it was fed down a chute through a vibratory screen and passed by a conveyor belt to a weighing machine and then packed into small bags. The Revenue contended that the coal could not be said to have been subjected to a process because the operations did not result in any alteration to the nature of the material --- all that had been done was to pack it into smaller units. This argument was not accepted by the judge who said:

“I am unable to find any warrant in the subsection for requiring that the nature or size of the material must be altered before one can say that it has been subjected to a process. In my opinion, when the coal was cleaned and then packed into containers of a convenient size, it was subjected to a process. ‘Subjected to’ means that it went through a process, and ‘process’ means some course of operations. The nature of the material remained the same but it had been made more marketable.”

In a Hong Kong tax case, CIR v Aberdeen Restaurant Enterprises Ltd. 2 HKTC 330, the taxpayer argued that the processing of food in a restaurant qualifies the test of “subjection of goods or materials to a process” and therefore, a restaurant is an industrial building. The court held that the cooking of food was “subjection of goods or materials to a process” but it refused to allow IBA in that case because the cooking was only incidental to the trade of a restaurant.

Author’s note: A restaurant business is, on the whole, of a service nature and cooking is just only part of the service trade. Following the decision of CIR versus Tai On Machinery Works Ltd, part of a taxpayer’s trade qualifies is not sufficent; it must be the trade as a whole qualifies the test of “subjection of goods or materials to a process”.

Qualifying expenditure

Not all expenditures on an industrial building qualify the allowance. Only the capital expenditure in respect of the construction of the building qualifies the allowance. The cost of site is specifically excluded by Section 40 of the Inland Revenue Ordinance.

Construction cost of a building should exclude the cost of site or preparation or leveling of land. But it includes expenditure on work done preparatory to laying foundations, laying drains, sewers and water-mains to serve the building. The part of construction cost to be reimbursed by any grant or subsidy should be excluded. However, any interest or commitment fee incurred in respect of a loan obtained for the construction of the building can be added to the construction cost.

Not only a building, but also a structure can qualify. The words "building" and "structure" are not defined in Inland Revenue Ordinance. So, they should be interpreted according to their ordinary meanings under the Literal Rule. In practice, a "structure" is interpreted as covering an artificial work such a walls, a bridge, a dam, a roads, bore holes and wells, sewers, water mains, tunnel linings and a wharf. Furthermore, boundary walls, railway sidings and other works are also acceptable as part of the premises for the allowances. It should be noted that "industrial building or structure" includes part of a building or structure.

Any building or structure provided for, or in use for, the welfare of workers, or for the housing of manual workers employed in a specified trade will also qualify.

Where a building or structure is only used partly for the purposes of a qualifying trade, then only the relevant proportion of the capital expenditure can qualify. Nevertheless, proviso (i) to section 40 says that where the capital expenditure on the part of the building or structure which is not an industrial building or structure does not exceed 10% of the total capital expenditure, the whole building shall be treated as an industrial building or structure. In that case, no apportionment is necessary.

It is advisable to separate the cost of plant and machinery (e.g. central air - conditioning, lift machinery) from the cost of construction of the building. This is because plant and machinery can attract more generous depreciation allowances.

It should also be noted that Industrial Building Allowances refers to "expenditure on construction", which was unlike Plant and

Machinery allowances refers to “the provision of the asset” --- the price paid for a second-hand building does not by itself give rise to IBA. In fact, there are special provisions for such cases. See below paragraphs for details. On the other hand, the price paid for a second-hand machinery may qualify Plant and Machinery allowance providing it is used for the purpose of the trade.

“Expenditure incurred” means the expenditure for which the claimant has become legally liable to pay. This is in line with the concept of “incurred” under section 16(1).

If a qualifying trade is established, all part of the building or structure used for that trade will qualify except the following parts: dwelling house (other than that for manual worker), retail shop, showroom, hotel or office. Nevertheless, if the expenditure on the above non-qualifying parts does not exceed 10% of the total expenditure of the whole building, the exception will be disregarded.

Qualifying persons

To put it in simple words, the person incurring the expenditure can get the initial allowance. Thereafter, the person entitled to “the relevant interest” in relation to the expenditure can get the annual allowance and balancing allowance or balancing charge on sale or demolition of the building.

“Relevant interest” is defined as the interest in the building which the person who incurred the expenditure was entitled to when he incurred it. Thus, if the person originally incurring the expenditure was the Government lessee, any subsequent owner who is the Government lessee has the relevant interest; or if the original expenditure was incurred by a person occupying the building under a lease, anyone subsequently occupying the building under the remainder of that lease has the relevant interest.

It is not necessary for the building to be used by the landlord for a qualifying trade. If a building is leased and used by the occupant for a qualifying purpose, the landlord, being the person having the relevant interest in the capital expenditure incurred on construction, is entitled to the allowances.

A lessee who merely pays rent for the lease of an industrial building cannot get the allowances. But a tenant who incurs expenditure on a building and uses it for a qualifying trade can get the allowances.

It is possible for two separate persons to be given industrial building allowance in respect of the same building; for example, the owner who incurred the cost of the construction and subsequent holders of his relevant interest may get an allowance in respect of the original cost of construction; while the lessee who incurred capital expenditure on constructing alterations and improvements can also get an allowance on his own expenditure and so may any subsequent holders of that relevant interest acquired from the lessee.

Initial allowance

Section 34(1) of Inland Revenue Ordinance allows an initial allowance of 20% on the capital expenditure incurred in the basis period of the year of assessment.

Any expenditure incurred before trading is taken to be incurred on the first day of trading --- see section 40(2).

If the expenditure is paid by installments, it is necessary to determine the basis period in which each installment is legally due. In that case, initial allowance will be granted in all the years of assessments concerned.

Building bought unused from a property developer or from other persons

Where the building is bought from a property developer, the purchaser can claim initial allowances (in addition to annual allowance) if no initial allowance has been granted to the developer. The person who buys the interest is deemed to have incurred, on the day on which the purchase price is payable, capital expenditure on construction of an amount equal to the "price" paid by the purchaser in respect of the construction cost of the building. That is to say, the "price" must exclude the part paid for the "land".

Where the building is not bought from a property developer, the purchaser can also claim initial allowances (in addition to annual allowance) if no allowances have been granted to the seller or the developer. In that case, the person who buys the interest is also deemed to have incurred, on the day on which the purchase price is payable, capital expenditure on construction of an amount equal to the "price" paid by the purchaser in respect of the construction cost, or the actual cost of the construction if that is lower. In any case, the "price" must exclude the part paid for the "land".

Annual allowance

Section 34(2)(a) of Inland Revenue Ordinance grants an annual allowance of 4% on the qualifying expenditure for any year of assessment if the building is used as an "industrial building" at the end of the relevant basis period.

If the building is sold before the end of the basis period, no annual allowance will be granted. A depreciation allowance or a balancing charge will be calculated instead, based on the disposal proceeds and the written down value of the building.

If a building is not used as an industrial building at the end of a basis period, no annual allowance is granted, but instead, a notional allowance (equal to the annual allowance) will be written off from the residue of expenditure. Nevertheless, the taxpayer may claim commercial building allowance if the building (no longer an industrial building) is still used for production of assessable profits.

Disposal of industrial building

Balancing adjustments have to be made if any of the following occurs:

1. the relevant interest in the building is sold; or
2. that interest, being a leasehold interest, comes to an end; or
3. the building is demolished, destroyed, or ceases altogether to be used.

The balancing adjustment is to adjust the total allowances to "the cost of construction less the disposal proceeds". If the total allowances granted are less than "the cost of construction less the disposal proceeds", the adjustment (that is the difference) will be a balancing allowance --- a deduction from assessable profits. Otherwise, the adjustment will be a balancing charge --- a claw back of the excessive allowances granted.

In practice, the balancing adjustment is usually computed by comparing the residue of expenditure before sale with the sales price for the building.

"Residue of expenditure" is defined in Section 40 as the original cost of the building as reduced by any initial or annual allowance, or in the case of a subsequent owner, as reduced by the balance allowances or increased by the balancing charges made to the seller. A notional annual allowance of 4% should be made for those years in which the building is not used as an industrial building.

No balancing charge or allowance is to be made unless the building is an industrial building at the time of the prescribed events of (a), (b) or (c).

No balancing allowance is granted if the building is demolished for purposes unconnected with the trade for which the building is used, for example, where the building is demolished for a property re-development.

Basis period

The basis period for initial and annual allowances is the same as the basis period for determining assessable profits.

Example 1

Mr. Lee, a government lessee, built a factory building for his toy-manufacturing business during his accounting year ending on 30 September 2003. The cost of construction incurred in the accounting year was $8,000,000. 95% of the building was used for qualifying purposes. When the building completed on 15 September 2003, it was used as an industrial building.

Computation of IBA

Year of assessment 2003/2004
Cost of construction: $8,000,000
Less: Initial allowance: $8,000,000 * 20% = $1,600,000.
Less: Annual allowance: $8,000,000 * 4% = $320,000.
Residue of expenditure c/f to 200/2005 = $8,000,000 - $1,600,000 - $320,000 = $6,080,000.

From 2004/2005 onwards, if the building continues to be used an industrial building, an annual allowance of $320,000 will be granted until the residue of expenditure becomes zero.

Example 2

Follow the data of Example 1. And then during the accounting year ending on 30 September 2004, Mr. Chan incurred further capital expenditure of $1,000,000 on building an additional structure to the building.

Computation of IBA

Year of assessment 2004/2005
Original building:
Annual allowance: $8,000,000 * 4% = $320,000.
Residue of expenditure c/f : $6,080,000 - $320,000 = $5,760,000.
Additional structure:
Cost of construction: $1,000,000
Less: Initial allowance: $1,000,000 * 20% = $200,000.
Less: Annual allowance: $1,000,000 * 4% = $40,000.
Residue of expenditure c/f = $1,000,000 - $200,000 - $40,000 = $760,000.

The original building and additional structure are treated as separate block of expenditure for IBA purpose. If they are sold as one building in future, the sales proceeds will have to be split between them, usually on the proportion of their then residue of expenditure.

Example 3

Company A built a factory for $10,000,000. It was completed and used for its qualifying trade in July 2001. Its accounts end on 31 March. On 31 October 2004, the factory was sold for $13,000,000 to Company B which also carried on a qualifying trade. Company made up its accounts on 30 June. All values shown here do not include "land" value.

Company A:

Year of assessment: 2001/2002
Initial allowance: $10,000,000 * 20% = $2,000,000.
Annual allowance: $10,000,000 * 4% = $400,000
Year of assessment: 2002/2003

Annual allowance: $10,000,000 * 4% = $400,000
Year of assessment: 2003/2004
Annual allowance: $10,000,000 * 4% = $400,000
Year of assessment: 2004/2005
Residue of expenditure before sale: $10,000,000 - $2,000,000 - $400,000 - $400,000 - $400,000 = $6,800,000 less: Sale price: $13,000,000 = $6,200,000 (Balancing charge restricted to total allowances granted $3,200,000).

Company B:

Year of assessment 2005/2006
Residue before sale: $6,800,000 plus balancing charge $3,200,000 equal to Residue after sale $10,000,000 (that is the original cost of construction)

No initial allowance as the building bought was a used one. Annual allowance: from 2005/2006 to 2026/27 (that is the 25th year after the year of first use): $10,000,000 / 22 years = $454,545. This allowance is the same up to 2026/27.

3.45 Commercial building allowance

As said earlier, an industrial building attracts generous Industrial Building Allowance. However, if a taxpayer incurs capital expenditure on construction or purchase of a building which does not meet the requirements of an industrial building and that building is used in the production of assessable profits, then he can claim an allowance called Commercial Building Allowance in respect of the capital expenditure.

A commercial building is defined under section 40 of the Inland Revenue Ordinance as a building other than an industrial building used in a trade, business or profession. In fact, commercial building allowance (CBA) has been introduced since 1998/99 to replace Rebuilding Allowance (RA) which is even a smaller allowance.

CBA works like Industrial Building Allowance, except there is no initial allowance. The terminologies under CBA follow those of IBA; therefore, they can be construed as having similar meanings.

An annual allowance of 4% on cost of construction is granted to a person who has a relevant interest in a commercial building or structure at the end of the basis period for the year of assessment. Part of a building can qualify --- it is not necessary for the whole building to be used for the trade. The meaning of “relevant interest” is similar to that for industrial buildings --- In short, a person will have a “relevant interest” in a commercial building when he incurs capital expenditure in it.

Like IBA, CBA is based on the cost of construction. From the cost of construction, CBA will be deducted. The balance is carried forward as “residue of expenditure”. In fact, the definition of “residue of expenditure” is also similar to that under IBA. If the building is not put to use at the end of the basis period, no CBA will be granted --- Instead, a notional allowance equal to 4% of the capital expenditure will be written off from the residue of expenditure, similar to IBA.

In practice, 50% of the first sales price is taken to be for the cost of construction. The first sales price is usually found in the record kept by the Land Registry. Likewise, for computation of balancing allowance or balancing charge on sale of the building, 50% of the sales price is usually taken to be in respect of the cost of construction.

A practical example of CBA

A commercial property was purchased from a property developer in 2001/02 for $3,000,000. The property was sold in 2005/06 for $2,000,000.

CBA granted for 2001/02 to 2004/05: $3,000,000 * 50% * 4% per annum = $60,000. Generally speaking, in view of the small amount of CBA, no queries will be asked by IRD to ascertain the actual cost of construction.

Total CBA granted for 2001/02 to 2004/05: $60,000 * 4 = $240,000
Residue of expenditure before sale: $1,500,000 - $240,000 = $1,260,000
Computation of Balancing Allowance in 2005/06:
Sales price attributable to the cost of construction: $2,000,000 * 50% = $1,000,000.
Balancing allowance: $1,260,000 - $1,000,000 = $260,000 (It is a deduction in computation of assessable profit).

Assuming the purchaser uses the property for a trade chargeable to profits tax, the purchaser is entitled, from 2005/06 onward, to CBA per annum which is determined as follows: Residue of expenditure after sale x 1 / Number of years of assessment from the purchaser’s first year of CBA to the 25th year after the year of first use. In this example, the Residue of expenditure after sale is: $1,260,000 - $260,000 = $1,000,000. The first year of CBA is 2005/06. The year of first use is 2001/02 and the 25^{th} year after the first use is 2026/27. Therefore, the number of years of assessment from the purchaser’s first year of CBA (i.e. 2005/06) to the 25th year after the year of first use (i.e. 2026/27) is 22. Therefore, the annual CBA is $1,000,000 / 22 = $45,454.50 from 2005/06 to 2026/27 (Total CBA for the purchaser: $45,454.50 x 22 years = $1,000,000 --- 50% of his purchase price)

Annual allowance

If the construction is after 1998/99, the annual CBA will be 4% of the capital expenditure incurred on the construction until the residue of expenditure is zero.

If a person buys a relevant interest in a commercial building which has been used in a trade, he can get CBA by reference to the residue of expenditure immediately after the sale (not as 4% on the capital expenditure). There are two methods of determining the residue of expenditure immediately after the sale:

The first method is applicable where the building was constructed prior to 1998/99: Annual allowance = Residue of expenditure immediately after the sale / Number of years from the year of assessment of sale to 2023/2024.

The second method applies in any other cases: Annual allowance = Residue of expenditure immediately after the sale / Number of years of assessment from the year of assessment of the sale to the 25th year of assessment after the building was first used.

Residue of expenditure after sale has a similar definition to that for IBA. In short, it is the residue of expenditure before the sale as increased by balancing charge or reduced by balancing depreciation allowance on the sale.

Decoration expenditure before business commencement

Decoration or renovation expenditure incurred before commencement of business may qualify CBA. Nevertheless, it is advisable for the taxpayer to identify those expenditures attributable to plant and machinery on which the taxpayer can claim for greater amount of depreciation allowances. Where the commercial building is disposed of, the taxpayer can claim balancing allowances like IBA. Furthermore, if the building is held on a lease and the lease expires in the basis period, the taxpayer can also claim balancing allowances in respect of the balance of capital expenditure. In that case, the whole of the decoration expenditure can qualify the CBA --- The 50% apportionment is not required as no cost of land is involved.

Another example of CBA in which cost of construction is

available

Company X bought an office from a property developer on 1 May 2009 at $10,000,000 (site value excluded). The office's construction cost is $4,000,000. The company's accounts end on 31 December. On 12 January 2011, the office was sold to Company Y for $3,000,000 (site value excluded). Company Y makes up its accounts on 31 January.

<u>Company X</u>
Year of assessment 2009/2010
Annual allowance: cost of construction $4,000,000 * 4% = $160,000.
Year of assessment 2010/2011
Annual allowance: cost of construction $4,000,000 * 4% = $160,000.
Year of assessment 2011/2012
Disposal of CB ==> Balancing adjustment:
Residue of expenditure before sale: $4,000,000 - $160,000 - $160,000 = $3,680,000 less sales price for building $3,000,000 equal to $680,000 (balancing allowance) --- a deduction from assessable profits.

<u>Company Y</u>
Year of assessment: 2011/2012
Residue of expenditure after sale: $3,680,000 – balancing allowance $680,000 = $3,000,000.
Annual allowance: residue of expenditure after the sale / number of years of assessment from the year of assessment of the sale to the 25th year of assessment after the building was first used
= $3,000,000 / no. of years from 2011/2012 to 2034/2035 = $3,000,000 / 24 = $125,000.

The annual allowance is the same until 2034/35 when the residue of expenditure is completely written off. Form 2035/36 onwards, no CBA will be granted.

3.46 Plant and machinery allowance

Plant and machinery used in the production of assessable profits attract depreciation allowance --- which is a deduction from assessable profits. Theoretically such allowances can also be claimed under Salaries Tax but this rarely occurs in practice.

Plant and machinery used for scientific research are fully deductible under Section 16B of Inland Revenue Ordinance. Besides, plant and machinery for manufacturing process and computer hardware and software used for a trade are wholly deductible under Section 16G. As the traders should claim full deduction for such assets, plant and machinery allowances are no longer needed.

Before 1980/1981, the allowances are separately computed for each asset. This system is generally called “the old system”. Obviously, this system gives a lot of computation work if the taxpayer has many assets. Now this method only applies for assets which are not wholly used for the trade and also for those assets purchased on hire-purchase.

From 1980/81 onwards, the allowances are computed for each pool of assets which have the same rate of annual allowance. This system is called “pooling system”. This system saves a lot of computation work because it dispenses separate record and computation for each asset.

The allowances are based on the “capital expenditure incurred on the provision of plant or machinery” used in the production of assessable profits. This includes not only the price of the asset, but also the related purchase expenditure, and delivery and set-up cost. Besides, purchase of second-hand asset attracts the allowances just the same as the new ones.

The basis period for the allowances follows that for determining assessable profits. If the asset is purchased before the commencement of the trade, it is deemed to be incurred on the first day of trading.

Pooling system

Under this system, the reducing values after initial allowance of all assets with the same rate of annual allowance are put together into the same pool. Then, from the reducing value of the pool, disposal proceeds of any asset belonging to that pool are deducted. Then, annual allowance at the proscribed rate of the pool is deducted from the reducing value of that pool.

An initial allowance of 60% is granted on the capital expenditure incurred (that is on purchase of an asset) --- Capital expenditure means the purchase price plus delivery and set-up cost. Then, the reducing value (that is the cost less the initial allowance) is transferred to the pool for annual allowance.

The rate of annual allowance is proscribed in Inland Revenue Rule No. 2. Applying this rate on the reducing balance gives the annual allowance which is to be deducted from the reducing value of the pool. Annual allowance will be granted if the asset has been used for the trade during the basis period --- Unlike the old system, the asset must be used at the end of the basis period. There are three pools of annual rates of allowance: 10%, 20% and 30%. Below are some examples of assets of the three pools.

- 10% pool: sprinklers, water mains …
- 20% pool: room air-conditioners, furniture, domestic appliances …
- 30% pool: motor vehicles, machines, electronic equipments …

Clearly, the pooling system dispenses with keeping record for each asset and the frequent computing of balancing adjustments on disposal of assets. If the business is going on, there will be no balancing allowance. Moreover, balancing charge will only arise when the sales proceeds exceed the reducing balance of the pool --- That is obviously very rare in practice.

On cessation of business, if the assets are sold, there will be balancing adjustments --- That is to adjust the total allowances to the total net cost of the assets (that is the total costs less total sale proceeds). If the sale proceeds exceed the reducing balance, the difference being the adjustment will be a balancing charge --- which is a taxable receipt. If the sale proceeds is less than the reducing balance, the difference being the adjustment will be a balance allowance --- which is a further allowance.

When an asset bought for private use is later used for the trade, a notional reducing value of such asset will be added to the pool for annual allowance. The notional reducing value is computed by deducting from the cost of the asset by a notional allowance at the proscribed rate of annual allowance for each complete year of not being used for the trade. No initial allowance will be granted for such asset. If an asset of a pool ceases to be used for the trade, then the reducing value (as determined by the IRD) will be deducted like disposal proceeds from the reducing value of the pool.

An example of how the pooling system works

In October 2007, a trader bought a motor vehicle for $100,000 and some furniture for $200,000. In August 2008, he bought another motor vehicle for $150,000 and sold part of his furniture for $50,000. In November 2008, he bought some new furniture for $100,000. He makes up accounts on 31 March.

2007/2008:	30% Pool	20% Pool	Allowances
Addition – motor vehicle			
Cost: $100,000			
Less: I. A. @60%	40,000		60,000

Addition – furniture			
Cost: $200,000			
Less: I. A. @60%		80,000	120,000
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	40,000	80,000	180,000
Less: A. A.	12,000	16,000	28,000
	---------	----------	-----------
Reducing value c/f	28,000	64,000	208,000
			=======
2008/2009:			
Addition – motor vehicle			
Cost: $150,000			
Less: I. A. @60%	60,000		90,000
Addition – furniture			
Cost: $100,000			
Less: I. A. @60%		40,000	60,000
Less: Disposal proceeds		50,000	
	----------	-----------	----------
	88,000	54,000	150,000
Less: AA	26,400	10,800	37,200
	----------	----------	----------
Reducing value c/f	61,600	43,200	187,200
	======	======	======

Assets purchased on hire purchase

For the assets bought on hire purchase terms, the old system applies. In other words, such assets are not pooled under the new system. But when all hire-purchase installments have been paid, the reducing value of the asset will be transferred to the relevant pool.

Legally speaking, assets on hire purchase do not become asset of the buyer until all hire purchase installments are fully settled. Nevertheless, Section 37A of Inland Revenue Ordinance provides initial allowances on the capital portion of each installment and annual allowance on the reducing balance of the full cost (which is the cash price excluding the hire-purchase interest).

Interest paid under hire purchase is deductible. So, it should be separated from the capital cost of the asset for depreciation allowances purpose.

Below is an example showing how depreciation allowance is computed on a hire-purchase asset.

A trader bought a motor vehicle on hire purchase on 1 July 2007. The hire purchase price is $240,000 to be paid by 24 monthly installments. First installment paid on 1 July 2007. The cash price is $210,000. He makes up accounts on 31 March.

Monthly installment: $240,000 / 24 = $10,000.
Capital portion of each installment: $10,000 * $210,000 / $240,000 = $8,750.

<u>Year of assessment 2007/2008</u>
Initial allowance: 9 * $8,750 * 60% = $47,250.
Reducing balance: $210,000 - $47,250 = $162,750
Annual allowance: $162,750 * 30% = $48,825.
Reducing balance: $162,750 - $48,825 = $113,925

<u>Year of assessment 2008/2009</u>
Initial allowance: 12 * $8,750 * 60% = $63,000.
Reducing balance: $113,925 - $63,000 = $50,925
Annual allowance: $50,925 * 30% = $15,278.
Reducing balance: $50,925 - $15,278 = $35,647

<u>Year of assessment 2009/2010</u>
Initial allowance: 3 * $8,750 * 60% = $15,750.
Reducing balance: $35,647 - $15,750 = $19,897
Annual allowance: $19,897 * 30% = $5,969.
Reducing balance: $19,897 - $5,969 = $13,928. This will be transferred to 30% pool because the hire-purchase installments

have been fully paid.

3.47 When to file profits tax returns?

There are two types of issue of profits tax returns: (a) the odd issue and (b) the bulk issue.

The odd issue of tax returns is on a case by case basis throughout the year of assessment at the discretion of the assessing officer. In such cases, the time limit to file a tax return is usually set at one month from the date of issue --- save the urgent cases, for example, a sole trader has ceased his business and is going to leave Hong Kong permanently, in which the time limit may be less than one month.

The bulk issue of tax returns is done by the computer in every April to a large number of taxpayers according to their accounting dates. Although the time limit for filing the tax returns on a bulk issue is also set at one month from the issue date, the taxpayer can ask for an extension of the time limit if his accounting date falls in the categories “M” and “D”.

Category	Accounting date	Extension of time limit up to
M	The accounting date falls in the period of 1 Jan to 31 Mar	Early November
D	The accounting date falls in the period of 1 Dec to 31 Dec	Early August
N	All other cases.	No extension

It should be noted that the above extension applies to the current year of assessment only. Automatic extension is granted to those taxpayers who are represented by a tax representative. Unrepresented taxpayers will be granted the extension only upon written requests. The exact dates and details of the extension may differ slightly from year to year and they are published on the IRD's website. Although in general no further extension will be granted beyond the above time limits, the assessor may extend the time limit in special cases where the taxpayer has pressing problems in meeting the deadline.

3.48 Computation of assessable profit

The determination of assessable profit is based on the accounting profit as shown in the taxpayer's Profit and Loss Account. Put it simply, the beginning figure of the computation is: net profit / loss per accounts. Then, to this figure, we

add:

- depreciation,
- remuneration to business owners (for unincorporated business),
- domestic or private expenses (for unincorporated business),
- non-deductible contribution to retirement scheme (for unincorporated business),
- expenses or losses of a capital nature, and

less:

- gain on disposal of fixed assets,
- dividends income,
- bank interest (the exemption does not apply to financial institutions)
- non-assessable profits (e.g. those do not have a Hong Kong source),
- cost of computer hardware and software,
- cost of patents ... etc.,
- cost of manufacturing plant or machinery,
- depreciation allowance of plant and machinery,
- Industrial Building Allowance,
- Commercial Building Allowance,
- tax loss brought forward,

and the balance (if positive) is Assessable Profit. If the balance is negative, it is a tax loss. On this assessable profit, profits tax at the standard rate is demanded.

To put it mathematically,
Tax payable = Assessable Profit * Tax rate
(Tax rate for corporation: 17.5%; for sole-proprietor and partnership business: 16%)

3.49 Demand for Profits Tax

Where a sole-proprietor or a partner elects to be personally assessed, the relevant profits will be transferred to Personal Assessment --- and if Personal Assessment can reduce his total tax payable, the tax payable will be demanded under Personal Assessment instead of Profits Tax --- in that case no profits tax will be demanded.

Because the actual assessable profits will not normally be known until a final assessment is made --- a final assessment will not usually be issued until after the year of assessment (the exceptional case is the taxpayer ceases his business or is going to leave Hong Kong). In order to demand tax promptly, Section 63G of Inland Revenue Ordinance empowers the Revenue to demand provisional profits tax for the estimated provisional profits earned for the period up to the date of tax payment.

Normally, for an ongoing business: Provisional profits tax = Assessable profits for the preceding year of assessment x Tax rate.

In special circumstances such as business commencement, the Revenue may estimate the amount of provisional profits --- The estimation is usually based on a projection of accounting profits for 12 months.

The provisional tax is normally demanded in the notice of assessment which contains the final assessment of the preceding year of assessment. The provisional tax as demanded last year will set-off the final profits tax payable in the final assessment concerning the same current year of assessment and, any difference will be added to the provisional profits tax demanded for the next year of assessment.

3.50 When to pay profits tax

The due date for payment of profits tax depends on a number of factors including: (a) whether it is a current year of assessment (b) when the taxpayer files the tax return, (c) when the tax return is processed by the IRD officer, (d) the date of issue of the assessment, (e) whether it is an urgent case, e.g. the taxpayer has been broke, (f) whether provisional tax is demanded and (g) which category of accounting date ('N', 'D' or 'M') does the case belong to. Only one due date is set for back-year assessments. But for current-year assessments, two due dates are normally set for 'D" and 'M' cases in which provisional tax is demanded.

The general practice is as follows:

- D code: Two due dates are set in December to May if the assessment is issued before early November and if issued thereafter, one due date of about 6 weeks after the date of the assessment.

- M Code: Two due dates are set in December to May if the assessment is issued before early February and if issued thereafter, one due date of about 6 weeks after the date of the assessment.

- N Code: One due date in November.

3.51 Hold-over of provisional profits tax

A taxpayer can apply for the hold-over on the following grounds:

- The actual profits are likely less than 90% of the provisional assessable profits assessed. On this ground of application, the taxpayer has to provide certified management accounts covering at least 8 months of the basis period.

- Loss brought forward is omitted or incorrect.
- The taxpayer has ceased trading.
- The taxpayer (who is a sole-proprietor or a partner) elects for Personal Assessment.
- The person has objected to the prior-year assessment.

Notice of hold-over should be given to IRD at least 28 days before the due date or 14 days after the date of the demand for payment, whichever is the later.

3.52 Tax losses

If the balance of the tax computation is negative, it is called tax loss which is to be carried forward to set-off the following year's assessable profits.

An individual taxpayer may elect for Personal Assessment to have the tax loss set-off against his total income for the same year of assessment. If so, any unabsorbed loss will be carried forward under Personal Assessment and he is deemed to elect for Personal Assessment until the loss is fully absorbed.

If an individual taxpayer having a business loss does not elect for Personal Assessment, then the loss will be carried forward under that business to set off its future profits. If the business is ceased permanently, the loss will lapse --- even though the individual has another business or he starts a new business earning assessable profits. So, it is generally advisable for him to elect for Personal Assessment when he has business losses.

If a partnership (with less than 20 partners) incurs losses, the losses will be allocated among the partners and then carried forward separately under the name of each partner. If a partner elects for Personal Assessment, his share of loss will be transferred to his Personal Assessment and the loss will be used for setting off other incomes like an individual as above. If a partner withdraws from a partnership, his share of loss in the partnership will lapse. So, it is generally advisable for him to elect for Personal Assessment when he has a share of partnership loss.

If a corporation incurs losses, the losses can be used to set off assessable profits of the corporation from any trade, including its share of profits from a partnership. (Note: The corporation's share of profits from a partnership is taxed at corporation rate of 17.5% while the profits attributable to other individual partners taxed at 16%). Moreover, the corporation’s share of loss from a partnership can also be used to set-off its own assessable profits and if unabsorbed, it will be carried forward under its own name and will not lapse even if the corporation withdraws from the partnership. Besides, tax losses brought forward from back years can also be used to set off its share of profits from a partnership set up in the current year. However, if the corporation is liquidated, the loss will lapse forever. It should be noted that Section 22B, an anti-avoidance provision, has been introduced to restrict the loss set-off to the amount of contribution by the corporation into the partnership. In this respect, the contribution is defined as the net amount of the corporation's capital injected into the partnership plus its share of the partnership's retained profits. By the way, it should be noted that Section 61B can be used by the IRD to counteract the tax avoidance that involves sale of loss companies. See Chapter 1, paragraph 1.11.

Where a taxpayer incurs loss on qualifying debt instruments, such loss cannot be fully set-off his trading profits. This is because any gains on such debts are only taxed at half the relevant profits tax rate. In fact, there are special rules for the set-off. As such rules, which are quite complicated, rarely apply in practice, I am not going to talk about them. If you want to study them, you can go to the IRD’s website at http:///www.ird.gov.hk.

3.53 Registration of Business

Any person carrying on a business in Hong Kong must apply for business registration. The statutory time limit for the registration is one month from the start of business. Failure to do so may lead to a fine of $5,000 and one-year imprisonment.

The application requires payment of a registration fee. It should be lodged with Business Registration Office of Inland Revenue Department. On approval of the registration, a business registration certificate will be issued. A fee is normally required for the renewal of the registration. Renewal can be on one-year or three-year basis. Small businesses may apply for an exemption of business registration fee. If there are any changes of particulars of the registration, the applicant should report such changes within one month after the change. The changes include business nature, name, address, or retirement or admission of new partners… etc.

3.54 Keeping business records

According to section 51C of the Inland Revenue Ordinance, every person carrying on a trade, profession or business in Hong Kong must keep sufficient business records, either in English or Chinese, for his income and expenditure so as to enable his assessable profits to be ascertained. He must keep such records for at least 7 years. Failure to do so may render him liable to a penalty of $100,000.

Business records include:

1. books recording receipts and payments, income and expenditure;
2. original documents such as vouchers, bank statements, invoices, bills, receipts … etc;
3. books recording assets and liabilities;
4. books recording daily cash receipts and cash expenditures;
5. where the business involves dealing in goods -
   - a record of all goods purchased and all goods sold

showing date of transactions, the goods concerned, the suppliers, the customers;

- a record of trading stock at the opening and also at the end of the accounting period and details of the stocktaking for preparation of the stock record;

6. where the business involves the provision of services -
   i. records of all the services provided showing date of transactions, the services and the customers.

3.55 Sole-proprietor

A sole-proprietor carrying on a business in Hong Kong has to file a tax return BIR 60 for every year of assessment. The tax return must be supported by the followings:

- a certified copy of audited Balance Sheet and Profit and Loss Account;
- a tax computation showing how the Assessable Profits are computed from the accounting profits;
- schedules of the following items (where applicable):
- mandatory contributions made under the Mandatory Provident Fund Schemes Ordinance in respect of the proprietor;
- capital expenditure incurred, capital assets sold, depreciation charged in the accounts and assets not in use at the end of the basis period;
- details of expenditure incurred on, and disposal proceeds of, scientific research;
- details of expenditure incurred on refurbishment of buildings --- the location and the usage of building during the year;
- details of the bad debts written off and provided for including the name of debtors;
- details of any service / management fee received including name and address of each payer,
- details of interest paid or payable, including name and address of the lender, any security to the lender, and the usage of the loan;

- details of income claimed to be with a non-Hong Kong source;
- details showing the name and address of payments involving contractor / sub-contractor fees, management fees, commission, royalties, legal and other professional fees, and hiring charges for the use of a movable property in Hong Kong;
- details of bad debt provisions and write-offs;
- details of change in valuation of stock; and
- details of rent payments including name and address of the landlord, the property location, the total rent paid and the period covered.

Normally, the Revenue will issue the first tax return about 18 months after a person registers his business.

Where a taxpayer has assessable profits for the year of commencement, he should inform the Revenue within 4 months after that year of assessment. In other words, if he starts a business on 1 April 2007 and makes profits in the year ended 31 March 2008, he should inform the Revenue of his chargeability not later than 31 July 2008.

The Inland Revenue Ordinance does not require a taxpayer to appoint a tax representative to act on his behalf or hire a professional accountant to prepare the final accounts. But if the business is big, it is advisable for him to seek professional advice.

3.56 Partnership

Section 14 of Inland Revenue Ordinance levies profits tax on a person carrying on a trade, a business or a profession in Hong Kong in respect of his profits derived from Hong Kong. Section 2 defines “person” to include a partnership. Section 22 empowers the IRD to issue a profits tax assessment on a partnership.

Normally, the precedent partner is responsible to file a Profits Tax Return (BIR 52) for every year of assessment. According to Section 2, "precedent partner" is the one first named in the partnership agreement. If there is no such agreement, the one who is first named in the usual partnership name or in any statutory document such as Business Registration Certificate will be regarded as the precedent partner.

If the precedent partner fails to file the tax return or to do any acts required by the Inland Revenue Ordinance (including payment of tax), every partner will be jointly and severally liable to do it (including payment of the outstanding tax of the precedent or other partners).

As far as a partnership is concerned, the tax return must be supported by the followings:

- a certified copy of audited Balance Sheet and Profit and Loss Account;
- a tax computation showing how the Assessable Profits are computed from the accounting profits;
- a schedule showing he allocation of Assessable Profits between partners, taking into account any salaries payable to partners, and balance apportioned in their profit and loss sharing ratio;
- schedules of the following items (where applicable):
- mandatory contributions made under the Mandatory Provident Fund Schemes Ordinance in respect of each partners;
- capital expenditure incurred, capital assets sold, depreciation charged in the accounts and assets not in use at the end of the basis period;
- details of expenditure incurred on, and disposal proceeds of, scientific research;
- details of expenditure incurred on refurbishment of buildings --- the location and the usage of building during the year;

- details of the bad debts written off and provided for including the name of debtors;
- details of any service / management fee received including name and address of each payer,
- details of interest paid or payable, including name and address of the lender, any security to the lender, and the usage of the loan;
- details of income claimed to be with a non-Hong Kong source;
- details showing the name and address of payments involving contractor / sub-contractor fees, management fees, commission, royalties, legal and other professional fees, and hiring charges for the use of a movable property in Hong Kong;
- details of bad debt provisions and write-offs;
- details of change in valuation of stock; and
- details of rent payment including name and address of the landlord, the property location, the total rent paid and the period covered.

A single Profits Tax assessment is issued to the partnership. The tax payable is computed at the standard rate 16% on the assessable profits. However, if a partner elects for Personal Assessment and such election can reduce his total tax liabilities, then allocation of profits or losses will have to be made so that his share of profits will be transferred to Personal Assessment and will not be taxed under Profits Tax.

If a partner is a corporation, its share of profits will be taxed at the corporation rate 17.5%.

If there is a change of partners e.g. death of partner or retirement of a partner, or admission of a new partner, the change should be reported to Business Registration Office within one month of the change.

Normally, the Revenue will issue the first tax return about 18 months after a partnership registers his business.   But if it has assessable profits for the year of commencement, it should inform the Revenue within 4 months after that year of assessment.

What is a partnership?

In practice, there should not be many disputes on whether a partnership exists because most of them will register themselves as such upon application for business registration. But in some cases, if there should be a dispute, it is usually quite difficult to solve the dispute.

Section 3 of Partnership Ordinance states that "partnership" is the relation which subsists between persons carrying on a business in common with a view of profit. This definition is almost the same as that under the UK law. Section 4 of that Ordinance goes on to provide a number of rules for determining the existence of a partnership but none of them are conclusive. Among them, it states that a person getting a share of profits is stated to be prima facie evidence that he is a partner --- but even this factor is not conclusive. Other points to consider include:

1. Are profits or losses shared?
2. Is capital shared?
3. Are separate capital and / or current accounts kept for each party?
4. Name of the business in invoices, business correspondence, billboards, advertisements, bank accounts… etc.
5. The existence of partnership agreement is, of course, important evidence. But without it does not mean that there is no partnership.

Let us see the following case. It is an important case on the question although it is not a tax case.

Chan Sau-kut versus Gray & Iron Construction & Engineering Co.

The question of what is a partnership has once been decided in the Hong Kong court case Chan Sau-kut and Another versus Gray & Iron Construction & Engineering Co. [1986] 1 HLLR 84. The case concerns whether a partnership exists where there is an express agreement stating that it is not a partnership but a debtor / creditor relationship. In the case, Mr. Gray wanted to embark on a drainage project. He had not enough capital and so he asked Chan and others to contribute money to the project. The contract between Chan and Gray and others stated the relationship to be a "co-operation" and provided for joint control of the bank accounts and equal sharing of profits. It also contained a clause stating: "this contract shall not constitute a partnership…" The question is: if it was a partnership, Chan would have to responsible for the business's liabilities. If it was only a debtor / creditor relationship, Chan would not be responsible for the business liabilities but rather, he would be entitled to get back his investment in the business from Gray as a debtor. In his judgment, the judge held that a partnership existed notwithstanding the agreement stating otherwise. His decision was based on the substance of relationship, namely the operations, the sharing of risks and profits, and the management and control of the business.

Author's comments: The Revenue usually regards the factor "whether the taxpayer had a share of profits" as the most important one in determining the existence of a partnership.

Allocation of profits or losses between partners

The allocation is necessary if one of the following situations happens.

1. A partner has elected for Personal Assessment. In that case, his share of profits or losses is to be transferred to his own Personal Assessment.
2. The partnership makes a loss. The loss has to be apportioned between the partners and carried forward to set-off their own share of profits in future.
3. A partner is deemed to elect for Personal Assessment. The deemed election applies when any partner has a loss

brought forward from his prior-year Personal Assessment.

The allocation is like that under normal accounting practice: That is doing salaries to partners first, and then the balance is allocated among the partners according to their profits and loss sharing ratio.

If a partnership makes a profit, no loss to any partner will be allowed --- any such loss will be re-allocated to other partners according to the balance before the re-allocation. Likewise, if a partnership makes a loss, then no profit will be allowed to any partner --- any such profit will be allocated to other partners according to the balance before the re-allocation.

Examples of profits allocation among partners

Example 1

A partnership ABC & Co. has assessable profits $749,000 for 2008/2009. It has three partners A, B and C with a profit and loss sharing ratio 2 : 2 : 1 respectively. A, B and C are entitled to a monthly salary of $30,000 each.

Partner	Total Salaries	Share of balance	Net total
A	360,000	-132,400	227,600
B	360,000	-132,400	227,600
C	360,000	-66,200	293,800
	-----------	----------	---------
	1,080,000	-331,000	749,000
	=======	======	=======

Example 2

A partnership CLW has assessable profits $500,000 for 2008/2009. It has three partners Chan, Lee and Wong with a profit and loss sharing ratio 2 : 2 : 1 respectively. Chan is entitled to a monthly salary of $50,000 and Lee $40,000.

Allocation of profits:

Partner	Total Salaries	Share of balance	Net total	Reallocation	Net allocation
Chan	600,000	-232,000	368,000	-69,299	298,701
Lee	480,000	-232,000	248,000	-46,701	201,299
Wong	0	-116,000	-116,000	+116,000	0
	-----------	----------	---------		---------
	1,080,000	-580,000	500,000		500,000
	=======	======	=======		======

The re-allocation of Wong's negative balance between Chan and Lee is based on their respective net totals.

Example 3

A partnership XYZ has adjusted losses $200,000 for 2008/2009. It has three partners X, Y and Z share profit and loss in the ratio of 1 : 1 : 2. X is entitled to a monthly salary of $20,000.

Allocation of profits:

Partner	Total Salaries	Share of balance	Net total	Reallocation	Net allocation
X	240,000	-110,000	130,000	-130,000	0
Y	0	-110,000	-110,000	43,333	-66,667
Z	0	-220,000	-220,000	86,667	-133,333
	-----------	----------	---------		----------
	240,000	-440,000	-200,000		-200,000
	=======	======	=======		======

Re-allocation of X's balance between Y and Z is based on their respective net totals.

Allocation of loss among partners is a must even though no partner elects for Personal Assessment. The loss allocated to a partner belongs to him (not the partnership) and if he elects for Personal Assessment, his share of loss will be transferred to Personal Assessment. If he does not make the election, his share of loss will be carried forward to set off his share of future assessable profits of the partnership. If he withdraws from the partnership, his share of loss will lapse.

A partnership with more than 20 partners

Section 345 of Companies Ordinance prohibits a partnership from having more than 20 partners unless it is a partnership of solicitors, accountants or stock-brokers.

For counting of partners where a partnership is a partner of another partnership, the total number of the latter partnership must include every one in the former. Say, if a partnership (B) is a partner of partnership (A), then in counting the total number of partners in (A), it will be the total number of partners in (B) plus the total number of partners in (A) minus one. In other words, every individual partner (other than a partnership) must be counted separately and added together.

Where a partnership has more than 20 partners, there will be no allocation of profits or losses between the partners. In other words, its profits will be assessed at standard rate for individuals (that is 16%) in a single assessment.

3.57 A body of persons

Normally a person chargeable to profits tax is an individual, a partnership or a corporation. If a “person” carrying on a business or a trade in Hong Kong does not belong to the aforesaid categories, he is probably a body of persons --- maybe a club, a trade union or a trade association. These “persons” may still be chargeable, but subject to special provisions of the Inland Revenue Ordinance.

A charity, which is usually a body of persons, will be exempt from tax if it does not carry on a trade or business. As established from case law, a charity is one doing the following: (a) relief of poverty, (b) advancement of religion, (c) furtherance of education or (d) any activities concerning public benefit. Political organizations, however, do not normally meet these criteria. If an organization claims to be a charity, it should apply to the IRD for tax exemption under Section 88 of Inland Revenue Ordinance.

3.58 Corporation (limited company)

According to section 2 of Inland Revenue Ordinance, a corporation is any company incorporated or registered under any enactment or charter in Hong Kong or elsewhere. For tax purpose, the terms “limited company”, “corporation” and “incorporated” have the same meaning.

The question of whether a corporation is a resident or a non-resident of Hong Kong does not affect its profits tax liability --- although there are special provisions applicable to non-residents concerning collection of tax.

A corporation carrying on a business in Hong Kong has to file a tax return BIR 51 for every year of assessment. The tax return must be supported by the followings:

- a certified copy of audited Balance Sheet and Profit and Loss Account and Director Report;
- a certified copy of Auditor Report;
- a tax computation showing how the Assessable Profits are computed from the accounting profits;
- schedules of the following items (where applicable):
- capital expenditure incurred, capital assets sold, depreciation charged in the accounts and assets not in use at the end of the basis period;
- details of expenditure incurred on, and disposal proceeds of, scientific research;
- details of expenditure incurred on refurbishment of buildings --- the location and the usage of building during the year;
- details of reserves and provisions, showing transfers to and from the related accounts;
- details of extraordinary gains and losses;
- details of any service / management fee received including

name and address of each payer,

- details of interest paid or payable, including name and address of the lender, any security to the lender, and the usage of the loan;
- details of income claimed to be with a non-Hong Kong source;
- details showing the name and address of payments involving contractor / sub-contractor fees, management fees, commission, royalties, legal and other professional fees, and hiring charges for the use of a movable property in Hong Kong;
- details of bad debt provisions and write-offs;
- details of change in method of valuation of stock;
- details of rent payment including name and address of the landlord, the property location, the total rent paid and the period covered.

The Inland Revenue Ordinance does not require the corporation's accounts to be audited. Rather, it is the Companies Ordinance that makes the requirement. So, if the corporation is registered in a country without audit requirement, the Revenue may accept unaudited accounts providing they are certified by the directors. Besides, a Hong Kong limited company may be exempt from audit under the Companies Ordinance --- for example, it is a dormant company. In that case, the Revenue may also accept unaudited accounts.

Tax payable by a corporation = Assessable profits x Corporation rate 17.5%.

The corporation’s share of profits from a partnership is also taxed at the corporation rate of 17.5%% although the partnership’s profits attributable to other individual partners are taxed at 16%.

Companies in liquidation

In general, the IRD does not insist on audited accounts if the accounts are signed by a responsible person (e.g. the liquidator).

However, audited accounts must be submitted if they are available.

3.59 Non-residents of Hong Kong

Section 14 of Inland Revenue Ordinance lays down the basic charge of profits tax: Every person carrying on a trade, profession or business in Hong Kong --- who has profits arising in or derived from Hong Kong --- is chargeable to Profits tax. This applies to both Hong Kong residents and non-residents.

Profits tax may be levied on the non-resident directly (assessed in his own name) or indirectly (assessed on his agent). The tax can be recoverable from the non-resident or the agent in Hong Kong. According to Section 2 of Inland Revenue Ordinance, “agent” includes (a) the agent, attorney, factor, receiver or manager in Hong Kong, and (b) any person in Hong Kong through whom the non-resident is in receipt of any profits arising in or derived from Hong Kong.

The agent should withhold an adequate amount out of the non-resident's assets within his control for payment of tax. Failure to do so may render him personally liable to pay the tax.

The agent can object to the assessment on behalf of the non-resident.

The Inland Revenue Ordinance does not define “resident” or “non-resident”. In fact, the question of “residence” is largely based on facts. From case law, an individual is a resident of where he maintains a place of abode. As far as a company is concerned, the place of residence is generally located at the place where the central management and control is exercised --- vide De Beers Consolidated Mines Limited v. Howe (1906) 5 TC 198. It follows that a company is normally resident in the place where its board of directors meet and carry out their duties.

A person, including an individual or a company, may be resident in more than one country at the same time. According to Departmental Interpretation & Practice Notes No. 17, paragraph 8, the Revenue regards a person having no permanent business presence in Hong Kong as a “non-resident”.

The assessable profits of a non-resident carrying on a business with a permanent establishment in Hong Kong are based on the financial accounts kept for the Hong Kong business. Where such accounts are not available or where such accounts do not reveal the true profits of the Hong Kong business, then the non-resident’s assessable profits will be determined in accordance with Inland Revenue Rule 5 of the Inland Revenue which is quoted as follows:

Rule	Situation	Assessable profits
5(2)(a)	The local accounts reflect the true Hong Kong profits.	Per the local accounts
5(2)(b)	The Local Accounts do not reflect the true Hong Kong profits	Hong Kong Turnover / Total turnover x Total profits, whereas total profits are subject to Hong Kong profits tax adjustments [rule 5(2)(c)]
5(2)(d)	Rule 5(2)(b) and 5(2)(c) are not practicable.	A fair percentage of HK turnover

If the non-resident is a bank, then Inland Revenue Rule 3 applies. In fact, the computation under Rule 3 is like Rule 5: it is done with an apportionment of the worldwide total profits in the proportion of Hong Kong assets versus total worldwide assets.

Collection of tax from the non-resident’s agent

Section 20A empowers the IRD to collect tax of a non-resident taxpayer from his agent. In section 2, “agent” is defined to include any person through whom the non-resident is in receipt of the profits.

The meaning of "agent" has once been discussed in a Hong Kong tax case: CIR v. Asia Television Limited 2 HKTC 198. It was held that the non-resident in receipt of licence fees was not through but rather from ATV. Therefore, ATV was not an "agent" and it could not be charged by virtue of Section 20A of Inland Revenue Ordinance in respect of the licence fees paid to the non-resident. It followed that the non-residents could only be charged by direct assessments. The ATV case makes it clear that the word "agent" does not apply to a person who makes a direct payment to a non-resident on a principal-to-principal basis.

To counteract the limitation of "agent" since the ATV case, Section 20B was enacted to assess on a Hong Kong person paying to a non-resident for the following types of income:

- royalties and other receipts deemed assessable under section 15(1)(a) or (b) of Inland Revenue Ordinance; or
- income received by entertainer or sportsman performing in Hong Kong.

Anti-avoidance involving non-residents of Hong Kong

Section 20 of Inland Revenue Ordinance empowers the Revenue to nullify the effect of pricing arrangement between a non-resident and a closely-connected Hong Kong resident that gives no or less than the ordinary profit to the Hong Kong resident.

The case CIR versus Rico Internationale Limited (1965) 1 HKTC 229 illustrates when Section 20 may be invoked. In this case, the taxpayer credited certain commission to an US associated company. In this regard, the court commented that it was "clearly open" to the Commissioner to act in accordance with Section 20.

A person is closely connected with any person if the Commissioner considers that such persons are substantially identical or that the ultimate controlling interest of each is owned or deemed to be owned by the same person or persons.

Consignment Tax

Section 20A(3) of Inland Revenue Ordinance says that a local person who sells goods in Hong Kong on behalf of a non-resident is required to furnish quarterly returns to the Revenue showing the gross proceeds from the sales. When he files the quarterly return, he should at the same time pay to the Revenue a sum equal to 1% of the sales proceeds or such lesser sum as accepted by the Revenue. In most cases, only 0.5 % of the sales proceeds is demanded.

Non-resident sportsman or artiste performing in Hong Kong

These people are chargeable to profits tax under Section 20B of Inland Revenue Ordinance. Since they normally stay in Hong Kong for just a few days, the normal procedures of issuing tax returns before making of assessments will not be followed. Instead, the Hong Kong promoter of the performance will submit a questionnaire to the Revenue showing the name of the performer, the gross income and the tax withheld (see below). Then, an estimated assessment under Section 59(1) proviso and Section 59(3) will be issued to assess and collect the tax withheld.

Tax withheld by the Hong Kong promoter = Gross income x 2/3 x tax rate.

The tax rate is 16% in most cases or 17. 5% if the performance is procured through an overseas corporation.

The ratio of 2/3 is based on the assumption that the total deductible expenses is 1/3 of the gross income. If the Hong Kong promoter does not accept this ratio, he can object to the assessment --- in that case a tax return must be filed and supported by detailed profits and loss accounts and schedules.

3.60 Returns filed by small businesses

If the annual gross income of a business does not exceed $500,000, the business is not required to supply Balance Sheet, Profit & Loss Account, Audit Report (for corporations only) and supporting schedules when it files the tax return. This filing concession applies to all kinds of small businesses including sole-proprietors, partnerships and corporations.

Gross income includes:

- sales and other ordinary business income;
- sales income from closely connected persons;
- proceeds from the sale of capital assets; and
- other non-taxable income, whether or not it is derived from the principal activity.

The filing concession does not dispense with the legal requirements for keeping sufficient business records and preparation of final accounts. In other words, business records and accounts must still be kept as if there had been no filing concession. Failure to keep business records may lead to a penalty of HK$100,000.

Notwithstanding the filing concession, the Revenue may from time to time request production of business records for tax audit or investigation.

Chapter 4 Property Tax Tips

4.0 Overview of profits tax

4.1 A checklist for reduction of property tax

4.2 Charge of tax

4.3 Hold over of Provisional Property Tax
4.4 Property tax versus profits tax
4.5 Is the management fee received from tenant assessable?
4.6 How to reduce Property Tax

Chapter 4 Property Tax Tips

4.0 Overview of property tax

Section 5 of Inland Revenue Ordinance levies property tax on the property owner in respect of the rental income of his land and building in Hong Kong. In general, the tax is equal to: Standard rate (16%) x 80% x (rental income – rates paid by the owner).

Rental Income includes license fee, lump sum premium or management fee paid or payable to the owner.

The owner's expenses (e.g. maintenance and property tax) borne by the tenant is regarded as taxable income.

No deduction for decoration fees, rent-collection fees, insurance and mortgage interests under Property Tax. In theory, such expenses have been covered by the 20% flat-rate deduction. No more allowance even though the owner actually incurs more expenditure.   Nevertheless, mortgage interest may be deductible under Personal Assessment if the owner elects to be personally assessed.

An example of property tax computation

Rental income for 1 July 2007 to 31 March 2008: $38,000 per month. Rates paid by owner for the 3 quarters ending on 31 March 2008: $12,000. Provisional Tax paid per last tax bill for 2007/2008: $35,000.

Rent for 9 months ($38,000 x 9): $342,000 less rates paid by owner of $12,000 equal to $330,000 (assessable value). Then, less 20% allowance for repairs and outgoings of $66,000, gives $264,000 (Net assessable value).

Property Tax for 2007/2008: $264,000 *16% = $42,240.
Less: Provisional Tax paid for 20007/2008: $35,000.
Balance payable for 2007/2008: $7,240.
Add: Provisional Tax for 2008/2009: $264,000 x 12 / 9 x 16% = $56,320.
Total tax payable to be shown in the tax bill: $7,240 plus $56,320 equal to $63,560.

The tax $63,560 is payable in two installments: the first one in November 2008 and second in April 2009. The November tax payable is 7,240 plus 7 / 12 of $56,320 totaled $40,093. The

April tax payable is 5/12 of $56,320 equal to $23,467.

4.1 A checklist for reduction of property tax

1. Are you a low-income person? If yes, you should elect for personal assessment to remove or to reduce the tax.
2. Have you borrowed money to purchase the property and paid interest? If yes, you should elect for personal assessment to claim deduction of interest.
3. Have you claimed deduction of rates?
4. Have you claimed deduction of irrecoverable rents?
5. Do you include rent deposits in your rental income? If yes, you should exclude them from the assessable value.
6. Have you received lump-sum premium? If yes, the premium can be spread over 36 months in order to reduce tax.
7. Do you pay management fee as an agent of the tenant? If yes, such fee received from the tenant is not assessable.
8. Do you know what property incomes are assessable and what are non-assessable? If no, please read my tax tips below.
9. You do not agree to the income assessed or the deduction or relief or allowances granted. In that case, you should read "What can you do if you disagree with an assessment" under Basic Tax Tips.

4.2 Charge of tax

Rent deposit returnable to the tenant is not taxable.

The lump-sum premium received at the start of the lease period can be spread throughout the lease period up to a maximum of 36 months if the owner makes such an election.

Irrecoverable rent (i.e. bad debt) is deductible from the rental income.

The “rates paid by the owner” does not include government rent. In other words, the government rent levied in the rates bill is not deductible. To claim the rates deduction, it is advisable for the property owner to keep all the rates bills.

Where the tenant pays management fee through the landlord and such fee is not included as rent under the lease, the fee is not assessable.

If the lease makes no provision for payment of management fee and the rent payable to the landlord includes the management fee, then the rent comprising the management fee will be assessable in full, and the management fee paid by the landlord will not be deductible. So, it is advisable for the landlord to have the lease stipulating the rent only and the management fee to be borne by the tenant.

Where the landlord dies, his executor will be liable to pay the tax for the rental income up to the date of death. Thereafter, the beneficial owner will be liable to pay the tax.

The landlord may reduce his tax liability by electing for Personal Assessment which brings all his income including property income, salaries income and business income into a single assessment with deductions for married person allowance, child allowance, dependent parent allowance, etc. from the chargeable income. Besides, he can claim mortgage interest on loans for purchase of the property under Personal Assessment --- Such interest is not deductible under Property Tax.

If the landlord has property income only, it is always advisable for him to elect for Personal Assessment. If he has other incomes, he can also make the election in the tax return because such election will not take effect if it is not to his advantage.

Where the landlord is a limited company, the rental income will be included in the company's assessable profits. If the company pays interest on a loan for buying the property, the interest is a deductible expense under Profits Tax.

Property held by one owner: the owner should disclose the rental income in his Tax Return – Individual (BIR 60).

Property held by more than one owner: strictly in law, every owner (whether he is a joint owner or an owner-in-common) is legally obliged to file a Property Tax Return (BIR 57) to disclose the rental income and pay Property Tax as if he were the sole owner. But in practice, the tax return will be sent to the precedent owner (the owner as first named in the title deed) --- then the precedent owner will be required to file the tax return and pay the tax on behalf of the other owners.

Tax penalty may be imposed on the owner if he commits the following offence:
(1) failure to notify the Revenue within 4 months after the year of assessment if he has not received a tax return;
(2) failure to file the tax return within the time specified;
(3) filing an incorrect tax return; or
(4) failure to keep sufficient rent record so as to compute the tax.

4.3 Hold over of Provisional Property Tax

The taxpayer can apply for hold over of Provisional Property Tax on the following grounds:

1. The provisional rental income is likely less than 90% of the amount assessed.
2. He ceased to be the owner.
3. He applied for Personal Assessment that could reduce his total tax payable.
4. He has objected to an assessment forming the basis of the provisional tax.

The application for holding over of Provisional Tax must be in writing, setting out the grounds for the hold-over and proposing a suggested provisional income if applicable. It should be sent to the Revenue not later than 28 days before the due date of the provisional tax.

4.4 Property tax versus profits tax

Corporation cases

According to section 2, the letting and sub-letting of properties by a corporation is a business liable to Profits Tax. So, a corporation is normally not liable to Property Tax because its property income is assessed under Profits Tax. But in the following cases, property tax assessment can still be charged on the corporation:

(a) the corporation holds the property as trustee or agent for other individual owners
(b) the corporation is an association or a club deemed under Section 24 of the IRO as not carrying on a business
(c) mortgagee-in-possession cases
(d) the corporation is a foreign corporation
(e) the corporation is joint owner or co-owner with other persons

If a Property Tax Assessment has been issued to a corporation which later claims the income from letting should be assessable under Profits Tax, then the property tax assessment will be cancelled and the tax paid, if any, will be set off its profits tax liability. A corporation wishing to exempt from Property Tax on the grounds of Profits Tax assessment should lodge a claim in Part 5 of the Property Tax Return (B.I.R.58).

Other cases

As for a person other than a corporation, the sub-letting of properties is liable to profits tax whereas the letting income is generally liable to Property Tax.

In special cases, letting of property by an individual can constitute a business liable to Profits Tax. Of course, this is a question of facts. In general, the Revenue does not accept a claim for Profits Tax unless there is a large number of letting properties and the owner has hired staff to handle the tenancies and deal with the tenants. Where the properties concerned are ballrooms, cinemas or restaurants, the letting of such is likely to be accepted as a business. Nevertheless, income from letting by an individual will be chargeable to Profits Tax in the following cases: (a) letting by a property dealer: the rental income is regarded as part of the income of the property dealing business, and (b) where a property is used for a trade or a business of the owner and no rent has been charged in the Profits and Loss account or the rent charged is added back in the Profits Tax computation, and (c) the property is partly used for a trade or a business and partly let out.

Besides, furnished letting can also be accepted as carrying on a business. But for administrative reasons, the Revenue is not inclined to assess it under Profits Tax, particularly where a single-property case is concerned. Therefore, Property Tax returns are issued to assess the whole rental income, including any hire charge for the use of furniture or equipment. But if the owner claims for a Profits Tax assessment instead of a Property Tax assessment, either before the issue of a Property Tax assessment or upon objection to the Property Tax assessment, the hiring income for the use of furniture or equipment will be assessed under Profits Tax. The Revenue may require the taxpayer to supply the tenancy and hire agreements and the Business Registration number to substantiate his claim.

What is furnished letting?

In general, the Revenue accepts furnished letting if the landlord under the terms of the tenancy agreement provides furniture and domestic equipments so that the tenant needs only bring in his personal belongings. If only a few items of furniture and equipments are provided (e.g. a refrigerator and cooker in the kitchen, or a wardrobe and an air-conditioner in the bedroom), the Revenue will not normally accept the letting as furnished.

Section 25 tax set-off

Where a corporation has paid property tax and has the property income assessed again to profits tax, the property tax paid can be used to set off its profits tax liability. In effect, the property tax assessment is canceled.

The relationship between sections 5(2)(a) and section 25 of IRO was examined by the Privy Council in the case Harley Development Inc. and Trillium Investment Limited v. CIR 3 HKTC 800.

4.5 Is the management fee received from tenant assessable?

Property Tax is levied on a property owner who receives rental income. The income assessable is called assessable value which is defined as the consideration payable in the year of assessment in money or money's worth in respect of the right to use of the property. Income of a capital nature and income in connection with the provision of any services or benefits in relation to the property are assessable too.

Given the wide definition of assessable income, the management fee received from the tenant is assessable --- It is an income in connection with the use of the property. On the other hand, if the property owner pays the management fee to the management company, such payment is not deductible from the assessable value. This is because the law only provides for two types of deduction, namely: the rates paid by the owner and the statutory deduction of 20%.

Nevertheless, if the tenant pays the management fee directly to the management company (not through the property owner as part of the rental income), the payment that is not received by the property owner will not be part of the rental income assessable.

On the other hand, if the lease stipulates that the monthly rent does not include the management fee and the tenant is solely liable to pay the management fee, then the management fee paid to the property owner (who subsequently pay it to the management company) will not be assessable. This is because the property owner only collects and pays the management fee as an agent of the tenant.

4.6 How to reduce Property Tax?

Property tax is levied on rental income. So, if there is no rental income, there will be no property tax.

It is of course stupid to leave a property vacant just for avoidance of tax. But if you use the property for purposes other than letting out, you pay no property tax for such other beneficial use. For example, you can use the property as your business premises or your residence. In these cases, the property will not attract any property tax. You can also let your friends or relatives use your property without monetary rent. That won’t make you pay property even though you receive certain benefits in return (for example your friend let you use his car free of charge).

But if you let out the property, then you must disclose the rental income in your tax return in accordance with the law. And if you don’t make the disclosure, you will bear the risk of penalty of the non-disclosure including criminal prosecution or monetary fine. Here, I must warn you that your tenant or the nearby residents or even your enemies (including those known or unknown) may tell the IRD that you do not pay tax on the rental income. In fact, from time to time, there are a lot of unexpected events that make a secret property letting out known to the IRD. So, do take my advice: Always comply with the law; or else you may pay the price of the non-compliance that can far exceed the tax savings obtained. In fact and indeed, there are a number of ways to reduce property tax legally.

First, if you a low-income taxpayer, the best way to reduce your tax is electing for Personal Assessment. If your total income does not exceed your total personal allowances and deductions, the election will remove your tax totally and legally.

If you pay interest on loans financing the purchase of the property, you can claim deduction of the interest under Personal Assessment. If you want to know more about personal assessment, please read the topic “Election for Personal Assessment” under Chapter 1 Basic Tax Tips.

Remember only rental income is taxable. Rental deposits received at the beginning of the rental period are not rental income and therefore not taxable. So, don’t treat the rental deposit as rental income in your tax return.

You can exclude management fee from the assessable value if you arrange for the tenant to pay the management fee and for the tenancy agreement clearly to state so.

If you receive lump-sum premium, you can apply for spreading it over 36 months of the rental period in order to reduce tax.

If you pay the rates, don’t forget to claim deduction in the tax return.

If some rents are not yet received, don’t forget to exclude them as “irrecoverable rents”.

If you own, say more than ten “furnished properties” for letting out, you can argue that you are running a business and so you can be taxable under profits tax so that you can claim for deduction of a lot of actual expenses, including salaries and wages, management fee, director’s fee, repairs, accounting, travelling, entertainment, advertising… etc. However, for those taxpayers with just a few let-out properties, the IRD will likely reject your claim.

A limited company receiving rental income is normally taxable under profits tax instead of property tax. So, you may consider using a limited company to own the properties and to receive the rental income so that you can claim for deduction of actual expenses under profits tax as aforesaid. However, I would like you to consider carefully about the set-up cost as well as the running cost of a limited company. A limited company requires filing of annual returns with the Company Registry, maintaining of statutory records and auditing of the company accounts. Besides, the IRD may disallow certain “actual expenses’ on the grounds that they are of a private nature or they are not incurred in the production of assessable profits. In general, if the estimated total expenses qualifying the deductions under profits tax cannot exceed the 20% of the total rental income, the property tax will be less than the profits tax on the same rental income.